Policy Options for Reform of Chinese State-Owned Enterprises

Harry G. Broadman

Proceedings of a Symposium in Beijing June 1995

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Policy Options for Reform of Chinese State-Owned Enterprises

Proceedings of a Symposium in Beijing, June 1995

Edited by
Harry G. Broadman

The World Bank
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FOREWORD

The World Bank has played an important role supporting China’s progress in industrialization since the reentry of China into the Bank in 1980. As part of that process, the State Economic and Trade Commission (SETC), the Ministry of Finance and the Bank cosponsored an international symposium in Beijing in June 1995 on “Policy Options for Reform of Chinese State-Owned Enterprises.” The symposium brought together leading policymakers, prominent international experts, and senior staff of the Bank. This discussion paper is a compendium of the conference papers and written commentaries. It was edited by Harry Broadman, who was the task manager for the symposium.

I had the pleasure of leading the Bank delegation to the conference. Its timing was opportune: It took place in the wake of the 50-point economic reform program embodied in The Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure, adopted by the Third Plenary Session of the Fourteenth Congress of the Chinese Communist Party in November 1993. Chinese authorities have been actively considering policies for implementation of the Decision, particularly with respect to state-owned enterprise (SOE) reform. The symposium provided an opportunity for an open exchange of minds in this regard. Five policy option papers on SOE reform were presented by Chinese officials, followed by comments from leading international policy practitioners. The Bank presented a paper with policy recommendations to guide China’s actions in this area.

In publishing this volume we very much hope it proves to be of interest to policymakers in China and to the international community that specializes in Chinese affairs and economic transition.

Nicholas C. Hope
Director
China and Mongolia Department
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ABSTRACT

This Discussion Paper presents the proceedings of a high-level international symposium on “Policy Options for Reform of Chinese State-Owned Enterprises” that was held in Beijing in June 1995. The conference was cosponsored by the State Economic and Trade Commission, the Ministry of Finance and the World Bank, and brought together many of China’s leading policymakers, prominent foreign experts, and senior staff of the Bank Group. Its timing was opportune, taking place in the wake of the 50-point economic reform program embodied in “The Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure” adopted by the Third Plenary Session of the Fourteenth Congress of the Chinese Communist Party in November 1993. The “Decision,” considered a watershed event in China’s recent economic history, is a blueprint for reform by 2000, and Chinese authorities have been actively considering policies for its implementation, particularly as regards SOE reform, one of the critical economic challenges confronting the Chinese leadership. The format of the conference centered on five policy options papers presented by Chinese officials, each followed by comments from leading international policy practitioners. In addition, the Bank Group presented a paper on international experience in SOE reform that sets out policy principles that it believes should guide China’s actions in this area.
CURRENCY EQUIVALENTS
(As of May 1995)

Currency name = Renminbi
Currency unit = Yuan

$1.00 = Y 8.5
Y 1.00 = $0.12

FISCAL YEAR
January 1 - December 31

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS USED

CCPC - Central Communist Party of China
CEE - Central and Eastern Europe
CEO - Chief Executive Officer
CITIC - China International Trust and Investment Corporation
EBRF - Enterprise and Bank Reconstruction Fund
ETC - Economic and Trade Commission
GDP - Gross Domestic Product
GNP - Gross National Product
GVIO - Gross Value of Industrial Output
HMT - Hindustan Machine Tools
IPO - Initial Public Offering
IRI - Instituto per la Ricostruzione Industriale
KPF - Ksiaz Porcelain Factory
KPFL - Ksiaz Porcelain Factory, Ltd.
LLC - Limited Liability Company
LLSC - Limited Liability Shareholding Company
LSE - Large State-Owned Enterprise
MISOA - Managing Institution for State-Owned Assets
MoU - Memorandum of Understanding
NABSOP - National Administrative Bureau for State-Owned Property
OECD - Organization of Economic Cooperation and Development
RRTS - Reform, Restructuring, Technological Transformation and
Strengthening Management
SETC - State Economic and Trade Commission
SHC - State-Owned Holding Company
SOE - State-Owned Enterprise
Telecom - Telecommunications
TVE - Township and Village Enterprise
UK - United Kingdom
US - United States
INTRODUCTION AND OVERVIEW

Harry G. Broadman

Introduction

In November 1993, the Third Plenary Session of the Fourteenth National Congress of the Communist Party of China gave a new impetus to the process of Chinese economic reform by issuing the "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure." The "Decision" outlines a 50-point reform agenda to be attained by the end of the century across an unprecedented array of economic fronts, with reform of state-owned enterprises (SOEs) in the industrial sector taking center stage. Lying at the heart of the SOE reform initiative is the "Decision's" call for establishing a "modern enterprise system," under which industrial SOEs would be transformed into companies having well-defined legal rights and responsibilities; encouraging the growth of diversified ownership forms of nonstate enterprises, including collectives, township and village enterprises (TVEs), privately and individually owned businesses and foreign-invested firms; and requiring the state to implement a policy regime that allows all industrial enterprise forms to compete on "equal terms" in the marketplace. The "Decision" is undoubtedly the most ambitious plan for China's economic reform since the launching of reform in 1978, and may well prove to be a watershed in China's modern economic history. But it is only a blueprint statement of principles and does not contain a detailed plan for implementation.

Establishing a policy program for implementation of the agenda embodied in the "Decision" soon became a key challenge for the Chinese authorities. In mid-1994, the State Economic and Trade Commission (SETC), which has lead responsibility for SOE reform, approached the World Bank with the idea of arranging an international conference on the topic of Chinese enterprise reform. In collaboration with the Ministry of Finance (MOF), the Bank and SETC decided to focus the conference on assessing pragmatic policy options on specific aspects of SOE reform the Government should consider as it implements the November 1993 "Decision." Moreover, it was decided that the conference would benefit from an examination of other countries' enterprise reform experiences. Accordingly, SETC identified five main areas on which it wished the conference to focus: state asset management, corporate governance, reducing SOEs' social service obligations while establishing a government-based social insurance system, reform of large group enterprises, and restructuring SOEs' financial debts with banks. An innovative approach to deal with

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Introduction and Overview

these topics was conceived: SETC selected five senior Chinese policymakers and requested them to prepare position papers on each of the areas that would be presented at the conference; in conjunction with the Bank, five foreign experts who had served in senior policy positions were selected as commentators on these papers; and the Bank would present a paper on international experience in SOE reform, on which a prominent Chinese economist would comment.

It was decided by SETC, MOF and the Bank that it would be important to publish and disseminate the proceedings of this conference to encourage policy discussion among the Chinese authorities, business community and scholars, and to share its insights with others around the world who observe the Chinese economy. A companion volume to this English version of the proceedings is being published in Chinese.

Overview

The conference, which took place in Beijing in June 1995, turned out to be very timely. A spate of potentially far-reaching reforms had been launched at various points in 1994, including enactment of a Company Law, reform of the tax and foreign exchange regimes, announcement of a new industrial policy (under which five “pillar” industries were identified), initiation of the “10,000-1000-100-10” enterprise reform experiment (whose name derives from the number of SOEs and cities involved) and reduction of budgetary subsidies to industrial SOEs. By June 1995 some of these reforms were beginning to have an effect on SOE incentives and performance. For example, many SOEs began or completed transformation into limited liability companies (LLCs) and limited liability shareholding companies (LLSCs), resulting in about 170 companies listed on the Shanghai Stock Exchange, 110 listed on the Shenzhen Stock Exchange and more than 30 receiving approval for listing on foreign stock exchanges. Greater neutrality in tax treatment among different enterprise forms enhanced interenterprise competition, with the national share of industrial output accounted for by SOEs falling from 43 percent at year-end 1993 to 34 percent at year-end 1994.

Still, ever-present on policymakers’ minds at the time of the conference was the fact that important features of a modern, market-based enterprise system are still lacking in China, particularly in the industrial sector, which accounts for half of the country’s GDP. While recognizing that in light of the sheer scale of China’s “SOE problem” the reform process will take time, without further, proactive SOE restructuring, macroeconomic stability will be difficult to sustain. These are the themes struck in the opening remarks of both Wang Zhongyu and Nicholas Hope. Indeed, SOEs cannot freely dispose of assets, bona fide financial and labor markets are nascent, and most firms do not have the right to engage directly in international trade. Mandatory investment planning remains extensive, and in some cases, price controls still prevail or have been reintroduced. SOEs still bear obligations to provide an array of “cradle to grave” social services for workers and their families such that they are referred to as “small societies,” and most SOEs continue to
employ obsolete technologies. Both of these burdens give rise to pervasive financial losses, with more than 40 percent of industrial SOEs losing money. SOEs are rarely allowed to go bankrupt, however, and these losses, which translate into low after-tax profits insufficient to cover SOE investments, are met through subsidies via budget transfers (although they have been declining) and (increasingly) soft bank loans. The overall gap between SOE investment needs and after-tax profit generation—about 7 percent of GDP annually—has resulted in higher consolidated fiscal deficits for China. While the inflationary pressures from using money creation for financing these deficits have been recently stemmed by Chinese authorities through greater reliance on domestic borrowing, clearly, only by systematically solving the “SOE problem” can China maintain high economic growth and low inflation.

Magdi Iskander’s presentation on international experience in public enterprise reform sets the scene for the five topical papers that follow. Highlighting the fact that in advanced economies worldwide—and in virtually all economies in transition—the corporation is the defining characteristic of the successful industrial firm, he argues (based on a series of eight international case studies) that effective transformation of SOEs into modern corporations depends on two sets of incentives—internal and external to the enterprise—being established. The internal incentives Iskander calls attention to include (a) the enterprise should have a separate legal identity, with well-defined governance roles for owners (shareholders), managers and board of directors, (b) there is limited liability for the firm’s owners (shareholders), (c) the enterprise has centralized management, (d) ownership interests (shares) are transferable, and (e) the firm pursues commercial objectives, transferring the provision of social services to government. He characterizes an effective external incentive regime as comprising (a) competition both from domestic and foreign firms, (b) imposition of “hard budget constraints” as regards fiscal and financial subsidies to ensure prices in the market reflect economic costs, (c) subjecting enterprises’ financial accounts to independent audits, and establishment and enforcement of other internationally accepted legal/regulatory frameworks, (d) diversified ownership of enterprises’ equity shares, and (e) well-developed labor and capital markets. He concludes the paper by developing a taxonomy from the international case studies of how these incentives have been most effectively applied, and based on these lessons, sketches out an SOE reform agenda for Chinese policymakers to consider.

The key question of how to institute a market-based system for managing state assets, as embodied in SOEs, is addressed by Jiang Qiangui. She notes the challenges inherent in establishing agencies to represent effectively the state as owner of modern corporations in such a way as to maximize asset values, firm profitability and managerial and worker performance. Her assessment of the reforms required in this area point to the need for clear separation of the administrative, regulatory and social functions of government from the commercial functions of enterprises. In this regard, she emphasizes the creation of separate corporate entities that oversee on behalf of the state and through boards of directors the performance of individual enterprises (grouped geographically,
sectorally or both). In most cases, these “managing institutions for state-owned assets” (MISOAs) are to be wholly new bodies established under the Company Law, will replace existing line bureaus and ministries, and are to be located at the central, provincial and local levels. In some cases, MISOAs will be existing large enterprises and holding companies authorized by the state to take on the state asset management role. Jiang also calls attention to the need for transparent rules for the disposition of earnings from managing state-owned assets and for implementing market-oriented performance indicators. She concludes by observing that because there are risks and costs in the drive for SOE reform, experiments with diverse models of state asset management should be conducted and uniform approaches are to be avoided.

**Jia Heting** focuses on the “corporatization” process and policies to improve governance within SOEs. His analysis traces the evolution of the internal structure of Chinese SOEs, from the earlier central planning regime to the current trend of incorporation under the Company Law. Within the context of the various institutional relationships that comprise the emerging SOE governance system, specifically those involving the shareholders’ congress, boards of directors, and managers, Jia identifies several problems lingering from the earlier regime requiring resolution; among others, continued administrative interference by governmental authorities over the business affairs of enterprises and “insider control,” brought about by extensive decentralization coupled with weak mechanisms to ensure the interests of the owner (the state) are being best served. He posits multiple policy options to deal with each of the identified problems and assesses them from the standpoint of effectiveness for ensuring establishment of modern corporate governance structures within a “socialist market economy.” For example, he argues that boards of directors overseeing corporatized SOEs should be directly hired and fired by the separate legal entities representing the state within the context of meetings of the shareholders’ congress, rather than the current practice of selection by personnel departments at various levels of government. Similarly, he notes that appointment of an SOE’s senior managers should be at the sole discretion of the board of directors. He also argues that the composition of an SOE’s “supervisory council,” as stipulated in the Company Law, should include outside experts with knowledge of business management and of the market for the firm’s products. Finally, he suggests that the functions of the head of the Party committee within an SOE should be carried out through the board of directors, the supervisory council and management rather than the traditional practice of the Party head serving as the Chairman of the board. Jia concludes his paper by noting that full implementation of modern governance structures within Chinese SOEs will take several years, perhaps a decade and a half, and that competition and ownership diversification are essential to ensuring this outcome.

**Hu Xiaoyi** presents an overview of the major problems confronting SOEs arising from their obligations to provide an array of social services. His analysis of the scope and economic impacts of SOEs’ social burdens is comprehensive, focusing on surplus labor (which he estimates to be 20 percent of SOE staff and workers); provision of pensions (data
are presented showing the severe impacts on old-line industrial firms and cities, where there is increasingly a retiree-worker ratio of 1:1; medical care (SOEs operate 110,000 medical institutions employing one third of the country's health professionals); housing (51 percent of China's urban residents live in SOE-owned housing) and schools, restaurants, and other services. Hu argues that unless these problems are solved, SOEs will not be successfully transformed into modern corporations pursuing commercial objectives and freely functioning labor markets will not emerge. He offers a detailed assessment of policy options to establish a government-sponsored social insurance system. They include expanding the unemployment insurance fund and fostering growth of the labor-intensive services sector; widening the pooling of pension funds, relieving SOEs of administering pensions and introducing individual retirement accounts; divesting hospitals from SOE operations through a contracting scheme, implementing co-insurance for medical care and rationalizing health service fees and prices for medicines so they reflect costs; accelerating the process of housing commercialization by divesting large portions of the housing stock from SOEs, setting rents at market rates and offering housing for sale to individuals; and transferring schools and other social services to governmental or nonstate entities. Hu concludes with observations about sequencing reforms and expanding the tax base to ensure meeting the larger demand for public finance.

The formidable challenges associated with reforming the largest of China's industrial SOEs—the "giant" conglomerates of the state sector—are the focus of the paper by Qin Xiao, who writes with authority since he is the general manager of one of these enterprises. His approach is to apply research results from the modern theory of the firm and experiences of multinational corporations to the realities of large Chinese SOEs and the goal of establishing a "modern enterprise system" in China. He presents an analytical framework that identifies three "layers" of problems that need to be considered by policymakers for reform of large SOEs: (a) unclear property rights, which gives rise to an agency problem, (b) potential diseconomies of scale and scope from excessively large internal organizational structures otherwise designed to be efficient substitutes for open-market transactions, and (c) weak management skills and entrepreneurial talent. Qin's principal message is that while reform efforts have focused heavily on the agency problem, more emphasis should now be placed on restructuring internal organizational mechanisms and modernizing management. He argues that only with better-defined, market-oriented internal organizational structures and well-trained managers can new business strategies by SOEs be successfully deployed (that is, corporate structure and strategy go hand in hand). His paper concludes with a menu of policy changes that large SOEs should adopt, with an emphasis on creating strong internal incentive mechanisms), as well as a series of reforms needed in the overall external economic environment, such as competition, a vibrant capital market, and a freely functioning market for managers.

Wu Xiaoling addresses the important issue of restructuring SOE bad debts with banks. She distinguishes between the large "fiscal liabilities" of SOEs, which she defines as arising from policy losses due to price controls, enterprise social obligations and errors in
policy decisions concerning project design and implementation or macroeconomic changes, and “excessive liabilities,” which she defines as engendered by SOEs’ overreliance on bank credit and excessively low capital depreciation rates. Noting that the growing overhang of bad SOE debts poses risks to macroeconomic stability, Wu analyzes a number of restructuring methods to address the problem, including debt-equity swaps between SOEs and banks; using commercial intermediaries, such as trust and investment companies, to purchase enterprise debts from banks and turn them into enterprise ownership shares; interenterprise debt reorganization through mergers and acquisitions between debt-ridden firms and less leveraged ones (including foreign joint venture partners); transformation of SOEs into shareholding companies, either LLCs or LLSCs; and creating a public intermediary (an “enterprise and bank reconstruction fund”) that would issue bonds to banks for recapitalization and oversee (with the banks) financial workouts of enterprises. Wu also presents her own proposal that envisions the Ministry of Finance providing funds to enable banks to wipe out the nonperforming SOE loans, based on new MOF borrowing from the People’s Bank of China (the central bank). Throughout her framework for policy analysis, she emphasizes the importance of both cutting “the flow” of new bad debt to SOEs and implementing a one-time only “last supper” for cleaning up “the stock” of accumulated bad debts on bank and enterprise balance sheets. She concludes her paper with a detailed agenda of supplementary reforms required for ensuring a sustained solution to the debt issue, such as improved corporate governance with SOEs, creating a professional class of managers, and development of a market-based system for state asset management.

In their closing remarks, Chen Qingtai and Nicholas Hope offered observations, in light of the conference papers and discussions, on the progress that has made been made in China’s SOE reform program and the challenges that lay ahead. Chen stressed the need to coordinate systematically policies directed at reform of SOEs with other economic policies. He noted that SETC has proposed a policy of “RRTS”, to combine “reform, restructuring, technological transformation and strengthening management” to create the necessary external conditions and implement complementary reforms for improving SOE performance. He called for more research on several thorny issues, such as the appropriate scale and role of holding companies, whether pension funds should be invested in SOE shares and how best to develop mortgage instruments as a way of dealing with SOE housing obligations, creating investment opportunities for workers and developing the capital market. Hope presented his appraisal of conference participants’ deliberations on each of the Chinese policy options papers and sketched out a set of policy principles that should guide future actions in the various areas discussed. Recognizing there is no easy solution to the principal-agent problem, he suggests that the emerging multilayered state asset management and other organizational structures should be streamlined and transparent to promote accountability and efficiency, and that enterprise ownership diversification should be fostered. Hope noted that strengthening corporate governance and enterprise management incentives will require ending SOE subsidies, whether provided through the fiscal or financial system (the latter via phasing out the credit plan and negative real interest rates), enhancing domestic and international competition, and improving financial
accounting and auditing systems. With respect to solving the problem of SOE bad debts with banks, he emphasized that priority should be given to shutting off the flow that adds to the stock of bad debt each year. Subsequently, there should be a one-time cleanup of both SOEs’ and banks’ balance sheets and introduction of market-based incentives so as to instill self-sustaining commercial banking practices. Finally, Hope endorsed many of the suggestions made for divesting SOEs of social burdens and establishing a social security system, including expanding unemployment insurance, phasing out housing subsidies and commercializing housing stocks, and intensifying pension pooling and co-insurance for health care and instituting a payroll tax earmarked for social insurance.

* * *

The conference and these proceedings would not have been possible without the efforts of a wide range of people. Particular acknowledgments are owed to Wang Zhongyu, SETC Minister, Chen Qingtai, SETC Vice Minister, Jin Liqun then-Director of MOF’s World Bank Department, Nicholas Hope, Director of the China and Mongolia Department of the World Bank, Richard Newfarmer, then-Chief of the Industry and Energy Operations Division of the China and Mongolia Department of the World Bank, and Pieter Bottelier, Chief of the World Bank Resident Mission in China, for their strong support to the conference and allocation of staff and resources; Jiang Qiangui, Chen Quangshen, and Qin Yongfa, Director, Deputy Director and staff member, respectively, of SETC’s Enterprise Department, and Liang Zhiqian and Li Dongxian, Deputy Chief and staff member, respectively, of the Industry, Energy and Transportation Division in MOF’s World Bank Department, who carried much of the burden in Beijing of conference administration; Masa Aoki, Claudio Frischtak, Athar Hussain, Yingyi Qian, Guan Weili, Wang Xiaqiang, Xia Jizhi and Zhang Weiying, who comprised the team of foreign and local consultants assisting in the preparation of the Chinese policy papers; Gao Xiaoning, Zhou Xiaobing and Li Li of the World Bank’s Resident Mission in China, for all their liaison work and logistical support; and finally, Meredith Dearborn of the World Bank’s China and Mongolia Department for editorial and secretarial assistance with the English translations of the Chinese papers. The conference was partially supported by a grant to SETC from the Bank’s Institutional Development Fund.
OPENING REMARKS

Wang Zhongyu¹

Mr. Chairman, Ladies, Gentlemen and Comrades,

At the opening ceremony of this conference on policy options for reform of state-owned enterprises in China, please allow my colleagues and me to welcome Mr. Hope, officials of the World Bank, senior economists and other internationally distinguished experts. I would also like to express our sincere thanks to the domestic and international consultants who have worked hard to assist the authors presenting papers to this conference.

The situation of state-owned enterprises (SOEs), particularly that of reforming them, has been the focus of attention both inside and outside the country. In 16 years, much effort has been made to reform China’s SOEs, especially the large and medium ones, to increase their vitality. Much work has been done effectively. The reform process has made great progress and accumulated rich experiences that provide a solid ground for further deepening.

Enterprise reform in any country faces the problem of policy choice. Over a period of more than a decade and a half of reform and opening up, the general line and policy measures for reforming SOEs in China have gradually formed. The major points are:

- Establishing a modern enterprise system is necessary for the development of socialized mass production and a socialist market economy, which must be the ultimate goals of China’s enterprise reform.

- The strategic objective of such reform is to introduce and strengthen, by the end of this century, the management mechanisms and framework of a modern enterprise system that allows the large and medium SOEs to continuously play a leading role.

Gradualism is the only feasible path for China’s enterprise reform program because the accumulated problems and difficulties are long-standing and their causes are complicated. Many factors, including the capability and endurance of all parties involved in resolving these problems, must be taken into account. So, on the one hand, we should take

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advantage of all opportunities to implement reform when it is possible, even though it is
difficult. On the other hand, the process takes time and we should be patient.

In order for the market to play a fundamental role in allocating resources under
macro regulation by the state, we must follow the policy of allowing the development of
enterprise sectors with varying ownership structures, with public ownership occupying a
dominant position. Within "public ownership," we include collective ownership. And by
"dominant position," it is meant that the assets owned by the state and collectives represent
a dominant share of the total assets in the economy, and that the state-owned sector controls
the key industries and plays a leading role in economic development. Combining public
ownership and a market economy is the path explored by Chinese SOE reform, not
privatization.

It is a hard and complicated task to establish a modern enterprise system. For this
aim, we must, therefore, accumulate experience, create proper conditions and push forward
gradually. We have to find solutions for many major issues through experimentation,
because there is no set model to follow and there is great variation among enterprises. It
must be stressed that the principle of individual guidance and discriminating treatment is
being exercised. Widespread implementation will follow only after lessons are learned
through experimentation.

The reform of SOEs must be carried out in coordination with other areas of
economic reforms. Last year, a series of major reforms on the fiscal, financial and foreign
exchange systems were implemented successfully, which have created an ideal external
environment for enterprise restructuring. An important aspect of SOE reform lies in
coordinating such restructuring with technological transformation and strengthening of
enterprise management.

Fundamentally speaking, the purpose of SOE reform is to improve enterprise
performance, and the quality and efficiency of economic growth. However, improving
SOEs never means to make every single SOE better. Rather, it means improving the state
sector as a whole. The policy is to provide help to those SOEs that are capable of surviving,
and to let the uncompetitive ones die. To be specific, the state should provide better aid for
those that can grow stronger, and to make proper decisions as early as possible on loss-
making enterprises. The State Council has announced a policy to encourage enterprises to
reduce their labor force and to increase their efficiency, and has given permission for
mergers and bankruptcy. This year, more effort will be made in implementing this policy.

Reform of SOEs faces a number of important and difficult problems, and the
process of reform cannot deepen if these problems are not solved. In many aspects,
solutions require a significant amount of resources. What we can do now, based on our
financial limits and capability, is to select priority issues on which to move forward and try
to achieve some breakthrough: to get maximum result with minimum cost.
The direction of SOE reform in China has been determined. The major contents of the reform program in the short term are covered in the "Proposal for Deepening Enterprise Reform to Improve Large and Medium SOEs," initiated by the State Economic and Trade Commission (SETC) and approved by the State Council. China’s enterprise reform can only be based on the reality of the country; we will follow the road of SOE reform with Chinese characters. However, in the process, we must pay great attention to successful and enlightening experiences from abroad. This is the main aim of this conference.

This conference marks the first cooperation between SETC and the World Bank. It is important for both of us to acquire an understanding and trust for each other and to pave the way for future cooperation. At this conference the World Bank will present a lengthy report, proposing suggestions for China’s SOE reform in three areas. There also are five Chinese experts who will be presenting five papers relating to specific areas of SOE reform. Five senior economists from abroad will then give comments on each of these papers. We hope that all participants will say what they want to say, and express their opinions freely to provide useful advice for China’s SOE reform. We expect this conference to spur policy-making efforts for further Chinese SOE reforms.

Enterprise reform in China is entering the stage of implementation. We are confident it will succeed as long as we carry out the experiment properly, are brave to explore, are bold to exercise, and work on solid ground and march forward actively. China’s SOEs will be managed well.

Now, may I wish this conference to be a great success. Thanks to all of you.
OPENING REMARKS

Nicholas C. Hope

Distinguished authors, discussants, colleagues, ladies and gentlemen, let me begin by expressing my appreciation for all the efforts that Minister Wang Zhongyu and his staff at SETC and Minister Liu Zhongli and his colleagues at the Ministry of Finance have devoted to the preparation of this timely event.

After a break of 10 years, I am delighted once more to be in China to participate in an important conference that focuses on economic management and reform. For the next two days, we will be debating issues of fundamental significance for the reform of China's SOEs, one of the biggest institutional transformations ever attempted anywhere.

The consequences for China's economy cannot be overstated. In the industrial sector alone, reform will affect more than 100,000 enterprises, employing about 80 million people. Even though the relative size of the state sector in the Chinese economy has declined since 1978, SOEs continue to loom large in China's industry: They account for more than 40 percent of industrial production and almost two-thirds of investment in fixed capital. The state enterprises employ roughly two-thirds of the urban work force. Workers depend on these enterprises not only for their wages, but also for housing, health and unemployment benefits, and security in retirement.

State enterprises are wed to the banking system through the credit plan, which assigns to them more than two-thirds of total domestic credit, as well as through historic financial and managerial ties. In the aggregate, state enterprises in the industrial and other sectors account for about 65 percent of total government tax revenues. Whereas our discussion will focus in particular on the reform of state enterprises in the industrial sector, including mining and energy, I am sure that many considerations will also apply to state enterprises in such other sectors of the economy as commerce and trade, transport and financial services.

What Needs Reform?

The respectable growth performance and their sheer size in the economy convey a sense of the strengths of China's SOEs. Indeed, some of them are performing well.

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Others have the prospect of performing much better with only modest changes in their equipment, technology, the skills of their workers, and management practices. Given the right incentives, those enterprises—their managers and workers—could be a powerful force for economic modernization and growth. But there are also telling failures of many SOEs; these problem firms sap the vigor of Chinese industry and depress the performance of the whole economy through the burden they place on the budget and the banking system, while using scarce national resources that could be employed better elsewhere.

The productivity of state enterprises is rising—but at only about one-third to one-half the rate observed in nonstate enterprises. Although direct subsidies to state enterprises from the budget have been declining in the 1990s, aid through preferential access to credit—quasi-fiscal subsidies—has risen. The net result is that total subsidies to SOEs remain large (approaching 5-6 percent of GDP). China can ill-afford to use its public resources in this way. The funds that prop up poorly performing state enterprises could find better use in boosting the supply of infrastructure services and in improving the health and skills of the Chinese people, especially those people who are still poor.

Why should China reform its SOE system? For two reasons. First, because an enterprise sector that functions independently of state subsidies is an essential component of the measures needed for effective management of a modern market economy. Unless the enormous subsidies now going into the state enterprise sector are reduced and made transparent, it will be very difficult for macroeconomic management to control inflation, reduce the fiscal deficit, and prevent wide swings over the business cycle. Secondly, reform of state enterprises will improve the efficiency with which China’s resources are used, thereby raising productivity and laying the foundation for faster sustained growth in years and decades to come.

Managing a Market Economy

The essential challenge confronting Chinese authorities is to implement the “Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure,” issued in November 1993, at the Third Plenary Session of the Fourteenth Party Congress, in a way that allows China to capture the efficiencies of decentralized (or market-oriented) decision-making without forsaking macroeconomic stability.

Freeing economic agents—producers and consumers—to make their own decisions in an incentive system that promotes economic stability requires China to develop the indirect instruments of macroeconomic management that mark the modern market economy. Specifically, that means relying on flexible prices and interest rates to guide economic agents in the allocation of resources, and using monetary and fiscal policy to equilibrate the demand and supply of goods and services at the aggregate level in the economy. And it also means that public expenditure decisions will be based on the public sector’s ability to raise revenues, and on the needs of the nonstate sector. Modern
economic managers succeed in sustaining macroeconomic stability only to the extent that they are able and willing to adjust planned public expenditure to accommodate the activities of the nonstate sector.

China needs healthier public finances; sound banks and bankers, who are free to direct savings to the highest yielding investments; and a dynamic enterprise sector, unencumbered by the obligation to provide lifelong security as well as housing and other social services to its work force.

**Making Enterprises Efficient**

A modern market economy fosters efficient allocation of resources by confronting its economic agents with information (mainly embodied in prices) that conveys a reliable, accurate measure of the economic costs of their decisions. The fundamental mechanism that ensures the reliability of market information in a well-managed economy with well-developed laws, regulations and institutions is *competition*. In competitive markets, firms are free to enter and exit. Access to information and capital is available to all. To survive and do well in those markets, firms have to allocate and use resources efficiently. The creation of a competitive environment for state enterprises, therefore, should lie at the heart of the Government’s reforms.

By progressively exposing its state enterprises to competition, as it develops the capacity for indirect management of economic activity, China will ensure (a) the longer-run health of its enterprise sector; (b) its ability to compete vigorously and successfully in the international arena; and (c) the framework for the rapid, sustained growth needed to eliminate poverty and improve the well-being of all of China’s people.

**The Business of This Conference**

Chinese authorities know all of this. We are here not to debate what to do, but how to do it. The road lies clear before us; direction is less the issue than is pace and sequencing.

As this Conference attests, the Chinese Government is fully aware of the importance for the establishment of a market economy of reforming its state enterprises. Shortly after November 1993, the Government initiated the pilot project called the “10,000-1,000-100-10 experiment.” Under this project, 10,000 medium-size and large SOEs will adopt a new accounting system and enjoy financial autonomy. New state asset management requirements will govern the management of 1,000 enterprises deemed critical to the economy. Another 100 enterprises will be transformed into shareholding companies under the Company Law. And 18 (up from 10) municipalities will embark on comprehensive restructuring of their state enterprises and social welfare systems.
Indeed, a fundamental reform of the social welfare system, including in particular the responsibility for housing and pensions, is needed for the creation of a competitive environment in a modern market economy. But China, like other transition economies, also needs to deal effectively with the large debt overhang that impedes the reinvigoration of many state enterprises. In many cases, much of the enterprises' debt was incurred on behalf of the state; it should be dealt with accordingly. Without workable solutions for the debt overhang, the reform of many state enterprises cannot proceed far. Several conference papers will allow us to discuss these important subjects in the context of China's specific circumstances and in the light of relevant international experience.

Many experiments are underway in China to rejuvenate state enterprises. Some enterprises are entering into bankruptcy, others are merging, still more are forming joint ventures with private foreign investors, and some, with the blessing of the Government, are being sold directly to nonstate interests. The business of this Conference is to give focus to and to stimulate those experiments by exposing the recommendations of Chinese scholars and officials to the mirror of international experience as embodied in the wisdom of the commentators assembled to discuss the proposals before us for accelerating state-enterprise reform.

Let's begin then, and turn to the key questions:

- What changes will create better incentives for the managers of China's enterprises to strive for superior enterprise performance?
- How can heavily indebted enterprises be helped to restructure their finances and regain profitability and dynamism?
- How best can the social needs of the enterprise work force be supplied without impairing enterprises’ ability to compete efficiently?
- How should the production of state enterprises be organized, and what benefits derive from forming large group companies?
- And how should the assets of the state be managed to ensure that society receives adequate return on its investments of capital, natural resources and labor?

I believe the scene is set for two fruitful days of discussion.

Thank you.
IMPROVING STATE-OWNED ENTERPRISE PERFORMANCE: RECENT INTERNATIONAL EXPERIENCE

Magdi Iskander

EXECUTIVE SUMMARY

Introduction

In advanced economies worldwide—and in virtually all economies in transition—the corporation is the defining characteristic of the modern industrial enterprise. The resiliency of the corporate form throughout more than four centuries reflects the fact that it is the most efficient institution through which commercial activity—in essence the transformation of inputs into outputs—can be carried out. Since the advent of reform in China in 1978, much effort has focused on restructuring state-owned enterprises (SOEs), with the goal of increased efficiency, profitability and accountability for assets and performance. The main vehicle China has chosen as the basis for restructuring its SOEs and achieving a “modern enterprise system” is the corporation.

Chinese SOE reform efforts in the 1980s centered on decentralizing governmental controls and increasing managerial autonomy through the Contract Responsibility System. These earlier measures were strengthened with the 1992 promulgation of the “14 Autonomous Managerial Rights.” In November 1993, the 14th CCPC issued the Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure, which established a 50-point agenda for “creating a modern enterprise system.” In early 1994, the State Council announced the “10,000-1,000-100-10” SOE reform experiment introducing new accounting methods (10,000 SOEs), new state asset valuation methods (1,000 SOEs), corporatization (100 SOEs), and comprehensive reform (10, now 18, cities). China’s first modern company law came into effect in July 1994 and, today, China is actively developing related implementing legislation and institutional mechanisms.

1 Magdi Iskander is Director, Department of Private Sector Development, The World Bank. Mr. Iskander was assisted in the drafting of this paper by Russell Muir and Joseph Saba, in collaboration with Harry Broadman.
While China's policy commitment to reform is clear and strong, determining the specific, practical means to implement the reforms presents complex challenges. However, these problems have been confronted elsewhere and many of the lessons learned have relevance to China. Chinese policymakers should be able to draw upon considerable international experience in structuring the corporate form and in defining the state's relationship to the corporation when the state is its owner.

The Worldwide Evolution of the SOE

Many countries established SOEs after 1945 to promote economic growth by undertaking commercial activities that the private sector could not or would not perform. Over time, SOEs gradually took on noncommercial objectives, such as regional development or providing more jobs. Many SOEs increasingly resembled a governmental, not commercial, structure in terms of organization, management, operation and funding. Large holdings emerged with many of the negative features of inefficient bureaucracies (for example, Italy, United Kingdom, Turkey, Egypt, Austria). The state, although the "residual risk-bearer" for SOE losses, had few effective means to monitor and discipline management performance. The performance of SOEs deteriorated in most countries in the 1970s and 1980s as global markets fueled competitive pressures. In response, governments often protected their SOEs from competition, frequently provided direct and indirect subsidies, and often failed to develop mechanisms to discipline management. The combination of noncommercial objectives and related burdens, the difficulties of holding SOE management accountable, and the continued blurring of governmental functions with SOE ownership and management led to poor performance in most countries. The results were budget deficits, growing external debt and falling productivity. Governments thus began to search for means to reform SOEs.

During the 1980s, many governments explored new ways for their SOEs to be reorganized, governed and operated. Governments used all three avenues at their disposal—(a) "corporatization" and restructuring, (b) bankruptcy and (c) divestiture—to achieve reforms. In the main, SOEs were reformed along the lines of the modern commercial corporation to raise efficiency and profitability.

Lessons from International Experience on SOE Reform

International experience in SOE reform suggests that the dynamic interplay of two sets of incentives—internal and external to the enterprise—ensures the success of the modern corporate form. Concerning internal incentives, the modern corporate organization has a core of four attributes: (a) separate legal identity; (b) limited liability for its owners (shareholders); (c) centralized management; and (d) transferability of ownership interests (shares). Corporations that possess all these attributes function most effectively when they are also subject to certain external disciplinary measures, such as
(e) domestic and foreign competition, (f) independent audits, and (g) a sound policy regime—where prices in the market reflect economic costs.

Appropriate internal incentives are necessary, but not sufficient, for enhanced SOE performance; thus, successful corporate performance requires *both* internal and external incentives to impinge effectively on the enterprise. Where reformed SOEs have lacked one or more key internal incentives or are not subject to appropriate external disciplinary factors, they have been constrained in achieving the objectives of efficiency, profitability and accountability. Where the state has remained the sole owner of a corporation, gains have been difficult to sustain and there are few such examples of long-term success stories. Even where there is progress with SOE reform, governments have increasingly recognized that to sustain or lock in these reforms, there is a compelling case for the participation of nongovernmental entities or persons in terms of competition, financing, management and, most importantly, as equity shareholders.

Two sets of lessons emerge from the growing body of empirical international evidence as to how SOE performance can be improved. To be effective, SOE internal incentive structures should: (a) provide for "corporatization" and well-defined roles for the SOE's owners and its managers; (b) separate SOE's commercial objectives from social functions, if any; (c) avoid the creation of large holding companies or similar multitiered institutions; (d) provide for nongovernmental representatives on SOE boards of directors; (e) permit the appointment of commercially oriented chief executive officers; and (f) allow for managers' salaries to be competitively structured.

An effective external incentive regime is characterized by: (a) competition (both from domestic and foreign enterprises) in SOEs' product markets; (b) imposition of "hard budget constraints" as regards fiscal and financial subsidies—that is, ensure enterprises bear the full economic costs of all inputs purchased and sell their outputs at market-determined prices; (c) well-developed labor markets; (d) subjecting enterprises to independent audits; (e) establishment and enforcement of internationally accepted legal frameworks; (f) avoidance of complex performance monitoring schemes; and (g) diversified ownership of enterprises' equity shares.

**An Agenda for Chinese SOE Reform**

The lessons of international experience with SOE reform can be applied to the Chinese experience and incorporated into future reform initiatives. Needed reforms of Chinese SOEs are grouped under the following broad headings: (a) internal governance; (b) the policy regime; and (c) external incentives.

**Internal Governance**

- **Clarify Property Rights and Owner/Manager Relationships.** Poorly delineated property rights and inappropriate governance mechanisms are a
widespread feature of SOEs in China. The introduction of governance structures embodying clarification of owner/manager relationships, application of incentives and sanctions for management and employees, and effective monitoring through commercially-oriented boards of directors are essential prerequisites for improved SOE efficiency. In that respect, it will be important to increase the pace of SOE corporatization in China based on governance systems that closely replicate the salient features of modern corporate structures.

- **Simplify State Asset Management Structures.** International experience with large holding company structures for SOEs indicates that the efficiency gains, if any, have been very limited. Thus, the evidence suggests that China should review carefully its current state asset management systems. The present institutional arrangement for state asset management, including large group companies and the multitier management bureaus and investment companies, should be reformed with simplicity in mind and with greater clarity in the role and function of these bodies. Wherever possible, the state’s interests as owner should be represented at enterprise-level board structures rather than through intermediary asset management bureaus—particularly for larger and more strategically important SOEs.

- **Separate Commercial from Social Objectives.** One of the most striking features of the Chinese SOE sector is the policy of linking SOEs’ productive functions with the provision of a wide range of social services. It must be a high priority to establish mechanisms for passing many of the social service burdens—such as hospitals, schools and nurseries—to municipal or regional governments or to new or existing nongovernmental entities (such as housing) as appropriate. The work under way at national and local levels in China to create social safety nets should be accelerated and given high priority, drawing on the experience in transition economies and market economies.

*Improving the Policy Regime*

- **Eliminate Distortions in the Policy Framework.** Although there has been significant progress in developing and reforming China’s policy and regulatory regime over the past few years, international experience highlights the need for further improvement. Chinese authorities need to focus on reforms including: (a) decontrolling prices and further rationalizing relative prices, for example, in energy, grain and cotton; (b) continuing to liberalize foreign trade and investment, including the elimination of lingering indirect export subsidies, the granting of direct
export and import rights to all enterprises, and streamlining the regulations governing foreign direct investment; (c) establishing greater neutrality of tax policies among economic activities and across income groups; and (d) introducing broad policy neutrality across enterprise ownership forms in the state and nonstate sectors.

- **Establish Legal Framework for Enterprise Reform.** If Chinese SOEs are to develop modern corporate structures, further reforms in the company law and in implementing regulations related to SOEs will be required. Equally importantly, reduction of entry and exit barriers—through liquidation and bankruptcy—needs to be accelerated.

- **Encourage Service Sector Development.** International experience in many other countries indicates that the development of “newer” services industries, such as an independent accounting profession with recognized international standards, informatics, and legal services, is essential for promoting internal discipline in SOEs as well as facilitating commercial relationships with third parties—particularly nonnational corporations and investors. In addition to providing direct benefits to SOE performance, the development of these services, as well as traditional service sectors, such as insurance and banking, will create additional employment opportunities for some of the employees that may be shed from less productive industrial SOEs.

**External Incentives**

- **Encourage Competition.** One of the most forceful messages that emerges from the international experience in SOE reform is the importance of introducing competition in both product and factor markets as a force for achieving efficiency gains at the enterprise level. Chinese authorities have made much progress in promoting the free flow of competitive market forces. However, there remain a number of rigidities in the industrial sector that have to be tackled including: (a) allowing equal access to factor markets, for example, bank credit for state and nonstate enterprises; (b) promoting competition between SOEs across regions; and (c) liberalizing entry conditions for nonstate firms—both domestic and international—into product markets.

- **Increase Fiscal and Financial Discipline.** International experience highlights that the benefits of competition can only be captured if “hard budget” constraints are applied to SOEs—that is, the enterprises pay full economic costs for all their inputs and charge market-determined prices for their outputs. In China, there has been progress since 1990 in
decreasing fiscal and financial subsidies to the SOE sector—down from about 6 percent of GDP in 1990 to just under 4 percent in 1993. However, these subsidies are unsustainable. Chinese authorities need to impose tougher conditions on SOEs if harmful implications for macroeconomic performance, resource allocation and social stability are to be avoided.

- **Facilitate the Operation of Labor Markets.** Worldwide, better performing SOEs are characterized by their ability to operate in freely functioning labor markets. In China, many SOEs are still obliged to provide permanent employment to their work force. In addition, there are further in-built rigidities in the labor market exacerbated by the SOE-level welfare regime. If China is to achieve significant efficiency gains in the SOE sector, the link between labor markets and enterprise reforms needs to be developed through the establishment of: (a) the labor contract system throughout all SOEs; (b) commercialized housing markets separate from SOE control; (c) portable employer-employee funded pension schemes; and, (d) government-provided or -sponsored schemes for education, retraining, medical care and unemployment compensation.

- **Increase the Level of Nongovernmental Participation in SOEs.** International experience demonstrates that sustaining hard-won reforms in the SOE sector is difficult without increasing the role of nongovernmental entities or persons in terms of SOE management, financing and ownership. In the Chinese context—even within the framework of the “socialist market system”—there are ways of increasing nonstate participation in the SOE sector through: (a) the appointment of nonstate representatives on the boards of SOEs; (b) contracting out the provision of services (transport, accounting and even social services) to the nonstate sector; and, (c) accelerating the diversification of SOE ownership through selling shares on national and international stock exchanges as a vehicle for introducing external forces that will motivate improved efficiency.
1. THE WORLDWIDE EVOLUTION OF THE SOE

Since 1978, Chinese authorities have embarked on wide-ranging reforms aimed at transforming the world’s most populous country from a centrally planned system to a “socialist market economy.” These reforms—often characterized as “gradualist”—have comprised a package of measures aimed at the steady reduction of mandatory planning, decentralization, increased autonomy in economic management, the introduction of market forces and competition and the opening of the economy to international trade and investment.¹

A centerpiece of China’s reform program has been the restructuring of the country’s state-owned enterprises (SOEs). China’s 105,000 industrial SOEs suffer from a number of problems, including: inefficiencies in production processes and the use of factor inputs; lack of incentives for profit generation; and overall declining competitiveness in relation to the nonstate sector.² Yet SOEs account for about 70 percent of the country’s industrial net fixed assets and almost half of its industrial output. They provide a significant share of tax revenues for government at virtually all levels, and provide employment for 68 percent of Chinese urban industrial workers.³ In addition, SOEs bear heavy social burdens—providing a wide range of social services and safeguards for their employees and families.

To be sure, some Chinese SOEs are able to compete effectively in domestic and export markets. But many more continue to perform poorly. Although annual total factor productivity for China’s SOEs is rising, this growth is only about one third to one half the corresponding rate for nonstate enterprises. SOE losses currently stand somewhere between 2.4 percent and 5.3 percent of GDP. China’s authorities


² See Harry G. Broadman, op. cit.

³ SOEs account for 18 percent of total employment and 43 percent of industrial employment in China.
acknowledge that over a third of SOEs are loss-making despite absorbing at least 70 percent of all bank credit. These losses have required substantial fiscal and financial subsidies, which have impacted negatively on macroeconomic performance, resource allocation and social stability.

In advanced economies worldwide—and in virtually all economies in transition—the corporation is the defining characteristic of the modern industrial enterprise. The resiliency of the corporate form throughout more than four centuries reflects the fact that it is the most efficient institution through which commercial activity—in essence the transformation of inputs into outputs—can be carried out. The main vehicle China has chosen as the basis for restructuring its SOEs and achieving a “modern enterprise system” is the corporation.

While China’s policy commitment to reform is clear and strong, determining the specific, practical means to implement the reforms its leaders have announced (see Chapter 4) presents complex challenges. However, these problems have been confronted elsewhere and many of the lessons learned have relevance to China. Chinese policymakers should be able to draw upon considerable international experience in structuring the corporate form and in defining the state’s relationship to the corporation when the state is its owner.

This paper reviews the international experience with SOE reform. The focus is on how SOEs might be structured, governed, operated and financed as modern corporations; and what incentives are needed if the goals of the reform program are to be achieved.

**The Emergence of SOEs**

The growth of state involvement in the production of goods and services after World War II stemmed from an amalgam of political and economic forces. These included:

(a) a belief that the scale and range of investment required for sustainable economic growth was beyond pure market forces and the private sector;

(b) the reluctance or inability of equally devastated business communities to commit resources to capital-intensive investments with long pay-back periods in the years immediately following World War II;

(c) a political commitment to noncommercial objectives for enterprises, such as employment generation, income redistribution and economic welfare, which, it was argued, only the State could provide, or direct, through enterprises;
the electoral success of political parties founded on socialist principles emphasizing the State's control of the "commanding heights" of the economy; and

the near collapse of banking systems and stock exchanges and the inability of these institutions to provide medium and long-term finance for capital-intensive projects.

Against this background, several policies were implemented that shaped the economic profile of developed and developing economies alike and planted the seeds for the emergence of the SOE. In Western Europe, socialist Governments in the UK, France, Italy and elsewhere embarked on nationalization programs focusing primarily on energy, transport, and other utilities, but also extending into some of the tradable, heavy industry sectors. In a period when conventional wisdom emphasized the importance of economies of scale, these Governments focused on the consolidation of privately owned companies in sectors such as steel and chemicals under the control of large state-owned enterprises. In some instances, these nationalized companies were transformed into entities that became part of Government Departments. In other cases, the nationalized company became a State-Owned Enterprise, retaining the broad corporate form of the formerly private firm, but taking on the attributes of an administrative bureau. In addition, many enterprises were created as new net investments by the State, either to fill a gap left by the private sector or to compete with existing private producers.

Some of the factors that give rise to the SOE in Western Europe were felt with equal force in developing economies—particularly in countries under colonial rule. Private companies reluctant to invest in capital-intensive projects in Europe were—with the exception of trade in raw materials—in capable of, or disinclined to, extend their exposure in these developing markets. Faced with rebuilding their home economies, colonial powers had little appetite and limited resources available for investment outside those minimal expenditures deemed essential to maintain traditional trade patterns.

During the past 25 years, governments in developing countries have added significantly to the number of SOEs (as well as to the number of marketing boards, utilities and other enterprises they inherited at independence). With the challenging objectives of fostering infant industries, promoting indigenization, creating employment and controlling strategic resources, many developing country Governments responded by accelerating the role of the State from the late 1960s until the early 1980s. For instance, the World Bank estimates that between 1967 and 1980, more than half of Africa’s

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4 In some countries, such as the UK, the nationalization process began shortly after World War I when the State intervened to take-over mines and railways where the existing private owners were facing financial ruin.
extensive SOE sector was established by Governments seeking a variety of these—often conflicting—economic and political objectives. During this same period, the number of SOEs continued to grow rapidly in most other parts of the world—in countries as diverse as the Philippines, Mexico, Brazil, India, Bangladesh, Costa Rica, Portugal and Egypt. The most recent systematic estimates of public ownership indicate that, in the 1980s, SOEs accounted for an average of 10 percent of global GDP, while their average share of worldwide gross capital formation was much higher, at 35 percent. In these circumstances, SOEs clearly have achieved such a degree of prominence that their collective financial performance has had a decisive impact on their respective economies.

THE ECONOMIC IMPACTS OF SOEs

In the 1950s, higher growth rates in a large number of developed and developing countries masked some of the deficiencies in SOE performance. Many SOEs performed relatively efficiently and served to support the growth of the economy. However, as growth declined and severe resource constraints heightened in the late 1970s and 1980s, many governments began to recognize that poor SOE performance was introducing rigidities in the economy, as well as contributing, in large measure, to fiscal deficits, foreign debt and inflationary problems. This resulted in disastrous spillover effects on the banking systems. In both product and factor markets, SOEs were increasingly crowding out the private sector and raising the cost of doing business across-the-board. Rather than providing solutions to problems of economic development, as originally intended, the prominence of SOEs in many economies exacerbated them.

At the same time, the business environment in which SOEs have operated has changed markedly between the 1950s and the present. First, the 1960s began to see the emergence of consumer-driven markets, where the objective of raising the quality of goods and services became paramount. Second, technological change had the impact of fueling competitive pressures, forcing private firms to adopt new processes or upgrade existing product lines to maintain sales and market shares. In contrast, many SOEs remained insulated from the market forces that were directing the behavior of private firms. In addition, in the absence of protection or subsidies, many of these SOEs were increasingly unable to compete with private enterprises in international markets. Over time, SOEs became unfocused in their objectives and undisciplined in their operations, with many firms lacking a clear governance structure as to who was owner and who was manager. These issues—central to the achievement of efficiency at the level of the firm—became buried beneath other priorities in the rush to expand the scale and range of the State sector.

The findings of an increasingly large body of literature and research, strongly suggest that the economic impacts of SOEs—both at the microeconomic and macroeconomic levels—have been largely disappointing. Indeed, in many cases, the negative impacts have been accelerating. To illustrate:

(a) In the UK, the profitability of SOEs over 1970-85 has been substantially lower than comparable returns for private firms: 4.1 percent over the period for SOEs as against 17.6 percent in the private sector.

(b) In Egypt during the 1970s and 1980s, the SOE sector was characterized by a large and growing fiscal deficit, mounting external debt and low rates of savings. Financial rates of return fell from a modest 7.8 percent in 1975 to a meager 3.6 percent in 1990. The deficit of nonfinancial SOEs rose from about 1 percent of GDP in the early 1970s to around 4 percent of GDP in 1990—accounting for between 20 and 25 percent of the consolidated deficit of the central government.

(c) In Turkey, the borrowing requirements of SOEs soared to 7.4 percent of GNP in 1991—more than 50 percent of the public sector’s borrowing requirements. The increasing financing needs of SOEs not only crowded out the private sector from domestic financial markets, but also increased the burden on the rest of the public sector. The rise in the SOE sector’s deficits was accompanied by a deterioration in financial performance, with return on capital employed falling from an average of 17.2 percent in 1985 to 5.3 percent in 1991. Significantly, over 1985-91, SOEs on average earned only half as much as the largest 500 private industrial enterprises in Turkey.

(d) In India, an estimated 40 percent of SOEs are currently loss-making. Since independence in 1948, it is estimated that the Government has spent (in nominal terms) $40 billion on SOEs, while returns on capital employed have barely covered depreciation costs over the last two decades.

(e) In Viet Nam, of the 12,000 SOEs that existed in 1990, 2,000 have ceased operation or been liquidated, and another 3,000 have been merged. In 1994, 20 percent of the remaining 7,000 SOEs were estimated to be losing money.

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(f) In New Zealand, prior to a major corporatization and divestiture program that began in 1987, many of the SOEs and firms operated as Government Departments were poor performers. In 1984, the public sector accounted for 22 percent of all economic activity and consumed 28 percent of all investment, while the level of services provided to consumers in sectors such as telecommunications was well below comparable OECD standards. Average rates of return for four of the largest companies—Coalcorp, Electricorp, New Zealand Post and Telecom—stood at a disappointing 5.7 percent in 1988; they rose to 11.9 percent in 1991 after comprehensive corporatization plans were implemented.

(g) In Kazakhstan, gross SOE losses rose from 14.1 percent of GDP in 1992 to 23.7 percent of GDP by 1993. SOEs experienced severe liquidity problems despite large transfers through credit subsidies and nonpayment of dividends to the State. Net interenterprise arrears increased twentyfold over the first nine months of 1993, with new credit to the SOE sector running as high as 46 percent of GDP in the same period.

(h) In Mexico, the poor financial performance of SOEs precipitated a wide-ranging divestiture program. The Minister of Finance announced in 1991 that a fraction of the $10 billion in annual losses incurred by the steel sector—prior to the divestiture of the company—would have been sufficient to bring potable water, educational facilities, sewerage and hospitals to an entire region of the country.

(i) In Argentina, SOE losses reached 9 percent of GDP in 1989, while SOEs’ share of total public debt stood at 50 percent. These alarming figures contributed to the decision to implement the subsequent SOE divestiture program in Argentina.

These examples of international experience are only illustrative of the microeconomic and macroeconomic impacts of poor SOE performance. The existing body of research on SOE reform worldwide permits more systematic findings, as summarized in a forthcoming World Bank study. To assess the performance of SOEs, it adopts a unique analytical approach: it compares the performance of SOEs before and after divestiture to the private sector; divested and undivested SOEs; or divested SOEs with a hypothetical counterfactual in which the same firm is assumed to continue under public ownership.

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7 Bureaucrats in Business, op. cit.
On balance, the microeconomic evidence suggests that, in competitive or potentially competitive markets, SOEs are less efficient than private firms. Moreover, there are benefits to private ownership, such as improvements in welfare because of better compliance with pollution regulations, that are not readily captured in measures of efficiency.

On the macroeconomic side, SOEs are often unable to generate the resources to finance their operation and expansion and service their debt. This results in an “SOE sector deficit,” which has to be filled by government transfers, domestic borrowing, foreign borrowing, or a mix of all three. Of course, a temporary SOE sector deficit is not necessarily bad; private firms, too, borrow to finance their operations and to expand. SOE sector deficits are a problem, however, when public enterprises run deficits because their productivity is low or because their prices are set below an economically efficient level; this means a country’s scarce resources are being wasted. In general, SOE deficits undermine fiscal stability and contribute to inflation, making it more difficult for governments to provide a macroeconomic environment conducive to rapid, sustained growth.

Large SOE sector deficits are correlated with large government fiscal deficits. Figure 1.1 shows that the average annual SOE sector deficit for 38 developing countries from 1978-91 moves closely in tandem with their fiscal deficits. SOE deficits averaged 35 percent of the government fiscal deficit in the same 38 countries.

**Figure 1.1: SOE Sector Deficits and Governments' Fiscal Deficits**

![Graph showing SOE sector deficits and government fiscal deficits from 1978 to 1991.]

*Note:* Sample of 38 developing countries: 1978-91 averages.


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8 We define the “SOE sector deficit” as the difference between the SOE sector’s current surplus and the SOE sector’s investment.
Overall, evidence on the generally poor performance of SOEs at the micro level, together with the presence of SOE sector deficits, suggest that a large public enterprise sector is likely to have a negative impact on a country’s growth. The inefficiencies of individual SOEs would be expected, in the aggregate, to exert a drag on growth, so that, other things being equal, the larger a country’s state enterprise sector, the lower its growth rates. The most obvious and dramatic evidence that the inefficient public firms constitute a drag on growth is the collapse of the former centrally planned economies of Eastern and Central Europe. After a rapid postwar spurt, growth in Eastern Europe slowed markedly in the 1970s and 1980s, for example, to an annual rate of only 1.0 percent in Poland during 1980-88. Firm-level studies of the impact of public ownership in mixed economies, while less dramatic than the sweeping changes in the former centrally planned economies, also support the premise that, with the possible exception of a small number of infrastructure monopolies, public ownership is bad for growth.

**GOVERNMENTS’ POLICY RESPONSES TO POOR SOE PERFORMANCE**

Over the past 15 years, against the backdrop of increasingly poor performance by SOEs, governments around the world have substantially reformed these enterprises, with varying degrees of success. Apart from liquidating SOEs that were bankrupt, governments have pursued two principal SOE reform strategies: (a) corporatization and (b) divestiture.

To improve the performance of SOEs, some Governments have sought reforms through initiatives that followed and copied models of modern corporate governance—the reform process known as “corporatization.” The UK and New Zealand were among the first countries to embark on widespread programs of this nature. At its bare essentials, corporatization involves clarifying the respective roles of the owners of the enterprise and those who manage the enterprise’s operations. Corporatization programs aim at achieving major improvements in SOE efficiency by:

(a) Allowing bureaucratic civil service administration to be replaced by commercially oriented management;

(b) Facilitating the introduction of transparent, unambiguous financial and operational performance targets and introducing accounting procedures based on market principles;

(c) Distancing the enterprises as much as possible from political interference; and

(d) Replacing centralized production-orientated decisions with consumer, market-driven ones.
Since the late 1970s there have been other reforms to deal with poor SOE performance. These reforms have sought to reduce the role of the public sector either through divestiture or through broad forms of owner diversification, such as concession agreements and leases. This trend has continued into the 1990s with the divestiture of large numbers of SOEs in Eastern Germany, Russia and other parts of Eastern Europe. A number of the larger SOEs in Latin America and East Asia also have been sold to foreign and domestic private buyers. Finally, many OECD countries, such as the UK, France, Italy, Germany, Spain, Greece and Sweden, have accelerated their respective divestiture. It is estimated that, internationally, the sums raised from divestiture reached approximately $328 billion since 1985; in recent years the value of divestiture transactions has grown rapidly—$60 billion worth of sales in both 1993 and 1994—with many analysts forecasting further increases in transaction values over the next five years. The evidence on international experience in SOE divestiture is summarized in Annex C.

A fundamental question posed by governments’ responses to poor SOE performance is how can SOEs best achieve a high degree of efficiency and profitability by taking on a modern, commercial corporate structure while retaining public ownership. Equally importantly, how can corporatized SOEs sustain or lock in efficiency gains without “slippage” occurring through renewed Government interference in the running of these enterprises? The next chapter examines different international models of corporations and governance and explores how best these approaches can be applied to SOE reform. The broader international experience with these SOE reforms is discussed in Chapter 3.

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2. THE CORPORATION AS AN OWNERSHIP AND MANAGEMENT STRUCTURE

THE INCENTIVE FRAMEWORK

Virtually all recent international SOE restructuring has employed the modern corporate form as a vehicle for seeking gains in efficiency. While the corporation is the most successful, universal form of organization for large-scale mobilization of resources for production of goods and services, even under a system of private property rights achieving efficient corporate performance requires the corporation’s adherence to a certain set of incentives. Such incentives generally concern how owners and managers of the corporation mediate control, accountability, and risks associated with the corporation’s operations, as well as how the corporation responds to market forces. When the owner of the corporation is the state, the applicability of this incentive regime to engender efficient corporate performance still holds, although some modifications are necessary to account for the absence of private property rights. Therefore to establish a basis upon which international SOE restructuring experiences might best be applied to China’s circumstances, it is useful to analyze the fundamental attributes of the modern, private corporate form and review models drawn from international best practice of SOE restructuring that have used this corporate form.

The specific incentives whose dynamic interplay determine the performance of the modern corporation fall into two categories (see Figure 2.1) and can be summarized as follows:

(a) **Internal Organizational and Governance Systems.** These include: (i) four inherent attributes of the modern corporation; and (ii) corporate governance structures—the institutional arrangements between the corporation’s owner(s) and its managers by which the managers pursue the goals set by the owner(s); and

(b) **External Discipline.** This relates primarily to market, policy and institutional factors, which, while not under the direct control of the corporation’s owners, exert discipline on managers and owners in yielding efficient corporate performance.
FIGURE 2.1: Factors Impacting Corporate Performance

INTERNAL ORGANIZATION AND GOVERNANCE SYSTEMS
- Four Corporate Attributes
  - Corporation as Legal Entity
  - Limited Liability
  - Centralized Management
  - Transferability of Shares
- Governance Structures

EXTERNAL DISCIPLINE
- Product Market Competition
- Equity and Debt Markets
  - "Market for Corporate Control"
- Well-Developed Labor Market
- Corporate Legal Obligations
  - Independent Audits
- Bankruptcy

THE MODERN CORPORATION

EFFICIENT PERFORMANCE

INTERNAL ORGANIZATIONAL AND GOVERNANCE SYSTEMS

The Four Attributes of the Private Corporate Form

As a general principle, companies law in most countries requires that a modern business corporation have at least the following four basic structural attributes:

(a) Separate Identity. The corporation is a legal entity distinct from its shareholders, with a clear definition of, and accounting for, its own assets and liabilities;

(b) Limited Liability for Shareholders. Shareholder risk of loss is limited to their contribution to the corporation’s capital;

(c) Centralized Management. The day-to-day affairs of the corporation are conducted by one or more persons chosen by the shareholders; and

(d) Transferability of Shares. The shareholders’ ownership interests are transferable, and a transfer by a shareholder does not, in itself, change the
rights and obligations of the corporation with respect to its own assets and liabilities. ¹⁰

These attributes combine to enable the corporation to mobilize resources and to undertake commercial activity on a large scale with a clarity and singleness of purpose. The absence of one or more of the attributes significantly impairs the corporation as an effective vehicle for efficiency.

The separate identity of a corporation permits specificity, clarity and accountability for property rights. The corporation has its own assets and liabilities, clearly defined and expressed in a balance sheet. If the balance sheet is prepared in accordance with international accounting rules, then the corporation’s property, at any time, can be valued, compared and controlled in relation to all other property. This clear definition of property rights affords owners a control mechanism. It also gives the corporation the possibility of significant growth, through independent access to capital markets; and through reliance on its own, not its owners’ assets and commercial potential. Finally, it allows the Government to collect taxes efficiently, with predictable effects on economic activity.

The attribute of limited liability encourages ownership diversification and mobilization of capital, while at the same time limiting shareholders’ liability to their contributions. Limited liability also facilitates exit of commercially nonviable corporations; the company’s liability is limited to its assets.

Centralized management facilitates mobilization of specialized and efficient management. The separation of ownership and control permits hiring managers who are most skilled in the intended activity, and directing them to achieve the intended gains. Centralized management also permits owners to establish incentives and monitoring mechanisms for management linked to attainment of the owners’ goals.

Finally, transferability of ownership affords owners significant flexibility in allocating their capital and, in so doing, encourages corporate management to respond flexibly and rapidly to changes in market conditions that affect performance. Owners can lock in gains or express dissatisfaction by selling shares, thus creating incentives for keeping the corporation focused on achieving shareholders’ objectives. When an owner can transfer the risk of gain or loss that is part of share ownership (“residual risk”), managers have a powerful incentive to operate the corporation to achieve its goals efficiently. Unhappy owners may transfer the residual risk of shareholding to new owners.

¹⁰ In many countries, particularly those following the French corporate model, there are different forms of corporations, some of which limit the number and transferability of shares in small corporations to facilitate business forms more similar to individual partnerships.
owners who may appoint new management. Transferability creates a "market for corporate control," which, in turn, also disciplines corporate management to satisfy their owners' goals.

Corporate Governance

In countries throughout the world, corporate owners have faced the challenge of how best to structure the corporate organization and regulate its operations in a manner that assures attainment of the goals of efficiency and profitability. A key issue in meeting this challenge is how owner-shareholders ("principals") have held managers ("agents") accountable while permitting them adequate autonomy to operate the corporation profitably in a market environment.11

Models of Governance. Over time there has been a significant degree of international convergence in the forms of corporate governance. All of the three models of modern corporate governance—the Anglo-American, Continental European and Japanese—generally follow a common scheme for allocation of powers among the major participants in the corporation; these models are described in Annex A. Each model represents each society's attempt at achieving an efficient corporate organization and solving the principal/agent problem—that is, how shareholders can best manage the managers.

The primary participants in the modern corporation are: (a) the shareholders; (b) a supervisory board; and (c) the executive, sometimes referred to as officers, management or managing directors. The shareholders provide risk capital for which they have certain rights: (a) to elect and remove the board; (b) to approve or disapprove fundamental or nonordinary changes (such as changes in the corporate charter, mergers, increase/decrease in capital); and (c) to determine and receive dividends. Boards manage the corporation on behalf of the shareholders through appointment and supervision of the executive, and by reviewing and ratifying all major decisions not reserved to the shareholders. The executive is usually a set of persons elected by the board, who undertake the day-to-day affairs of the corporation.

Board of Directors. Boards of directors serve three functions: representation, direction and oversight.12 Concerning representation, most systems provide for the right of shareholders to elect board members and for minimum representation for minority shareholders. In some countries there is board representation by labor, banks, creditors,


suppliers and customers even if they are not owners. In Japan, the board is the least representative in composition and is generally an extension of management. However, through extensive cross-shareholdings, informal influence is imposed on the boards through stakeholders or “insiders,” such as suppliers, customers and the corporation’s “main” bank. Germany has the most inclusive representation with its two-tiered board system; this includes strong labor representation. The Anglo-American board is based on “outside” control, since shareholders are often passive institutional investors (such as pension funds with little day-to-day interest in the corporation). In contrast to the German model, banks play no direct role in the Anglo-American model, but are very influential as an “external” influence in their role as creditors.

The Board function of providing direction over management also varies somewhat from country to country but is generally focused on three major factors: strategic planning, including mergers and acquisitions; the appointment or dismissal of executives; and setting appropriate incentives for management. The oversight function of the board is taking on increasing importance as shareholders demand greater information and accountability. Board oversight is weakest in Japan, moderately rigorous in France and Italy and strongest in the US. In the US and UK, the legal duties of board members to the shareholders (“fiduciary” duties) are now delineated and clarified by law, and are enforceable against both the company and the individual board members by the shareholders.

**EXTERNAL DISCIPLINE**

While internal incentives are necessary to achieve efficiency, they are insufficient. Rather, external incentives—forces that are outside the direct control of the corporation but which promote management accountability to the shareholders—also must play a role. These external factors are:

(a) **Product Market Competition.** Competition among firms in product markets forces management to adopt the most efficient operations. Inefficient operations in a competitive market expose the firm to the prospect of losses and possibly bankruptcy. Managers thus have a strong incentive to perform most efficiently in a highly competitive market, particularly when their compensation is tied to the corporation’s performance.

(b) **Competitive Capital Markets.** Both competitive equity and debt markets impose substantial constraints on management. An all-equity corporate structure gives substantial discretion to managers to use the corporation’s assets for their own benefit, subject only to internal governance controls. However, management also relies on equity markets for raising capital. Because those markets quickly and continuously monitor and place an
objective value on the company, they are also placing a value on the performance of management. This value permits shareholders to make quick, rational decisions as to management performance and constrains management in its ability to dilute existing shareholders equity or take economic decisions that would undermine the value of owners' investments. Debt markets impose additional and often more stringent constraints. To raise debt capital, management must often agree with creditors on a plan, which requires the maintenance of a specified debt/equity ratio and a certain cash flow.

(c) The "Market for Corporate Control". Stock markets in many countries provide effective discipline mechanisms for management. This discipline is manifested in tender offers, takeovers or other actions triggered by management failure to maximize the shareholders' stock value as signaled by the share price. Operation of this constraint on management requires freely transferable shares and a market through which existing shareholders can exit and new ones enter—purchasing shares at a perceived discount when management fails to maximize shareholder value—and replacing management with more efficient management. In the US, this is often characterized as a "hostile takeover." However, in Europe and East Asia, the failure of management to maintain share value has resulted in a growing market for corporate control engineered among friendly, related shareholders who accomplish their goals through management replacement.

(d) Well-Developed Labor Markets. Not only do managers compete with each other to attain the top positions within the modern corporation, but there also is an active market outside companies for managers to improve corporate performance. In addition, middle and lower level management can and often do leave a company when they perceive that it is poorly managed. Thus management is disciplined from inside and outside the company by well-developed labor markets.

(e) The Corporation's Legal Obligations. In most market economies, laws directly affecting corporate governance, such as company and securities laws, set minimum norms and standards for management, aimed at protecting shareholder rights. These laws are vigorously enforced. Such legislation normally details shareholders rights and mandates a high degree of disclosure and transparency of corporate affairs, permitting easier shareholder monitoring. Other laws on antimonopoly, fair trade,
and competition impact management in varying degrees in different countries. The net effect of these laws is to force management to adhere to competitive norms. In the Anglo-American case, there is heavy reliance on the legal system, an approach that has gained favor in Europe as well. Throughout much of East Asia and in Japan, long-established social constraints operate with similar effect.

(f) **Bankruptcy.** The threat of surrender of day-to-day control to a trustee in bankruptcy or to a liquidator is a powerful incentive for managers to achieve the owners' commercial goals of profitability. Bankruptcy, and, perhaps more relevant, the threat of bankruptcy, impose strict discipline on corporate management, monitored by creditors and generally to the benefit of owners. Conversely, the lack of credible bankruptcy facilitates "asset stripping" and rent-seeking since there is no credible end, or exit, for the poor performing enterprise.

**USE OF THE CORPORATE FORM WHEN THE STATE IS THE OWNER: PRECONDITIONS FOR EFFECTIVE SOE REFORM**

Over the past decade, many governments have transformed SOEs into modern corporations and, to varying degrees, exposed them to external market forces. The success of these transformations has rested, in part, on how effectively all of the four attributes of the modern corporation described above have been implemented, and how well-established are the internal and external incentives. The attempted use of the corporate form to restructure SOEs in several reforming states has often failed due to an absence of one or more of these attributes. For example, in some cases, there is an absence of transferability of shares. In many, the separate identity of the corporation and its property rights are not clear due to a lack of strong accounting rules and practice. In others, the identity of the corporation and its owners are blurred, resulting in unclear objectives, incentives and accountability. Still, in others, management or board supervision has been dispersed among different agencies or distant holding companies, with the result that no one person or entity can be held responsible for assets and performance. Finally, there have been cases where limited liability of the owner is in fact nonexistent because the state explicitly guarantees all creditors of the corporation.

The evidence from international experience in transforming SOEs into corporations suggests that certain preconditions must exist if such reform is to be successful. The following are the principal preconditions:

(a) **Administrative Changes for the State.** Once a policy decision is taken to put a large public enterprise into the corporate form with the objectives of increased efficiency and profitability, the role of the state as the firm's shareholder must also change to resemble more closely the private
shareholder. This means that the state's overriding objective for the corporation should be to maximize the value of the corporation's assets.

(b) **Separation of Ownership and Government Functions.** A private shareholder has clear, commercial objectives. Reforming the role of the state as shareholder of a modern corporation requires the state also to separate its various functions in respect of the corporation it owns, including its functions as: (i) owner; (ii) contractor for (potentially unprofitable) public services; and (iii) regulator and protector of public safety, environment, competition and fair trade.

(c) **Designation of an Ownership Agency.** One of the first tasks in the corporatization process is to define which state agency should represent the state as owner/shareholder. Best practices based on international experience suggest the separation of powers of the line ministry from the government supervisory body of the corporation. This is done to limit the leverage the Minister and his/her staff have on the corporation's management. Ministers are often politically rather than commercially motivated and thus ministerial interventions can often result in adverse effects on profitability.

(d) **Management and Social Objectives.** Early reform decisions must be made as to responsibility, means of payment and accountability for the corporation's social objectives as assigned by the state. Best practices suggest that this be accomplished by contract. Also, the state has the initial task of determining the company's capital structure and dividend policy.

(e) **Clarification of Regulation and Ownership Roles.** The state's motives as regulator and shareholder are quite different. If these functions are performed by the same actor (such as a Ministry) then mixed signals or even conflicts of interest are likely to occur resulting in the SOE's financial loss or lack of competitiveness. Consequently, without separation of the state's ownership and regulatory roles, distortions are likely to appear at the outset of the reformed SOE's corporate life.

(f) **Internal Governance is Insufficient.** The State often lacks the objective means to test or monitor performance of management where the objective is profitability. In the absence of external incentives, such as competition and a capital markets judgment (stock price), this problem is even more acute. In recent years a number of governments have tried setting performance and financial targets; elaborate indicators and performance contracts have also been developed. In general, however, these techniques
have not been entirely successful. In many countries there has been increased efforts at improving the information flows from the corporation to state agencies. But that, too, requires the recipient to have the capacity to form a judgment on the information and act on it in a timely manner. The “periodic-current-cost valuation” model of New Zealand is considered among the best for SOE monitoring.
3. THE INTERNATIONAL EXPERIENCE WITH SOE REFORMS

The analytical framework outlined in Chapter 2 argues that enhancing the efficiency of SOE performance is determined by a set of internal and external incentives. Moreover, establishing commercially oriented governance systems and related internal incentives—corporatization—is a necessary but not sufficient condition for achieving efficiency gains in SOE performance. External incentives must also be in place if improved SOE performance is to be realized.

International experience teaches that the financial and economic performance of SOEs are not uniform; they vary between and within countries as well as across sectors. The differences in broad country experience are mirrored in eight case studies, as detailed in Annex B. Such variation is to be expected given the diversity in sector coverage, size of operations and the country context and legal frameworks in which SOEs operate. Nonetheless, there are a number of broadly consistent lessons from international experience. These lessons are examined below in detail and summarized in Figure 3.1.

INTERNAL INCENTIVES: KEY LESSONS OF EXPERIENCE

Separate Commercial from Social Objectives

Many SOEs are faced with a complex agenda—that of pursuing a range of social and political targets that often conflict with sales or profit maximization objectives. Whenever possible, the temptation to mix social with commercial objectives should be avoided. SOEs should be reformed in such a way that they are be assigned clear and unambiguous objectives in which commercial profitability features prominently. In other words, SOEs should pursue commercial objectives and be given incentives to succeed similar to those that apply to private firms.

The case studies include the following SOEs: Semen Gresik, Cement (Indonesia); Usinor Sacilor, Steel (France); Statoil, Oil & Gas (Norway); Coalcorp, Coal (New Zealand); IRI, Holding Company (Italy); Sumer Holdings, Holding Company (Turkey); Hindustan Machine Tools (India); and Ksiaz Porcelain Factory (Poland).
The noncommercial roles of SOEs and their economic impact can be categorized under the following headings: (a) provision of a social safety net; (b) meeting employment objectives; and (c) directed investment.

**Provision of a Social Safety Net.** In many former socialist economies, SOEs were expected to provide employees and their dependents with a broad range of social services, services normally provided in most market economies at the national or local level by government or nongovernmental entities. These services ranged from free (or subsidized) housing to childcare facilities, schooling, occupational health care, hospitals, recreation facilities and company pension plans. Although less prevalent in market economies, there are also some examples of SOEs in Europe and developing countries that also shoulder the burden of such social assets as housing—particularly in regions where the SOE is the main employer.

However, for many SOEs in Central and Eastern Europe (CEE) or the former Soviet Union, social assets represented significant levels of capital investment and maintenance costs that had to be funded from the enterprise’s company’s operating budget. In addition to the financial burden that the provision of these services placed on
the individual enterprise, the operation of these facilities represents a significant drain on the scarce managerial resources within the enterprise. In a number of countries, there has been some progress in tackling these enterprise-level constraints with two main types of reforms: (a) the transfer of assets such as schools, hospitals and housing to municipal or national level civil authorities; and (b) the sale of services such as transport, hotels, holiday resorts and housing directly to employees or to other bidders from the private sector (see also Box 3.1). In the case of pension schemes in CEE, most countries have now transferred and consolidated enterprise-level funds into national level programs normally administered by the State. Increasingly these schemes are being supplemented by private pension funds offered by newly privatized companies.

**Box 3.1: Social Assets: How Russia is Facing up to the Burdens of SOE Housing**

The former Soviet Government relied heavily on larger SOEs to finance and manage housing programs. In some cases, SOEs were even responsible for generating electricity, water and heat. It is estimated that by mid-1992, enterprise housing comprised some 40 percent of all housing in Russia; municipal authorities owned 38 percent of the total stock, with cooperative and private housing accounting for the remainder. As enterprise reforms began to accelerate in 1992, it was recognized that SOEs' responsibilities for housing—and other social assets—were impeding attempts to restructure their core business activities. A typical enterprise in Russia might have up to 10 percent of its labor force involved in maintaining housing stock. Although there is broad agreement that housing should be removed from the enterprises either through privatization to incumbent tenants or through transfer to municipal authorities, the implementation of this policy is fraught with obstacles. Only an estimated 25-30 percent of enterprise housing has been privatized to date, and municipal authorities are generally reluctant to accept the housing. Most cities would face rapidly escalating costs of managing and maintaining these houses. To deal with these problems, initiatives are under way in a variety of areas including:

- **Acceleration of Privatization.** Since many tenants fear that as private owners they would have to pay higher maintenance charges and property taxes, the pace of divestiture could be increased by: introducing a rent payment for nonowners equivalent to the property tax for owners; clarifying owners' rights to receive the same (albeit declining) level of subsidization for maintenance and utilities as nonowners; and, setting a clear time limit on privatization of housing.

- **Improving the Management of Housing.** Several cities have begun to establish condominium associations and to delegate to them the authority to contract for their own maintenance. Other municipal authorities are contracting out the management of former enterprises housing to newly privatized maintenance organizations, which have improved standards without an increase in costs.

- **Reforms in Financing and Taxation.** One way of financing the municipal authorities' responsibilities for housing maintenance will be to require enterprises to pay taxes equivalent to the decrease in their direct expenditures on housing following divestiture. Also, additional revenues can be realized from increased cost recovery from tenants in both municipal and enterprise housing. However, the ability of enterprises to increase wages will determine, in large measure, the pace at which this cost recovery can be increased. This in turn will require further reform of the pattern and level of taxation. Finally, successfully raising cost recovery from the bulk of the population will require implementation of the federally mandated housing allowance scheme, a process which is already underway in many cities.

- **Reducing Housing Maintenance Costs.** Since the Russian housing stock is four to five times more energy-intensive that in Western Europe, there are considerable incentives and opportunities for decreasing the cost of maintaining housing. It is anticipated that modest investments in insulation, weatherproofing, thermostatic controls, meters and related measures will assist tenants in sharply reducing their energy usage.
Meeting Employment Objectives. In addition to meeting financial targets, many SOEs have faced implicit, but nonetheless real, pressures to generate significant levels of employment or, at least, to protect existing jobs. On the one hand, SOEs do have an opportunity to act as "model employers" by honoring labor legislation such as equal pay requirements, job security and occupational safety, as well as providing comprehensive benefits to employees. While in theory SOEs may set an example for labor practices in the private sector, actual experience is less encouraging. In fact, typically, SOEs are overstaffed to such a degree that the financial objectives set by the Government for the firm are unattainable in the face of excess labor costs. International examples abound in developed and developing countries of SOEs with unacceptably low levels of productivity, absenteeism rates well above the average for comparable firms in the private sector and unbridled growth of nonmonetary benefits. Notable examples from the case studies in Annex B are Hindustan Machine Tools, Sumer Holdings and Ksiaz Porcelain Factory.

Yet despite these inefficiencies, governments are often unwilling to liquidate or even downsize SOEs precisely because of the impact on employment levels. Incumbent politicians view the short-term costs of downsizing or closure as exceeding the medium-term economic benefits—benefits that may be diffuse and that may often accrue only after their tenure in office is complete. This dynamic has created systemic market rigidities which, in turn, have impacted adversely on the performance of SOEs.

Where governments have downsized SOEs—such as the restructuring of British Steel in 1981 or the reforms in IRI in the mid-1980s (see Box 3.2)—they have been successful largely because they put in place social safety nets that have provided for redundancy payments and retraining. In the British Steel case, the UK Government and the European Coal and Steel Community developed substantial retraining grants and redundancy packages (an average of 26 weeks pay) with further financial and technical assistance from the company itself through a specially created subsidiary known as BSC (Industry) Ltd. BSC (Industry) was able to offer subsidized loans, training and leasing facilities to retrenched employees. The success story of Corby New Town in the heart of the traditional steel industry in the British Midlands and the thriving private sector that developed alongside newly established small businesses opened by former steel workers, is testimony to the potential of well-planned, adequately funded and imaginatively implemented regeneration schemes.

Directed Investment. In several countries, governments direct SOEs to invest in sectors that are viewed as essential to national security, or in economic activities that the

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private sector might neglect, such as the provision of essential foodstuffs or infrastructure. In these latter cases, the investment is often accompanied by pricing decisions designed to provide subsidized goods and services to consumers or targeted groups of consumers. Unfortunately, uneconomic prices or tariffs will result in financial losses for the companies operating in these sectors, and without a resolution of this conflict through full and transparent financial compensation for these subsidized goods and services, the result will be widespread underinvestment and misallocation of resources.

Box 3.2: Changing Policies on Employment: The Case of IRI

Over 1974-80 nearly 70 percent of the losses of the IRI Group came from the declining industries in the steel and engineering subsectors. These losses peaked at $2.4 billion in 1980, equivalent to 9 percent of IRI’s consolidated sales. During the same period, employment at IRI reached 530,000—this had been reduced to 385,000 by 1992—or 1 percent of the Italian population. Yet despite mounting financial losses and poor industrial relations, the maintenance of employment was a critical Government objective over this period and labor shedding was difficult.

However, by the mid-1980s, IRI embarked on a major restructuring of loss-making firms and, where necessary, a concomitant redeployment or downsizing of the labor force. In some instances, the holding company was able to transfer blue collar workers in the industrial north out of the production facilities of one IRI subsidiary company to another. But where redundancies were inevitable, IRI did not operate a special fund to assist laid-off workers but instead relied on the Government’s CIG (Cassa Integrazione Guadagni) scheme. Established originally in 1947-48 as a vehicle to assist with temporary problems, the fund—financed largely from employer contributions—was extended in 1977 from temporary stoppage to reconversion and then to closure. Without the benefit of the GIG, it is unlikely that IRI could have achieved the extensive labor-shedding that took place from 1985-90.

Lessons on Separation of Social and Commercial Objectives. A critical element contributing to the poor performance of many SOEs has been the diverse, ill-articulated and often conflicting roles set by the owners for the management of the enterprises. It has, as a result, been difficult for many SOEs to achieve and to sustain the productive, allocative and dynamic efficiencies required for maximizing economic benefits. Thus, wherever possible, social and commercial objective should be separated.

Where governments are nonetheless determined to utilize SOEs to achieve noncommercial objectives, two principles should be applied with rigor and with consistency. First, any noncommercial objectives must be explicitly identified and agreement reached between the firm’s shareholders and management. Second, the costs—in financial and human resource terms—of achieving these objectives should be delineated fully, and transparent arrangements should be made to compensate the enterprises for the provision of these noncommercial objectives.
Clarify Owner/Manager Relationships

Clarifying the relationship between SOE managers and the firm’s owner is one of the most fundamental issues for the State as owner of the corporation to address. How should the state interact with SOE management in such a way that the firm best achieves its commercial goals? What owner/manager framework for SOE control has worked? International experience to date offers several lessons.

First, the most effective SOE owner/manager regimes have been those where there has been a separate legal identity of the corporation from its owners. Nonetheless, too often the state tends to blur its function as owner and manager. One of the most common features associated with inefficiently run SOEs has been the predilection for the state’s designated representative as owner to intervene repeatedly in day-to-day management (to achieve noncommercial goals) to the detriment of the enterprise’s profitability. International examples abound throughout the developed and developing world of undue political influence by Governments in the running of SOEs. This is a dominant theme in countries as varied as India (Hindustan Machine Tools), Turkey (Sumer Holdings), and Italy (IRI). In many such cases, the property rights of the corporation were not clarified and accounting systems were weak. In Turkey for instance, accountancy followed state agency rules, not the principles applicable to commercial enterprises. Audited accounts were sent to a Government agency, but were not used to evaluate management’s commercial performance.

Second, international experience in countries as diverse as France, Italy, Norway, New Zealand, Korea, Indonesia, India and Turkey suggests that effective internal governance for corporatized SOEs has been achieved when the state has provided adequate incentives to boards, managers and employees to meet commercial objectives. In countries where this has not been the case and actions have been taken to redress the problem—such as New Zealand, Norway and Korea—SOE performance has improved. However, underpayment for outstanding performance and failure to discipline nonperformers are common errors. All too often, state-owned corporations have not made the rewards commensurate with the risks in reformed SOEs. Incentives to managers for profit and efficiency gains are notably missing. In many socialist systems, rewards were given for quantitative production achievements, but usually without regard to quality, cost, efficiency or return to the owner. In many cases, managers are civil servants, and performance evaluation, dismissal, compensation and benefits are all tied to the government’s noncommercial standards.

One of the features that has most consistently distinguished efficient from inefficient SOEs has been the introduction of salary and benefit incentives for managers that reflect market conditions. Most SOEs were originally established based on the terms and conditions offered to civil servants. On the one hand, SOE managers and workers enjoyed implicit assurances they would receive the security of tenure offered to
traditional employees in the civil service. On the other hand, they were constrained in their performance by the lack of incentives manifest in pay scales and benefits designed for such employees. In these circumstances, it is difficult to reward or sanction the performance of managers, and the ability of the State, as owner, to provide incentives for their "agents," that is to say, management, is severely circumscribed. Efforts to seek efficiency gains through increased managerial autonomy in the day-to-day operation of the SOE will inevitably fail if there are insufficient financial rewards available to management. International experience, including the case studies in Annex B, shows that some of the most efficient reformed SOEs—Statoil, Semen Gresik, Usinor Sacilor and Coalcorp—have all recognized that, in order to attract and retain top level managers who are willing to assume the full responsibilities of their positions of authority, the link with civil service pay and attendant conditions must be severed. Other incentives for employees can also be devised; in this regard, profit-sharing and some equity distribution have proved effective. The most successful reformed SOEs have offered terms and conditions more akin to the risks and rewards available to private firms, and have sought to compete with private firms in the market for hiring experienced and competent management.

The board of directors' role vis-à-vis management's decisions also lies at the heart of clarifying owner/manager relations in SOEs. International experience and research demonstrate that the most effective SOEs are those where the board's compensation is tied to managerial performance. The board must thus receive incentives to monitor and control the corporation's executives, including the right to hire, fire and monitor their decisions and set their compensation. In turn, the board's success is monitored by the shareholders, and disciplined or rewarded by shareholders' actions.

International experience also suggests that share transferability is a fundamental attribute of successfully reforms SOEs. This finding stems from the concept of "residual risk"—that is, the risk accepted by the owners of the enterprise who take the ultimate risk of loss and also benefit from the ultimate gains. In private firms, the bearers of residual risk must have effective control over management decision-making and/or be able to sell their ownership rights to new purchasers (such as through the sale of shares). In these circumstances, the owners of the enterprise have powerful incentives to be efficient since they bear the full consequences of their own decisions. In the case of SOEs, however, the residual risk is borne by the population as a whole, which, in turn, has no ready vehicle for either controlling the enterprise or for divesting its ownership rights. In these circumstances, the incentives to perform efficiently are weakened since residual gains or losses are not borne in full by the local, municipal or national authority that controls the enterprise, but by the population at large.

In practice, many countries have confronted this problem by diversifying SOE ownership; in some cases, to secure the gains from ownership diversification, SOE divestiture has been pursued. The case of the UK provides an instructive example.
Despite the clear intention that, through ownership diversification, SOEs in the UK should operate at arms-length from government as commercial organizations, this did not occur. Poor SOE performance was due primarily to the lack of incentives for greater efficiency; over 1970-85, there were few rewards or penalties for management or employees if profits of SOEs were unsatisfactory. After several years of disappointing reform efforts, the UK Government concluded that sustained improvement of SOE performance would be brought about by divestiture. As a result, the Government embarked on a program to divest most of the larger SOEs.

**Appoint Nongovernmental Representatives to Boards**

One of the key factors that has continued to frustrate the efficient operation of SOEs after corporatization has been the failure to attain a clear separation of overt political influences from the commercial and business objectives of the enterprise. While it is important to establish a strong board structure to develop the overall strategy for the SOE and to monitor the performance of management, the creation of a board that facilitates undue political interference in the day-to-day operation of the business will achieve little by way of improved corporate performance.

International evidence suggests that an effective way of ensuring boards are able to perform their strategic and monitoring role is through the appointment of nongovernmental representatives to the boards. Experienced and civic-minded representatives with nongovernmental or technical backgrounds can provide the substantive and motivational underpinnings necessary for improved corporate governance of SOEs. In Norway, Statoil has had nongovernmental representatives on its board for some time, as has the French steel firm Usinor Sacilor, all of the large Korean SOEs (known as Government Invested Enterprises) and, more recently, Semen Gresik in Indonesia. However, even the most commercially-oriented SOE boards, such as Coalcorp in New Zealand, have struggled with the ability to “lock in” the positive impact of good governance that comes from these types of appointments. The New Zealand Government has decided that the most effective way to consolidate the gains of nongovernmental representatives on SOE boards is to permit market forces to operate with even less interference. As a consequence, it has recently decided that Coalcorp will be divested.

**Appoint Independent Commercially-Oriented CEOs**

In addition to creating board structures with nongovernmental representation, there are also clear advantages to be obtained from appointing chief executive officers (CEOs) with commercial and industrial backgrounds. In many instances, SOEs come under severe pressure from politicians seeking short-term political advantages at the cost of the commercial viability of the firm. The recent developments in Italy suggest that IRI may have suffered in some measure from undue political interference at the board level.
On the other hand, countries such as France and New Zealand have emphasized the need for independent commercially-oriented CEOs. Usinor Sacilor, the current Chief Executive, while appointed to the post for a three-year (renewable) term by the President of France, is accorded significant independence from the board in the day-to-day running of the company.

**Avoid the Creation of Large Holding Company Structures**

The notion that the holding company structure is an efficient vehicle for enhancing corporate performance has been the subject of debate. This issue is of particular interest to economies in transition where political and economic forces have created pressures to seek radical forms to try to enhance governance of SOEs. International experience, however, suggests that the significant disadvantages of large holding companies outweigh any limited advantages: many of the aims of these structures can best be achieved by improving governance structures at the level of the enterprise. The main disadvantages of holding company structures can be summarized as:

1. the creation of additional layers of bureaucracy to the operating companies;
2. a failure to shield the operating companies from undue political intervention;
3. the propensity for cross-subsidization between the operating companies in the group and the concomitant distortion of signals and incentives to management that this practice promotes; and
4. the difficulty in controlling the growth and longevity of these corporate forms once established.

Various country experiences illustrate each of these points.

In the cases of IRI (Italy) and HMT (India), the “apex” institution has been unable to provide many of the efficiencies the structure was purported to deliver in terms of strategic planning and improving centralized functions. In IRI, the structure of vertical links has involved cumbersome, multiple layers of decision making comprising the apex

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holding company, under which are the subholding companies and affiliated companies. The HMT structure is similar.

The IRI structure also has palpably failed in one of its prime objectives—to shield the subholding companies and the operating companies from interference from politicians. Indeed, recent political scandals in Italy have pointed to widespread and deep-seated involvement by political parties in many financial and operational aspects of IRI’s operations. On the other hand, in Sumer (Turkey) and HMT, centralized management has shielded the operating companies from external market factors, which otherwise would provide incentives for competitiveness.

In Usinor Sacilor, the management and board of the profitable stainless steel division, Ugine, have long complained that the decision to use profits from their operation to cross-subsidize the loss-making long-products company—Unimetal—has the effect of sending the wrong signals and incentives to the management of both companies. The arbitrary reallocation of surplus funds by the apex institution has become a dangerous practice, which has the effect of minimizing the incentives for Ugine management to improve profitability while at the same time reaffirming Unimetal’s belief that their financial shortfalls will be met from external sources.

Finally, experiences in Austria, Zambia, Germany and Sweden indicate that holding companies have a propensity to grow in size and influence, and that, once established, become the enemies of reforms that involve any reduction in their longevity or influence. In socialist countries, holding companies have tended to replicate the vertical monopolies of the old system, locking in inefficiencies and resisting change mandated by external market factors. Countering this trend is Kazakhstan, where the Government has taken the unusual step of annulling the 1993 decree that established holding companies in light of the negative influence these structures imposed on the Government’s reform program.

**EXTERNAL INCENTIVES: KEY LESSONS OF EXPERIENCE**

**Encourage Competition**

Perhaps the most important exogenous factor impacting the efficient operation of any firm—including SOEs—is the overall degree of competition. Economic theory and practice demonstrate that firms in a “contestable” market, facing the full rigors of competition with freedom of entry and exit, will react to these pressures in a manner that fosters and maintains high levels of efficiency. Conversely, companies in a monopolistic or oligopolistic market protected by barriers to entry and exit will be in a position to extract “economic rents” from their position, with few incentives to seek cost reductions; indeed, the outcome will be higher prices, losses in consumer welfare and restrictions in output.
Even when there are numerous SOEs operating in the same sector, governments have been known to prohibit competition between SOEs and/or restrict entry or competition from nonstate firms in an effort to provide protection to potentially inefficient SOEs. Equally important, governments have seldom displayed a willingness to liquidate persistently poorly performing enterprises. Instead, they have sought to provide direct fiscal subsidies or indirect quasi-fiscal subsidies, such as concessionary credits from the banking sector, debt-for-equity swaps and exemptions from the payments of customs duties, dividends, taxes and supplier credits. International country experience varies from fierce competition with negligible interference from Government—the UK and New Zealand—to overt protection by the State for heavily subsidized operations—Turkey and India. In all cases, the impact or absence of these external competitive forces on corporate performance has been marked and direct. Several examples illustrate the range of experience.

Statoil, the fully integrated Norwegian oil company, is a firm that has had to compete vigorously in the production and sale of oil in international markets with large multinational companies. As a consequence, both its owner—the Norwegian Government—and its managers have been united in their resolve to match the efficiency levels of their larger competitors from the private sector in order to survive commercially, particularly in the absence of large subsidies from the State. Similarly, Coalcorp in New Zealand has maintained acceptable levels of financial performance despite the imposition of hard budget constraints and competition from other energy sources. In large measure, this has been due to the pressures Coalcorp faces within the domestic market from forty to fifty privately owned coal mining companies; at the same time, in the international market, the company is a small player in a highly competitive environment. The increases in export sales in 1993 and 1994 are testimony to Coalcorp's relentless emphasis on commercial practices and productive operations.

The case of Semen Gresik provides a counterexample. The Indonesian cement industry comprises nine companies, of which five—including Semen Gresik—are in the public sector. The Government intervenes in the domestic market by setting regional benchmark prices and by allocating regional markets based on proximity ("defined regional markets"), installed capacity and projected cement demand; export of cement must also be authorized, and is only done when domestic cement demands have been met. This market control system presents Semen Gresik and the other producers with captive regional markets. However, the minimal competition that results has led to supply bottlenecks and shortages. Significantly, the Government is now actively considering deregulation of cement pricing and marketing to improve efficiency and provide incentives for investment promotion in the sector.
Improve Financial Discipline: the Role of Debt and Government Subsidies

When markets for debt finance operate according to commercial principles they induce corporations to demonstrate they can employ the debt profitably, by servicing it or covering the creditor's losses if it cannot be repaid. Thus, creditors exert a discipline on corporations akin to the discipline imposed by shareholders. However, where the state protects the SOE from such discipline (usually by guaranteeing the firm's debts), it removes a strong incentive for management to be efficient; in so doing, it creates "moral hazard."

International experience demonstrates that the existence of such guarantees has undermined discipline and, in some cases, contributed to serious financial difficulties for the State. Turkey's Sumer Holdings is a case in point. Most of the borrowing by Turkey's SOEs has been backed by a government guarantee of some form or another. This debt has had a major adverse impact on the Government's finances.

Analogous to the absence of external discipline arising from softness in guaranteed debt markets, when SOEs are permitted to bypass government's attempts to impose "hard budget constraints," a similar problem emerges. Thus, when fiscal subsidies to SOEs are stopped, these enterprises must not be given the opportunity to then turn to banks or other financial institutions for "easy" credit or to continue their operations by running up large interenterprise arrears. The threat to macroeconomic stability that such practices engender cannot be overestimated, and recent economic history is replete with examples to verify this point. By the same token, SOEs must also be exposed to the discipline of paying taxes and customs duties.

Diversify Ownership of SOE Shares: The Role of Equity

Coupled with an active equity capital market, international experience shows that diversified sales of SOE shares or the dilution of Government ownership through rights issues can have a major impact on improving a company's performance. When a company's shares are listed on a stock exchange, the day-to-day performance of these shares is a transparent reminder to the managers and owners of the perceived viability of the company. Threats of takeovers, fluctuations in stock prices—particularly for managers with share options—and the influence of nonstate shareholders are pressures that effectively concentrate the minds of management on the need for corporate efficiency and commercial success.

Importantly, it is possible to create external pressures that can motivate improved SOE performance by selling even a minority portion of the Government's shares. IRI, for instance, has embarked on a diversified ownership program where many companies in the IRI Group have some measure of private shareholding, and nonstate acquisitions and sales of smaller companies have occurred frequently. Similarly, both Statoil and Usinor Sacilor have a number of joint ventures and strategic alliances with private investors that
have yielded significant and positive external pressures on enterprise behavior. Overall, the trend of nonstate minority ownership of SOEs has accelerated in recent years (see Box 3.3).

**Encourage the Efficient Operation of Labor Markets**

For an SOE to operate efficiently, it must be free to use, and be disciplined by, the availability of its inputs, including labor. This implies the right of the corporation to hire and fire the labor it needs, and to have the freedom to optimize how to employ labor as well as the freedom to change managers and skilled technicians. This fact also provides the incentives to labor and management alike to increase productivity to maintain or improve their positions.

**Box 3.3: Semen Gresik: The Impact of the Initial Public Share Offering**

In recent years, the Indonesian Government has become increasingly reluctant to increase its capital participation in SOEs and has encouraged companies to seek long-term investment financing from the capital market. As a consequence, in July 1991, Semen Gresik became the first Indonesian SOE to issue shares on the Jakarta Stock Exchange to finance a major capital investment project. This Initial Public Offering (IPO) comprised 27 percent of total share capital and generated about $140 million equivalent. Of the new shares sold, about 85 percent of the total are held by foreigners, mostly institutional investors.

Following the successful listing of the company, the management and oversight of the enterprise have been affected in significant ways. First, as a result of Indonesian Government Regulation 55/1990, the company is exempt from cumbersome regulations on Government supervision and monitoring as well as onerous Government procurement rules, while enjoying greater flexibility in sourcing of funds. Second, a very significant impact of the IPO has been the much greater scrutiny of company performance by the (minority) private shareholders and stock analysts. Public reporting now takes place every three months, while company finances are audited in line with international accounting standards by a reputable international audit firm. Company performance is also scrutinized by external financial analysts, who publish periodic recommendations on the attractiveness of Semen Gresik’s shares for current and potential investors. Management and Government officials agree that the much closer scrutiny and the external pressures that accompany the listing of shares have led to greater transparency of the company’s performance and have created a greater sense of accountability by company management for efficiency improvements. While Semen Gresik’s performance in 1994 remained satisfactory, further efficiency improvements leading to improved financial performance is anticipated as a result of the new capital investments coming onstream.

Efficiency gains have been severely limited in enterprises where state interference has separated SOEs from labor markets and denied them freedom to optimize. In Sumer Holdings, for example, the management and most staff have civil service or equivalent status. Dismissal is almost impossible, while at the same time, offering monetary or other incentives for extraordinary performance is illegal. In HMT, rigid rules applicable to SOEs similarly freeze labor utilization patterns, resulting in overstaffing and an inability to attract the most promising skilled workers.
Avoid Complex External Performance Monitoring Schemes

To a greater or lesser degree, performance of SOEs is assessed using recognized parameters, such as target rates of return on assets or return on sales, as well as standard key operating ratios. In a number of countries, such as Korea, Pakistan, France, Indonesia, New Zealand and Mexico, a great deal of effort has gone into designing and monitoring these targets, drawing both on observed enterprise performance as well as applying international comparisons. However, there is little hard evidence that these systems have been able to develop and maintain objective performance benchmarks in such a way that they reflect decisions that can be controlled by management. In a number of instances, the systems are fraught with poor design parameters, distortionary incentives and lack the facility for enforcement.

In the Indonesian performance monitoring system, there have been several reforms aimed at reflecting technical differences among sectors and a number of nonfinancial indicators have been added to the long list of financial indicators. Financial performance indicators now account for 70 percent of enterprise evaluation, and technical indicators tailored to each sector or enterprise make up the balance. However, once Semen Gresik’s shares were listed on the stock exchange, the company was exempted from this cumbersome scheme—an explicit recognition by the Government that a strong board and capital market pressures are actually a more effective method for monitoring the company’s performance. In Pakistan, a relatively innovative annual monitoring program with rewards and sanctions for management has deteriorated from its influential role in the 1980s; today, the system is no longer being energetically applied.

One of the key lessons from international experience appears to be that such external performance monitoring systems are successful only when the monitoring units—as in Mexico and Korea—are directly linked to bodies with real policy-making and political influence. However, even in these cases, the solutions involve significant costs in terms of the bureaucracy required to perform the external monitoring functions.

Improve the Policy Regime

Legal Factors. In many countries, SOEs are exempt from various legal or regulatory provisions otherwise applicable to the modern corporation, such as tax, customs, competition laws or labor laws; in other cases, special privileges such as tariff protection or government procurement preferences are granted. These exemptions and privileges are intended to confer competitive advantages on SOEs aimed at improving their performance. The evidence shows, however, that not only do some measures constrain SOE’s competitors, but they also yield no improvement in SOE performance. On the contrary, there is some evidence that the grant of legal protections or exemptions actually deprives SOEs of incentives to improve efficiency, technology and profitability. In this context, SOEs have tended to grow complacent. HMT, for example, receives
numerous legal benefits including high tariff protection and government procurement preferences. Yet, it continues to lose market share; its technology level is precariously low; and its cost of production now exceeds world market prices for many of its core products.

**Permit Bankruptcy.** In the tradable sector, there is no sound economic reason why an SOE should not be subject to bankruptcy. Protection from creditors removes from SOE managers one of the strongest incentives for efficiency and profitability. Indeed, the absence of a threat of bankruptcy has kept alive most of the failing SOEs in reform. Moreover, the case of the Polish firm, Ksiaz Porcelain Factory, demonstrates that bankruptcy does not always result in a complete loss. There, the process resulted in a liquidation and restructuring exercise, which in turn led to a rejuvenation of the firm and an opportunity for regeneration. Thus a significant, but often overlooked advantage of bringing bankruptcy to bear on SOEs is that part of the reconstruction of a firm after its bankruptcy often involves establishing arrangements for motivating new and surviving managers and employees.

**Develop and Enforce Independent Auditing Standards.** One of the features that has frustrated attempts to improve the efficiency of SOEs is an absence of reliable financial information on the performance of the firm. This type of information is important from a number of perspectives. First, accounts that are audited by an independent, professional organization subject to internationally accepted standards will provide the owners and the board of directors with a reliable data base to supplement management accounts and on which a commercial strategy for the enterprise can be developed and monitored. Second, these independent data are a necessary precondition for entering into significant joint ventures—particularly with nonnationals—or for preparing the company for stock listing or partial divestiture. The vast majority of countries has recognized that this type of information is necessary for improving the performance of SOEs. With sound audits in place, governments are better able to design and implement taxation and customs regimes that both satisfy revenue generating requirements and, at the same time, broaden the tax base in such a way that principles of equity are more efficiently achieved.

**SUMMARY: LESSONS OF INTERNATIONAL EXPERIENCE**

Broad international experience, cross-sectional data and case studies examining SOE reform suggest a number of conclusions. These are summarized in Table 3.1. The main lessons are:

(a) SOE performance can be improved measurably through reforms such that the enterprise, Government and consumers *all* benefit from efficiency gains, even in the absence of divestiture;
(b) Improvement in internal incentives is a necessary but not sufficient condition for enhanced SOE performance. External factors, such as competition and implementation of a sound policy framework, also must be allowed to discipline the performance of SOE; and

(c) Nongovernmental representation on SOE boards of directors, appointment of commercially-oriented SOE management, and broad diversification of SOE ownership will help to sustain the reform process. The whole package of reforms must be implemented—partial reforms are seldom sufficient—and they must be sustained over time.
### Table 3.1: International Experience with SOE Reform

#### WHAT HAS WORKED:

<table>
<thead>
<tr>
<th>I. Internal Incentives</th>
<th>II. External Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Separate commercial from social objectives*</td>
<td>* Encourage competition between SOEs and with nonstate firms (foreign and domestic) and open trade and investment channels*</td>
</tr>
<tr>
<td>* Clarify owner/manager relationships*</td>
<td>* Eliminate fiscal and financial subsidies*</td>
</tr>
<tr>
<td>* Pay market-determined salaries to managers and provide similar incentive packages to workers*</td>
<td>* Diversify sales of SOE equity shares*</td>
</tr>
<tr>
<td>* Appoint private and union representatives on boards*</td>
<td>* Allow labor markets to operate freely*</td>
</tr>
<tr>
<td>* Appoint strong, independent commercial oriented CEOs*</td>
<td>* Encourage the development of external, independent auditors*</td>
</tr>
<tr>
<td>* Minimize bureaucracy in the organization of the firm(s)*</td>
<td>* Avoid complex external performance monitoring schemes*</td>
</tr>
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#### WHAT HAS NOT WORKED:

<table>
<thead>
<tr>
<th>II. External Incentives</th>
<th>I. Internal Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Create multiple and conflicting objectives*</td>
<td>* Separate commercial from social objectives*</td>
</tr>
<tr>
<td>* Permit ad hoc political interference in running of the company*</td>
<td>* Clarify owner/manager relationships*</td>
</tr>
<tr>
<td>* Link SOE managerial salaries to civil service pay scales*</td>
<td>* Pay market-determined salaries to managers and provide similar incentive packages to workers*</td>
</tr>
<tr>
<td>* Staff Boards with politicians and civil servants*</td>
<td>* Appoint private and union representatives on boards*</td>
</tr>
<tr>
<td>* Appoint CEOs responsive primarily to governmental agendas*</td>
<td>* Appoint strong, independent commercial oriented CEOs*</td>
</tr>
<tr>
<td>* Create large holding company structures*</td>
<td>* Minimize bureaucracy in the organization of the firm(s)*</td>
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4. IMPROVING SOE PERFORMANCE: LESSONS FOR CHINA

PROGRESS WITH SOE REFORMS

Much of the reform of SOEs in China over the last decade and a half has focused on improving corporate governance and orienting SOEs to pursue commercial objectives. Efforts in the 1980s centered on decentralization of governmental controls and, today, all but about 2-3,000 of the 105,000 SOEs in China have been placed under the supervision of local governments. At the same time, Chinese authorities sought to increase managerial autonomy in SOEs through the Contract Responsibility System. These earlier measures were strengthened with the 1992 promulgation of the “14 Autonomous Managerial Rights.”

The reforms for management autonomy brought to light the need to tackle other issues, particularly clarity of property rights and improved management accountability and monitoring. As is the case elsewhere where the state is the owner and property rights in SOEs are unclear, increased management autonomy in China created the opportunity for “asset stripping” and a masking of losses.

Against this backdrop, new initiatives have been recently launched aimed at the creation of a Chinese “modern enterprise system.” In November 1993, the 14th CCPC issued the Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure, which established a 50-point SOE reform agenda. In early 1994, the State Council announced the “10,000-1,000-100-10” SOE reform experiment introducing new accounting methods (10,000 SOEs), asset valuation (1000 SOEs), corporatization (100 SOEs), and comprehensive reform (10, now 18, cities). In 1994 China’s first modern company law became effective. Taken together, these initiatives indicate China has embarked on a program to restructure proactively its SOEs using the modern corporation as a basis for reform.

At the recent opening of the People’s National Congress in March 1995, Premier Li Peng announced that the Government would be pursuing further reforms as part of a concerted effort to deal with the growing problems associated with inefficient SOEs. This initiative would include redefining the government-enterprise relationship through policies aimed at “altering the functions of the government, separating them from those of the enterprises and thus creating a favorable environment in which enterprises can operate...
independently and be accountable for their own profits and losses.” Premier Li also noted that chronic loss-making enterprises would be liquidated, and technologically backward enterprises must either adapt or “change hands,” while small SOEs should be reorganized through lease, contract or sale by auction.

APPLICATIONS OF INTERNATIONAL EXPERIENCE

The lessons of international experience with SOE reform can be applied to the Chinese experience and incorporated into reform initiatives under way. Recommendations for further reform of Chinese SOEs are grouped under the following broad headings: (a) the policy regime; (b) internal governance; and (c) external incentives.

Improving the Policy Regime

- **Eliminate Distortions in the Policy Framework.** Although there has been significant progress in developing and reforming China’s policy and regulatory regime over the past few years, international experience highlights the need for further improvement. Chinese authorities need to focus on reforms including: (a) price decontrol and the further rationalization of relative prices for energy, grain and cotton; (b) continued liberalization of foreign trade and investment policy, including the elimination of lingering indirect export subsidies, the granting of direct export and import rights to all enterprises, and streamlining the regulatory regime governing foreign direct investment; (c) tax policies that establish greater neutrality among economic activities and across income groups; and (d) introducing broad policy neutrality across enterprise ownership forms in the state and nonstate sectors.

- **Establish Legal Framework for Enterprise Reform.** If Chinese SOEs are to develop modern corporate structures, further reforms in the company law and in implementing regulations related to SOEs will be required. Equally importantly, reduction of entry and exit barriers—through liquidation and bankruptcy—needs to be accelerated.

- **Encourage Service Sector Development.** International experience in many other countries indicates that the development of “newer” services industries, such as an independent accounting profession with recognized international standards, informatics, and legal services, is essential for promoting internal discipline in SOEs as well as facilitating commercial relationships with third parties—particularly nonnational corporations and investors. In addition to providing direct benefits to SOE performance, the development of these services, as well as traditional service sectors, such
as insurance and banking, will create additional employment opportunities for some of the employees that may be shed from less productive industrial SOEs.

**Internal Governance**

- **Clarify Property Rights and Owner/Manager Relationships.** Poorly delineated property rights and inappropriate governance mechanisms are a widespread feature of SOEs in China. The introduction of governance structures embodying clarification of owner/manager relationships, application of incentives and sanctions for management and employees, and effective monitoring through commercially-oriented boards of directors are essential prerequisites for improved SOE efficiency. In that respect, it is important to intensify the process of SOE corporatization in China.

- **Simplify State Asset Management Structures.** International experience suggests that gains have been most pronounced where SOE reforms have not utilized holding company structures. The inherent economic and political disadvantages of these bureaucratic structures suggests that China needs to review carefully its current state asset management systems. The present arrangement for state asset management administration, including large group companies and the multitier management bureaus and investment companies, need to be reformed with simplicity in mind and with greater clarity in the role and function of these bodies. Wherever possible, the State’s interests as owner should be represented at enterprise-level board structures rather than through intermediary asset management bureaus—particularly for larger and more strategically important SOEs.

- **Separate Commercial from Social Objectives.** One of the most striking features of the Chinese SOE sector is the policy of linking SOEs’ productive functions with the provision of a wide range of social services. The experience in the Former Soviet Union and Eastern Europe amply demonstrates the problems associated with the blurring of commercial and social objectives. In China, a high priority is to establish mechanisms for passing many of the social service burdens—such as hospitals, schools and nurseries—to municipal or regional governments or to new or existing nongovernmental entities (housing) as appropriate. The work now under way nationally and locally to create social safety nets needs to be accelerated and given high priority, drawing on the experience in other transition economies and market economies.
**External Incentives**

- **Encourage Competition.** One of the most forceful messages that emerges from the international experience in SOE reform is the importance of introducing competition in both product and factor markets as a force for achieving efficiency gains at the enterprise level. Chinese authorities have made much progress in promoting the free flow of competitive market forces. However, there remain a number of rigidities in the industrial sector that have to be tackled including: (a) allowing equal access to factor markets, for example, bank credit, for state and nonstate enterprises; (b) promoting competition between SOEs across regions; and (c) liberalizing entry conditions for nonstate firms—both domestic and international—into product markets.

- **Increase Fiscal and Financial Discipline.** International experience highlights that the benefits of competition can only be captured if “hard budget” constraints are applied to SOEs—that is, the enterprises pay full economic costs for all their inputs and charge market-determined prices for their outputs. In China, there has been progress since 1990 in decreasing fiscal and financial subsidies to the SOE sector—down from about 6 percent of GDP in 1990 to just under 4 percent in 1993. However, these subsidies are unsustainable. Chinese authorities need to impose tougher conditions on SOEs if harmful implications for macroeconomic performance, resource allocation and social stability are to be avoided.

- **Facilitate the Operation of Labor Markets.** Worldwide, better performing SOEs are characterized by their ability to operate in freely functioning labor markets. In particular, they are able to hire and fire management and employees at will—subject to appropriate labor legislation and industrial relations practices—and provide financial and nonfinancial incentives that mirror best practices in modern corporations. In China, many SOEs are still obliged to provide permanent employment to their work force. In addition, there are further in-built rigidities in the labor market exacerbated by the SOE-level welfare regime. If China is to achieve significant efficiency gains in the SOE sector, the link between labor markets and enterprise reforms needs to be developed through the establishment of: (a) the labor contract system throughout all SOEs; (b) commercialized housing markets separate from SOE control; (c) portable employer-employee funded pension schemes; and, (d) government-provided or -sponsored schemes for education, retraining, medical care and unemployment compensation.
• Increase the Level of Nongovernmental Participation in SOEs. International experience demonstrates that sustaining hard-won reforms in the SOE sector is difficult without increasing the role of nongovernmental entities or persons in terms of SOE management, financing and ownership. In the Chinese context—even within the framework of the “socialist market system”—there are ways of increasing nongovernmental participation in the SOE sector through: (a) the appointment of nongovernmental representatives on the boards of SOEs; (b) contracting out the provision of services (transport, accounting and even social services) to the nonstate sector; and, (c) accelerating the diversification of SOE ownership through selling shares on national and international stock exchanges as a vehicle for introducing external forces that will motivate improved efficiency. In addition, it would be advantageous to introduce appropriate checks and balances related to nongovernmental participation in SOEs through transparent competitive tendering procedures for contracting-out of management and services and the acceleration of capital and financial markets reforms.
ANNEX A: MODELS OF CORPORATE GOVERNANCE

"Anglo-American" Model of Corporate Governance
CORPORATE GOVERNANCE
"Anglo-American" Model

BOARD OF DIRECTORS

Appoint & Supervise

OFFICERS

Manage

COMPANY

Elect

SHAREHOLDERS

Own

CREDITORS

Lien

STRUCTURAL FRAMEWORK

INSIDE DIRECTORS

QUASI-INSIDE DIRECTORS

OUTSIDE DIRECTORS

RIGHTS & RESPONSIBILITIES

- Review corporation's performance
- Elect and replace officers
- Approve dividend payments
- Approve corporate finance, debt and equity
- Change the nature of the corporation's business
- Approve major contracts
- Review and approve corporation's financial statements
- Inspect books and records

COMMITTED OF:
- Inside Directors
- Quasi-inside Directors
- Outside Directors

COMMITTEES
- Audit
- Compensation
- Executive
- Nominating
CORPORATE GOVERNANCE
"Anglo-American" Model

BOARD OF DIRECTORS
- Appoint & Supervise

OFFICERS
- Manage

COMPANY
- Own
- Hold Stake
- Structural Framework

SHAREHOLDERS

CREDITORS

STAKEHOLDERS

LEGAL SYSTEM

RIGHTS & RESPONSIBILITIES
- Policy making function
- Manage day-to-day affairs

OFFICERS

PYRAMID STRUCTURE
- President or CEO
- Secretary
- Vice President
- Treasurer
- Managers
CORPORATE GOVERNANCE
"Anglo-American" Model

SHAREHOLDERS

CLASSIFIED AS:
- Preferred (Class A, B etc.)
- Common (Class A, B, etc.)

RIGHTS & RESPONSIBILITIES
- Receive dividend payments
- Approve or disapprove fundamental changes
- Elect and remove directors
- Inspect books and records
- Amend bylaws and articles of incorporation
- Communicate with shareholders
- Enforce shareholder rights
CORPORATE FINANCE
"Anglo-American" Model

Classifications

DEBT (creditors/lenders)
- Senior
  - A
  - B
- Subordinate
  - A
  - B

Characteristics

- Preference to corporate assets re: liquidation or dissolution
- Corporate control pursuant to loan agreement (non-variable)
- Guaranteed loan payments (fixed amount)

EQUITY (shareholders)
- Preferred
  - A
  - B
- Common
  - A
  - B

- Corporate control through shareholder voting rights (variable)
- Discretionary dividend payment
- Ability to share in the corporation’s profits (increased dividends)
GERMAN MODEL OF CORPORATE GOVERNANCE
(Share Company)
Firms with more than 2,000 Employees
COMPOSITION OF THE SUPERVISORY BOARD (AUFSICHTSRAT)

Outside Company

Shareholders

elect half including president

AUFSICHTSRAT

elect 1/3

elect 1/6

Employees

Unions

Inside Company

Corporate Structure

Supervisory Board

Managers

Appoint

Managers

Appoint

Electors

Employees & outside directors

Shareholders (Owners)

Indepedently runs (day to day)

Company
AUFSICHSTRAT
(SUPERVISORY BOARD)

Chairman
Chosen by shareholders
Chosen by employees
Chosen by unions
This appointment is generally considered to be a ratification of nominees for the Board chosen from within the company.
The majority of the finance entering a Japanese company is through loans not shares. This is slowly changing.
JAPANESE MODEL OF CORPORATE GOVERNANCE

COMPOSITION OF BOARD OF DIRECTORS

Outsiders
- Shareholders
- Main Bank

Inside Company
- Board of Directors
  - Chairman of the Board
  - President
  - Executives of Company

Shareholders supply a few members, appoint
Board of Directors makes decisions for new members
Chairman of the Board appoints some to Board
ANNEX B: SUMMARY OF THE CASE STUDY SAMPLES

All of the companies chosen for the case studies are large enterprises operating in the manufacturing tradable sectors in a cross-section of developed and developing countries. It is acknowledged that this sample of SOEs errs significantly in favor of the more efficient SOEs but, in the event, this reinforces some of the lessons of experience. These companies were selected for this review primarily because of their relative importance in the state sector and their significance at the national level in terms of financial and economic impact. Infrastructure companies, often referred to as "natural monopolies," were excluded from the sample since these enterprises raise a number of quite specific issues concerning the regulatory framework which are of particular importance to firms in these nontradable sectors.

The companies covered in the cases are described briefly below:

(a) **Semen Gresik**: This Indonesian SOE was established as a legal entity in 1953 and is engaged in the cement industry. Semen Gresik is one of the top three cement producers in Indonesia, an industry that is comprised of nine companies, four of which are in the private sector and five from the public sector. In 1991, Semen Gresik became the first Indonesian SOE to issue shares on the Jakarta Stock Exchange. The public offering comprised 40 million shares or 27 percent of total share capital, generating about $140 million.

(b) **Usinor Sacilor**: One of the largest SOE manufacturing operations in France, the company was created in 1986 as the result of a merger of two companies taken over from the private sector by the State. The tonnage of liquid steel produced by Usinor-Sacilor is the third largest in the world after Nippon Steel (Japan) and Posco (Korea). The company is set up as a holding company with four main subsidiary operations with a significant

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1 This validity of the concept of "natural monopolies" as a rationale for state ownership has been challenged in recent years, particularly with the privatization of utilities and the break-up of larger utility companies into smaller competing entities. In addition, questions of economic efficiency have often been addressed by establishing regulatory systems to monitor potential abuses of concentrated power. Important as they are, the issues of infrastructure enterprise reform and divestiture are not dealt with directly in this paper given the special features of the nontradable sectors.
degree of autonomy from the owners (Government) in the running of the companies. The company is subject to rules covering competition from the European Union and does face stiff challenges from both SOEs and private companies in all of its market sectors. In addition, the French Government has imposed a "hard budget" constraint on the company, thus imposing strict commercial criteria on the company's dealings with commercial banks. Following the restructuring of the company and the return to net profits of Ffr 1.5 billion ($282.2 million) in 1994, the company is now being prepared for privatization.

(c) **Statoil:** The largest company in Norway measured in terms of revenues, Statoil occupies a dominant position in the economy. The company was established as a SOE in 1972 to engage in the exploration, production, transportation, refining and marketing of petroleum and derived products. The company operates in a truly international market for its downstream products and has had to operate on primarily sound commercial principles, receiving no direct or indirect subsidies from the Government. It is a technologically innovative firm and has, over the years, entered into a number of joint ventures and cooperation agreements with other European companies in the sector to secure and expand its share of international markets.

(d) **Coalcorp:** As the major producer of both thermal and coking coal in New Zealand, Coalcorp operates 12 mines and accounts for 50 percent of the domestic market. The remaining market share is supplied by in excess of 40 privately owned mines. Coalcorp is one of the 19 enterprises that were corporatized under the New Zealand Government's initiative to enhance SOE efficiency. In 1987 the company was transferred from the auspices of a Government Ministry and established in a corporate form with a Board of Directors with dominant private sector participation. The company is expected to operate along purely commercial lines and its financial performance since corporatization has been markedly improved.

(e) **IRI:** In Italy, SOEs have played a significant role in the economy and in the early 1990s accounted for 20 percent of value added and 25 percent of fixed investment. Many of these enterprises have been organized as private joint-stock or limited-liability corporations in which the government held a controlling interest through principal State-owned Holding Companies (SHCs). The largest of these SHCs is the Instituto per la Ricostruzione Industriale (IRI), a multisector holding company with involvement in: steel, advanced technology manufacturing, food processing and distribution, shipbuilding, civil and industrial plant engineering, telecommunications, sea and air transport as well as banking
and finance. The total number of Group employees in 1991 reached more than 408,000. Most recently, the 1992-93 crisis of public finances across the state sector in Italy has precipitated moves toward the privatization of many of the firms in the IRI Group.

(f) **Sumer Holding:** The manufacturing arm of what used to be Sumerbank Holding, Sumer Holding employs over 25,000 in 28 manufacturing units, 435 retail and distributing outlets, primarily in the textile sector. By the early 1980s almost all of its operations were in financial difficulty and lagging behind the growing private sector in production. Following reforms in the 1980s, the banking unit split off (and has since been privatized and made profitable) and most non-textile production was also split off in separate enterprises, some of which have now been privatized. Today, Sumer Holdings’ remaining operations are all losing money. Market share and productivity have declined in favor of private sector companies. Early reform efforts have been disappointing. Although Sumer Holding is in the form of a corporation under the peculiarities of Turkish law, the majority of state-owned corporations are not subject to the same commercial laws as are privately owned corporations. Their debts are guaranteed by the Treasury; their assets could not be seized for nonpayment of debts. Yet their management does not report to the Treasury but rather to a Minister whose objectives are primarily largely noncommercial (regional development and local empowerment). Sumer Holding’s senior managers are civil servants and pressures form public sector unions make it hard to release or reshuffle them. Sumer Holding is currently undergoing a consolidation of its potentially viable assets in preparation for divestiture.

(g) **Hindustan Machine Tools (India):** Established with the collaboration and equity participation of Oerlikon of Switzerland to produce machine tools in 1953, HMT became a fully owned undertaking of the Government of India in 1957. One of India’s largest producers of machine tools, HMT has diversified its businesses and now produces a broad range of industrial and consumer goods (machine tools, tractors, printers, bearing, watch, lamp, etc.). HMT has a work force of more than 27,000 and its turnover in 1992-93 was about Rs. 8 billion ($240 million). Though HMT has grown rapidly since its creation through the 1980s in terms of sale and production, its profitability has remained low and declined since the mid-1980s, except its tractor unit. Due to protectionist measures, HMT has not been motivated or able to take advantage of “state-of-the-art” technology that might otherwise have been imported. HMT’s performance is monitored through targets stipulated in a Memorandum of Understanding (MoU) signed with Government each year. The MoU sets production and
sales targets; however, the MoU takes into account Industrial Policy and employment targets and a growth pattern, based in part, on regional development.

(h) **Ksiaz Porcelain Factory (Poland):** Built in the 1970s with production commencing only in 1980s, KPF, with over 1,400 employees in 1990, never reached full production of its line of tableware and other consumer products. Its situation deteriorated significantly in 1991 when loses totaled almost 50 percent of sales. Exports accounted for 72 percent of sales in 1990. KPF in 1990 had significant overstaffing with only 70 percent of labor in direct production. Product quality was very poor with the domestic markets taking the worst production. Exposure to competition in 1990-91 resulted in liquidation. KPF went into liquidation in June 1991. Management was replaced by a liquidator appointed by the local government. The liquidator sought a restructuring business plan that resulted in the creation of a limited-liability company “Ksiaz Porcelain Factory, Ltd.” (KPFL) in October 1991, with state-owned enterprises (primarily a commercial bank that was KPF’s main creditor) as shareholders. The Executive Board is supervised by a nine-member Supervisory Board representing shareholders. Production at KPFL recommenced in June 1992. By 1994 it was marginally profitable due to improvements in quality and direct foreign marketing.
ANNEX C: SUMMARY OF INTERNATIONAL DIVESTITURE EXPERIENCE

Global Trends in Divestiture

The divestiture process began in Chile, the UK and a limited number of other countries in the 1970s and early 1980s but it was not until the mid-1980s that SOE equity sales began to accelerate internationally. More than 8,500 SOEs in over 80 countries have been sold over the past 15 years. The former socialist countries of Eastern Europe and the former Soviet Union—most notably the Czech Republic, Russia, Kazakhstan, Poland and Hungary—have all embarked on ambitious divestiture programs. But this activity has not been confined to economies in transition; developed, middle-income and, to a lesser extent, poorer countries have also carried out divestiture initiatives. To illustrate:

- In France—historically a country with the strongest SOE sector in the European Union—the Government decided in late 1993 to sell all or part of 21 public sector groups. These recent equity sales in 1993 and 1994 have included very large enterprises such as the giant oil group Elf Aquitaine, Rhone-Poulenc the chemicals conglomerate, a large Bank, BNP, and the insurance group, UAP. The remaining 17 firms slated for divestiture range from loss-makers such as Air France and Aerospatiale to currently profitable firms such as Usinor Sacilor and the tobacco firm, Selta.

- In Italy, a number of the IRI subsidiaries and companies such as Alitalia, Agip and the telephone company, STET, are being offered for full or partial sale. The Government hopes to raise as much as $15 billion from these sales.

- In Germany, a decision was recently taken by the Government to divest shares in two of its largest companies—Lufthansa and Deutsche Telecommunications. It will take some time to prepare the telecom company for divestiture given the regulatory and competition issues involved but it is anticipated that the sale will take place in 1996.
In *Indonesia*, the Government—initially wary of divestiture—has already floated shares of the cement company Semen Gresik and Indosat, the telecom satellite enterprise. It has recently announced plans to float shares of the telecom and electricity companies on the Jakarta and international stock exchanges as well as divesting shares of a major toll road company.

In *Pakistan*, the Government has sold 22 companies since October 1993 when Benhazir Bhutto took power, adding to the 60 companies previously divested during the period 1991-93. In 1994, shares of Pakistan Telecom were sold along with power plants and gas companies.

In *Argentina*, as recently as January 1995, the Government announced its intention to embark on another round of divestitures aimed at selling several hydroelectric plants, three nuclear power stations and a large petrochemical plant. The Government intends to utilize to consolidate Argentina’s public debt and to build up a budget surplus.

In the *Philippines*, a series of Governments have implemented a comprehensive divestiture program, which began in 1985 and which has generated over $4.5 billion in sales revenues. During the course of 1995 major companies targeted for divestiture include the National Steel Corporation, the Manila Electric Company and the National Power Corporation.

In *Kenya*, the Government has recently signed a Letter of Intent with the IMF in which it has agreed to sell—or, as appropriate, liquidate—all of the nonstrategic parastatals over the next three years. In addition, the Government is committed to contracting out the services of parts of the Ports Authority and preparing the Telecom company for divestiture.

In *Ghana*, divestiture has already begun with the sale of a number of the larger SOEs. For example, Ashanti Gold Mines shares were floated on the Ghana and London Stock Exchanges in 1994 coupled with the earlier involvement of strategic private sector investors. By the end of 1996, the Government plans to divest a further 50 SOEs including the telecom company and Ghana Airways.

**Preconditions for Effective Divestiture Programs**

One of the main lessons of international experience from divestiture programs is the importance of planning and structuring the implementation process carefully. The other principal lessons are:
• The more market-friendly a country’s policy framework, including the capacity to regulate, the less difficulty it will have in privatizing and the higher the likelihood that the sale will yield positive results. Countries in this category include Chile, the UK, New Zealand and France;

• An appropriate regulatory framework must be in place before privatizing monopolies [for example, British (telecom), Chile (telecom)]. Failure to regulate private monopolies or oligopolies properly can not only impact consumers welfare and efficiency levels adversely but also reduce popular support for privatization;

• Low-income countries with a limited regulatory and institutional capacity should consider increasing the role of the private sector through management contracts, contracting out, leases or concessions [such as Côte d’Ivoire (water)] as a first step towards ownership change;

• Some restructuring of SOEs may be necessary before divestiture, but this should be restricted to legal changes, managerial reorganization (British Airways), labor shedding (steel and railways in Argentina), financial engineering and organizational changes. The State should avoid large capital investments in new projects prior to divestiture;

• Emphasis should be placed on developing comprehensive and sustained public relations campaigns (such as Russia and the UK gas divestiture program) aimed at educating consumers, labor, the general public, civil servants and the politicians on the economic and welfare benefits of divestiture;

• Transparency in transactions is essential if the process and the results are to be deemed fair from the perspective of potential investors and the general public. Public offerings, although more complex and time-consuming than trade sales, are normally the most transparent form of transaction;

• Governments must consider the establishment of appropriate social safety nets (for example, UK, Italy, Argentina, Tunisia) in anticipation of the short-term impact of possible down-sizing and the need for retraining of the labor force. Many countries in Eastern Europe and Central Asia are developing social safety nets to address these issues; and

**Divestiture Process: Implementation Options**

At the heart of any divestiture program lies the need to assess the benefits of different divestiture processes. Table 1 below outlines the main divestiture options that
have been utilized internationally in the full or partial sale of SOEs. The table provides a broad framework for analyzing various considerations in attaining divestiture objectives.

### Table 1: SOEs: DIVESTITURE OPTIONS

<table>
<thead>
<tr>
<th>Divestiture Method</th>
<th>Preconditions</th>
<th>Benefits</th>
<th>Issues to be Considered</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial Public Offering:</strong></td>
<td>• track-record of profitability</td>
<td>• transparency</td>
<td>• takes time</td>
</tr>
<tr>
<td>Domestic</td>
<td>• independent audits</td>
<td>• wider share ownership</td>
<td>• preparation complex</td>
</tr>
<tr>
<td></td>
<td>• minimum size</td>
<td>• promotes capital market development</td>
<td>• needs effective secondary market</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• absorptive capacity may be limited</td>
</tr>
<tr>
<td><strong>Initial Public Offering:</strong></td>
<td>* International listing requirements</td>
<td>* introduce foreign exchange</td>
<td>* often difficult to meet listing standards</td>
</tr>
<tr>
<td>International</td>
<td>* minimum size</td>
<td>* management and marketing skills</td>
<td></td>
</tr>
<tr>
<td><strong>Trade Sale</strong></td>
<td>* must fit with buyer's strategy</td>
<td>* speed</td>
<td>* less transparent than IPOs</td>
</tr>
<tr>
<td></td>
<td>* company performance data</td>
<td>* management, marketing and technical skills</td>
<td>* more concentrated ownership</td>
</tr>
<tr>
<td></td>
<td></td>
<td>* sales revenue maximization</td>
<td></td>
</tr>
<tr>
<td><strong>Liquidation</strong></td>
<td>* poor financial performance</td>
<td>* reduce losses</td>
<td>* risk of redundancies</td>
</tr>
<tr>
<td></td>
<td>* future prospects poor</td>
<td>* release some productive assets</td>
<td></td>
</tr>
<tr>
<td><strong>Employee Shares</strong></td>
<td>* financing must be available</td>
<td>* gain employee commitment to privatization</td>
<td>* majority employee shares can lead to asset stripping</td>
</tr>
<tr>
<td></td>
<td></td>
<td>* spreads ownership</td>
<td></td>
</tr>
<tr>
<td><strong>Mass Divestiture Programs</strong></td>
<td>* strong political and popular support of divestiture</td>
<td>* speed once system established</td>
<td>* on its own does not introduce additional capital and/or technology</td>
</tr>
<tr>
<td></td>
<td>* infrastructure required to disseminate vouchers and hold auctions</td>
<td>* promotes broad domestic ownership</td>
<td>* may provide inadequate corporate governance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>* promotes capital market development</td>
<td></td>
</tr>
<tr>
<td><strong>Combination of Methods</strong></td>
<td>* good performing enterprise</td>
<td>* flexible method to promote share sales</td>
<td>* takes time to prepare</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>* complex negotiations</td>
</tr>
</tbody>
</table>

**Benefits of Divestiture**

Transferring ownership from state to private hands has a number of immediate consequences. First, the political influence on the management of state enterprises, a major cause of efficiency loss, is reduced. Second, it transfers the residual risk of the company to the private owners, thus providing powerful incentives for efficiency gains. Third, under private management and ownership enterprises are forced to face “hard budget constraints” because they are unable to borrow “soft money” with implicit or explicit subsidies and guarantees. Finally, privately owned firms are more likely to face closure or liquidation than SOEs and thus have a strong incentive to operate efficiently.

While there are a limited, but growing, number of empirical studies examining post-divestiture performance, the evidence strongly supports the contention that ownership matters in terms of enterprise efficiency gains and positive welfare consequences. Selected examples of post-divestiture changes in enterprise behavior are summarized below.
- **Enhanced Productivity and Improved Services to Customers.** During the 1980s, the British government sold a number of SOEs; most notable among the enterprises sold were British Airways, British Telecom, and British Gas. In a short period of time following divestiture, these enterprises were transformed from being loss-makers to high profit-makers. A recent study by the Center for Study of Regulated Industries in the UK\(^1\) found that since divestiture, the average productivity in British Telecom, for example, increased by 7.2 percent annually between 1989 and 1994. Moreover, this increase in productivity has been delivered at lower prices to consumers largely due to increased competition. In Bangladesh, the sale of a loss-making chemical company led to a 30 percent increase in production and a 50 percent increase in sales. Worker productivity increased fivefold and the cost of production was significantly reduced by lowering procurement costs of raw materials and labor. Although some workers became redundant when the enterprise was sold, the increase in production and sales is expected to result in an expansion of the enterprise and, subsequently, to a growth in employment. A study undertaken by the World Bank and Boston University (see Galal, Jones, Tandon and Vogelsang, 1992) that examined the experience of 12 divestitures in four countries concluded that, in all but one case, divestiture yielded positive gains for the economy as a whole in terms of the efficiency of the enterprise, subsequent investment and consumer welfare. The Chilean telephone company doubled its capacity in four years after sale while the Mexican telephone company reduced its per-unit labor costs sharply.

- **Rationalizing the Labor Force.** One of the main causes of poor SOE performance has been the rigidities inherent in the labor markets of these state-owned firms. Divestiture will allow market-oriented solutions to facilitate the more efficient use of both labor and capital inputs. However, fear of immediate redundancies is one of the most common and difficult obstacles faced while implementing divestiture and there is evidence form the Eastern Europe divestiture experience of heavy unemployment costs. However, a recent study of the divestiture of 61 companies in 18 countries has shown that performance of state enterprises can improve significantly with relatively low layoffs (see Megginson, Nash, Randenborgh, 1993). Another study\(^2\) found that 41 firms divested through public offerings—

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\(^1\) "Privatization and Recession", Center for the Study of Regulated Industries, March 1995.

including Chile, Jamaica, Mexico and Singapore—also expanded their work force by small margins while increasing returns on sales. A study of the Chilean privatization programs\(^3\) indicated that privatized firms increased employment levels significantly faster than SOEs once the boom of the late 1970s started. The study concludes that while divestiture will tend to increase employment to its optimum level per unit of output, instead of maintaining the excess levels of employment associated with SOEs, this does not imply that divestiture will increase overall unemployment in the economy.

**Fiscal Gains.** Although net revenues from divestiture may be limited due to large transactions cost and/or settlement of outstanding debts and taxes, in some countries (especially in Latin America) revenues earned from the sale of enterprise equity has been significant (Table 2). In some cases, proceeds from divestiture may even be negative, but over the long run, the reduction in transfers of resources from state to enterprise and an increase in tax revenue as the enterprise becomes profitable, is likely to offset the transaction cost for divestiture. In Argentina, the telecommunications company paid $100 million more in taxes within the first year of its divestiture. Divested public enterprises in the UK now pay close to $4 billion in taxes to the government. In Mexico, transfers to state enterprises were reduced by $4 billion between 1982 and 1988 due to an overall stabilization program, the imposition of hard budget constraints on SOEs and divestiture.

<table>
<thead>
<tr>
<th>East Asia &amp; Pacific</th>
<th>Europe &amp; Central Asia</th>
<th>Latin America &amp; Caribbean</th>
<th>Middle East &amp; North Africa</th>
<th>South Asia</th>
<th>Sub-Saharan Africa</th>
<th>Total</th>
<th>OECD countries</th>
<th>Total all countries</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>16.1</td>
<td>17.9</td>
<td>55.2</td>
<td>0.7</td>
<td>3.6</td>
<td>3.4</td>
<td>95.9</td>
<td>174.0</td>
</tr>
</tbody>
</table>

*Source:* World Debt Tables 1994, World Bank

**Capital market development.** Divestiture of SOEs has led to the creation or revival of long-moribund capital markets. Stock exchanges have opened or re-opened all over Eastern Europe to facilitate trading by new shareholders. The ability to exercise ownership rights through equity

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markets imposes discipline and prudential management on enterprises. Daily published prices of enterprise shares serve as a public barometer to measure a company’s performance, and managers of companies quickly become alert and sensitive to this reality. This has been the experience with partial minority sales of equity as well as majority sales. At the same time, equity prices allow managers to see the perception of their company’s performance, thus enabling them to make well-informed decisions. In addition to providing corporate governance, equity markets are a significant source of much-needed capital for enterprises and in a number of cases rights issues, leading to a dilution of Government’s ownership share, have been designed to fund new capital-intensive projects (Semen Gresik in Indonesia).

- **Foreign Investment.** Divestitures have also proved successful in attracting foreign investment—both long-term flows in the form of direct investment in enterprises and portfolio flows. Between 1988 and 1993, of the nearly $100 billion received in privatization revenues by developing countries, roughly one-third was from foreign investors (Table 3).

| Table 3: Foreign Exchange Flows in Divestiture Transactions, 1988-93 ($ billion) |
|-------------------|-----------------|--------------|--------------|--------------|---------------|---------------|
| East Asia & Pacific | Europe & Central Asia | Latin America & Caribbean | Middle East & North Africa | South Asia | Sub-Saharan Africa | Total |
| 5.0 | 10.2 | 16.8 | 0.03 | 0.007 | 0.07 | 95.9 |

*Source: World Debt Tables 1994, World Bank*

**Issues to be Considered**

The potential benefits associated with divestiture can only be realized when transactions are carried out under a competitive regime, in a transparent manner and within the context of a social safety net program.

- **Competitive Regime.** The replacement of a public monopoly by a private one will lead quickly to disillusionment among the general public and may not lead any improvements in enterprise performance, if the incentives it faces remain the same as before.

- **Lack of Transparency.** Poorly designed and implemented divestitures have resulted in allegations of corruption and selling state assets to privileged individuals. For example, in Guinea, information regarding
divestiture was not distributed widely among investors and, in some cases, the government received less than two offers per enterprise. Moreover, the price of enterprise equity was not based on valuation of enterprises assets but on financial offers made by investors. There were no sales via public tender and excessive sweeteners (in the form of long payment terms and various tax breaks) were given to new owners resulting in reduced competition and efficiency. The early examples of “spontaneous privatization” in Hungary and Russia also resulted from poorly designed divestiture programs that gave managers and employees an opportunity for asset stripping and less than transparent joint-ventures with foreign investors.

Lack of Political Will to Divest. Lack of commitment to divest by politicians, civil servants in Line Ministries and some SOE managers often leads to disinterest among potential investors and a rapid deterioration of SOEs performance and poor governance as they get caught in the hiatus between the decision to divest and the conclusion of the transaction. In Cameroon, the state-owned sugar company CAMSUCO was offered for divestiture in 1992 after overcoming a four-year long opposition from enterprise managers. The performance of the company, which was too weak to begin with, only worsened during the four-year period. As a result when it was finally offered for public tender, investor interest was low and only one bid was received. The bidder not only offered a heavily discounted price, but demanded additional benefits such as a 10-year payment plan, 30 percent increase in the price of sugar, and strict protection from imports. While the government waited to receive more offers, the enterprise’s technical and financial situation deteriorated precipitously and in 1994—two years after the company was offered for sale—it ceased production due to mounting losses.

Conclusions

International experience across-the-board provides evidence that the sale of equity to outsiders is an effective way of improving performance of SOEs. It is not enough, however, simply to divest. Experience has also shown that without the proper institutional and sociopolitical framework, divestiture may compound the existing problems of SOEs and create perceptions of unfairness. Implementing and managing divestiture should, therefore, be done with well-defined institutional responsibilities and through transparent and competitive procedures.
 COMMENTS ON “IMPROVING STATE-OWNED ENTERPRISE PERFORMANCE: RECENT INTERNATIONAL EXPERIENCE”

Wu Jinglian¹

The paper submitted by the World Bank, “Improving State-Owned Enterprise Performance: Recent International Experience,” is impressive in its clear, logical and analytical framework and its rich empirical evidence. It provides insights to those who participate in and show concern for SOE reform in China. Using the perspective of international comparison, it first reviews the emergence of global SOEs, their related problems and the efforts of governments in reforming SOEs. And then, taking internal incentives and external incentives as basic analytical concepts, the paper summarizes the experiences and lessons of restructuring SOEs through corporatization in many countries. Finally, based on these experiences and lessons, it makes a series of policy recommendations for SOE reform in China. The focus of this paper involves many aspects of SOE reform, and the paper provides many insights. Here, I would like to make comments on three of them.

SOE Reform as a Complicated Systematic Project

The paper draws a significant conclusion after summarizing the relevant international lessons: enhancing internal incentives is vitally necessary for improving the performance of SOEs. However, proper internal incentives alone are not sufficient. To obtain efficient operation of a corporation, a coordinated application of both internal and external incentives is required. This is verified by China’s experiences in SOE reform. Both international and Chinese experience show that reform of SOEs could never be accomplished by enterprises alone. For instance, reforming the management of state-owned assets involves changes of government function; encouraging competition and establishing a labor market involve the development of a set of competitive markets; and hardening budget constraints depends on reforms of fiscal and financial regimes and commercialization of banks. Therefore, the paper represents a confirmation, from the viewpoint of international experience, of the validity of an argument stressed repeatedly

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in recent years; that is, SOE reform is a complicated systematic project. It involves many aspects of the economy and society, and only through comprehensive reform can it possibly succeed.

After over a decade of reform, China has made great progress in introducing external incentives for SOEs. For example, up to 1992, about 90 percent of prices were free of state control. In 1994, primary reform measures were taken in fiscal and foreign exchange regimes, which brought forward, to some extent, the creating of fair taxation and making currency convertible in current accounts. The imperative tasks in introducing external incentives are: (a) separate the government function from the enterprise function in order to eliminate the institutional basis for government micro-intervention in SOEs; (b) achieve the important goals of financial system reform: commercialize the specialized banks, make commercial banking competitive by allowing the establishment of more banks to create an environment for enterprises to enter capital markets under fair conditions, and hardening banks’ financial constraints; and (c) accelerate the provision of a new social security net to promote labor market operation.

As the paper points out, SOEs would be impaired in their efficiency, profitability and financial discipline if, in their restructured form, one or more internal or external incentives are still missing. This proposition, which has been proven by repeated experiments in China and in other countries as well, may often give rise to such an argument that SOE reform will be a process that takes a long period of time, and one should not “be impatient for quick success,” given that the efficient operation of SOEs requires a set of integrated reforms. This idea and the practices that followed were responsible for the fact that SOEs in socialist countries ran into deeper trouble in spite of many years of reform efforts. In my view, precisely the opposite conclusion should be drawn: the key reforms should be implemented more comprehensively and rapidly. This is even better justified today since China has the necessary conditions fully in place.

Diversity of Internal Governance

The paper views the transferability of ownership as one of the four core features of internal governance in a corporation, and argues that transferability creates a “market for corporate control,” which, in turn, also disciplines corporate management to satisfy their owners’ goal. I share basically the same idea on the significance of transferability of ownership and market for corporate control.

I would like, however, to emphasize that a well-developed and well-regulated securities market is required for transferability, to give rise to discipline on management’s behavior as expected. It takes time for such a securities market to develop in a developing economy such as China’s. With a poorly developed securities market, internal governance structures that differ from the classic shareholders’ sovereignty model (the Anglo-American model) are of special value. In this respect, I noted that
detailed descriptions of the internal governance structures of German and Japanese corporations were provided in Annex A. Compared with the Anglo-American model, the German and Japanese models are less dependent on the operation of a securities market and better equipped with the interests of banks, employees and society as disciplines on management behavior. Therefore, for SOE reform in China, great importance should be attached to the diversity of the models of internal governance. This is particularly true when one notes that China has inherited both socialist and Oriental culture and tradition. In this respect, I believe that for SOE reform in China, the experience of the Japanese main banking system and employee participation in decision-making in northern European countries deserve detailed study.

State-Owned Assets Management Structure

One of the policy recommendations the paper presents is to simplify the system for state assets management. This touches upon an important issue of SOE reform in China: that of the separation of the government function and the enterprise function. As the paper points out, a separate legal identity of an enterprise is one of the key attributes of a modern corporation. SOEs in China have long suffered from the mix of government function and enterprise function, which stems from the mix of the state’s function as social and economic regulator and as asset owner. After corporatization of SOEs, the state is expected to maintain a considerably large, though smaller than before, share of equity in the enterprises. In this circumstance, it becomes a key issue of how the two functions of the state can be separated and its ownership rights be implemented.

It is a common practice in China at the present time to set up state-asset management agencies by establishing multitier holding companies, authorizing the legal representatives of those companies to operate state assets. As the paper rightly points out, the efficiency of these holding companies is of great doubt. With a developed capital market, it is difficult, if not impossible, for the state to obtain an objective evaluation of the portfolio value and thus the performance of those holding companies. Inefficiency can easily occur as insider control is out of control. The recommendation given in the paper is that the state interests as owner should be represented on enterprise-level board structures to avoid these problems.

In my view, however, another side of the coin is worth noting as well. The assets owned by the Chinese government are thousands of billions of yuan; large and medium SOEs total more than 10,000. Only for a small number of enterprises can the representatives of the state serve directly on board structures and intermediary tiers be reduced. For the majority of SOEs, it is thus still a problem as to how the agencies of state ownership can be established. This convinces me that the problem must be solved by various measures, of which the following are worth considering:
First, diversify the forms of public ownership and holding of state shares. As far as the former is concerned, I would like to reiterate the proposal I put forward before; that is, part of the state shares in SOEs should be transferred to social security funds as social security contributions for employees who are already working in SOEs. This will create a new form of public ownership shareholding by social security funds. As to the latter, I agree with many other authors that banks' debt claims can be substituted by equity claims in the process of liability restructuring of SOEs.

Second, create a regime of multilevel government ownership of state assets. China has such a vast territory and huge amount of state assets that an ownership structure in which the central and each local government owns a fraction of state assets may well be a realistic choice. That governments at each level hold state assets may create, through cross-shareholding, a competitive external environment, which may discipline various representative agencies of governments at each level.
STATE ASSET MANAGEMENT REFORM: CLARIFIED
PROPERTY RIGHTS AND RESPONSIBILITIES

Jiang Qiangui

In the current efforts of deepening the reform of SOEs and establishing a modern enterprise system, the central issue is the separation of government function from enterprise function. To realize this separation, it is critical to gradually change the government’s functions; in particular, to: (a) separate the government’s role of administering economic policy from its role as the owner of state-owned assets; (b) separate the function of monitoring state-owned assets from that of managing state-owned assets; and (c) construct a system that clearly delineates functions and responsibilities for monitoring enterprise performance and the day-to-day operation of enterprises.

Current System for Management of State-Owned Assets

According to statistics provided by the ministries concerned, the present state-owned assets reserve of China is about 3,500 billion yuan, of which 2,600 billion yuan are operational state-owned assets. Seventy percent of operational state-owned assets are owned by SOEs. Within the context of establishing a socialist market economy and a modern enterprise system, one finds that there are some major problems in the system of management of state-owned assets.

- There is no representative of the owner of state-owned assets whose rights and obligations are clearly defined. According to the “Regulations on Transforming the Operating Mechanism in State-Owned Enterprises” promulgated in 1992 and the “Regulations on Supervision and Management of the Property of State-Owned Enterprises” promulgated in 1994, the State Council represents the state in exercising proprietary right over all state-owned assets in enterprises. However, it is not clear who is the concrete representative of the owner of the state-owned assets in an enterprise comprised of or directly using such assets.

- The structure of state-owned assets is not rational, particularly from a national perspective. The distribution of industries is unbalanced, and the introduction

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of foreign technology and construction projects are duplicated unnecessarily in different places. In addition, there is a tendency of seeking “completeness” for all projects, large or small. The internal structure of SOEs is also irrational. Moreover, there are huge stockpiles of products that do not meet market demands.

- Inefficient operation of businesses with state-owned assets is prevalent. This is mainly demonstrated in the fact that there is no mechanism of “survival of the fittest,” no mechanism of taking responsibility for profits and losses and no mechanism of incentives and punishment in enterprises. Some enterprises suffer severe losses because of poor management. In 1994, 34.3 percent of the SOEs within the state budget suffered losses, up 3.6 percent over the previous year. The total loss reached 33.41 billion yuan, increasing by 7.9 percent over the same period of the previous year.

- There is loose control over state-owned assets. This is mainly evident in the drain of state-owned assets through various channels, such as that occurring in activities to set up joint ventures, cooperative enterprises and joint stock firms; loss of foreign trade revenues and state-owned assets in foreign countries; loss caused by extra-account assets; loss of land earnings and natural resources; the free use of state-owned assets in conducting various “income-creating” businesses; and so on. According to a survey and auditing of 124,000 SOEs in 1994, asset loss and unaccountable expenses accounted for 11.6 percent of the total assets.

- SOEs are incapable of continuous development because they have had insufficient capital injections for too long a time. During the period from 1980 to 1993, the average ratio of profits and tax handed into the state to total profits and tax for industrial SOEs under the budget was 86 percent. Suffering from outdated plant and equipment and backward technologies, most SOEs are incapable of updating their products quickly enough and maintaining continuous development.

Principal Reforms for the State Asset Management System

As previously noted, according to the “Regulations on Transforming the Operating Mechanism in State-Owned Enterprises” and the “Regulations on Supervision and Management of the Property of State-Owned Enterprises,” the State Council represents the state in exercising proprietary rights over all state-owned assets in enterprises. Therefore, in terms of ownership, it is fairly clear that the state is the owner of the state-owned assets. Reform of the management system of state-owned assets does not mean a change in the ownership of the assets, but a change in the concrete methods for the state to manage, supervise and operate these assets. The principal orientation of
the drive to reform the system for managing state-owned assets is to realize “two separations”: separation of the government’s function of socioeconomic management from its function as the owner of the state-owned assets; and separation of the function of supervising state-owned assets from the function of managing state-owned assets. To design and establish a system for management, supervision and operation of state-owned assets with clear definitions of rights and obligations in line with the “two separations” is a major objective of the reform of SOEs.

A major problem with the current system of state-owned asset management is the “mixing-up of government role with asset ownership role.” On the one hand, many government departments exercising the power of owner of assets are also playing the role of administrative control; on the other hand, each department only performs part, rather than the whole, of the function of owner. As a result, many government departments can exercise the rights of owner, but none of them are able to be responsible for the bottom-line result of the business operations of state-owned assets. The property rights and responsibilities stemming from ownership of state-owned assets is not clear. The situation is a coexistence of “the presence of multidepartments on the upper level and the absence of an owner’s representative on the lower level.” To change this situation, the government’s role should be reformed in accordance with the orientation set in the “Decision” of the Third Plenary Session of the Fourteenth Central Committee of the Chinese Communist Party so that the government’s functions of socioeconomic management and state-owned asset ownership can be separated from each other. Reform attempts along this line have been made in Shanghai and other locales where government departments are organized into a State-Owned Assets Management Committee to exercise the owner’s function.

Institutions authorized by the state to make investments play the role of managing state-owned assets. The specific way of separating supervising state-owned assets from managing those assets is to set up “managing institutions of state-owned assets” (MISOA), which are institutions authorized by the state to make investments. A MISOA is a corporate body managing state-owned assets. It is a solely state-owned corporation. The basic function of a MISOA is, in line with the authorization by the state, to invest the state-owned assets it manages in industrial and commercial enterprises so as to realize asset value preservation and appreciation. The state conducts supervision over MISOAs, including sending a supervisory council to MISOAs, according to provisions in the “Regulations on Supervision and Management of the Property of State-Owned Enterprises.”

The investment of a MISOA in an enterprise constitutes its equity claims on the enterprise. This appears on the liability side of the enterprise’s balance sheet and is recorded as the owner’s equity. The physical assets formed by the investment by the MISOA are the enterprise’s corporate property and are recorded as assets in the enterprise’s balance sheet. What the MISOA owns are only assets in the form of value
(equity claim) rather than the physical assets. The enterprise owns all properties formed from the "fund contributed" by the investor and from loans contracted "with the fund as the capital in trade," such properties being the enterprise's corporate properties. In this way, the investor's ownership right and the enterprise's corporate property rights are separated from each other. However, as the investor is the shareholder of the enterprise, the separation of the investor's ownership rights and the enterprise's corporate property rights does not mean that the investor has no right of disposition over the enterprise's corporate assets. For instance, when an enterprise is in financial distress, the MISOA may acquire the right of disposition over the enterprise's corporate assets through bankruptcy procedures. Also, MISOAs can exercise a shareholder's right over the enterprise authorized by the "Company Law," including joining the board of directors and participating in decision-making in the business of the enterprise. However, the rights enjoyed by the MISOA, as a holder of equity claims to the enterprise, are limited to the rights granted to a shareholder by law; and performance of this right must be done in line with legal procedures. In other words, the relationship between government and enterprises is to be transformed from administrative subordination into one of assets linkage. The government cannot dispose of the enterprise's corporate property in the same way as it deals with its own property.

**Establishing and Structuring MISOAs**

MISOAs represent the owner of state-owned assets in an enterprise and directly shoulder the responsibility to ensure preservation and appreciation of these assets. How to establish and structure MISOAs is one of the difficult issues in reforming the system for managing state-owned assets. According to recent practices, three methods have been adopted to establish and structure MISOAs:

*First, the state can authorize large enterprises and holding companies to be MISOAs.* In some cases, the state has directly authorized large enterprises and holding companies that have well-developed business management systems and are in comparatively good economic shape to become MISOAs in accordance with the stipulations of the "Company Law." This approach brings the following benefits. First, by turning large enterprises and holding companies, which normally do not exercise administrative functions, into MISOAs and appointing directors, deputy Chairman and Chairman, the state introduces representatives of the owner into enterprises and helps establish a mechanism of internal motivation and constraint. In this way, it becomes comparatively easy to match risks, responsibilities and rights while avoiding renewal of the old mechanism with which the government role and enterprise role are mixed up—the situation of "boss being also father" and similar problems that have caused widespread worry. Second, the practice helps reduce the number of tiers in the system and thus the agency cost; in so doing, it will help improve the efficiency in decision-making and the operational efficiency of managing state-owned assets. Third, the practice not only helps enterprise groups grow on the basis of expanding units already in operation, but also
helps bring forth new transregional and transindustrial enterprise groups joined by asset linkages. These groups will become very powerful and competitive entities representing the state-owned economy, hence promoting readjustment of the economic structure.

One problem most likely to occur in the practice of authorizing large enterprises and holding companies that are qualified to become MISOAs is that they may become excessively widespread and there may be too many small-scale MISOAs. At the end of 1993, the equity value of 80,586 state-owned industrial enterprises was 1,061 billion yuan (Statistical Yearbook of China, 1994, pp. 390, 391). Suppose each MISOA manages 2 billion yuan worth of state-owned assets; the state industrial sector alone would need 530 MISOAs. There are two ways to solve this problem. One is to set strict preconditions for authorization to ensure that each MISOA reaches a proper scale of assets; the other is to encourage authorized MISOAs to merge or combine themselves.

There is another question needing clarification: “Does an MISOA own itself?” As stated above, an MISOA is a solely state-owned corporation. According to the Company Law, a solely state-owned corporation does not set up a general meeting of shareholders; the board of directors is authorized to exercise the power of a general meeting of shareholders. Members of the board of directors are appointed by the state. Therefore, by asserting that an MISOA “does not own itself,” we mean that the state sends its representatives to these enterprises to form the board of directors, which shoulders the responsibility to manage the state-owned assets.

Second, national general companies of various industrial sectors and government departments governing various industrial sectors can be turned into MISOAs. An obvious benefit of such a practice is that it promotes reform of current government organs and lets the reform measures changing both the government role and the operational mechanism in enterprises go on side by side. These general companies and government departments, when turned into MISOAs, should lay down their previous roles of government administration and industrial sector administration and hand these roles over to comprehensive economic departments and associations of industrial sectors. Another benefit of the practice is that it will create favorable conditions for readjusting the asset stocks within a certain scope. Funds can thus be raised through methods such as turning asset stocks into cash and leasing land, which will support projects that restructure enterprises, separate nonproductive functions and arrange for employees to be discharged from their posts. It is therefore especially suitable to those industrial sectors that need large-scale readjustment.

However, the practice of turning general companies of industrial sectors and government departments in charge of the industrial sectors into MISOAs may well give rise to the problem of overconcentration. The fact that an MISOA dominates a region or even a whole industrial sector of the country will impede the forming of a unified and competitive market system; it will also prevent the MISOA itself from diversifying risks.
To forestall this problem, two principles have to be followed in reforming the general companies of industrial sectors and government departments in charge: “comprehensiveness” and “competitiveness.” The so-called principle of comprehensiveness means that the entire investment of an MISOA should be dispersed into several different industrial sectors rather than concentrated into the sector that the MISOA has been in charge of before the transformation. The so-called principle of competitiveness means that in an industrial sector there should be at least a few MISOAs competing with each other; the sector should not be monopolized by one MISOA. To attain these objectives of comprehensiveness and competitiveness, the asset share that an MISOA holds in the sector that it was previously in charge of should be strictly limited when authorizing the transformation. On the other hand, MISOAs should be encouraged, after the transformation is authorized, to achieve various forms of assets combination through shareholding, share exchanging and share purchasing.

Third, state-owned assets in municipal and county-level enterprises can be managed by MISOAs set up by these respective governments. As state-owned assets in enterprises administered by governments of municipalities and cities of prefectural and county levels are generally small in amount, it is allowable that relevant local governments be put in charge of setting up the MISOAs. This will prompt governments at all levels to handle the relations among themselves and help bring about a situation where MISOAs compete with each other.

Disposition of Earnings from Management of State-Owned Assets

Disposing of earnings from the management of state-owned assets is a difficult problem. To research this problem, the first thing is to clarify the definition of such earnings. In some discussions, earnings from ownership of state shares—dividends and bonuses—have been viewed as earnings from management of state-owned assets. This does not seem to be the right concept. As is stated above, an MISOA is a corporate entity. Like other enterprises, it has its own earnings, costs and profits. An MISOA’s earnings are the returns on investment with state-owned assets, including earnings from the interest of the state stocks that it holds. Therefore, so long as the MISOA’s status as a corporate entity is acknowledged, the earnings from its investment with state-owned assets are the normal business earnings of an enterprise. If, as suggested by some people, all earnings—such as dividends of the state stocks—are taken away, there can be no self-compensation for the operating costs of an MISOA. In other words, prohibiting an MISOA from retaining its own earnings from investment is tantamount to forbidding its existence as a corporate entity. In fact and in a strict legal sense, the assets operated by an MISOA are no longer state-owned assets in their normal sense; rather, they are the MISOA’s corporate assets or “state-owned corporate assets.” The consequent earnings are the returns brought by the investment with such corporate assets and should be indisputably obtained by the investor, the MISOA. Genuine “state-owned assets” are neither the MISOA’s equity or debt claims, nor the enterprise’s machines and factory
buildings, but rather the state’s ownership of the MISOA, or in other words, the “owner’s equity” in the MISOA’s balance sheet. The earnings the state needs to consider how to dispose of are not the business earnings of the MISOA, but the distributable profits—after productive costs are deducted, taxes are paid and the public welfare funds are set aside from the business earnings.

Now, after we have clarified that the earnings from management of state-owned assets needing disposition are the distributable profits of the MISOAs, the next question is how to dispose of these earnings? First, it must be made clear that ownership of these earnings belongs to the state. The state has the final say in the disposal of these earnings. Under this premise, the issue of disposing of such earnings becomes two questions: (1) How large a portion of these earnings should be used for public consumption and how large a portion should be used for reinvestment? (2) Who shall act as the agent to conduct this reinvestment?

The first question should be probed in consideration of the actual situation in SOEs. Since the 1980s, SOEs have handed in most of their profits to the state. According to statistics, in the period 1980 to 1993, 86 percent of total profits and taxes realized by state-owned industrial enterprises within the state budget were handed into the state. But in the same period, the state, as the owner of the enterprises, did not inject capital into SOEs. The consequence was that SOEs suffered a high debt-equity ratio, outdated machines and equipment and backward techniques and thus became incapable of continuous development. At present, with the intense competition in both domestic and international markets, SOEs face serious challenges in their struggle for survival and development. What is more, the task of restructuring the internal constitution of SOEs is very arduous. Restructuring needs money; merger, expansion, reform, separation and branching all need money. At present, however, the state treasury is not powerful enough to shoulder the responsibility to inject money into SOEs; the only way out is for SOEs to rely on their own accumulation. But the enterprises, left with few after-tax profits, have to play the role of supporting the society, a role that should be played by the state. Therefore, most SOEs, even those that are successful in making profits to some extent, find it hard to build up a fund large enough for self-development. They usually resort to selling their state-owned assets and even land rights to raise funds needed in many restructuring measures. Therefore, if SOEs are to be managed well, there should be a guarantee that earnings from management of state-owned assets are used in building up state-owned capital and enterprise restructuring, at least for the present and near future.

About the second question, the acceptable alternatives are none other than the following two ways: first, let the government to take charge of investment; or, let the MISOAs take charge of investment. If the government holds the asset earnings that can be used in investment in its own hands and then decides for itself which enterprises and projects the investment should go to, this is no different from the choice when the government itself engages in management of the assets and usurps the functions of the
“state-authorized institutions for investment.” Decades of practices of a planned economy have proved that placing the decision-making power for investment totally on the government is unfavorable for improvement of investment efficiency. And such a practice is tantamount to denying the necessity of the “state-authorized institutions for investment.” Therefore, the only correct way to be chosen is to let the MISOAs make the investment.

Does the practice of leaving earnings from management of state-owned assets to the MISOAs mean that the state will no longer be able to adjust and control their destination of investment? We do not think so. First, the state as the authorizer and owner of the MISOAs has the right to adjust and regulate the behavior of the MISOAs. Second, the state can strictly examine the qualifications of the agency to be authorized to ensure the comprehensiveness and competitiveness of MISOAs and forestall any irregularities in their business performance. Third, the state can use industrial, financial and monetary policies to guide the MISOAs’ investment in the right direction. Fourth, the state can make necessary laws and rules to regulate MISOAs’ investment behavior. Therefore, the state has enough means to interfere in MISOAs’ decisions concerning investment and to adjust and control the destination of investment of state-owned assets. Besides, one should know that there is no need for the state to control the orientation of every investment decision. If it is basically well-behaved in business performance, an MISOA certainly will inject money into projects that involve the least risks and bring the largest returns. When a mature capital market indicates that a project of normal commercial investment would bring high economic returns and incur small risks, then such a project is just what society needs. Under this condition, there would not be too large a gap between MISOAs’ behavior and the expectation of the state. Therefore, only when MISOAs’ behavior is irregular or when the capital market becomes poorly informed will the state need to interfere in MISOAs’ investment.

Supervision, Motivation and Constraint of MISOAs

MISOAs are solely state-owned corporations; therefore, supervision over them must be conducted in line with the “Regulations on Supervision and Control of the Property of State-Owned Enterprises.”

First, authorization and supervision should well coordinated. Whatever is the level of their authorization, their supervision should be conducted at the same level; whatever time the authorized agency begins to excise its right, supervision should start at the same time. Efforts must be made to prevent unsupervised power from being abused. And, to ensure effective supervision, the supervising agency and the MISOAs must be separated from each other so there will not be collusion.

Second, a board of supervisors should be formed and sent to MISOAs. The board of supervisors has the right to monitor and supervise the business status of MISOAs and
make suggestions on appointment and dismissal of members of their boards of directors. When monitoring and supervising the business status of MISOAs, the board of supervisors should seek help from independent agencies such as accounting and auditing offices that are established as partnerships to check on and assess the financial state of MISOAs. The board of supervisors, however, must not violate the MISOA’s corporate property rights and the self-decision power of management.

Motivation and discipline over MISOAs are key factors affecting the effectiveness of the management system of state-owned assets. Where the current capital market is still not fully developed, one way to motivate and discipline MISOAs is to adopt an assets management responsibility system. An assets management responsibility system is a mechanism by which the state, as the authorizer, examines, awards and penalizes an MISOA as the authorized agency. The rate of value preservation and appreciation of state-owned assets managed by an MISOA are the main indexes in the examination. Another way to motivate and discipline MISOAs is to establish a system of regulations by which managers will be certified for job qualification, trained, tested, awarded and penalized; this will give rise to a highly efficient mechanism for selecting managers and bring forth a professionalized team of managers. The method of choosing managers should be different from that of selecting Party and government cadres and public servants. The choosing of the former should be done through market competition. The practice that managers get their salary on an annual basis is the basic form of payment by which their salaries are linked to management ability and business performance. Standards of annual salary for managers will be determined by market forces through experiments in pilot enterprises.

Reform of the system for management of state-owned assets involves many problems, which need more research. The total amount of China’s state-owned assets is huge and they are immensely diversified in various localities. There should not be a unified and standard model that applies to all localities for management and business operation. Keeping diversification in models is an effective way to reduce risks and costs in the reform drive. So far, there has not been enough research on the question of how many and which models can be chosen. An especially urgent subject is how many and which models can be adopted in handling the relations between the state and MISOAs, and between MISOAs and the enterprises.
COMMENT ON “STATE ASSET MANAGEMENT REFORM: CLARIFIED PROPERTY RIGHTS AND RESPONSIBILITIES

Rolf J. Lüders

I hardly need to present a summary of Jiang Qiangui’s article, since it has a title that is explicit enough to accurately reflect its content. In fact, Ms. Jiang first summarizes the main problems of the present State-owned Assets Management System and then analyzes several aspects of a possible reform: the basic orientation it should have, an operational mechanism, the desirable distribution of income from the operation of those assets and some possible solutions to the problem of supervision, motivation and restraint of the operational agencies. Finally, Jiang suggests some further areas of research. Although not all state-owned assets are owned by SOEs, 70 percent of them are and Jiang restricts the discussion of the management issues to the latter, an example I will follow.

The issue of SOE management in China is very important, so much so, that according to Jiang it has become the focus of the reform of the economic structure. In just the industrial sector there are over 100,000 SOEs producing over 40 percent of the Gross Value of Industrial Output (GVIO) and in addition the township and village enterprises (TVEs) produce 26 percent of GVIO (Broadman 1995). Jiang describes many problems of the SOEs and I will only highlight two. Jiang indicates that the losses of all SOEs reached 33.4 billion yuan in 1994, almost 10 percent of the state-owned assets reserve, which suggests inefficiency and has resulted, among other reasons, in many cases in “excessive” firm-level indebtedness. Another major problem of the present system is that, in general, SOEs provide and finance the social security coverage of its employees, which reduces labor mobility and makes firm adjustment to changing market and technological conditions difficult, besides impeding the generation of a leveled “playing field” for all participants of a given market with free entry.

The subject of the management of SOEs is complex everywhere; however, in China it is probably even more so than in most places. The sheer size of the SOE sector and the high absolute number of governmental institutions involved in their management contribute to that complexity. Political, social and economic factors, difficult to

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comprehend for an outsider, which nevertheless are essential to be able to make policy descriptions, induce me to react to some of the aspects contained in Jiang’s paper describing lessons learned, mainly in the West, on the subject from history, theory and my own country’s experience. Given the time available, these descriptions will necessarily be sketchy and incomplete, but I hope they can throw some light on the discussion of this important subject.

My comments can be summarized as follows. Economists rationalized SOEs as one way of correcting market failures; however, experience everywhere as well as Principal-Agent Theory, both in market and centralized economies, proved that more often than not, government failures are even more significant than market failures. That is why today, in market economies, including in developing countries, the trend is to have private enterprises operate in competitive markets and to correct for market failures through regulation, including antitrust legislation and fiscal actions (Pigouvian taxes and subsidies as well as income redistribution measures). The historic record of mixed enterprises is not positive, since they tend to adopt the negative, instead of the positive, aspects of both private and state-owned enterprises. Over relatively short periods of time, SOEs subject to a hard budget constraint, independent management and competition, as proposed by Jiang, tend to operate efficiently, but such conditions are unlikely to prevail over the longer run. Moreover, under the terms just outlined, which imply a complete separation of the SOE management and economic policy functions of the government, as proposed by Jiang, it is difficult to justify the existence of SOEs, since they are expected to perform exactly the same function as a private firm. I end up suggesting one possible set of institutions to increase the efficiency of the SOE sector through competition of state-owned Pension and Mutual Fund Administrators who would manage the stock of those SOEs.

Lessons from History and Theory

The historical verdict of the economic inefficiency of SOEs is indisputable. There are many well-known positive explanations for the existence of SOEs; however, from a normative point of view, SOEs are supposed to be one way of correcting market failures: monopolies, badly functioning input markets, especially capital markets, income distribution, and so on. In practice, SOEs in general did not contribute to improving allocative efficiency, or income distribution and, in addition, tended to be operated, from an efficiency point of view, in a very inefficient manner (Hanke 1987). The Principal-Agent Theory does explain this behavior as the result of the inherent contradiction between the interests of the “managers” (agents) and the “owners” (principal); that is, the general population of a country. As a rule, there are several layers of agents, each one with its own private aims, which only by an extraordinary coincidence are those of the “common good.”
For example, in most Western democracies, citizens (the principal in the case of an SOE) elect representatives and, directly or indirectly, a chief executive. The latter appoints Ministers or Secretaries and these appoint the managers and/or board of directors of the SOEs. Citizens, one presumes, would like to see efficiently run SOEs. However, representatives are interested in being reelected, the chief executive might be concerned about his future employment, the Minister about becoming the candidate for the executive position and the managers might seek to maximize power and, especially if in charge of public utilities, might be interested in a political career. The result is patronage, more often than not lower-than-optimum tariffs or prices, larger employment than required, sometimes a larger-than-optimum output, etc.

As a result, in most developed and developing countries there is now a trend to privatize SOEs, as one way of achieving what Jiang correctly proposes in her article: to separate the public policy functions of the government from the enterprise management functions. These latter are left to the private sector, while the government is charged with the task to (1) create a competitive environment, another important objective Jiang correctly stresses, (2) correct market failures through regulation, antitrust legislation and fiscal policies, and (3) equalize opportunities for all citizen and redistribute income as deemed necessary.

According to the proposals of Jiang, China should strive to achieve some of the same objectives (separation of functions and competition), but within the framework of the existence of a large SOE sector. This is not an easy task, since it implies finding ways not yet tried anywhere, to solve the agency problem described above.

Analysis of Some Proposals to Solve the Agency Problem

Attempts have been made elsewhere, of course, to break the agency problem. These attempts, as far as I know, have usually been accompanied by a decision to treat SOEs as if they were private-sector firms. This implies that the SOEs were relieved of the need to achieve any other “social” objective except maximizing profits and therefore the economic policy function of the government could be separated from the control of state-owned assets function. Moreover, management in these cases was usually granted considerable autonomy from government, although not necessarily from the board of directors of the SOEs.

We will analyze two of these attempts. In some countries, a solution to the agency problem has been tried by inviting the private sector to take a minority shareholding position in corporatized SOEs, as has already happened in some cases in China. In others, a solution similar to that proposed by Jiang has been tried: the SOEs are transformed into corporations and the shares are held by some specialized asset management agency of the government; the agency appoints an independent board of
directors that chooses the manager and a hard budget constraint is imposed in exchange for managerial autonomy.

**Mixed Ownership Enterprises**

It is tempting to look for a corporation with mixed ownership as the solution to the agency problem, given the appropriate policy environment. The minority shareholding of the private sector is then to provide the necessary discipline to avoid patronage, excessive employment, inefficient levels of output, subsidized prices, etc., given that the private shareholders will be interested in maximizing profits.

In fact, as has been shown in innumerable cases, nothing like that happens (Vuyisteekc 1988). As a rule, sooner or later, government officials will pressure management, for example, for lower tariffs or extra employment, and the private sector representatives on the board will agree in exchange for compensating benefits. These latter could take the form of certain input subsidies, like low interest rate credits for example, or even more sophisticated, the implicit promise to bail the company out in case of a future bankruptcy threat. Another form the mentioned compensation takes is a lower share price, given that private investors probably anticipate that the government will sooner or later press the mixed firm for some nonprofit maximizing behavior.

The mixed enterprises are controlled by the representatives of the state-owned shares on the board and profits are distributed according to the policy defined by the same board. The same is true with respect to investment policy.

**SOEs with Managerial Autonomy and Facing a Hard Budget Constraint**

In this case, the SOEs are also transformed into corporations and are to be managed according to the law that governs these. The shares of the corporations are handed over by the government to one or more government-controlled agencies (Jiang talks about Operational Organs of State-owned Assets), which appoint the board of directors of the SOEs. These agencies (in China they are corporations in their own right) in principle are to set the business policies of the subsidiary corporations independently of government intervention and appoint management. The SOEs are faced with a hard budget constraint, which opens the possibility of bankruptcy. These corporations operate according to the usually implemented accompanying policies, either in a competitive environment or face regulation in the case of monopolies.

This is, in essence, the setup that was used in some developing countries with a large SOE sector and the one suggested by Jiang for China. Most of her article is then devoted to dealing with some additional features that intend to solve the agency problem. Do the agencies own themselves? The answer, according to Jiang, if I understood well, is a correct NO, since the SOEs belong to the state. Who should receive the profits of the state-owned corporations? The reply, according to Jiang, is the government, but only
after adjustment costs and new investments approved by the agency have been financed, since otherwise SOEs could not develop. Who should supervise the agency? A supervisory agency says Jiang. Evidently Jiang is looking for the supervisory agency to solve the agency problem and this seems to me highly unlikely, if past experience in other countries has anything to say about it. In fact, adding another layer of supervision might actually make things worse.

In Chile, a similar scheme to the one described in the first paragraph of this subsection of the comments was in effect for a relatively large number of SOEs between 1974 and 1978 and still is in effect for a small and diminishing number of large SOEs. At the time, the existing Military Regime provided high credibility for the hard budget constraint and made sure there was no political interference with the management of the SOEs. Moreover, and this is an important difference with the Jiang proposal, the government established a dividend policy for the SOEs of 100 percent profit and allowed them only to reinvest freely the depreciation allowances. The aim of such a policy was not only to assure the efficient operation of these corporations, but also to create "room" for investment by private, competitive firms. This is, of course, very different in the case of China, where the objective, at this stage at least, seems to be to allow the SOEs to develop.

Nevertheless, investment could take place in the Chilean SOE sector. This was, however, only authorized after careful evaluation through a rather sophisticated institutional mechanism called the National Investment Scheme. According to this scheme, which still exists, every investment project of the Public Sector has to go through a highly regulated and technical, preestablished Social Project Evaluation Process, in which projected cash flows are discounted at technically established discount rates. According to that process, projects with positive net present values can be carried out if resources are available. Since in Chile the holding agency was forced to forward to the Central Government the distributed profits of the SOEs, these could only invest if the financing institutions (investment and commercial banks) were willing to lend them money without government guarantee or if the government itself put up new funds for that purpose.

SOEs subject to this extremely hard budget constraint and competition in Chile, accompanied by effective managerial autonomy, rapidly increased; during the 1970s, their rates of return on assets and net worth approached, within relatively few years, levels found in the private sector. Moreover, statistical analysis applied during the 1980s to a large sample of firms was unable to distinguish the operational efficiency of the SOEs and the private firms.

The question is, however, if such draconian conditions as those imposed on the Chilean SOEs can persist over a very long period of time. The government of Chile did not believe so, and that is why it has engaged in privatization. In particular, allowing the
agencies to decide on investments, although more flexible, opens a big door for inefficiencies, since under the umbrella of new investments they can hide operational expenses and losses of the SOEs under their management. Furthermore, the relaxation of the hard budget constraint is much more likely to happen for a SOE with losses, than for a government to provide financial assistance to a private firm in trouble. Even under the Military in Chile, several of the SOEs were bailed out. LAN Chile, the Chilean flagship airline, is one good example, since it twice received, during the described period, significant amounts of debt relief from the government.

The basic question here is, however, different. Even if we assume that SOEs can be managed under the conditions outlined in the first paragraph as efficiently as private enterprises, why would a country wish to retain these firms? The above-stated conditions in which the SOEs operated in Chile and, according to Jiang, are to operate in China, imply that the economic objectives of the SOEs do not differ from those of private enterprises. If so, through divestiture, the government could get rid of a major problem, namely the control of these SOEs, and the economy would not suffer any loss. The minimum net gain of such a divestiture policy for the country would be the release of the public sector resources now used for control of the SOE sector, to be applied to purposes in which the private sector is not a good substitute of government programs, especially the financing of minimum social services (education, health, pensions, etc.).

SOEs, Debts And Pension Funds

Two major problems facing the SOEs in China are that they are, in effect, excessively indebted and that they are financing the provision of most social services of their workers, including pensions. Given that pensions are financed on a pay-as-you-go basis, SOEs have, in effect, an implicit pension liability with their active and retired workers. This suggests another way of organizing the holding and management of SOEs, similar to the one proposed to the Bulgarian authorities some years ago (Lüders 1992), which would allow, at the same time, the reduction of indebtedness of the firms to normal levels and the elimination of pension liabilities. Moreover, although the agency problem cannot be eliminated, a competitive and more efficient management system can be developed with only partial SOE divestiture.

There is no time to describe the system in detail, but it can be sketched out. As before, SOEs are transformed into corporations, the government applies a hard budget constraint and grants management autonomy. Then, the pension liabilities and the excess indebtedness levels of the SOEs are calculated. Thereafter, stock prices are estimated and both the excess indebtedness levels and the pension liabilities are expressed in shares of stock.

The next step is to set up a number of state-owned Pension Funds, along the lines of the Chilean mandatory, individual account, funded type. The Pension Fund
Administrators, however, would be state-owned, at least until otherwise decided, and their boards of directors would be appointed by one or more government agencies. Workers of SOEs, as well as all others, would be mandated to make monthly contributions that would engross the Funds, together with the shares with which the SOEs would pay for their implicit pension liabilities. Shares should be initially distributed in such a fashion that each Pension Fund has a controlling, but significantly less than majority, interest in a number of SOEs and a balanced portfolio of the rest. Other means, perhaps additional shareholdings of the government in SOEs, would have to be found to pay for the implicit pension liabilities of other workers. Workers would be free, as in the Chilean system, to switch Pension Fund Administrators according to services provided, commissions charged or expected returns on Funds. This is the main competitive element of the scheme. Investments of these Funds would be, as in the Chilean case, highly regulated to avoid excessive risk-taking. Pension Fund Administrator management would be rewarded on the basis of performance, one element of which should of course be the growth of affiliates.

In parallel, a set of state-owned Mutual Funds should be set up. As in the case of the Pension Funds, the Mutual Fund Administrators would, at least for the time being, be state-owned institutions, whose boards of directors should be appointed by one or more government agencies. The required capital of the Administrators should be contributed by the state in the form of portfolios of SOEs. These Mutual Funds would initially receive shares of SOEs in the amounts of the excess indebtedness, distributed in such a way that each Mutual Fund has a balanced portfolio. Mutual Funds should be allowed to expand in size and, for that purpose, the government could offer each year part of the remaining shares it will have of the SOEs. Mutual Funds investments would be highly regulated, but Mutual Funds would be allowed to trade shares. In turn, the shares issued by the Mutual Funds would be used to pay commercial bank depositors for deposits that were financing loans not repayable by the SOEs. This is in line with some of the proposals made in this Workshop. These Mutual Fund shares would, at least until decided otherwise, not be redeemable, but would have a right to dividends. They would be freely tradable and, as with the Pension Fund system, Mutual Fund managers would be compensated in proportion to performance, which in this case should consider especially the relative values of the portfolio.

As mentioned before, the government could use the remaining shares, if they exist, of the SOEs to (1) pay for the implicit pension liabilities of non-SOE workers, (2) sell them to Mutual Funds in a gradual fashion to finance, for example, additional social programs, or (3) “sell” them to Mutual Funds in exchange of Mutual Fund shares, to receive dividends, etc.

The system does provide for competition among Pension and Mutual Fund administrators and allows for incentive mechanisms for managers, but the agency problem is not eliminated completely, since the boards of the Administrators have to be
supervised by one or several government agencies. It has the advantage that, at least potentially, capital markets might expand very rapidly, as was the case in Chile, especially if the government decides to divest all the shares among these institutional investors. It also has the feature to allow easily, if so decided, a gradual opening of the Mutual Funds and eventually the Pension Funds to purchases of stock issued by private investors. Finally, if so wished, the whole system could easily be privatized, divesting the net worth of the Administrators free of charge to the general public, perhaps using for that purpose a voucher system similar to the one of the Czech Republic.

**Final Comments**

The task of managing efficiently the state-owned assets in China is enormous. Ms. Jiang suggests, in my opinion, the correct policies, especially when she refers to the need to separate the economic policy and the enterprise management functions of the state. She then proposes an institutional setup to supervise and manage the corporatized SOEs, which is not too different from the one that has been used in other nations, including my own country, with relative short-run success, but which does not eliminate the agency problem. Under such a proposal, SOEs are treated like private enterprises. If so, economic efficiency could be improved by divesting stock of SOEs, since that eliminates or reduces the agency problem. If for noneconomic reasons this cannot be done at present, a system of state-owned, competitive Pension and Mutual Funds like the one sketched out above, or something similar, in which stock of SOEs is used to pay for excessive debt and implicit pension liabilities of the SOEs, might be explored.

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ON CORPORATIZATION OF ENTERPRISES AND CORPORATE GOVERNANCE

Jia Heting

INTRODUCTION: RAISING OF THE QUESTION

Historical Background of Corporate Governance Structure

In the early stages of capitalism, enterprises usually took the form of proprietorship or partnership due to their small size and low production capacity. These entities operated on the basis of their owners’ individual assets, and the owners themselves were the managers. Ownership and control of these enterprises were integrated. This form of organization, far from meeting the demand of large-scale production, had therefore many limitations.

With rapid industrialization in Europe and America in the 18th and 19th centuries, increasing demand for capital and the risks of business enterprise went beyond the capability of any single individual investor. There came the requirement of combining together more than one investor. They invested in one enterprise, and the corporation with shareholders emerged. In such a corporation, shares of all investors formed the property of an independent legal entity. Investors only bore responsibility according to the value of their shares, and the risk of any individual investor was dispersed. The life of the corporation depended on profitability of the entity, not on the life of its shareholders. The above positive factors paved the way for large-scale operation of corporations. Plurality of the investment of the corporation determined that it could not be run directly by its owners like a proprietorship or partnership. A governance structure was required. A governance structure is a set of organizational management systems for a corporation’s normal operation as an independent legal body. The systems consisted of the owners, a board of directors and the senior managers. Ownership and control of the corporation was separated through this structure. Owners put their assets in trust of the board of directors. The senior managers were hired by the board of directors and ran the corporation following the instructions of the board.

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Constitution of the Governance Structure

The governance structure of a corporation consists of many administrative levels. The first level is a shareholders' congress. Any investor of the corporation is a shareholder of it. A shareholder has all the rights associated with the property right; namely, investment beneficiary, major decision-making right and the right of selecting managers. The shareholders' congress has the ultimate control of a corporation, and it is the mechanism through which the shareholders express their opinions.

The second level is the board of directors. It is virtually impossible for a corporation with numerous shareholders to have a regular shareholders' congress for daily management of the entity. Therefore, a board of directors with only a few members is established to run the company on behalf of the shareholders and to maintain and increase the value of the investment of the investors. The board of directors is the top decision-making body of the corporation; it provides strategic guidance, selects senior managers and supervises daily operation of the entity.

The third level of the governance structure is the executive committee; that is, the senior managers. The senior managers form an executable body that works under the instructions of the board of directors and is responsible for the daily management of the company.

These three levels of a governance structure are generally found in a developed economy. However, there are unique variations in many countries. For example, there is a supervisory board and a council in German companies. The supervisory board has the same functions as the board of directors in British or American companies, and the councils are like the executive committee. In China, the “Company Law,” published in December 1993, adds one more level in the governance structure—the supervisory board. The Law says that a supervisory board should be established in shareholding companies. The major function of the supervisory board is to supervise the activities of the board of directors and the senior managers.

Feature of the Governance Structure

The essence of the governance structure lies in the separation of ownership from control of the corporation. This separation determines the basic relationships underlying corporate governance:

- **The relationship of trust between the shareholders’ congress and the board of directors.** The directors are trustees of the shareholders. The board of directors is entrusted to run the corporation and is the legal representative of it. The shareholders do not interfere in any business of the corporation’s management once the board of directors is set up.
- **The relationship of agency between the board of directors and the managers.** To manage and run a company requires the expertise of one who has specialized knowledge of corporate management, ability for innovation and awareness of risk. These are the criteria for the board of directors to appoint the managers, who, as the agents of the board, have the rights of the corporation’s operation and commercial agenting. But, their rights are confined by the board of directors. Managers must get permission from the board whenever they make a decision out of the rights range they are given by the board.

- **The relationship of balance among the shareholders, the board of directors and the managers.** Each of the three parts have their own rights and responsibilities. On the other hand, they balance powers with each other in order to guarantee efficient operation of the company. First, the shareholders cannot interfere in any decision-making in the company once the board of directors is entrusted to run the business, although they have the ultimate control of the entity. Second, the board of directors is in charge of the management of the company, and has the rights to the entity’s assets and selection of managers. But, it must be responsible to the shareholders and cannot do anything against their requirements. Finally, the managers, hired by the board of directors, are in charge of the daily management of the company as the appointed representatives of it. They have the complete rights in decision-making within the range set by the board. However, their work is under the supervision and assessment of the board of directors at the same time.

**The Current Problems**

Corporations are the product of large-scale production and development of a market economy. The modern corporation constitutes an important organizational basis for the emergence of large-scale industries and business. Although there were entities named as corporations in China in the past 40 years, they were basically production entities, not corporations in the genuine sense. In China, it was only after economic reform that the modern corporation came into being, whose original form was called a stockholding company. In the 1980s, the early form of stockholding companies appeared with development of the commodity economy. Now, after over a decade of experimentation, the number and scale of stockholding companies has increased rapidly from almost nothing. According to incomplete statistics, there were 33,000 stockholding companies up to the end of 1994. Of that number, 6,320 were limited-liability shareholding corporations; the value of the shares amounted to 286.7 billion yuan. The remaining majority of the entities were limited-liability companies. At the Third Plenum of the Fourteenth Party Congress in November 1993, the corporation system was accepted as a major organization of the modern enterprise system in the Decision of the
meeting, which clearly pointed out that "corporatization of the state-owned enterprises is a positive experiment for building up a modern enterprise system (in China)." Soon thereafter (as noted above), the People's Congress promulgated the first "Company Law" since 1949, which established the legal status of the corporation system in the Chinese economy.

However, there are still several problems in the governance structures of a number of enterprises that have been transformed into corporations. One is the relationship between the shareholders' congress and the government, which is not well-coordinated. In some cases, the shareholders' congress is required to get permission from its higher authorities for major decisions that were approved by the corporation's Charter, which interrupts the normal operation of the company. The second problem lies in the relationship between the board of directors and the managers. In these cases, the managers have not been appointed by the board but by higher authorities. The general manager of many companies has been held by the chairman of the board of directors in order to avoid dispute between the two posts, which mixes up the two different roles. In some corporations, managers have ignored the interests of the shareholders and the instructions of the board of directors and behaved on their own will without any restraint. The third problem is that the organizations of the Party and the governance structure do not have good coordination. In some companies, the chairman of the board of directors has been appointed by the head of a Party organization instead of being elected by the board itself. Last but not least, the democratic management of workers has not worked well with the governance structure. The functions of the workers' congress, the trade union and the shareholders' congress have been confused. The status of workers in the company has not been clearly defined and the democratic management of the workers does not get a proper form.

The main historical causes for the above problems could be summarized in the following three items:

- **Influence of the administrative nature of an enterprise in a centrally planned economy.** The enterprise was only a production unit in a centralized planning system, which was attached to the government and was basically a political entity, not an economic one. To the enterprise, the state was a political power. The system of centralized Party leadership and the manager responsibility regime under the Party committee in SOEs was for the strengthening of this kind of political power. At that time, the managers were appointed by the higher administrative authorities. The production plan of the enterprise was established by the higher authorities through instructions. The fact that modern corporations in China grew from such a ground means that the influence of the administrative nature of the old SOEs certainly could not be eliminated easily. The government departments still exercise an "approval
regime” and “administrative appointment” over the corporations because they are accustomed to the method of controlling old-style state-owned entities.

- **Decentralization and profit-sharing system brought about positive results to invigorate the enterprises, but they also intensified “internal control.”** Enterprise reform in over a decade before the Third Plenum of the Fourteenth Party Congress in 1993 followed a route of decentralization and profit-sharing. Various measures of this kind of reform have brought about positive results, but enterprises did not evolve to become independent legal bodies unattached from one of the administrative agencies. The manager responsibility system was a form of progress because managers know better than the higher authorities about management of the enterprises. But, an efficient mechanism of power balancing and supervision over the internal control by the managers and workers could not be established because there is no clearly defined owner or investor of SOEs. Internal control weaknesses have arisen in a number of areas. For example, some companies seek maximization of worker income by increasing wages and bonuses. Some managers take the companies as their own “kingdom,” bargain with the state on the same side of the workers, report loss as profit, and take away the state’s assets by manipulating accounts, which increases the costs of agency. In some companies, there were even “two account books” to cheat the state. With the development of decentralization and a profit-sharing regime, more and more autonomous rights of the enterprises and the rights of the managers were endorsed. Some managers took control of the enterprises as their own vested interest and refused to accept any supervision of the state as the owner. They showed no interest in corporatization of the SOEs because, to them, the reform would take away their rights. They, therefore, became the obstacle for further enterprise reform.

- **The transformation of the operating mechanism has not received enough attention in the shareholding experiments.** In recent years, a number of enterprises were transformed into shareholding companies, which is a significant experiment in China. However, there were severe distortions in the experiment due to many factors, such as lack of knowledge, flaws in practice and some objective limitations. The motivation for transformation to stockholding arose from two demands: the need for capital and the expected increase in workers’ income by getting the original shares of the enterprise. Biased by these aspects, the effective change of the operating mechanism and establishment of a proper governance structure in the enterprise was not paid sufficient attention after it was transformed into a stockholding company. The old troubles were not eliminated at all. The heads of the enterprises, including the chairman and general manager, were appointed by the higher authorities as was done before. As the shareholders of the entity, the state interfered directly
into its production, decision-making and even personnel affairs, instead of exercising its rights through the shareholders’ congress, which appoints members of the board of directors and makes decisions on strategic objectives. At the same time, the director or manager of the enterprise has been accustomed to some kind of autocracy when more autonomous rights were endorsed to the enterprise. The director or manager was defined as the legal representative in the past, but now the “Company Law” stipulates the chairman of the board of directors as the legal representative. To simplify the matter, in many cases, the two posts are held by one person. Although this kind of appointment is found in Japanese or American companies, there are other external mechanisms of supervision and constraint, such as the merger market in the United States and main bank takeover regime in Japan. In this country, where there is a lack of these mechanisms for supervision and auditing, one person holding the two posts hinders the function of the internal balancing mechanism.

PROPOSALS FOR RESOLUTION AND THE CONSEQUENCES

For an SOE, the prerequisite for implementing a modern corporate system is a clearly defined property right, which will clarify the ownership of state assets. Now, suppose there is a clearly defined owner of the state assets and that the state share is determined (refer to the paper by Madame Jiang Qiangui). Then the task of establishing a governance structure is to create the board of directors, the executive committee and the supervisory council; to define their functions and roles; and to establish the coordinating relationship between the Party organization, democratic management by the workers and the governance structure. The following is a detailed discussion of a set of policy proposals concerning these tasks.

Selection and Supervision of the Board of Directors

There are two proposals:

- **Proposal One:** the directors are hired and fired by personnel departments at various levels of government, according to existing regulations for the appointment of enterprise heads and their rights, taking into consideration the size of the entity.

- **Proposal Two:** the directors are hired and fired by the owners of the state assets in the entity; that is, the representatives of the state shareholders.

It is easier to implement Proposal One because it is more in line with the existing system. But it holds a stronger administrative taint. Proposal Two is based on separating the function of government as the administrator from its function as owner of the state
assets. It enables the representatives of the owners to select their trustees. This is more consistent with the character and requirement of a governance structure.

However, there are some points that must be paid attention to no matter which proposal is adopted. The first concerns the qualifications of the directors. They must be industrious, reliable, experienced and able to make decisions. They can be either shareholders of the company or not. They may have a technical background or be a public figure. But, government orderlies cannot be appointed as directors. A legal body can be the director on the condition that it appoints a natural person who is able to act as a director. The directors can be divided into two categories: executive and nonexecutive. The chairman and vice chairmen must be elected by more than half of the members of the board.

Second, consider the payment of the directors. The payment of the directors is decided by the shareholders' congress. And its distribution must be different from the one for workers and other staff in the company. External directors can receive small fees from the company.

Finally, there is the issue of supervision of the directors. One form of supervision comes from the investors. The shareholders' congress can dismiss unqualified directors, has the right to vote down decisions of the board or reappoint it. Another form of supervision is from some special committee established under the board of directors by the government; one of them is the auditing committee, which is responsible for supervision.

**Selection and Administration of the Senior Managers**

Here, there are two suggestions:

- **Suggestion One**: apply the appointment regime according to the administration of officers in government.

- **Suggestion Two**: appointment or removal of the senior managers is made by the board of directors.

It is obvious that Suggestion Two is more consistent with the requirement of corporatization because it enables the owners of the company to select its managers. Suggestion One is only a continuation of the traditional administration regime for government officers.

Several points must be considered as regards the administration of senior managers. They are:

- First, the state must make a completely different regime for administration of its officers and the managers of companies. The managers should not be
called officers. A class of managers should be formed gradually to make it a vocational choice. Managers must get the job by competition in the market, not by appointment by the authorities. The senior managers serve for the board of directors and can be retained or removed only by the board, not by any higher-level administrative body.

- Second, the chairman of the board of directors should not hold the post of general manager because the legal status of the two posts is different: the chairman is employer and the general manager is employee. There is a relationship of trustee and agent between the board of directors and the senior managers. The relationship would be destroyed if the two posts are shared by one person because, in China, the external supervisory mechanism has not been established yet.

- Third, there must be an efficient incentive mechanism for senior managers. As trustees, senior managers should seek to increase knowledge, ability and social status and maximization of income from their human capital. There must be an incentive mechanism to determine payment based on their achievement. The payment of senior managers, including annual salary and awards in connection with the performance of the company, is decided by the board of directors. In other countries, the awards consist of perquisites, bonuses, and stock or stock options.

- Fourth, supervision over managers must be strengthened by the board of directors. The board should not intervene in daily management after the managers have been appointed. But it must exercise its supervision over them in order to prevent them from seeking their own interests in the post. For this purpose, the auditing work must be done under direct control of the board of directors, and not be manipulated by the managers.

The Nature and Function of the Supervisory Council

The supervisory council stipulated by the "Company Law" in China is an internal supervisory organ. Its functions include ensuring that the directors and managers do not commit any illegal activities or activities that obstruct the interests of the company; and calling for additional shareholders’ congresses whenever it thinks it necessary. For efficient performance of the supervisory council, membership of the council must not be held by either a director, manager or anyone in charge of financial affairs in the company. Several additional issues should be highlighted:

- First, the supervisory council under discussion is different from either the one in Germany or the one stipulated by the "Regulations of Management of the Assets in State-owned Enterprises." The supervisory council in Germany is one similar to a board of directors, which is a decision-making body, not a
supervisory organ only. The one defined by the “Regulations,” which was published in July 1994, is an external body authorized by the state in the company.

- The second issue concerns the composition of the council. According to the “Company Law,” the members of the council must not be less than three persons; from them the head of the council is selected. The council is composed of representatives of the shareholders and workers; the ratio is determined by the company’s charter. The representatives of the workers are elected by the workers themselves. For small limited-liability companies, one or two supervisors can substitute for a supervisory council.

- Third, the supervisory council must play its role in a genuine sense. At present, some of the councils do not fulfill their role well due to the poor quality of members; they know less than the directors and managers about the management of business. So, it is very important that the members of the council must be those who are experts in the company. Moreover, the council should never become an organization to place redundant workers.

The Position and Role of the Party Organization in the Company

According to the Party rule, there must be a Party organization in a company where there are more than three Party members. It is the Party’s policy that the Party must play an essential role in the political life of the company. However, how to establish a good coordinating relationship between the Party organization and the governance structure so that the latter can play its role remains a question. Two proposals may be considered here:

- **Proposal One:** The head of the Party committee holds the post of the chairman of the board of directors, which makes the Party the central point in the company.

- **Proposal Two:** The head of the Party committee exercises the Party’s policy through the board of directors, the supervisory council and the managers.

The first proposal is adopted in many companies, which is more or less consistent with the existing system. The second is in line with the “Company Law,” which is the direction of the future.

In the longer term, the Party organization in a company should carry out its policy through the following aspects: (a) by educating and supervising the members of the board of directors, the supervisory council and the managers who are Party members to exercise their rights following the Party’s line, policy, laws and regulations; (b) by strengthening its leadership over the Trade Union and the Communist Youth League and
supporting them to undertake their activities independently; (c) by giving full play to workers’ political and ideological initiatives, with their focus centered around the operation and production of the company; and (d) by providing model performance of the Party members in their own posts.

**Ways and Forms of Participation in Management by the Workers**

In China, workers’ initiatives are the source of an enterprise’s vitality. The participation and support of the working class are the foundations of the modern corporation. We, therefore, must find the ways and forms for workers’ democratic participation in company management. There are two possible choices:

- **Scheme One:** The workers’ congress coexists with the Trade Union. The Trade Union, as the standing executive organ of the workers’ congress, organizes workers to participate in company management via the workers’ congress.

- **Scheme Two:** Only the Trade Union is retained. The workers’ participation can be realized in all aspects of corporate governance.

The first choice is similar to the current practice in SOEs. The second one should lead the way and form the core of the workers’ democratic initiatives as required by good governance.

In the future, the participation of workers in the management of the company should perpetuate in all aspects and be integrated within the governance structure. This can be realized by the following ways: (a) For enterprises whose assets are wholly owned by the state, their board of directors should include representatives from the workers. (b) The workers’ representatives must account for a certain proportion of the supervisory council. (c) The company must solicit the opinions of the Trade Union and the workers beforehand and invite them as nonvoting delegates to take part in the meetings that discuss and make decisions on such matters as the workers’ wages, welfare, production safety, labor protection and labor insurance, which are directly related to the workers’ immediate interests. (d) The company must listen to the Trade Union and the workers for their opinions and suggestions concerning production and management when important decisions are made.

**The Role of Market Competition and Diversification of Enterprise Ownership Structure**

We have mentioned many measures in corporate governance that may facilitate supervision over managers. However, the ultimate and most effective supervision comes from the pressure of market competition. Senior managers are subject to the constraint of market competition in three layers: (a) The competitiveness of the products of the
company. Judgment on the management of an enterprise will ultimately rest on whether its products are competitive in the market. (b) The pressure from the market on the value of managerial personnel. The capability and comprehensive qualifications for a management job are reflected in wages offered in the personnel market. This kind of market competition presents the managers with the possibility of either being promoted or replaced. (c) The constraint from the capital market upon the value of the enterprise. This constraint may take many forms. Price fluctuations in the stock market, when they can reflect the performance of company management, are strong incentives for managers. If the share price drops, it means a greater possibility for the company to be taken over or merged by another. If the company cannot repay its debts in time due to poor management and goes bankrupt, or is on the verge of bankruptcy, the creditors (the main bank in Japan, for instance) may take it over and undertake a reorganization. The various forms of property rights transfer are a powerful restraint on enterprises' senior managers.

Property rights must be made transferable (but may not necessarily be in the form of stock) in order to give the full play of market competition on the behavior of managers and to guarantee the effective operation of the markets, particularly those for entrepreneurs and capital. This will require diversification of investors to create conditions for the transfer of property rights and optimal reorganization. It should be pointed out that in advanced market economies, excessive dilution of stock usually leads to such problems as the deactivation of external supervisory mechanisms and the emergence of "insider control." For the majority of the SOEs in China, property rights cannot enter into circulation and it is impossible to form a market for property rights. Therefore, adequate but not excessive diversification of stocks (several or a dozen shareholders, for example) will promote the efficient operation of the enterprise.

**ALTERNATIVE APPROACHES TO THE STEPS OF IMPLEMENTATION**

The Third Plenum of the Fourteenth Party Congress pointed out: "It is the inevitable demand of the development of socialized large-scale production and the market economy as well as the direction of the reforms of state-owned enterprises to establish the modern enterprise system."

China's traditional forms of enterprise organization should be transformed and converted to new ones that are in conformity with the requirements of a socialist market economy. With the flow and reorganization of property rights, more and more economic entities will be under mixed ownership. There will be some new forms of enterprise organization: private corporations, partnerships, share-based cooperative entities, wholly state-owned corporations, limited-liability companies and limited-liability shareholding companies. Of them, limited-liability companies and limited-liability shareholding companies will be the main forms of enterprise organization in China.

There are two approaches to transform SOEs into corporations so as to build up a modern enterprise system in China:
• **Approach One:** All SOEs are transformed into corporations at one stroke and the transformation work is completed in two or three years. This scheme is based on the consideration that state assets are being drained away at an accelerating speed, the performance of SOEs is getting worse and that immediate and effective measures must be taken to find a new way out for these entities. Early corporatization may relieve the SOEs from the fetters of the old regime and create possibilities for further transformation in the future. The problem with this approach is that it is very hard to put in place all the necessary conditions for the corporatization in a short period of time and may result, therefore, in a situation of no substantial change.

• **Approach Two:** Pilot programs are carried out to find out the most desirable means of transformation and to accumulate experience before an across-the-board transformation begins. In this way, the transformation will be completed before the end of the year 2000 or the first 10 years of the next century. This scheme is slow but steady. It would not cause social instability brought about by any drastic changes and will leave both room and time for the auxiliary reforms in the process. The only problem here is that more state assets will be drained away; some SOEs will even waste away all their properties if the process of transformation is prolonged too much.

The second approach may be carried out in three steps: (a) The first stage: from 1995 to 1996, pilot projects shall be launched. The State Council has selected 100 enterprises, and local authorities have chosen more than 2,000 enterprises for experiments. Such pioneer enterprises will explore the way and accumulate experience for the overall work of establishment of a modern corporate system in China. (b) The second stage: the four years from 1997 to 2000 should be a period of large-scale transformation. The basic framework of the modern corporate system should be set up by the end of the century and all enterprises must be shifted onto the track of constructing a modern corporate system. (c) The third stage: the 10 years from 2001 to 2010 should be a period of consolidating and improving the new system. By then, all the various relationships in the modern enterprise system should be well-coordinated.
COMMENT ON “CORPORATIZATION OF ENTERPRISES AND REFORM OF CORPORATE GOVERNANCE”

Janusz Lewandowski

The paper by Mr. Jia Heting discusses the modern corporate governance mechanism as a vehicle for improving the management of the state assets in China. Sample empirical evidence from Eastern and Central Europe’s “economies in transition” provides an interesting point of reference in this respect. The scale of the challenge was different, but the economic structures and the political constraints were similar; therefore, some observations are clearly relevant:

- the various efforts to rationalize SOEs, particularly in Hungary and Poland, before 1989,
- the impact of these experiments upon the microeconomic capacity to adjust to the market reality after 1989, and
- decentralized management of the state sector as one of the important determinants of the policy options for privatization and restructuring in a postcommunist economy.

Out of the alternative strategies in the Eastern European Countries, the “massive and quick privatization” option was predominant in the early 1990s, accompanied by the expectation that suitable mechanisms of enterprise control will evolve in time. In the mid-1990s, confronted with a privatization slowdown, the question of improving the corporate structure of the residual public sector reappears on the policy agenda in many countries.

The international evidence, from the OECD countries, as well as from former COMECON member states, suggests that the establishment of a comprehensive corporate governance system is conducive to improved SOE performance. Introducing some basic corporate governance mechanisms, wherever this is politically feasible, usually brings about:

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- clarification of property rights allowing for the separation of ownership, supervision and management responsibilities;

- operational autonomy of the management, resulting in a more flexible and commercially oriented profile of the company; and

- compatibility of the SOE legal structure with the private sector, paving the way for the mixed shareholdings and international joint ventures.

Efficiency and depolitization gains through the corporatization upon the quality and consistency of the external macroeconomic framework.

The establishment of a formal corporate governance mechanism had been underestimated in the early stages of reforms in Eastern Europe. Before 1989, rationalization of SOEs had been attempted through the decision-making emancipation of management, the gradual relaxation of central planning and modifications of the financial system. Reorganization of enterprise governance in Hungary since 1984 and in Poland since 1981 evolved in the direction of the self-managed enterprise. The right to appoint the manager and to decide on mergers, spin-offs and other aspects of organization were given to the employees or their representatives. The dominant role of the managers was distinctive in the Hungarian model, in contrast to the dominant role played by labor in Poland.

This was a markedly different approach to SOE rationalization from the classic three-layer corporate governance installed on behalf of the Treasury. The East European approach was certainly efficient in developing managerial skills and labor self-organization. On the other hand, it was beneficial to "insider" interests. Insiders appeared reluctant to accept corporatization of SOEs, attempted in Hungary in 1989 and discussed presently in Poland. The neglected corporate governance issue in Eastern Europe resulted in an institutional vacuum after the withdrawal of the state from the economy in the early 1980s.

Current problems in practical operation of corporate mechanisms in China, as listed by Mr. Jia, are quite understandable, given the limitations of the reform. Administrative interventions, nomenclature nominations, informal role of the Party’s grassroots organizations as well as confusion over workers’ participation can be attributed not so much to old habits as to the nature of present-day management of the Chinese economy. Corporate structures growing organically in response to the complexity of modern private enterprises are not easily transferable into the context of state ownership and a monoparty political system.

The evidence of East European reforms demonstrates clearly that full separation of ownership and government functions and full depolitization of economic management are not attainable. Even with perfect formal designation of owner/management relations,
the Party’s control over nominations and incentives creates an informal channel of influence and company’s subordination (the logic of political loyalty). Tension between the economically best and the politically feasible is clearly visible.

Assuming that there are some preconditions of successful corporatization and acknowledging the political reality of Chinese reforms, it is relatively easy to select between the policy options presented in Mr. Jia’s paper.

Scheme 2 for both the company’s board nomination and managerial selection is more consistent with the goal of scientific corporate governance construction and in line with the criteria of professional qualifications. There is, unfortunately, no clear role for the supervisory committee, added as an additional level to the governance structure by China’s Company Law of December 1993. Scheme 2, defining the role of the grassroots Party organization, is compatible with the long-term evolution of its functions at the modern Company level.

The issue of workers’ democracy seems to be more complicated. It is worth noting that, in Poland, the strong prerogatives of workers in the 1980s constituted a real safeguard of enterprise autonomy. On the other hand, it contributed to the insider claims.

The above listed recommendations should improve the learning curve of corporate governance, although this structure, installed in the context of dominant state ownership and monoparty system, cannot achieve the goal of depolitization and full allocation and production management efficiency.

Reforming SOEs through corporatization (the Chinese way) or through self-management (the East European way) produces undoubtedly new quality in management of state assets. The emerging system is more flexible to the market-oriented internationally competitive macroeconomic framework. Nevertheless, there is a noticeable tradeoff between the benefits of decentralization and the increasing role of insiders (employees and managers). It adds an additional dimension to the “agency problem,” as the insiders tend to sabotage any efforts to set up any institutional structure that would subject them to external control. The decentralized system of corporate governance is sufficiently diffused to lease management practice control over the nominally state assets. On the other hand, the more centralized structure of a socialist economy (that is, Czechoslovakia and Eastern Germany before 1989), being less flexible and less efficient, facilitates smooth assertion by the state of its property rights over the enterprises and the eventual implementation of privatization programs.
REDUCING STATE-OWNED ENTERPRISES' SOCIA L BURDENS AND ESTABLISHING A SOCIAL INSURANCE SYSTEM

Hu Xiaoyi

The road leading China's SOEs to the market system is not without ups and downs. Apart from the unclear definition of property rights, heavy burden of debts, an improper industrial structure and product mix, and the imperfect internal management system, one problem that should not be ignored is: the functions of such enterprises are seriously distorted, namely enterprises have to shoulder a lot of social affairs, thus resulting in heavy financial and administrative burdens.

ANALYSIS OF THE PRESENT STATUS

Major Problems

At present, the main burden on the SOEs in the field of social affairs could be summarized in the following five points:

Burden of Surplus Labor. By the end of 1993, the number of workers and employees in SOEs totaled 76 million across the country. As for the number of workers and employees who are not required by the enterprises' production and operation and actually have little or no work to do, there are different estimates. The most conservative estimate is 10 million, and the most radical is 30 million, but all agree that the SOEs have a large number of surplus workers and employees. Most people tend to think that about 20 percent of the workers and employees in SOEs are surplus labor; that is, 15 million.

There are two hard nuts to crack in solving the problems of surplus labor: one is that "invisible unemployment" does not equal "visible unemployment." The status of surplus labor cannot be analyzed only in terms of the total number, and it is normally difficult to draw a clear-cut answer as to who is surplus labor. If the line is drawn in a compulsory manner, it will inevitably cause resentment among workers and employees. The second is that it is hard to define who or what department is responsible for solving the issue of surplus labor. Enterprises tend to think that this is the responsibility of the government and will be solved by the social security system; and the government, on the

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contrary, is more concerned about social stability and tends to rely on the enterprises to solve the problem by themselves.

**The Burden of Pensions.** In the past 10 years, the aging of the population in China has accelerated, and this is more obvious in the towns and cities. The available statistics can only provide the percentage of retirees in the total number of urban workers and employees. Because the percentage of SOE workers in the total number of workers and employees has been rather stable, the trend of increasing burden of pensions on SOEs can be seen from the following chart.

**Percentage of Retirees among the Total Number of Workers and Employees**

What is shown in the above chart is just the national average. As for specific SOEs, the actual burden is quite unbalanced due to such factors as different establishment dates and different age structures. In some SOEs with a long history, the ratio is 1:1; that means, each worker or employee now has to support one retiree; and some newly-established enterprises have virtually no retirees.

Under the old system, enterprises had to pay all the pension fund for their retirees, and this placed a heavy financial burden on some of the old enterprises. This actually increased marginally the costs of production and reduced their profits. And some old enterprises have run into trouble due to this. Since 1984 when the unified social pension fund was adopted, this condition has improved. At present, nationally, SOEs have adopted at least a city- or county-level unified pension system, and the premium rate paid into the social pension fund is 18 to 20 percent, on the national average. This to a certain extent has balanced the financial burden inflicted by pensions on SOEs. However, there are still three problems needing to be addressed. First, the burden on different industries is different. For some traditional industries, such as the mining industry, the contribution...
rate is as high as about 25 percent. On the other hand, for some newly-developed industries, such as banking and civil aviation, the contribution rate is less than 10 percent. Second, the regional disparity concerning this burden is rather large. The burden for old industrial cities is heavy, for instance, 1.98:1 in Guangzhou; on the other hand, the burden for newly-emerged industrial cities is very light, for instance, 10:1 in Zhuhai. Third, the unified pension system is implemented mainly in SOEs. Although conducive to balance the burden among SOEs, it is actually not conducive for lightening the burden on SOEs versus other types of enterprises. Private enterprises and foreign-invested enterprises, developed in the past few years, have a clear characteristic—young staff—but most of them are not included in the unified pension system.

Under the old system, another burden of pensions for SOEs is that they had to bear the responsibility of administering all aspects and social services of the pension, from distributing the pension fund, to organizing recreational and sports activities, to caring for the ill, to burying the dead and executing wills. At present, SOEs have nearly 20 million retirees; normally, every 100 retirees will require one administrator to take care of them. Based on this calculation, at least 200,000 administrative personnel will be needed within enterprises to manage the affairs of the retirees. This undoubtedly causes an increase in the staffing of the enterprises, although it does not mean that these 200,000 people have nothing to do.

**Burden of Medical Care.** This burden is shown in two ways: First, the “labor-protection medical care” system introduced in 1951 stipulates that all medical expenses by an ill worker or employee and salary subsidy during the leave period due to illness shall be shouldered by the enterprise, and that the enterprise shall reimburse 50 percent of the medical expenses if any family member of the worker or employee suffers from a disease. To the workers and employees, this is no doubt very beneficial welfare. This, however, also results in out-of-control medical expenses and serious waste of medical resources. Enterprises may, in accordance with stipulations, allocate funds equivalent to 10 percent of the salaries from the welfare fees for medical care. In reality, however, many enterprises, the old enterprises in particular, greatly exceed the set percentage. At the same time, such phenomena as “small family pharmacy” and “all family members of the workers and employees benefit from the enterprise’s medical care” are becoming more and more striking. Some changes have occurred since the adoption of reform and open-door policies. Some enterprises have adopted the package medical care system for the purpose of controlling medical care expenses; that is, an aggregate amount of medical fee is given to the employee; what he or she saves belongs to himself or herself; the amount spent in excess has to be paid by himself or herself. But the effect of this system is minor. The reason for this is that there naturally exists a “seller’s market” as far as medical service is concerned. Of the doctor-patient relationship, the doctor is always in control, and the patients are actually passive consumers. It will be impossible to limit the acts of doctors by controlling the amount of medical fees that are under the control of patients. In addition, this practice runs counter to the principle of labor risk dispersion in
social insurance, and thus causes the occurrence of another problem or phenomenon: some workers and employees, who suffer from serious diseases, have to pay a large percentage of the medical expenses, thus causing them personal financial difficulty. Some enterprises, due to poor operation and economic inefficiency, are unable to reimburse the medical expenses for their workers and employees or have to restrict the amount of expenses to be reimbursed and the number of workers receiving reimbursement. Thus, the workers and employees cannot get their medical expenses reimbursed after paying such expenses, called "white-paper IOUs."

Second, SOEs are running a large number of hospitals and clinics for their workers and employees. As statistics show, there are 110,000 medical institutions operated by SOEs and departments other than the public health departments, employing 1.4 million staff and accounting for one-third of the country's total number of medical personnel. Such medical institutions mainly serve the workers and employees of their respective enterprises and their family members; this group of people accounts for no more than 20 percent of the country's total population. Seeing the problems from the enterprise's viewpoint, the accounting and financial relationship between the self-run medical institutions and the enterprises is not clearly defined. Normally, the medical costs of these self-run institutions are lower than those of other hospitals in society, but such a low cost results because the capital construction of the self-run medical institutions, the purchase of equipment, the maintenance and the wages and welfare of the staff at these institutions are actually shouldered by the enterprises.

**Burden of Housing.** At present, enterprises are responsible for the housing of their workers and employees—from construction, housing distribution, maintenance and repairs. As a conventional practice, when one of a couple works in an enterprise and the other works in a government organ, their house is usually provided by the government organ. This practice, to some extent, eases the pressure of the enterprise providing housing. Generally, though, the housing burden is still rather heavy for enterprises. Some enterprises, not having sufficient capital for house construction, use funds otherwise targeted for capital construction, overhaul or technological renovation projects, thus affecting the enterprise's production. This, however, is the only choice they can take. Under the old system, if enterprises failed to provide housing for their workers and employees, the enthusiasm of the workers and employees would be diminished, and consequently affect production.

**Burden Caused by Various Welfare and Service Facilities.** An outstanding issue is that enterprises have to run their own schools, in particular schools for the nine-year compulsory education. At present, SOEs in the country operate a total of 18,000 primary and middle schools, employing 600,000 teachers and administrative personnel. Even with investment in capital construction excluded, they would require annual expenses of more than 3 billion yuan to keep them operating. The schools operated by the enterprises inevitably bring convenience for the schooling of their children; this is
particularly true for the enterprises and independent mines in remote areas. However, just as with the hospitals and clinics operated by the enterprises, the investment in capital construction, wages and other welfare of the teachers and staff of the schools also erode the profits of the enterprises. Some enterprises regard the self-run schools as a welfare measure to maintain a stable work force, but more enterprises tend to complain: although taxes and education surcharges are paid, the enterprises still have to run their own schools for the schooling of children of their staff and workers. In addition, enterprises still have to run a lot of welfare and service facilities such as canteens, stores, hostels, kindergartens, transportation fleet, bathrooms and barber shops, which also need large personnel and goods and materials to support them.

Undesirable Consequences

The undesirable consequences caused in the five aspects mentioned above could be analyzed from the micro and macro point of view.

Judging from the micro viewpoint, one of the consequences is the increase in the labor cost of enterprises. Although the average salary level of SOEs in China is still low, the labor cost calculated according to the unit product is actually no longer low, because of added welfare expenses disbursed covertly. In addition, the amount of welfare expenses disbursed covertly accounts for a large proportion, thus causing nontransparency in the actual labor production cost and making it difficult to calculate accurately their economic accounting. Furthermore, the roughly 15 million surplus workers can be translated into a 20 percent increase in the general labor cost. Some reasons may be found in chronic low labor productivity. For old enterprises in particular, various social burdens are even heavier and they find it hard to invest more funds for renovation and technological upgrade, and this places them at a disadvantage in market competition. They complain: all profits were turned over to the state when they were young enterprises; the state used the money to start new enterprises. These enterprises are now old, and while shouldering the pension and medical expenses for their retirees, they also need to compete with the new enterprises. This is obviously unfair.

Another consequence, from the micro viewpoint, is that the management goals of enterprise managers are not concentrated on production or operation. They have to devote some of their energy to handle such social affairs as pensions, medical care, housing and education, and cannot fully concentrate their energy and efforts on making the enterprises operate in a better way.

From the macro viewpoint, the large number of welfare and service facilities run by enterprises normally have a lower utilization efficiency than those organized and operated on the basis of professional principles, and an irrational allocation of resources is caused. Some resources are lying there idle and waste occurs. At the same time, the more internal welfare services are provided by the enterprises, the more dependent the
workers and employees are on their enterprises. Some workers and employees would prefer staying in their enterprises without work or insufficient work rather than leaving their enterprises. The main reason for this is, apart from the welfare and insurance treatment, the houses they live in. Such a phenomenon makes it difficult for the smooth flow of workers, posing an obstacle for efficient labor allocation in society as a whole.

Causes of These Problems

Causes in the System. Under the planned economic system, the functions of the government and enterprises have performed very poorly. SOEs, in particular, have become affiliated organs of governmental agencies. The government, through assigning quotas on product types, and quantity and quotas on labor and wages, directly intervene in the production, operation and management of the enterprises. Alternatively, enterprises have to bear a lot of responsibility for social affairs that should have been handled by the government. This system has resulted in the phenomenon of "enterprises running small societies," and the problem still requires further solutions, even after the adoption of reform measures.

Psychology and Habit. This distorted system has led to a problematic habitual psychology for the enterprises and their workers and employees. To the workers and employees, the enterprises are not just the units where they work, but also their support for birth, old age, illness, death, injury or disability, and a strong dependent psychology has developed. During the process of carrying out the social insurance system, some retirees refuse to draw their pension at the banks and insist that their enterprises should distribute the pension fund for them. One reason for this is that they could have a chat with their old pals while collecting their pension fund each month. This example illustrates to some extent the psychological dependence of workers and employees on enterprises. To the enterprises, it seems that "to run small societies of their own" has become the conventional practice. If no welfare facilities are established, an enterprise would be thought to be indifferent to their workers and employees. And those enterprises with a younger age structure also prefer to administer the affairs of pension and medical care for their workers and employees. They are displeased with social insurance, deeming the unified social insurance as "exploiting the rich to aid the poor."

Financial Reasons. Many people appreciate the huge burden and worrying future of "enterprises running small societies." But, when consideration is given to address the problem, a major obstacle is how to finance the program. If two-thirds of the current 15 million surplus workers in enterprises (that is, 10 million) are terminated, the government would have to provide at least 20 billion yuan in unemployment funds each year (the scale of the unemployment fund is just over 4 billion yuan). This is just a rough estimate, and the huge investment required to train workers so they can transfer to new jobs and to create new employment opportunities is not included in the estimate. For example, if all the hospitals and schools now being run by the enterprises are handed over to
governmental agencies to operate, 9 billion yuan will be required each year for the wages and welfare of the 22 million doctors, and administrators, let alone that a greater amount of operating funds will be needed. If the expenses are shouldered by the government instead of by the enterprises, it is obviously a not light burden.

COUNTERMEASURES AND SUGGESTIONS

What is pleasing is that the worrying status described above has begun to turn for the better along with the implementation of economic structural reforms, especially the establishment of a socialist market economic structure. Through reforms that have changed the functions of the government, weakened central planning, and delegated more power to the production and operation of enterprises, the functions of the government and enterprises are being restored to their normal position. Social insurance, which is worth mentioning in particular, has been progressing along the road for 10 years from self-insurance by enterprises to unified social insurance. To date, SOEs have adopted the unified social insurance for their pension insurance, and the unified medical insurance on serious diseases is being tested. Specific policy measures to tackle the five major social burden summarized above should include the following:

Measures to Solve the Problem of Surplus Workers

There are two policy orientations to be adopted: One is to adhere to the principle of “the internal settlement within the enterprises as the main channel and social settlement as the supplement channel.” The enterprises shall take various measures to separate and settle their surplus workers, and the government shall open social settlement channels to solve the issues enterprises cannot solve by themselves. The second one is the principle of “the social settlement as the main channel and the internal settlement within the enterprises as the supplementary channel”; that is, the enterprises shall do their utmost to create job opportunities for some of their own surplus workers and all the remaining shall be turned over to the government and society to tackle. The first principle is generally regarded as more practical. However, in the absence of positive government policies, the “digestive” function of enterprises will be impossible to strengthen. Therefore, even under the principle of “enterprise digestion as the main channel and social settlement as the supplementary channel,” the government should play a leading and dominant role. The specific measures are as follows:

- First of all, an analysis shall be conducted on the structure of the surplus labor in SOEs, and different measures shall be taken to tackle different circumstances. First, the elderly employees. Along with age their working ability decreases; and their ability, even after further training, will not improve. With the exception of a small number of elderly employees with special techniques and professions, there will be few employment opportunities for them to choose from. They may quit their posts before the
age of retirement and living expenses equivalent to their base wages will be
given thereto; they will be subject to pension insurance treatment when they
reach retirement age. This actually means that enterprises provide a reduced
pension for them before their retirement. For some unemployed elderly
workers, after the expiration of the term for unemployment allowance and
before the beginning of living on pension insurance, this approach—providing
them with a slightly lower unemployment allowance—may be taken until they
reach retirement age.

Second, consider women workers. In the manufacturing industry a large
number of women workers, at middle age and due to a declining physical
strength and vigor, find that they can hardly qualify for significant job
responsibilities that require strength and fast pace. An interindustry transfer
measure may be adopted. Under this measure, women workers could be
transferred to industries with lower labor effort after suitable training. In
Shanghai, the transfer of textile workers to the civil aviation and public
transportation sectors has been a successful practice.

Third, there are the young workers. The main measure shall be to strengthen
the training for them so as to improve their expertise to meet the requirements
of new technology.

Finally, for some special industries that recruit a large number of rural
laborers, providing retirement funds in a single installment may be adopted to
settle surplus laborers.

- **Develop and expand the tertiary industry so as to absorb more surplus
  workers.** The tertiary industry in China now can be divided into the
  following two types: The first type includes financial, telecommunications
  and information services that require high investment and specially-trained
  labor. The second type includes commercial, catering, tourism and similar
  services that are labor-intensive and have a lower training requirement. The
tertiary industry to get top priority for development in order to absorb more
surplus workers usually is the second type. At present, China’s economic
growth is fast, living standards are improving and working hours have just
been shortened to 40 hours a week. Thus, it is high time to develop the above-
mentioned second type of industry. In order to develop the tertiary industry to
absorb surplus workers, the following three measures should be implemented:
(1) Socialize the current service facilities of the enterprises so as to separate
the service personnel who are not directly involved in the production and
operation out of the enterprises. An independently operating tertiary industry
may also be established to absorb surplus workers. The Beijing No. 1 Light
Industry Group has set a good example by controlling the second industry and
developing the tertiary industry. (2) Transfer workers among different industries. The Dongan Group of Beijing merged with the No. 2 Watch Factory and trained the workers to become store clerks; this is the example of such a transfer and the experience is worth replicating. (3) The government shall, through a reasonable tilting in its policy, encourage the development of the tertiary industry. The government shall provide preferential policy treatment for tertiary industries operated by surplus workers, for instance, by reducing or exempting their taxes and various fees; or when an enterprise has settled a certain percentage of surplus workers, a certain amount of funds shall be allocated to them from the unemployment fund as a starting fund ("seed capital") or interest discount on loans.

- **Labor service enterprises shall absorb some surplus workers.** The labor service enterprise is one of China's inventions to solve the unemployment problem in the cities. At present, there are 200,000 such enterprises, employing 9.15 million laborers in the country. When such enterprises were initially established, they aimed at providing job opportunities to the waiting-for-job urban youth. In light of the present conditions, they should add one more function—to absorb surplus workers. When surplus workers go to work in labor service enterprises, their former employing enterprises regard them "being settled by the society," but for the workers themselves, they are not yet in the unemployed category and will psychologically accept the job change. The labor service enterprises might not be the permanent employing units. The surplus workers may seek more appropriate job opportunities after a certain period of training in labor service enterprises.

- **Encourage surplus workers to seek jobs on their own,** including those who quit government-sponsored jobs to engage in private business operations and those who join hands to start business operations. The policy toward those workers who take this option is to allocate their unemployment compensation in one installment to them as their starting fund, and solve issues such as the extension and connection of their social insurance. Because these employees from SOEs have been enjoying having a pension and free medical care, and if their departure from government-sponsored employment also means a deprivation of their rights to such social insurance, then there will be few willing to quit government-sponsored employment with guaranteed and stable social insurance and seek the nongovernment-sponsored jobs with risks. Therefore, corresponding policies shall be taken so that they will continue to enjoy social insurance, providing they continue to pay their premiums into the social insurance fund. If a term of employment is included in the requirements for enjoying social insurance, their working years in both
government-sponsored employment and nongovernment-sponsored jobs shall be combined.

- **Improve and perfect the unemployment insurance system.** The surplus labor problem is a micro issue that was caused by the old structure, under which enterprises neglected their efficiency and expanded their scale blindly; at the same time, it is also a macro issue, that is, whether or not the government can establish and administer an improved labor market through which the labor force can realize an optimized distribution by flowing freely. Many examples have proved that, during the transition period from the traditional planned economic structure to a market-oriented economic structure, inflation and unemployment are two hard nuts to crack. Therefore, to improve and perfect the unemployment insurance system shall be a matter of urgency for the government. The unemployment insurance system initiated in 1986 adopted a unified ratio of unemployment insurance premiums for the purpose of balancing the burden of pensions on enterprises, and the system has achieved an initial success. The number of workers benefiting from the system was increasing sharply in the past few years. During the period from 1986 to 1992, a total of 640,000 people benefited from the unemployment fund, and the number of people reached 1.03 million in 1993, and further increased to 1.97 million in 1994. This year and in the years to come, with the deepening of enterprise reforms, the implementation of enterprise bankruptcy from theory to practice and the provisions on dismissal of workers in Article 27 of the Labor Law, the fund must be expanded to cover more unemployed people. To raise the needed funds, an alternative to be considered, apart from the contribution of 0.6 to 1 percent of enterprises’ total wages in accordance with provisions of the “Regulations of Unemployment Insurance of the State-Owned Enterprises,” is that individuals shall also pay some premium for unemployment insurance. At the same time, the goal of maintaining a stable social order requires the unemployment rate to be controlled. The paradox between the inevitable increase in the number of unemployed and the goal to control the unemployment rate shall be solved through shortening the cycle of unemployment. At present, the average cycle of unemployment for urban residents is six months. If the unemployment cycle is shortened by one month, and the unemployment rate is maintained, the unemployment insurance fund will be able to support an additional one-sixth of the unemployed. Of course, this requires the government to strengthen on-the-job training and employment services. As for spending the unemployment fund—whether to be used for unemployment allowance or for training and employment services—the opinion on this is quite different. From the point of view of enterprises, if more unemployment compensation is distributed, it would mean that more surplus labor could then be settled and the pressure and burden on enterprises would be further lightened; they, of course, welcome the
first option. When seeing the issue from point of view of society, the current maximum term for unemployment compensation is 24 months. If suitable jobs cannot be found within two years, that would mean that a large number of workers would be falling under the care of society. Although they are no longer subject to unemployment insurance, the government has to take other means (such as social subsidy) to support their living so as to maintain social stability. Therefore, the total costs are not low at all if analyzed in terms of total social costs. In addition, a contradictory phenomenon does exist in Chinese towns and cities: many people have nothing to do while many jobs remain there without any people to perform them. The focal point is that the quality of the labor force is generally low and they are not qualified for jobs requiring rather high qualifications. From this viewpoint, strengthening the training of the unemployed will have a more positive impact.

Measures to Ease the Burden of Pension for the Retirees

The general policy orientation is to adopt the unified social pension insurance system and to socialize the management of the retirees.

Alleviate the financial burden of enterprises for the pensions of retirees. The socialized basic pension insurance should be adopted in a compulsory manner through state legislation. Each enterprise must pay the pension insurance premium at the same ratio of its wage quotas to establish the social pension insurance fund; workers of the enterprise will get their basic pension from the fund after their retirement. By doing so, the financial burden of the enterprises for the pension insurance of their workers is standardized and thus the burden on the old enterprises is alleviated correspondingly. It will also guarantee that the basic pension will not be affected by production or operation performances, and the risk of nonguarantee of the pension is shouldered by society as a whole.

There are two options for raising the socialized pension fund and the utilization thereof: the first is raising and utilizing the pension within the scope of SOEs, and the level of the unified pension fund shall be upgraded gradually, from the city and county level to the provincial level. The second is to raise and utilize the pension fund among all urban enterprises and laborers; the level of the unified social pension shall be centered at the level of cities, and there is no rush to unify the pension insurance at the provincial level, but a provincial-level regulatory mechanism may be established. Both options take "the law of great numbers" in the insurance sector to expand the scope of utilization of the pension fund and to minimize risks. The second option may suit practical conditions better, and its goals may be described as follows: a pension insurance system can be basically established by the turn of the century, which applies to all types of urban enterprises and private laborers, draws financial sources from various channels, diversifies its protection layers, combines the unified social pension and individual
pension accounts and managed socially. The basic pension insurance shall be in a unified system, based on a unified standard, unified management, unified allocation and used by various enterprises and laborers.

A few points need to be clarified:

- The integral pension insurance premiums may take two options—expanding geographically and expanding to a larger scope. Increasing the degree of the unified social pension within the scope of SOEs is conducive to alleviating the burden of some enterprises. For example, the ratio for pension fund contribution in Hubei Province is 19 percent, and in Wuhan, which is an old industrial city, the pension contribution ratio is as high as 29 percent. If Wuhan joins the provincial-level unified pension insurance fund, the contribution rate would surely drop considerably. However, the option, in the general standard, does not really alleviate the burden on SOEs. Furthermore, old industrial cities with heavier pension burdens are usually in economic developed areas, and the regions with a light pension burdens are normally newly-emerged and underdeveloped regions. If the geographic area of integral pension insurance of SOEs is expanded without any analysis, this would probably increase the contribution rate of premiums paid by the underdeveloped regions, and then the fund would be diverted to the developed regions, forming a phenomenon of "robbing the poor to aid the rich." Another phenomenon is this: the rapid development of foreign-invested enterprises, private enterprises and private industrial and commercial households in the past 10 years have clear characteristics of a young age structure, and most of their laborers have not yet participated in social insurance. And it is specifically the old industrial cities where the pension burden on SOEs is heavy that nonpublic ownership enterprises have concentrated. If the pension insurance is expanded to these enterprises and laborers, the social insurance rights of the laborers in the enterprises could be guaranteed; on the other hand, it will also help ease the practical burden on SOEs. Therefore, the government should implement a "coverage plan"; that is, expand pension insurance to all enterprises in three to five years and adopt a unified system and standard.

- Lowering the replacement rate of the basic pension is also one measure to alleviate the financial burden of enterprises. At present, the replacement rate of the basic pension for retirees in China is about 85 percent of the wage standard, and such a high pension replacement rate, of course, is related to the condition of low wage standard and high Engel coefficient, but it cannot exist for too long. In the cities, the pace of population aging is quickening, and by the 2030s, the retirees to be supported by each urban worker will increase from the current 0.18 to 0.5 people, on the national average. Therefore, it is
imperative to lower the replacement rate of basic pension insurance gradually from now on. And in the foreseeable future, it will be appropriate to lower the replacement rate to about 60 percent of the age standard. Of course, such a decrease must be a gradual process, must be carried out along with an increase in the wage standards and a drop in the Engel coefficient. Because our designated goal is to reduce the general burden of pensions on enterprises, and this burden is determined by the level of pension distribution multiplied by the number of years of pension distributed, therefore, another method may be taken, that is, to shorten the term of pension distribution. When China set the retirement age at 60 in the early 1950s, the national average life span at that time was no more than 40 years. At present, the life span on national average in urban areas has reached 70 years, and along with remarkable improvement in living quality and health standard, it is the time to delay the retirement age. However, the contradiction between the labor supply and shortage of job opportunities is acute, and it is not practical nor realistic to extend the retirement age. Therefore, a more flexible policy should be taken to encourage and direct some elderly workers who have special techniques and are capable of working to delay their retirement age, and as an incentive and encouragement, a high pension rate should be guaranteed and maintained for them. In addition, when the basic pension insurance is gradually lowered, enterprises shall be encouraged to initiate other supplementary pension insurance, and the individuals shall be encouraged to implement a pension insurance of a savings nature.

• Another method to alleviate the financial burden on enterprises of pension insurance is to increase the ratio of the contributions made by individuals. At present, the ratio contributed by enterprises is about 20 percent on the national average. However, the individual contributions account for only 2 to 3 percent of their wages. The percentage of individual contributions shall be gradually increased along with the rise in wage standard, for instance, to 8 percent of their wages in 5 to 10 years. At the same time, the percentage contributed by enterprises shall be maintained or even lowered. Such a change in the structure will be conducive for individuals to strengthen their sense of self-protection while weakening their dependence on enterprises. For the purpose of encouraging individual contributions, an individual pension account system may be adopted for the part that is contributed by the individuals.

In the past few years, extensive discussions and explorations have been carried out in China, just as in the rest of the world, on the issue of an individual account system in pension insurance. It is must be clarified, first of all, that most international examples cited are from Chile and Singapore, where the individual account system and the completely accumulated pension mode are in the same category. In China, however, the
mainstay opinion is that the two are in different yet connected and related categories. China favors the pay-as-you-go or partial accumulation mode for the pension insurance system. Alternatively, Chile and Singapore favor the adoption of the complete and partial individual account method for calculation and distribution of pensions. The choice of complete accumulation is excluded in China for the following reasons: China has a 40-year history of pension insurance; nearly 30 million retirees have enjoyed pension insurance, although the insurance method was not standardized. If a complete accumulation method of pension insurance is adopted, the government would have to raise an additional amount of funds to support the nearly 30 million people; at present, the scale of increase is about 80 billion yuan each year. In addition, about 150 million employees are working in SOEs. They have been working for several to dozens of years in public-ownership enterprises, and if a complete accumulation method of pension insurance is adopted, these people will certainly face the problem of insufficient accumulation, and the government would have to allocate additional funds to make up their insufficiency. If the average years of employment in such enterprises are 20 and 5,000 yuan are required to each individual to make up the insufficiency, the additional or supplementary fund for the 150 million people would amount to more than 10,000 billion yuan. This amount is about or even exceeds the total value of state property and state-owned land, and it is obviously unbearable. Some people proposed to appropriate part of the inventory assets and proceeds from land transfers to make up the “debts” left over from history so as to assist in the adoption of the complete accumulation mode. However, this proposal has to meet several challenges: first, SOEs can accumulate a certain amount of social insurance funds from state-owned assets and from transfers of state-owned land. But millions of millions of workers in the non-SOEs would have no source to make it up. Second, albeit such insufficiency is made up completely, it would only mean a change in assets management rights among different government departments. Put in simple words, it just means that assets of the State Administration of State Property and the State Land Administration are transferred to the government-sponsored social insurance organization to manage and administer. The actual significance of such a transfer to the incremental value of assets is doubtful. If these assets could increase their value and could guarantee the needs of an aging population in the future, it would be the result of the whole economic development instead of a result from the change of the management agencies over these assets. Therefore, China can only adopt the pay-as-you-go or partial accumulation method, or the mutual aid system. To adopt the individual account system under this condition is actually a method to calculate the replacement rate of the level of individual pension treatment.

There are two designs for the specific operation of an individual account system. One may be called “big individual accounts,” that is, to enter the part paid by the individuals and the part contributed by enterprises into the individual accounts and draw pension compensation completely according to the amount in the individual accounts (including interests) after retirement. The other one may be called “small individual accounts,” that is, to enter the part paid by individuals completely and a small portion of
the part contributed by enterprises into individual accounts. After retirement, part of the pension fund will be drawn from the individual accounts according to the amount deposited, the second part is distributed to the retirees according to the percentage of their wage incomes when working, and the third part is paid according to the social average level of wages. Those who agree with the first design think: China is, at present, at the stage of economic takeoff, seeking efficiency shall be a top priority, the individual accounts are deposited according to a certain percentage of the wage level of individuals, and the amount of pension they will get after retirement and the amount they pay now are clear. Such a “payment-based system” is conducive to develop a guiding trend, that is, those who perform their work well and have a high wage income will enjoy a better pension treatment after retirement, and thus it will stimulate the workers to work harder. At the same time, the distribution of pension is based on the payment by individuals; therefore, it will be helpful to stimulate the initiative of individuals to pay more into the individual accounts, and will also be helpful for individuals to supervise enterprises in making timely and complete contributions into the individual accounts. The second design is not that direct, and has a weaker stimulation effect, and the calculation for pension distribution is too complicated. Those who agree with the second design think: the basic function of social insurance is to guarantee the basic living for the laborers without working capability, to minimize the risks and to narrow properly the gap and difference in income distribution. Calculating the pension according to average wages, individual wage income and individual accounts produces an “income-based system”; the result is that the replacement rate for pension treatment is stable. In addition, the second part of the pension, which is related to the wage income of individuals, does reflect the difference in incomes, and such differences are reduced in the entire pension distribution structure. The first design, however, will have an unstable level of final pension, and is subject to the influence of interest rates. When the interest rates are too low, the individual accounts will depreciate in value; even if the interest gains are satisfactory, it actually widens the gap in the wage income.

By summing up the opinions from the two sides, an additional approach can be proposed: to divide the pension system into three parts—public annuity, professional annuity (enterprise supplementary insurance) and private annuity (individual savings insurance). The public annuity is mandatory; the professional annuity reflects the differences in different industries and different enterprises, but also has a certain mandatory nature. The private annuity is discretionary, left to individuals and their employers. The public annuity is further divided into two parts: one is the basic annuity, which is calculated according to the term of contribution and the social average wages, to guarantee a minimum treatment level; the longer the contribution is made, the higher the percentage of basic annuity equivalent to the social average wages; the second part is the individual accounts annuity, which is to be calculated and distributed according to the amount in the individual accounts (including interest payments). In this way, the individual account annuity reflects the difference in wage incomes, and a stimulating function is also introduced into the pension insurance; the difference in pension level is
properly narrowed because the existence of a basic annuity stabilizes the structure of pension treatment; it simplifies the payment structure and also minimizes the risks when the individual accounts are too dependent on interest rates.

No matter which method is adopted, there exist two difficulties: The first is that existing workers and employees will need a transitional period as long as dozens of years, and during that period a detailed and complicated method will be required to calculate the pensions for them. The second is the technical base. It used to be simple to calculate pensions according to the level of wages at the time of retirement; and if the individual accounts are adopted, it will require recording in detail and accurately the difference in wages and the payment made by each worker in each period (month and year). It will be an unimaginable task to accomplish if the work is done manually; computer processing must be adopted, but the construction and management of computer networks require a large amount of investment and many technical personnel, and this construction process will be rather long.

- To ease the burden on enterprises in managing the affairs of the retirees, it is imperative to change management of the affairs of the retirees into a social activity.

At present, one goal is to change as soon as possible the condition that the pension is distributed by enterprises and adjust to the fact that the pension is distributed by society; that is, after the amount is computed by the social insurance organizations, the banks or the post office distribute the pension on commission.

The second goal is to entrust the community service organs for senior citizens to manage the affairs, such as organizing cultural, recreational and sports activities, taking care of the ill and handling burial services. The staff at the community service organs may comprise three parts: one is the full-time and specialized community service personnel; the second is the volunteers who have been given some training; and the third is the physically healthy senior citizens; this is actually a kind of mutual service among elderly people. The funds for the community services organs for the elderly may come from four sources: first, governmental financial allocation for community service construction; second, a certain amount of management fees allocated by the social insurance organizations; third, donations by social groups and charity organizations; and fourth, profits from the profit-oriented projects operated by the community service organs as a subsidy.

Under the present circumstance, a transitional method may also be taken: the social insurance organizations set up agencies at the large enterprises and independent mines, and cancel the existing management departments managing the affairs of the retirees at the enterprises and mines and recruit the management personnel into the agencies (or a compromising method, the social insurance organization allocates a certain
amount of management fees). This transitional method to some extent realizes the separation of the management affairs of the retirees out of the enterprises’ production or operation; it also satisfies the psychological need of the retirees who are unwilling to quit the enterprises.

**Measures to Alleviate the Medical Care Burden on Enterprises**

The general goal shall be to guarantee proper medical treatment for each worker when he or she is ill, and to prevent and reduce the waste of medical resources. The basic method is to adopt a system that combines unified social insurance with individual special accounts.

It is apparent that the old “labor-protection medical care system” is not an advanced system. If an employee is ill and seeks treatment, he or she shall pay a certain amount of medical expenses; this is not only just a concept but is actually a practice in many regions. It is also a common opinion that some serious diseases requiring a large amount of medical expenses pose risks and burdens not only on the individuals, but also on the enterprises, particularly some small and medium-size enterprises. Some profitable small enterprises lose money or even go bankrupt when they have just a few workers who suffer from serious diseases hard to be cured. With this, more and more enterprises are appealing to adopt the unified social insurance of medical care on serious diseases so as to minimize the risks. By combining the two, a reforming concept called “unified medical insurance for serious disease and paying for minor diseases themselves” in China has been developed.

There are two options in the policy planning. The first one is the combination of unified social insurance with individual accounts. That is: (1) Establish individual medical care accounts in which an amount of money is allocated, and workers would pay the medical expenses first from their individual accounts. The deposits in the individual accounts are a kind of designated consumption and can be used only for medical care; if the allocation for the year is not used completely, the remaining part may transferred for use in the following year. (2) When all the allocation in the individual account is drawn up, the individuals would have to pay a certain amount of medical expenses themselves; if the amount to be paid by the individuals reaches a certain percentage (for example, 5 percent of their wages), they would be eligible for the unified social medical insurance fund. (3) Enterprises pay medical insurance premiums according to the same rate of wages to establish the unified social medical insurance fund. When the medical expenses to be paid by the individuals exceed the stipulated limit, the unified social insurance fund will pay partially for them; the higher the medical expenses, the bigger the part to be paid by the unified social medical insurance fund.

The second plan is: diseases of a minor nature would have to paid by the individuals themselves; serious diseases would be covered by the unified social medical
insurance fund. That is: (1) Enterprises would contribute at the same ratio to establish the unified social medical insurance fund. (2) Specifying the types of serious diseases and the percentage of the medical expenses to be reimbursed by the unified fund: if the workers and employees suffer from the stipulated disease, their medical expenses would be reimbursed by the unified social insurance fund at the stipulated percentage. (3) Distributing a certain percentage of medical care in the welfare allocation of enterprises to workers and employees as a pay increase: when workers and employees suffer from diseases other than those specified, the medical expenses would have to be paid the individuals themselves. This plan has the following advantages: First, the responsibility of the government is defined; that is, the medical expenses resulting from particular diseases are specified and they are easier to control; the contribution percentage by the enterprises is also quite clear. Second, it imposes no restriction on the consumption structure of the individuals; individuals may, according to different circumstances, decide to adjust their own medical care consumption. For instance, more of their income can be spent on other consumption when they are young; a larger amount can be used for medical expenses when they are old. Third, the structure is simple, the standard is clearly stipulated and thus it is easy to operate. However, this plan also has some problems. The main problems are: it is obvious that the burden on the enterprises is alleviated, but the price for such an alleviation might be the heavier burden on individuals. Because the probability of suffering from diseases increases with age, the middle-aged and old workers would be reluctant to accept it under practical circumstances, or worse, they might demand the enterprises to increase other additional welfare and subsidies. In addition, when the types of serious diseases are set, they would have to be adjusted, added or canceled along with the change of the practical circumstances, and experience tells us that such feedback is normally very slow. Thus, it would likely to cause resentment among the public. Therefore, the first plan, although a little bit complicated, is likely to be more applicable and practical if seen from the practical point of view.

Whichever plan is adopted, it is imperative to strengthen medical administration and pharmaceutical management. At any time, it is more important to control doctors than limit patients in the medical service field. The individual account system can only enhance the saving consciousness of individuals. The control on medical institutions must be strengthened so as to reduce the waste of medical resources. The specific measures include: (1) To adopt the designated contractual hospital system for medical insurance. While enterprises and employees can, in accordance with the medical service quality, choose their designated contract hospitals, the social insurance organization in charge of the medical insurance fund shall have the power to examine the prescriptions and the decision of hospitalization, to examine the utilization of advanced examination apparatus, and may cancel the designated contractual hospital once any serious waste of resources is discovered. (2) To draft a catalog of pharmaceuticals that can be reimbursed. The costs of pharmaceuticals included in the catalog will be reimbursed from the medical insurance fund; the costs of pharmaceuticals not included in the catalog shall be paid by
the individuals. The doctors, when writing prescriptions, shall have the responsibility to
tell the patients which pharmaceuticals are included in the catalog and can be reimbursed
and which are not and cannot be reimbursed. (3) To abolish the system under which
hospitals sell pharmaceuticals. To offer too many pharmaceuticals and unnecessarily
expensive pharmaceuticals is the method that hospitals take to gain profits, and this is
also the main reason attributed to the waste of medical resources. The disadvantages are
obvious and this practice should be canceled. Hospitals, apart from a small amount of
necessary pharmaceuticals, can only write prescriptions and the patients should go to the
drug store and pharmacy to buy the medicine. (4) To set the unit price standard for
clinics and hospitals separately to control the total costs of medical insurance. But such a
standard should be implemented equally so as to avoid a drop in medical service quality.

Measures to Solve the Housing Problem

The general policy orientation shall be: to accelerate the process of housing
commercialization, and to socialize the functions and organs of house construction,
distribution, management and repair.

Housing commercialization is a complicated government project that is just
starting. All localities are accelerating the process of housing commercialization through
means of rent increases, sale and the establishment of housing cooperatives. As far as
enterprises are concerned, they shall keep the same pace of progress of housing reforms
with the localities, but may not outpace the progress of the localities. Therefore, here we
just discuss the socialization of the housing management departments of enterprises.

Under present circumstances, it is impossible to completely socialize the housing
management organizations of enterprises, and the following three policies of a
transitional nature may be adopted:

- Large enterprises shall organize and combine the present house construction,
distribution, management and repair departments into real estate development
companies. These companies may exist as subsidiary companies of the
enterprises and shall be independent accounting units. While serving the
enterprises and their employees and workers, these companies may also
provide services to the local residents. If there is difficulty in striking a
balance in their capital, they may exist as branch companies of enterprises,
and enterprises shall allocate a certain amount of capital, but they shall also be
independent accounting units. The future of these real estate development
companies is like this: when the conditions are ripe, they shall be
organizations independent from their original enterprises; they shall establish
a service contract relation with the original enterprises in terms of house
construction, management and repair.
• The medium-size enterprises may establish real estate development companies through incorporation among enterprises and the organizations; equipment, personnel and capital may be used as the investment in these companies. These companies shall, according to contracts concluded, separately construct, repair and manage the houses for enterprises.

• The small enterprises may merge their original housing departments with the social real estate development companies, and turn over the enterprise-owned houses to the social housing management department for a unified management. Both parties shall conclude contracts, and the companies shall provide services to enterprises according to the provisions of the contracts.

Measures to Ease the Burden on Enterprises Caused by Welfare and Service Facilities

The general policy orientation is to separate the public organizations, such as hospitals, schools and other welfare and service facilities, out of the enterprises’ production and operations, and to restructure them according to the socialization principle. Due to the complicated circumstances at present, four methods for the separation may be designed and planned:

• Complete separation

  • The hospitals and other medical services run by enterprises shall be taken over by the public health department of local government. Assets and personnel shall be transferred and included in the local medical service network. Their expenses shall be covered by financial allocations. During the transitional period, the enterprises may cover some part of the expenses when the hospitals are first transferred and decrease the amount yearly. When medical institutions are separated from enterprises, they shall be under the unified planning of the government. Some unnecessary medical institutions, which are overlapping allocations of medical resources, should be abolished or have their size reduced. The remnant hospitals shall provide medical service to enterprises through medical insurance contracts.

  • The secondary and primary schools run by enterprises shall be handed over to the education departments of local governments. The entire assets shall be transferred gratuitously. The personnel system shall also be transferred and included in the local basic education system. Large enterprises or independent factory communities that have run many schools may join hands with local community organizations to set up a community basic education institution with part of the
functions and personnel separated from the enterprises. It will manage the enterprises' original secondary and primary schools within the community. After these two kinds of separation are adopted, the expenses shall be covered by allocations from the government budget. In the transitional period, the enterprises may cover the expenses at first and then decrease the amount yearly.

- Canteens, hostels, shops, bathrooms, kindergartens, garages and other service facilities shall be separated from the main production bodies. They shall each form independent companies or join to form service companies, which practice independent accounting and are responsible for profits or losses. They can offer services to the original enterprises through contracts. The enterprises may share the profit from the companies with their assets as investment.

- **Semiseparation**

  - Independent factory communities and some special enterprises (such as the railways), which can hardly have the medical and educational institutions separated due to limited conditions, may continue to run them. But they should practice independent accounting within the enterprises. While offering services to enterprise workers, they should also cater to society, and limit the costs according to the standard of socialization.

  - The enterprises that have difficulty in completely separating welfare services may practice internal separation, internal contract and independent accounting. The enterprises may specify their roles of such services and offer them subsidies according to set quotas.

- **Interenterprise Integration.** Medium-size and small enterprises may practice horizontal integration in an area and merge medical and other welfare facilities to set up joint medical institutions and service companies. The enterprises would enjoy the services according to the proportions of transferred assets. The government shall also offer some support to the joint medical institutions.

- **Keeping a Small Number of Institutions.** As part of the labor protection facilities, the clinics, bathrooms, nurseries and kindergartens of enterprises whose work positions are scattered, as well as professional training institutions, should not be, or can never be, separated from the enterprises. Their scales should be properly specified and the professional training
organizations may cater to society. But they should be verified by the local government.

**Feasibility Analysis**

How to ease the social burdens on enterprises is a complex question, concerning such important aspects as reorganization of enterprises, industrial policy, social insurance (pension, medical care and employment), financial budget, community construction, public health and rational allocation of educational resources. This article raised various suggestions from different aspects of this issue. The feasibility of these suggestions can be determined by reference to the following three points:

First, a consensus has been reached on how to ease the social burdens of state enterprises, which is related to their fate. The Central Economic Conference held in the fourth quarter of 1994 again listed state enterprise reform as the focus of economic reform. This question was one of the topical issues on the third session of Eighth National People’s Congress in 1995. In his “Report of Government Work,” Premier Li Peng said: “To ease the burden of enterprises running social services, we can first have the auxiliary and service units attached to the enterprises separated and reduce subsidies on them. They should practice independent accounting and be responsible for their gains and losses, and gradually cater to society. When conditions permit, these units may be transferred to local government. Diluting of surplus workers shall rely on the government, enterprise and workers, who may be rearranged by the enterprise, self-employed or helped by social services.” This consensus has made it possible for the various separation measures to enter the operational stage from the feasibility study stage as soon as possible.

Second, the above policy suggestions have been tried extensively at the grassroots level. A great number of state enterprises have taken measures to dilute surplus workers by offering professional training for workers to be reassigned, running sideline businesses to absorb surplus workers, encouraging workers to seek jobs by themselves and allowing some surplus workers to retire within enterprises. The pension and unemployment insurance systems have been initially founded and the medical insurance system is being experimented upon. The experiment of separating welfare services and production has proved to be successful in some large enterprises like the Wuhan Iron and Steel Company. The suggestions of this article have been made on the basis on these experiments. We suggest that they should be carried out on a larger scale.

Third, in the above suggestions, we have designed two choices for some important steps. Although these steps concern different aspects of social services, generally, one alternative is an ideal and radical one, while the other is a more moderate and practical one. This article is inclined to the latter one. The main reason is that we have to take into consideration the social, historical and ethical factors while making
policy decisions on easing the social burdens of enterprises, which is no doubt a major economic policy decision. The most typical question is the handling of surplus workers. From the point of view of business accounting, the enterprises can ease their burdens completely and rapidly, drastically reduce labor cost and raise productivity and efficiency by pushing all the surplus workers into society and relying on the social insurance system to solve their living problems. This is naturally the best choice. But from the point of view of society, after these burdens are transferred to the social insurance system, the government has to levy more taxes and social insurance premiums to ensure the lives of these jobless workers and maintain social stability and harmony. The total social cost for solving this problem may not be reduced. What is more, when millions of surplus workers become jobless and are left to society, they will create a huge social group, who shall plunge into economic plight. With no sense of security, they will see little hope about life and easily feel deserted by society, which will lead to social instability. If enterprises take on the main task of supporting the dilution of surplus workers, these workers will still have a certain sense of security and have reason to place hope in the future, thus better accepting the reform psychologically, although some of their incomes shall be lowered. This approach will diminish the risk of social shock in the course of the transition. Therefore, we prefer the moderate alternative.

Although the above policy suggestions are considered to be moderate and practical, the detailed operation has to be supported by the following three factors:

- First, in the reform of economic organizations, the division of labor in such professions as real estate development and service industries should be quickened so that social service units separated from enterprises may link up to social organizations. Community organizations should also be expanded and their functions intensified so that they can bear the responsibility of community medical care management, education, services to the elderly and disabled persons. These measures aim to improve the external environment, which is described as “digging ditch first and letting off water second.”

- Second, the reforms on pension, unemployment and medical insurance should be accelerated and expanded to a larger scale under a unified standard in order to diminish risk to workers and ease burdens on enterprises. The most urgent task is to quicken the legislation on social insurance and end the limited, voluntary and nonstandardized practices of the past decade so that social insurance may enter a complete, compulsory and unified state.

- Third, in the course of separating social burdens from enterprises, financial support will be required. The transfer of enterprise-run hospitals and schools to society will not be possible without an increase in public funding. Of course, the increased budget allocation will be offset by increases in enterprise
tax payments that will come with raised efficiency and profits after the social burdens of enterprises are eased.
COMMENT ON “REDUCING STATE-OWNED ENTERPRISES’ SOCIAL BURDENS AND ESTABLISHING A SOCIAL INSURANCE SYSTEM”

Ron Dean

Introduction

I am honored to be invited to open the discussion on Mr. Hu’s paper.

It is an extremely good paper that describes very clearly the problems faced by SOEs in China because of social obligations, as they move toward a socialist market economy. Similar problems would no doubt be faced by SOEs in a number of other countries but in few, if any, of them would the problems be of such magnitude or complexity.

Mr. Hu identifies the main burdens on SOEs under the following headings:

- Surplus labor—some 15 million or so workers, out of a total SOE work force of the order of 76 million, are thought to be surplus to the needs of the enterprises, but estimates range from 10 million to 30 million.

- Pensions—not only is the obligation to provide pensions a heavy burden but its distribution among enterprises produces distortions and inequities.

- Medical care—obligations in respect of the medical treatment of workers and their families add substantial costs to enterprises and can lead to administrative problems and inequities in the provision of health services.

- Housing—a substantial resource commitment.

- Other welfare and service facilities—schools, canteens, hostels, kindergartens, transport facilities and other services can add to the resource costs of enterprises.

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In general, Mr. Hu points out, these responsibilities for social or welfare matters add substantially to the cost of labor for SOEs, reducing the resources that they have available for modernization of their productive facilities. They also take up management time and energy, which might otherwise focus upon improving productivity of the enterprise. Provision of health and other welfare services by enterprises rather than the community at large is often inefficient and/or inequitable and can impede labor mobility, adding to the surplus labor problem of SOEs.

Mr. Hu makes some interesting contents on the underlying causes of these problems and the difficulties of resolving them. I was particularly interested in his reference to the concept of "enterprises running small societies."

In some enterprises in market economies, there has been strong psychological attachment of employees to their enterprises, reinforced with provision of welfare and other services and facilities. The scale of such "small societies" would seldom have been comparable, however, to the situation described in China, with the possible exception of some large enterprises in Japan.

The main focus of Mr. Hu's paper, of course, is on the measures being already implemented and suggestions of further measures that might be adopted to reduce the burdens on SOEs created by these social and welfare obligations.

**Enterprise Costs and Prices**

Before commenting further on Mr. Hu's paper, I would like to take a step or two back to consider what burdens should be borne by an enterprise in a market economy.

In looking at this question, I want to put aside the question of what should be the general level of taxation imposed by a national government upon business enterprises within its jurisdiction. Assuming that such taxes are levied at uniform rates, their level will be dependent upon decisions based on society values, administrative capacities and a number of other general factors.

A basic principle in a market economy is that the costs of producing a product, including an appropriate return on the capital employed in its production, should be included in the price of that product. If some costs attributable to the production of a product are not borne by it, such as, if subsidized from some other source, the price will be too low and production will be too high. If extraneous costs are imposed on the cost of the product, or monopoly profits extracted, the price will be too high and production will be too low.

This is, of course, a very simplistic proposition, and there have been hundreds of books written qualifying, debating, elaborating this idea.
Another way of putting it, also subject to innumerable qualifications, is that it is important to get the price structure right if you want the most efficient allocation of resources, if you want to get the most out of your economy.

In many countries, there are quite extraordinary distortions in price structure, introduced for political or social reasons, often to placate special interest groups. It might not matter very much if rich countries wasted their resources, if only the burden did not ultimately fall upon the poor in those countries, which it often does, but it is very important that other countries do not do so and that they use their resources efficiently to improve the welfare of their people as quickly as possible.

It follows that in looking at measures to relieve SOEs of social or welfare burdens we need to have in mind the distinction between burdens or costs that are costs of production of the enterprises from those that are not. The distinction is often by no means clear-cut, for example in respect of health and medical treatment.

**Surplus Labor**

In respect of the problem of surplus workers, Mr. Hu points to two policy orientations: the first being to put the main emphasis upon action by the enterprise, with lesser emphasis upon social or government measures; the second orientation being to reverse these and to put the main emphasis upon the community rather than the enterprise.

The measures discussed by Mr. Hu clearly require substantial efforts by both the SOEs and the broader community, which seems entirely appropriate in view of the major economic transition being undertaken in China.

They involve a wide range of measures, first to identify the age profile and other characteristics of the people who have become surplus workers to determine those too old for further work and retraining and those who could be replaced in different occupations, with appropriate steps to place them where possible. The expansion of tertiary industry is given priority and “labor service enterprises” assist in the temporary placement of surplus workers as well as their primary target of assisting unemployed urban youth.

One interesting suggestion is that surplus workers be allowed to take their unemployment benefits as a lump sum to help them start a business of their own or in association with others, but with them being able to retain their participation in social insurance. It would need to be recognized in considering a proposal along these lines that the risk of failure is quite high in small business ventures, particularly when they are initiated by people whose previous work experience has been mainly with very large enterprises.
Mr. Hu properly points out that a fundamental requirement is to improve the labor market so that labor can flow more freely to where it is needed in an expanding economy. An improved unemployment insurance system is an urgent priority.

I think that Mr. Hu has given us some valuable insights in this important section of his paper.

Two other questions occur to me, which would presumably need to be discussed elsewhere, but which could be relevant to the size of the surplus labor problem:

- Is the cost of capital to SOEs too low and too much labor being displaced;
- Is a crucial constraint preventing more rapid expansion of existing enterprises and creation of new ones to take up surplus labor to be found in shortages of experienced or trained managers?

The answers to these questions would have implications for the operations and training programs of SOEs as well as more broadly based national policies and programs.

**Pensions**

Mr. Hu explains very well the complexities in measures to shift the burden of providing retirement income for workers from SOEs to society as a whole.

They stem not only from the financial and other problems of moving from one structure of pension provision to another, but also from the effects of:

- moving toward a market economy;
- the rapid increase in life expectancy and the increase in the proportion of pensioners to workers—the “aging” of the population; and
- increasing living standards and expectations of improved living standards in retirement.

The World Bank study on the aging of the population (*Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, The World Bank: Oxford University Press, 1994) showed that this is a worldwide phenomenon with far-reaching financial and social implications. The long-term viability and adequacy of social security and pension schemes may be in question and the need for their review is being recognized in many countries.

As Mr. Hu has pointed out, there are different views on how best to respond to changing requirements of a retirement income system in the changing circumstances of China. Some put more emphasis upon the incentive effects of retirement savings
arrangements that reflect earning levels during employment, and others put more emphasis upon guaranteeing basic living standards for all workers in retirement and the narrowing of income disparities. He suggests a third approach that incorporates views from the two sides, with the pension system having three parts:

- a public annuity or pension;
- a professional annuity or supplementary enterprise insurance, and
- a private annuity or personal savings insurance.

I could not help but be struck by the similarity in concept with the system in my own country, although the details differ. Our system includes:

- a publicly funded age pension, based on a proportion of average weekly levels, available to all who need it (that is, subject to a needs or “means” test), the pension being at a flat rate financed out of general taxation, not personal or enterprise contributions;
- an occupational superannuation system that provides for contributions from enterprises and their employees assisted by concessional taxation treatment, with compulsory minimum levels of contribution to rise to 15 percent of earnings supplemented by voluntary contributions; and
- personal savings to provide additional benefits for retirement on a voluntary basis.

Other countries have also introduced or are exploring similar multilayered systems to respond to the changing needs for retirement income provision.

In his discussion of the more detailed questions and problems to be considered, Mr. Hu raises two main categories of issues:

- transitional problems in moving from the existing arrangements to a new system, including the important one of how to avoid “robbing the poor to aid the rich”; and
- system design issues involved in reaching long-run sustainable retirement income arrangements.

The transitional problems are very important and usually very difficult. It is important to get the right answers to them because of the very long lead times unavoidably involved. It can take three or four decades before the way a new system works in practice can be properly tested. In that period, large numbers of retirees will be
partly dependent on the old system and partly on the new one. If they are not treated fairly the new one will be discredited. It is difficult because the complexities of the new system are supposed upon those of the old.

I will confine my remarks to a few observations and questions on the system design.

The preference for a pension based on some relationship with an employee’s earnings, a defined benefit or promised benefit system as against an accumulation system would be fully endorsed by many of the superannuation experts in my country, particularly the actuaries. This system gives the worker an assurance as to what his or her pension will be. It depends, however, on an underlying guarantee that resources will be available to meet all pension obligations, even if the contributions and the interest or earnings on those contributions fall short of the necessary amount. This is not always a straightforward matter, whether the guarantee is given by a government or a major enterprise.

When it came to the design of improved retirement savings arrangements in Australia, trade unions representing the workers preferred the development of accumulation-style funds established on an industry basis, not managed or controlled by government but by independent boards of trustees, half of whom represented the workers and half represented by employers or enterprises. It might be said that in forgoing the security of defined benefit schemes the workers’ representatives chose the potential for higher benefits if their management and investment of the funds achieved consistently higher earnings than the interest they might expect from a government-controlled and managed system. Only time will tell whether this choice was in their interests, but at this stage, in spite of fluctuations in investment earnings, there is no suggestion of a desire on the part of the trade unions for a change in the basic design of the system.

At the macro level, a system of this kind with a large number of funds controlled by separate boards of trustees has the effect of decentralizing the management and investment of savings for retirement but it requires centralized prudential regulation of the funds. Decentralized investment is seen as likely to be more efficient and more responsive to the changing needs of a market economy than centralized management by government. Indeed, some criticisms have been made that trustees’ investment strategies are too cautious and do not provide investment to meet the needs of small business and new ventures. In general, nevertheless, the consensus view is that the growth of long-term savings for retirement through this system of decentralized management and investment will make an important contribution to the provision of resources for the growth and development of the economy.

From the viewpoint of the enterprise, whatever system is chosen it is likely to the channel for contributions to be made on behalf of its employees for their retirement
savings. It does not necessarily follow that these contributions are an impost on the enterprise itself and reduce the resources that would otherwise be available to it. It is argued by trade unions that such contributions are taken into account by employers in wage negotiations with their workers and in the final analysis the cost is borne by the workers, not the enterprise. In the case of defined benefit funds, however, where the enterprise guarantees the final benefit, there is clearly a contingent obligation carried by the enterprise.

Where the burden would actually fall in China or any other particular country would depend on the labor market and wage determination system there, as well as the nature of the market for the products of the enterprise.

To the extent that the enterprise wished to use the retirement benefits it offered to its employees over and above any compulsory uniform requirements in order to attract and hold its labor force in a competitive environment, it would probably wish to maintain its own pension scheme. The costs of doing so should properly be regarded as part of the costs of its operations and not passed on to society as a whole.

Medical Care

Mr. Hu outlines measures to alleviate the medical care burden on enterprises, the general goal being to guarantee proper medical treatment for each worker when necessary and to reduce the waste of medical resources.

This objective would be shared by many countries but I suspect that few would claim to have satisfactorily achieved it.

The measures described in Mr. Hu's paper seem well designed to move toward the objectives outlined.

In some countries enterprises play a major part in providing health insurance for their employees, but in many others it is organized on a national basis.

Even where health insurance is organized nationally, many businesses, I understand, are taking a closer interest in maintaining the health of their employees, not simply of ensuring that they are cared for when they are ill, but perhaps more importantly of encouraging them to develop a healthy lifestyle. My impression is that this might be part of the Chinese way. I would be interested in any comments Mr. Hu might like to add on this aspect.
Housing

To reduce the burdens on SOEs arising from the obligation to provide housing for their workers, Mr. Hu suggests a number of measures designed to move the housing and real estate units in the enterprises into fully or partially independent commercial entities.

These proposals would seem the right way to go. They would possibly also offer some opportunity to take up surplus labor from the enterprise if the new housing and real estate development businesses established through this process were able to expand to meet the needs of a broader market.

Other Welfare and Service Activities

A similar process of separating from the core business of the SOEs is envisaged in relation to facilities such as schools, hospitals, canteens, shops and the like, with the acknowledgment that some of these facilities, such as schools and hospitals, would need to be brought within community or provincial systems and others could be established as commercial enterprises.

Conclusion

I would like to congratulate Mr. Hu on a very thoughtful and comprehensive paper. He makes clear that the task before the Chinese authorities and the SOEs in moving toward a socialist market economy is indeed a challenging one. There are complex and difficult issues to be tackled, some of which will take a considerable period to make the necessary structural changes before these issues can be fully resolved.
RESTRICTURING LARGE STATE-OWNED ENTERPRISES: INTERNAL MECHANISMS FOR ALLOCATING RESOURCES AS A SUBSTITUTE FOR THE MARKET

Qin Xiao

MICROECONOMIC RESTRUCTURING: PROGRESS AND PROBLEMS

China is experiencing a historic process of microeconomic restructuring. Compared with more than a decade ago, profound changes have taken place both in terms of existing facilities and new ones. Governments at various levels have gradually removed themselves from the operations of enterprises. Economies of scale and the specialization of labor have prompted corporate mergers and regroupings, bringing into existence an increasing number of large corporations and enterprise groups. Township enterprises and foreign-funded enterprises have been spreading vigorously from the coastal regions to the interior of the country and have become a major force of the national economy. The establishment of stock markets has signaled the creation of capital market, which has enhanced the liquidity of assets as well as enterprises' capability for fund-raising, thus expanding the room for resource reallocation. Financial reforms are turning the traditional policy banks into commercial banks, various financial services including insurance securities and fund management have become new fast-growing industries, and new companies specializing in these services have sprung up. While the restructuring of foreign trade has deprived the state-owned trade companies of their monopoly status, China's fast-expanding imports and exports have offered them a good opportunity to become international trading companies. The reform of the science and technology system has accelerated the commercialization of scientific and technological achievements and initiated the emergence of a high-tech industry spearheaded by microelectronic technology. China International Trust & Investment Corporation (CITIC), China's first international conglomerate that incorporates industry with finance, has provided a successful new model for the reform of large state-owned enterprises (LSEs).

Corporatization, conglomeration, specialization, and internationalization have become current trends in China's microeconomic restructuring of most enterprises. Reform of enterprise structures and operating mechanisms has become a pressing issue

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that calls for study and resolution. This is not only necessary for modern production and management activities, but also a prerequisite for deeper reform of most enterprises and transformation of their operating mechanisms.

The transformation of LSEs has proven to be an especially difficult process. Although corporatization and market forces have been introduced in some industries and sectors, these giants on the whole are still finding themselves in a tight corner. LSEs are playing a predominant role in China's national economy, which can be seen from their industrial distribution, assets, workforce, tax contributions and market shares.[1] The problems faced by these enterprises have now, therefore, gone beyond the micro level, and become a major constraint for China's development and reform, both at present and in the future.

The reform of China's LSEs has traveled a very twisted way since the early 1980s, from "decentralization and profit sharing" to the "two-step process of replacing profit delivery with tax payment," "contract responsibility system," then to "shareholding system" and the "transformation of operating mechanism," to name just a few landmarks. The idea of building a "modern enterprise system," which for the first time outlines the objective model for enterprise reforms, indicates that the reform has gone from the stage of policy adjustment to the stage of institutional innovation. As a result, both the academic and business communities have begun a new round of discussion and experimentation.

The issue of property rights is now drawing the most attention. Within the framework of a modern enterprise system, it is undoubtedly very important to separate enterprises from government, to clearly define the property rights, and to establish a social security system. Furthermore, as China is in the process of transformation, raising and solving these problems is of particular significance at the macro level. But as far as a modern enterprise system is concerned, the core issue is the organizational structure and operating mechanism of the enterprises. The issue of property rights is an initial or boundary condition, not the objective function itself. In other words, it is a necessary prerequisite, but not a sufficient prerequisite. Overemphasizing this issue, or regarding the issue as the sole and decisive one, is not only a deviation from our concern, but also has a misleading impact on practice.

In a broader sense, the issue of organizational structure and operating mechanism of an enterprise is in fact an issue of scientific modern management. The core issue is to incorporate management into the framework of a modern enterprise system. The management of a large enterprise can be divided into two tiers. The first tier is the management of the production and operation of the subordinating plants or companies of the large enterprise. The Taylor System turned the issue into a specialized subject, namely the science of management or the Theory of the Firm. Behavior Science, which emerged in the late 1960s, developed the Theory of the Firm to a new stage. In China,
we summarized this tier in six words: "personnel, finance, material, production, purchase and sales." The contents of the six words have changed quite a lot during the course of transition from the former production units under the central planning system to a modern enterprise system in the present-day market environment. Internationally, recent years have seen new development and breakthroughs of scientific management at this tier both in theory and in practice.\[2\] By its basic nature, scientific production management should become an important component of a modern enterprise system. However, this issue does not get adequate attention in the ongoing reform of LSEs.

The second tier of scientific modern management is the internal organizational structure and operating mechanism of the large enterprises themselves. Classical economics regards the enterprise as a black box, which is supposed to be rational or, in other words, it seeks maximum benefits and interests. The price signals that reflect the market supply-demand relationship can then be regarded as an invisible hand, which optimizes the allocation of scarce resources. As far as the enterprises' internal organizational structure is concerned, there were no scientific descriptions and explanations of how the price signals are processed (namely, the decision-making process). Coase's Theory of Transaction Costs has brought about a breakthrough in this respect. The "black box" of the enterprise was thus decoded. This represents the creation of the Modern Theory of the Firm, which regards the enterprise as a form of organization. Organization and market are two different ways of resource allocation, both of which incur corresponding transaction costs or organization costs. To reduce these costs, organizations substitute for the market. The emergence of large modern enterprises is not only a requirement of economies of scale, but also a demonstration of human efforts to reduce the costs of market transactions by allocating resources through organizational means. The substitution of market by organization in resource allocation has a price: the defects in the organization's incentive and information mechanisms, which are caused primarily by the "agency problem." (We shall discuss the Theory of Transaction Costs and Agent Issue in the following section.) The head office of a large enterprise does not directly participate in the management of the personnel, finance, material, production, purchase and sales of its subordinate factories. There are two aspects of the roles and functions of the head office of a large enterprise: one is to improve the enterprise's organizational structure and operating mechanism so that the gain of the substitution of organization for market can be realized; the other is to constrain the "agent" through institutional arrangements so as to overcome and reduce the agent-related loss of organizational efficiency.

From the above analysis, we can see that the problems encountered in reforming LSEs can be classified into three layers within the framework of the modern enterprise system. The first is the initial or boundary conditions centering on the issue of property rights. The second is the optimization and improvement of resource allocation through organization, which centers on the internal organizational structure and operating mechanism of large enterprises. The third is the modern, scientific management of
personnel, finance, material, production, supply and marketing of its subordinate factories.

The first issue straddles across micro and macro levels, whose resolution requires not only the clarification of the corporate property and the establishment of the structure of corporate governance, but also the establishment of a series of macro-institutional environments. The initial and boundary conditions as we refer here are not a point of time or a line in space in the strict sense of mathematics. The changes and innovations of institutions are a process of evolution. Regarding the issue of property rights in terms of absolutes is not only erroneous in theory, but also renders the issue inoperable in practice.

The second issue is a problem yet to be raised and explored. It also constitutes the core of a modern enterprise system, which has major theoretical and practical implications for the reform of China’s LSEs. The third issue is in fact an important internal cause of the difficulties faced by LSEs. This issue was ignored for a considerable period of time due to the absolute interpretation of property rights. The situation has somewhat improved recently.

The Modern Theory of the Firm and the practice of large international companies indicate that if we regard the second layer, namely the functions of the head office of a large enterprise, as the micro level, then the third layer should be called the “micro-micro” level. The “micro-micro” level is primarily production management, rather than a “profit center” in a strict sense. It is also different from the “independent legal entity” as is generally understood in a market environment. Therefore decentralization, especially that of financial and personnel powers, is out of question. This layer, too, should not develop itself in isolation from the head office’s overall strategy. All these policy contentions originate from a misconception that has confused the micro and “micro-micro” layers. The result is that every layer in a large enterprise asks for independence and decentralization. This is very harmful to resource reallocation through organization in the reform process. Another cause is that China’s large enterprises are still in the formative stage. The roles and functions of their head offices are yet to be understood and explored, while the disintegration of the old central planning system has left an institutional vacuum.

This paper applies some research results in the field of Modern Theory of the Firm and the experiences of modern international enterprises to the realities of LSEs that attempt to establish a modern enterprise system. It presents a preliminary framework for reform of the internal organizational structure and operating mechanism at the second layer—large enterprises’ head offices. We hope that this effort will stimulate more studies and practices.
We would like to begin with a brief introduction of relevant theories and methods concerning the modern enterprise system in order to lay a necessary foundation for the exposition of the framework.[3]

**MODERN ENTERPRISE SYSTEM: THEORIES AND METHODS**

Institutional Economics holds that transactions on the market and the management within the firm (which in essence is also a form of transaction, namely the transfer of rights) are two means of resource allocations, both of which incur "transaction costs," a kind of operational cost that differs from production cost. Transaction costs arise primarily in the acquisition and processing of information, negotiations between two parties, and the implementation and supervision of agreed contracts. In this sense, the enterprise can act as a substitute for the market. In other words, a vertical administrative organization featuring centralized decision-making, artificial structure and hierarchical management is utilized to replace a spontaneously formed horizontal system of market exchange characterized by decentralized decision-making and free competition. The decisive factor for this substitution to take place is the reduction of transaction costs.

An enterprise system is a component part of the entire framework of social and economic institutions. Through formal and informal constraints, this system provides a relatively stable structure for the enterprise’s external transactions and internal organizational management. The core of the system is the enterprise’s internal organizational structure and the rules governing its operation.

The modern enterprise system was born and developed early this century along with the emergence of large modern enterprises. The system is a prerequisite for modern production and results from the efforts to reduce transaction (organization) costs. The system’s main characteristics are the separation of ownership and management, manifested in different forms of hierarchical structure within an enterprise.

The emergence of the professional manager and the hierarchical structure represent a breakthrough in the evolution of the modern enterprise system. It has enabled the enterprise’s management and decision-making to become specialized and scientific. The hierarchical structure is a form of the enterprise’s internal organization based on functions and specialization, which provides institutionalized constraints over the external transactions and internal operations of the enterprise. The hierarchical structure is like a pyramid that is vertical and is divided into different layers. It is a reflection of the distribution of information resources and powers within the enterprise. At the top of the pyramid, the enterprise’s highest authority or head office possesses the largest amount of information and the greatest decision-making power. Next to it down the pyramid is a series of principal-agent relationships in which information and powers are entrusted or delegated from one layer to the next. In essence, this relationship is a contractual relationship between two subjects, each of which has its own interests and objective
functions. How to supervise and stimulate these agents to pursue and realize the fundamental interests of the principal is a major issue confronting the modern enterprise system. In this sense, the introduction of hierarchical structure has also paid a price while reducing the transaction costs and improving the resource allocation: "bureaucracy failure" in place of "market failure." The American economist H. Leibenstein called this phenomenon "X-Inefficiency," namely the low efficiency caused by organizational factors. The development and innovation of the hierarchical structure is precisely aimed to minimize the negative effects of the agency problem on the enterprise while reducing transaction costs.

In accordance with A. Chandler, Jr.'s research, O.E. Williamson divided the internal hierarchical structure in enterprises into three basic forms: U-type (unitary structure), H-type (holding structure) and M-type (multidivisional structure).

The U-type structure is generally called the functional organization. It is highly centralized, adopted mostly by small and medium enterprises engaged in a specialized business (or turning out a single product). The H-type refers to the structure of holding companies that are engaged in diversified operations. Its subsidiaries are independent of each other; their products are unrelated; and each of them enjoys a fair degree of autonomy in its operation. The holding company has no clearly defined, overall development orientation and strategy, and its resource allocation is determined primarily by the financial performances of its subsidiaries. This form of management is similar to the fund management of institutional investors. Due to the lack of clearly defined development and operational strategies and due to their loose internal structures, the H-type companies often fail to demonstrate their long-term efficiency and overall vitality in an increasingly competitive market. Prompted by the emergence of various investment funds and asset management services, the predominance of the H-type companies among the large corporations was gradually taken over by the M-type companies in the late 1970s.

The M-type structure is an offspring of U-type and H-type structures through development and evolution. It is a structure for large companies that integrates decentralization and centralization, with an emphasis on overall efficiency. The M-type structure is composed of three interrelated layers. The head office, made up of the board of directors and the company executives, is the highest decision-making body. It is different both from the head office in the U-type structure, which directly participates in the day-to-day management of subsidiaries, and from that of the H-type structure, which is basically an empty shell. This layer's primary function is to develop strategies and coordinate internal transactions. The second layer comprises the functional departments as well as the supporting and service departments. The planning department at this layer carries out the company's strategy studies, which provides the head office with the options of operating strategies and related policy proposals. It also gives guidance to the subsidiaries in compiling their annual, medium and long-term business plans in
accordance with the head office's overall strategies. It is responsible for reviewing and approving these plans, as well as monitoring their implementation. The finance of the M-type companies is centrally controlled. The financial department is responsible for the fund-raising, budget and tax arrangements of the entire company. Each subsidiary is just an accounting unit under this umbrella. The third layer are the interrelated and mutually independent subsidiaries, which conduct the core businesses of the company. Each subsidiary is, in fact, a U-type structure. The head office's resource allocation and internal transaction coordination are not solely based on the financial performances of individual subsidiaries. More importance is attached to the company's strategic emphasis and overall optimization. In the eyes of the head office, the subsidiaries are only production units or operating units that produce certain products or provide certain services under the company's unified business strategy. They are neither "profit centers" nor "investment centers" in their real sense. The executives of subsidiaries are only agents, entrusted by the head office to manage a certain proportion of the company's assets or operations. They are not supposed to act as representatives of the interests of their subsidiaries. The M-type structure is more centralized. It emphasizes overall optimization, and has a stronger ability to develop and implement business strategies and to coordinate internal transactions. This structure has consequently become the mainstream form of the hierarchical structure for large corporations in the world, especially in North America and Europe.\[4\]

**OPTIONS OF STRUCTURAL MODELS: CENTRALIZATION VERSUS DECENTRALIZATION**

A structural model of a company, namely the organizational form of its hierarchical structure, is a company's internal framework, which to a considerable extent determines its operating mechanism and its means of internal transaction coordination.

The theory and practice of the hierarchical structure is a major topic in China's reform of LSEs. This is because:

- The development of a socialist market economy and the building of a modern enterprise system have prompted the corporatization of LSEs. In other words, the production units that used to operate under government mandatory controls in a centrally planned economy are turning into independent legal entities, which are autonomous in operation and are solely responsible for their profits and losses in a market environment. This change in nature and behavior is a result of different institutional arrangements. Within enterprises, corporatization is a process of establishing and improving the structure of corporate governance and its corresponding hierarchical structure. Ignoring this point or simply replacing the signboards of a factory with one of a company will inevitably lead to abortive corporatization. The actual situation in corporatizing LSEs has proved how serious the problem is.
Economies of scale and scope represent the trend in the development of modern enterprises. In China today, they are the fundamental driving forces behind the accelerated mergers and regrouping of enterprises, creating a so-called conglomerate phenomenon. In another sense, the emergence of large companies represents the substitution of organization for market, that is, reducing the costs of market transactions by internalizing resource allocation and transaction coordination. The extent to which this goal can be achieved depends heavily on the operating efficiency and the capability of a company’s hierarchical structure. Our investigation finds that many companies of considerable size are still adopting a highly centralized U-type hierarchical structure to manage their business. This, of course, has greatly increased the costs of organizational management and seriously impeded the enterprise’s growth and vitality. At the same time, some large, specialized companies with industrial backgrounds have shifted from the U-type structure to the H-type structure. As a result, their head offices have become an empty shell, and have lost both their authority over internal resource allocation and their competitive edge in particular fields. The overall strength of the companies has thus been drastically weakened.

How to handle the relationship between the head office and its subsidiaries is a major issue in the operation of the hierarchical structure of large companies. This relationship reflects the degree of centralization and decentralization, as well as the degree of market mechanism within an organization. In China, how the large companies should administer their subsidiaries has always been a puzzling subject. More often than not, centralization and decentralization go to their extremes. One of the reasons is the theoretical misconception that regards subsidiaries as ordinary companies in the market and overemphasizes their independence. Excessive decentralization, operational autonomy and growth of subsidiaries on their own within a group will only lead to too many “profit centers” or even “investment centers.” This is obviously a distortion of the relationship between a parent company and its subsidiaries. When it comes to management, the so-called profit contract system is widely adopted. Such an organizational structure has largely lost its advantages in allocating resources and reducing internal transaction (organization) costs. The theory of the M-type structure and its success in practice has offered a useful model for China’s LSEs in designing their organizational structure and in managing their subsidiaries.

A crucial component of the M-type structure is the second layer between the head office and the subsidiaries. This layer includes the functional departments of planning, finance, personnel, auditing and legal affairs, all of which are the principal divisions for the head office to carry out strategic studies, coordinate internal transactions and supervise the subsidiaries.
at the second layer, the departments of information, research and development (R&D), and market development are all specialized noncommercial departments whose resources are shared by the entire company. As an institutionalized arrangement, this layer ensures an orderly operation of the company, makes its decision-making process more scientific; the management is therefore strengthened and operational risks minimized.

This layer is rather weak in China’s LSEs. The management responsibility of a company is largely delegated to the deputy general managers, and the company’s major decisions and their implementation also lack the support of the functional departments. To realize a standardized, functional and scientific management is still a long and arduous process.

- Apart from the contents and degrees of centralization and decentralization, a more important merit of the M-type structure adopted by large corporations is the head office’s functions of strategic studies and internal transaction coordination. Small and medium-size companies do not have these functions, nor did the LSEs under the traditional central planning system. These two functions of the head office exert an important impact on how its resources are allocated; they have changed the structure of the market and therefore been called “the Second Visible Hand,” next to the government. The functions of organization, the substitution of organization for market, the innovation of organizational structure, and the efficiency of allocating resources through an organization have all become major theoretical and practical issues for the reform of China’s LSEs.

Internal transaction coordination is in fact a mode in which mandatory means, or mandatory plus paramarket means, are used to allocate resources within a company. Its most important aspect is the execution of the company’s internal transactions and the determination of “Transfer Prices.” Transfer prices are the prices at which “profit centers” within a company carry out exchanges of assets or commodities (or services). In the U-type structure there are no such “profit centers,” and the head office resorts to mandatory means in resource allocation. As for the H-type structure, internal transactions have basically become external transactions or market transactions. Within the M-type structure, internal transactions play a very important role, and are quite different in nature from the transactions on the capital market or commodity (or services) markets. Prices are determined so as to maximize the company’s overall benefit, and they can be in the form of mandatory cost price, mandatory market-based price and free-market price under different circumstances.

In the course of corporatization of LSEs and in the formation of conglomerates, more attention needs to be paid to the study and the cultivation of the functions of internal transaction coordination and strategic studies so as to promote large companies’
growth and to enable them to take full advantage of their organizational ability to allocate resources in a market environment.

In this section, we have discussed company models, introduced the principal types of hierarchical structure, and made a comparison and an evaluation of them in light of the realities of China’s LSEs. It should be noted that the so-called structures of U-type, H-type and M-type are merely a theoretical abstraction (and the theory has made new and major progress in recent years). Real life, especially the realities of China’s LSEs in the transitional period, are much richer and more complicated. Further discussions are necessary if we wish to build a corporate model of our own in light of China’s practical conditions.

**DETERMINATION OF BUSINESS STRATEGY: ORIENTATION AND STRUCTURE**

In a changing market environment full of uncertainties, the decisionmakers of a company have to respond in a timely manner to the external changes. More importantly, they should be able to determine the company’s own orientation and objectives in a longer time span and with greater scope. It is the issue of a company’s business strategy determination that we now discuss.

The research and implementation of the business strategies of a large company have the following six aspects:

1. **The Fields and Regions of the Company Development.** First of all, the company must decide whether to enter into or quit a certain market under certain circumstances. In the aftermath of the oil crisis in the 1970s, some major oil companies moved into the coal industry in order to prevent coal from becoming a competitor to their oil products. In the 1980s, IBM decided to enter the personal computer market because the success and momentum of growth of Apple, Wang Laboratories and others in this field were beginning to threaten IBM’s dominance in the computer industry. In the early 1990s, Australia’s largest aluminum company, CRA, decided to withdraw from the downstream processing businesses and concentrate on aluminum-smelting operations where it enjoyed a competitive edge.

Another major decision is the determination of key regions. For example, many international institutional investors have in recent years adjusted the composition of their investment portfolios, and massively entered into the Chinese and southeast Asian markets with funds drawn from the emerging markets in Latin America. Another case is that Australia’s mining companies are beginning to shift their market emphasis from Japan and Korea to China. The decision of entry or exit is primarily based on a company’s perception of its comparative advantage in reallocation of resources and on the assessment of costs
of the entry or exit, while determination of key regions reflects the readjustment of the company's global strategy.

2. **The Choice Between Specialization and Diversification.** The maturing of a market is accompanied by increasing degrees of specialization of labor, for it facilitates the concentration of limited resources to achieve higher competitiveness in specific areas. From a macro perspective, specialization of labor can make the utilization of the entire society's resources more effective and more rational. Since the middle of this century, specialization of labor has become a dominant trend of large international companies. Most of the 500 largest companies listed in *Fortune* are those specialized in certain products or services. However, diversification still has its place as an operational strategy, and is still fairly common in east and southeast Asia. This phenomenon reflects the historical, social and cultural differences between regions; it also has to do with the level of economic development and market growth.

In order to further evaluate and compare the two strategies, it is necessary to make a few more definitions. The Modern Theory of the Firm classifies enterprises into four categories according to their products: single product, main product, related products, and unrelated products. The first three produced by specialized companies while the last one by diversified companies. Even within a diversified conglomerate, its subsidiaries should in principle be specialized ones. The conglomerate as a whole should be supported by several core businesses. The so-called core businesses should reflect the proportions they take in of the total assets, income and profits of the company. A more important criterion is whether they have attained a certain scale and taken a certain market share. It is rare even in east and southeast Asia for a diversified company to handle unrelated products at all levels without core businesses. Such a company is unable to rationally and efficiently allocate its resources. Confronted by diverse, miscellaneous products and business fields, its operation cannot be sufficiently supported by capital, information, expertise and human resources. To overcome this shortcoming would require too high a cost. At the same time, the dispersion of resources caused by such diversification will impede the company's effort to gain economies of scale and market share in specialized fields.

Therefore, the choice of a diversified business strategy is in fact the determination of core businesses and fields. Diversification at all levels of a company cannot be called a business strategy at all.

3. **Adjustment of Product Mix.** One possible way is to transfer to different products. Some of China's state-owned armament plants have thoroughly remodeled themselves in recent years. For example, the Chongqing Jialing Group, which used to produce guns, is now China's major manufacturer of motorcycles.
This is actually industrial restructuring. One other way is to develop and promote new generations of products while maintaining a smooth transition between each generation. The third option is to readjust the product mix or develop new products according to market demand and the enterprise’s own comparative advantages so as to achieve a more rationalized mix of the products.

4. **Capital Structure and Fund-Raising.** Capital structure refers chiefly to the ratio between liabilities and assets. A rational, sound capital structure is a basic condition for a company to develop and operate; it also demonstrates its strength and risk-bearing capacity. The criteria for a sound, rational capital structure vary in different industries and at different stages of a company’s growth. Generally speaking, the debt-equity ratio can be relatively higher for financial, service and trade businesses, while machinery, chemical and mining industries should be well-capitalized. The debt-equity ratio is usually higher for a company in its early years or during the construction of large investment projects. However, when a company is more mature or during the period of investment recovery, the company’s debts should go back to a normal level. These are qualitative criteria. How can they be judged and controlled quantitatively? A company’s debt level is really determined by the market in a well-developed market environment. When a company is borrowing from banks or raising funds from the market, the two sides constitute a supply and demand relationship. In a broad sense, the capital market is highly competitive. If the company’s capital structure is poorer than its peers, it will find itself hard to enter into this market, or it will have to pay higher prices, such as shareholders’ guarantee, assets mortgage and a higher interest rate.

The method of fund-raising refers primarily to the selection of direct or indirect fund-raising. Direct fund-raising includes the seeking of joint-venture partners and listing on stock markets. Indirect fund-raising includes borrowing bank loans and issuing bonds. Either of the two ways has merits and weaknesses. In general, most companies raise funds in the indirect ways.

The two choices are different not merely in methods. A listed company is substantially different from an unlisted one in operation, management and development. We may say they are two different games governed by different rules.

5. **Priority of Scale or Efficiency.** Driven by the requirement of economic scale and the substitution of market by organization in allocating resources, the concentration of industrial scales, the rivalry for market shares, the emergence of large corporate groups and their impact on market structure have all been important events of the world economy in this century.
In the course of the formation and development of large companies, a question is often raised: which is the priority, scale or efficiency? The two goals are essentially interdependent in the long run. But at a certain stage of development of a company with limited resources, the two are at each other's expenses and cannot be achieved simultaneously. If one wants scale and greater market share as fast as possible, one must increase input and borrowing, and accept relatively low investment returns, sales profits and even losses during a certain period of time. On the other hand, if quicker investment recovery and better corporate capital structure are the priority, one must then slow down the pace of expansion and be prepared to tolerate the market share erosion by competitors.

These two business strategies are also described as market share-oriented and profit distribution-oriented. In general, strategic investors place more emphasis on scale and market share, while institutional investors pay more attention to investment returns. In practice, a company's capability, and the space and opportunity present under a given environment also have an impact on which orientation should be selected. Once an orientation is chosen, attention should be paid to the balance between the two objectives and the timing of changes in priority.

6. **Combination of Production, Finance and Trade.** Large companies are usually involved in production, finance and trade, or a combination of the three. The dependence of manufacturing companies on the market prompts the integration of production and trade, and brings into existence the enterprise groups that have stronger market-development capability, called "Industrial and Trading Companies" in China. In a modern economy, finance is playing an increasingly greater role. Financial groups come into being as a result of the integration of industrial capital and banking capital. Merchant banks have become the most active and fastest-growing financial institutions since the end of World War II. With capital markets as their principal venues of operations, merchant banks deal in securities, bonds, fund management and offer their clients a variety of financial products and services. In addition, they are also engaged in financial investment activities. Large trading houses primarily carry out international buying and selling of large amounts of commodities on behalf of their customers. They are also engaged in trading-related project investments in order to secure the supply of goods. These combinations are subject to certain legal regulations in various countries. For example, commercial banks are not allowed to undertake trading activities, and their direct investment is also subject to certain restrictions.

At a certain stage of growth, large companies inevitably have to make strategic choices between the combinations of product, finance and trade. Once
one form of combination is chosen, the nature and orientation of the company are also determined.

From the above six aspects, we can see that the so-called business strategy is, in the final analysis, an issue of operational orientation and operational structure of a company. Any neglect of this important issue will result in flawed decisions and bring about loss of opportunities in the company’s growth.

At present, serious attention needs to be paid to certain tendencies concerning the business strategies of China’s LSEs. They are seen in the following phenomena:

(a) The importance of business strategies is not fully understood or its function is totally unexploited. Some companies chase excessive growth without the guidance of overall business strategies.

(b) Policy decisions on entering into new markets, new fields and new regions such as securities, futures, real estate and overseas investment, are made blindly or in a rush, without adequate backing of prudent assessment of opportunities and risks, or without adequate support of resources (capital, expertise and personnel).

(c) Instead of fully utilizing their limited resources to consolidate and develop their core businesses, some companies are moving toward a structure of diversified unrelated products at every level;

(d) More emphasis is put on total assets instead of capital structure and product mix as well as their rationalization; and more attention is paid to production management; while ignoring marketing and financing;

In the course of introducing the modern enterprise system to complete the process of corporatization, China’s LSEs should put more emphasis on utilization of their functions of business strategy development and implementation and have these functions institutionalized.

POLICY SETTING: INCENTIVES AND CONSTRAINTS

In order to ensure that their operations do not deviate from the preset business strategies and that the chosen hierarchical structure functions efficiently, companies should formulate corresponding policies and criteria.

Policies and criteria are a set of principles that regulate and constrain the external transactions of the companies. The market is always full of temptations and pitfalls. Risk is a fundamental constraint for the companies’ operations and development. The formulation of policies and criteria is to provide institutionalized rules or standards in the
companies' external transactions in order to minimize risks. The cost of the rules is the decrease of the space in which the company can maneuver. In this sense, policies and criteria lay down a principle for the companies to assess risks and opportunities.

The hierarchical structure in a company is an organizational administrative system whose functioning, including information transmission, internal transaction coordination, and making and implementing decisions, also requires corresponding policies and criteria to define, regulate and guide. Therefore, the internal function of the policies and criteria is to minimize the organizational costs so that the system can run more efficiently.

The incentive mechanism is a basis for the efficient operation of the company as an organization. Another major function of the policies is to regulate and institutionalize the incentive mechanism of the company.

A company's policies and criteria should have the following features:

- consistency and compatibility with the company's structural model and its business strategies;
- a comprehensive system that embraces all areas of activities of the company;
- uniformity across the entire company;
- high transparency, and
- relative stability.

A company's policies and criteria should cover the following contents:

- **Investment**: differentiation of investments of different natures such as strategic, financial or trade-related; selection of key investment fields; return rate and discount rate for different industries; minimum economic scale of a project; regional policies; share controlling or share participation; selection of partners; requirement on the liquidity of assets; and degrees of involvement in project management.

- **Trade**: acting as a principal or an agent; the range of commodities to be handled; credit checking on trading partners; contract terms; payment terms.

- **Funds and Finance**: borrowing policies; selection of project loans or corporate loans; principles on providing corporate guarantees and mortgages; selection and control of debt-equity ratio and liquidity ratio; terms of authority over the use of funds and approval procedures; risk management on exchange rates and interest rates; distribution of profits.
- **Human Resources**: educational and age structures of the company’s personnel; recruitment, appointment and dismissal; rewards and penalty; promotion and demotion; training and appraisal of the company’s managerial staff.

- **Organizational Setup**: Relations between new subsidiary and existing ones in terms of functions, industry fields and geographic regions; minimum targets (business turnover, profit, etc.) for the short, medium and long term.

- **Legal Affairs**: standards for contracts, agreements and other legal documents; legal skills and resources for major transactions and decisions.

- **Internal Transaction**: the arrangement of supply of products and services between subsidiaries and the setting of terms and prices for these transactions.

- **Internal Administration**: the company’s decision-making procedures; differentiation between centralization and decentralization; clarification of responsibilities, rights and benefits; control and supervision over the operations of subsidiaries.

The lack of a clearly defined, uniformly consistent and authoritative system of policies and criteria, together with elements of structural models, business strategy, has been highly responsible for a number of problems encountered in the course of the development of some LSEs: excessively diverse investment portfolios, fast expansion of organizations (subsidiaries), extraordinarily high gearing ratio, loss of control in internal administration, and negligence in decision-making.

The formulation, implementation and optimization of the system of policies and criteria should be treated as an “infrastructure project” for the establishment of the modern enterprise structure, and should occupy an important position in the ongoing reform of LSEs.

**HUMAN RESOURCES DEVELOPMENT: ALLOCATION AND OPTIMIZATION**

Organizational structure in itself is only a framework for regulating the behavior of an enterprise. The vitality of the enterprise comes from the resources it possesses and can further explore. In modern economic life, human resources are no doubt the most important of all resources. People are the most active elements and the most valuable assets of an enterprise. In this sense, the development, allocation and structural optimization of human resources constitute the decisive factor that ensure the effective functioning of the organizational structure of an enterprise.
Of the various factors that constrain the development and reform of LSEs, the issue of human resources has become all the more prominent. The following are three main manifestations.

- **Inadequate Development.** Many social and ideological factors inherent in or imposed on LSEs such as their difficult financial position, the deficient incentive mechanism, the egalitarian reward system, and the traditional promotion system by seniority have all contributed to a significant weakening of the attraction of LSEs, resulting in a heavy brain drain. The development of human resources, including recruitment, training, employment and upgrading, is lagging behind and unable to meet the needs of the enterprises' growth and reform.

- **Unbalanced Structures.** There are gaps between different age groups, and the aging problem is more or less plaguing all levels of leadership. Young and middle-aged managerial personnel who are qualified to take over top-level leadership of large companies are not coming up in orderly successive echelons.

  Their existing knowledge is also seriously aging. Scientific management and technology renovation and upgrading are not properly supported by human resources equipped with modern knowledge and skills.

  The mix of specialists is ill-balanced. The traditional concepts of personnel, finance, material, production, purchase and sales of an enterprise under the central planning system have to take on new meanings in a market environment. In the fields of finance and marketing in particular, the existing specialist personnel must be retrained. Senior professional managers and wise positioning of other specialized experts are needed if the head office of a large company wants to successfully perform its functions of the internal transaction coordination, the study and implementation of its operational strategies, the information system, internal control, legal affairs, tax arrangements, financial management, and fund-raising. In particular, the senior managerial personnel at the top level of an enterprise, such as its CEOs, should be able to devise strategies and exercise effective control over the operation of a large complex organizational system. They should also have a keen insight into external environment market trends and cycles; they must be good at seizing opportunities, and have a strong sense in detecting risks and self-protection. They should understand the importance of institutionalized management of the operations of the enterprises and be capable of integrating and coordinating the internal structure and resource allocation. Executives with these skills are in serious shortage in China's LSEs. A modern managerial stratum is yet to be seen.
• **Inappropriate Deployment.** The deployment of personnel is also a form of resource allocation. Even very talented people can be wasted or bring about negative effects if they are put in wrong positions.

Pioneering, innovative personnel, technical personnel with specialized expertise and know-how, and managerial personnel who are professionally trained for scientific management are three pillars of the management of a company. Innovation and exploration, or the so-called spirit of the entrepreneur in the West, are the sources of an enterprise’s vitality. The well-known economist Schumpeter holds that production, distribution and consumption in human society are only a static cycle of circulation in which values are simply transferred from one point to another. The realization of value, namely the real growth of the economy, is a result of constant disturbances imposed on the circle by innovative “entrepreneurs” who dare to bear risks. LSEs indeed need large numbers of such personnel with the “spirit of the entrepreneur” to drag themselves out of the quagmires and enter into the market.

A major feature of the modern enterprise system is that professional managers have replaced the “proprietors” who were at once owners and managers of their enterprises, called “entrepreneurs” in the West. A large modern enterprise is a mammoth, complex and highly technological organizational system. Its operations need professional managers. In the world today, the executives running large companies are virtually all professional managers. The emergence of managers has not only provided institutionalized support and control to those so-called capable persons but also ensured that the technical experts’ skills can be brought into full play. Another famous economist, Galbraith, called the “technological structure stratum” made up of managers and technical experts the most important element of production, which determines the growth and well-being of an enterprise. Therefore, professional managers are no doubt the core of an enterprise’s personnel structure.

In China’s academic and media communities, the professional managers are often called “entrepreneurs.” This is inaccurate because, in the first place, the term “entrepreneur” has a particular meaning and should not be misunderstood; secondly, it scales down the importance of managers. Such a misunderstanding has a negative impact in practice. The “entrepreneurs” or the enterprising “capable persons” as commonly described are generally long on creating and developing but short on integrating and managing. Their success has more to do with personal authority and charisma than scientific decision-making procedures and institutional constraint. They tend to emphasize opportunities but neglect risk-prevention mechanisms. While their strength and talents deserve encouragement and support, their weakness and shortcomings are not quite compatible with the modern enterprise system.
The slogan "experts run factories" is also inaccurate. The "experts" here actually stands for technological experts. The development of modern enterprises and the birth of the modern enterprise system have turned management into an independent branch of science. As a result, managing has also become a highly specialized profession. Senior executives of a large enterprise should have some technological background, but generally speaking, they are different from technological experts in terms of the roles they should assume and in the expertise, experience and abilities they should possess. Technological experts can of course turn into managers; but the cost and risk of such shift of role must be fully recognized.

In sum, what a modern enterprise system needs is a rational structure made up of three categories of personnel with professional managers as its core.

The development and the rational allocation of human resources, the optimization of the personnel structure are an important task for the reform of LSEs. Without significant improvement or breakthrough in this area, all reform efforts will eventually fail.

If we shift our attention from the micro-level enterprise for a moment, it is not difficult to see that the issue of human resources is a synthetic and complex problem which relates to a variety of fields and the in-depth structure of the society. It has a lot to do with the degree of social development, which is why it has become a bottleneck problem hindering the developing countries on their way to internationalization and economic takeoff. In this sense, its improvement will be a long and gradual process. Along with the formation and development of market mechanism, there will emerge a market demand for professional managers, especially for those of the large enterprises. In the beginning, there will be greater demand than supply, which will inevitably lead to the recognition of the importance of the managers and more talented people will be attracted to this profession. Tertiary education and adult education will also respond to the market demand and turn out more graduates of business and commerce. When supply and demand are approaching balance, the market will become more competitive. The influence of this gradual process has just begun to be felt in the managerial class of Chinese enterprises. But for the LSEs, the shortage of professional managerial personnel is still very acute because, apart from the overall social background previously discussed, the situation is further complicated by the existing personnel inherited from the traditional planned system. This has already become a major restrictive factor for the reform of LSEs. The solution to this problem cannot rely only on the spontaneous process of market development. The assessment of and comments on the issue here are designed to stress the issue's importance, to analyze its cause and explore ways of improving the situation under the current environment.
BUSINESS PLAN MANAGEMENT: SUPERVISION AND ASSESSMENT

The business plan is an internal management tool widely adopted by enterprises worldwide. As an organization, the enterprise's internal operation must center on the implementation and management of its business plan. A business plan comprises the annual, medium and long-term operational targets and implementation programs formulated by an enterprise in a changing and competitive market environment in accordance with its set business strategies, policies and criteria and with given resources and constraints. It guides and regulates the day-to-day operations of the managers at various levels of the enterprise and also provides a basis for the shareholders and higher authorities to monitor, supervise and assess its performance.

A business plan is a comprehensive operational program, which not only outlines the major production and financial targets of an enterprise, but more importantly contains a series of major structural adjustments related to these targets.

A business plan is also a principal channel and carrier for the transmission of information within an enterprise's internal organizational system. One of the main considerations in designing and operating an organizational structure is how to improve the organization's information mechanism. The process of formulating, approving, executing and assessing the business plan is also a process of information gathering, processing, transmission and feedback. As information is passed on vertically through the hierarchical structure, the information distortion and loss is reduced, the volume of information increased, and the speed of information transmission accelerated.

A business plan is also an important means by which the head office of a large enterprise carries out its overall strategy. The business plan of a subsidiary should not only meet the head office's financial requirement for maintaining and increasing shareholder equity, but also reflect the position and role of the subsidiary's operation and development in the head office's overall strategies. Therefore, the first step in compiling a business plan is for the head office to issue to the subsidiary guidelines that set the main principles and requirements, based on its overall strategy as well as the operational and organizational structure of the specific subsidiary.

A business plan covers the following main contents:

- **Assessment of external environment**: macroeconomic climate, current market conditions and medium-term development trend of the industry and region in which the enterprise operates and their possible impacts on the enterprise's operations in current fiscal year.

- **Self assessment**: the enterprise's position and competitiveness in the market, principal internal restraints on growth, possibilities and approaches to
optimize resource allocation, reassessment of its organizational structure strategies and policies.

- **Major operational targets (including some of the nonquantitative ones):** sales, costs, profit, cash flow, new investment, loan repayments, changes in shareholder equity, and the structural optimization of capital, funds, assets, products, organization and personnel.

- **Implementation programs:** concrete measures with timetables to be taken in resource allocation and internal administration in order to achieve the above-mentioned targets.

- **Budget:** the financial framework for the entire business plan, focusing on the sources and applications of funds.

- **Organizational arrangement:** breakdown of responsibilities and authority among various departments and staff, and the control mechanism.

A business plan comes into effect on approval by the head office. In the course of implementation, the subsidiary should regularly report to the head office on the actual progress in achieving the planned targets. In case major deviations occur, the subsidiary should submit an analysis or explanation and propose remedial measures. Business plans should have a standard format so as to facilitate comparative analyses and computer processing.

The business plan management system has not been introduced to China’s LSEs. The current approaches widely practiced and their problems are as follows.

- **“Contract Responsibility System.”** Under this system, the subsidiary signs up a profit contract or operational contract with the head office. It has been widely adopted and even regarded for a time as the right direction of reform. This system is intended to introduce the market mechanism into the organization to cope with incentive problems. The substitution of the market by organization is determined not only by their respective comparative advantages but also reflected within the organization—the H-type structure for example. However, contracting, especially the profit contract, is a mechanism incompatible with the organizational system. Its introduction has undermined the structure of organization, and deprived the organization of the functions and strengths in coordinating internal transactions and allocating internal resources, leading to a state of semidisintegration of the organization. This system encourages the subsidiaries to become discretionary entities seeking their own benefits and interests, and reduces the transparency of the subsidiaries’ operations and financial state. Negotiations of contract terms are often a difficult process of tough bargaining. This system may also create
opportunities for internal collusion and “insider’s control” at the expense of the company’s overall interests. Legally speaking, these kinds of contracts are neither tight nor enforceable. In practice, if the subsidiary fails to deliver, it does not have the obligation nor the ability to bear any legal and economic consequences. Therefore, this is a harmful, unworthy system, even as a transitional approach.

- **“Target Management.”** This is a system of management that relies on financial indicators with profit as the centerpiece. But quantitative indicators can only reflect the performance of an enterprise “to a certain extent.” The accounting system in China’s enterprises is not standardized and a strict auditing system is nonexistent; hence this is why I add “to a certain extent.” As to the structural aspects of the enterprise, nonquantitative indicators are even more difficult to set and assess. This system cannot ensure the full implementation of the head office’s overall strategies, policies and criteria. Though target management is one step forward compared with the contract responsibility system, essentially it still cannot make full utilization of the organization’s function of allocating resources.

- **“Vertical Management.”** This is the way in which the head office manages its subsidiaries, primarily through its functional departments of finance, planning personnel, etc. Through their own vertical channels, these departments independently and separately obtain information from and issue targets to their counterparts in the subsidiaries. In return, the subsidiaries also submit separate reports to those departments of the head office on matters such as capital requirement, project approval and personnel changes. A company’s operations are an organic whole; its running must be guided by an overall plan. “Vertical Management” can only be used as a component of the overall plan. Without an overall plan, this system is unable to provide the head office with a complete picture of the subsidiaries’ performance since the information that it carries is fragmentary, often one-sided and incomprehensive, intercrossing and even self-contradictory to some extent. Similarly, the subsidiaries are also unable to have an overall, clear understanding of the head office’s requirements and targets.

- **“Block Management.”** In this model, the deputy general managers at the head office directly take charge of each subsidiary, or are concurrently appointed chief executives of the subsidiaries. This management system will inevitably weaken the roles of the functional departments, and it will be impossible for the company to base its management on institutionalized and standardized programs. In most cases, this system will lead to a situation in which the subsidiaries have their own representatives of interests in the head
office, thus prompting internal conflicts and weakening the authority of the head office.

Introducing a business plan-centered internal management system to China’s LSEs is a path-breaking task, but it will be a long, complex and arduous process. Business plans, as comprehensive methods of management, will help upgrade the enterprises’ internal management system. They will also be of vital importance for LSEs to get out of their predicament, and to diagnose and solve their deep-rooted structural problems.

**Brief Conclusions**

In a deeper sense, the reform of China’s LSEs is a renovation of organizational forms and a reallocation of organizational resources. The organization has the function of substituting for the market in resource allocation. Realization of such substitution depends to a very large extent on the cost and efficiency of the internal institutional arrangement.

As a large company is an advanced modern form of organization, the establishment and working of its hierarchical structure and operating mechanism are designed to take full advantage of its organizational efficiency of resource allocation, as well as to minimize the loss arising from the agency problem. This has always been the focus for both the theory and practice of the modern enterprise system.

This paper has presented a preliminary framework for the internal organizational structure and operating mechanism of large companies by applying the method of the Modern Theory of the Firm to the realities in China’s LSEs. The effort is intended to draw the attention of policymakers, academia and the business community to this issue in order to promote the reform of China’s LSEs.
NOTES

[1] The State Statistical Bureau so far does not have special classification and statistics for LSEs. However, the views in this paper are based on the following data:

a. According to the State Economic and Trade Commission, by the end of 1993, there were a total of 360,000 industrial enterprises (those with independent accounting at or above township level). Of those, there were 71,600 state-owned industrial enterprises with independent accounting, making up 19 percent of the total; there were 14,400 large and medium-size SOEs, accounting for 4 percent. The total output of state-owned industrial enterprises accounted for 53 percent of that of all enterprises; and that of large and medium-size enterprises accounted for 44 percent. The net value of fixed assets of state-owned industrial enterprises accounted for 75 percent of that of all enterprises; that of large and medium-size enterprises accounted for 62 percent. The tax and profit realized by state industrial enterprises accounted for 66 percent of that of all enterprises; that of state-owned large and medium-size firms accounted for 59 percent.

b. The Enterprise Evaluation Center of the Management World journal and the Industry and Communications Department of State Statistical Bureau presented an evaluation report on the country's 500 largest enterprises and the 50 largest in each industry in 1994. The report analyzed and evaluated the 17,000 large and medium-size enterprises in 40 industries according to the ranking of their sales revenues. The findings conveyed important information on the large enterprises (especially state-owned large industrial enterprises). The statistics show that the total sales revenues and the contribution of tax and profit of the Top 500 accounted for about 27 percent and 40 percent, respectively, of those of industrial enterprises at or above township level with independent accounting. The lowest of sales volume of the Top 500 reached 570 million yuan. Nearly 60 percent of the Top 500 enterprises' achieved sales volumes exceeding 1 billion yuan. The Top 500 enterprises are mainly distributed in the capital-intensive industries including energy, metallurgy, petrochemical, chemical and machinery, all of which are of great importance to the national economy.

c. A widely accepted estimate on the loss suffered by SOEs is that, in 1993, 31.8 percent of the enterprises were in the red and, in September 1994, the figure rose to 44.5 percent, with the total loss amounting to 29.2 billion yuan. In terms of the distribution of loss-making large enterprises, coal mining, crude oil and machinery industries have long been making losses industrywide.
The above data help to understand the importance of state-owned large enterprises and the difficulties they are facing.

[2] In his book *Information, Incentives and Bargaining in the Japanese Economy*, well-known economist Masahiko Aoki compares the micro-micro organization and management structures adopted in Japan with those of the Western countries, represented by the United States. He believes that the former is a horizontally functioning model of production; the latter is a specialization-oriented vertical hierarchical model. The American companies tend to emphasize achieving efficiency through elaborate specialization and clear labor division. The Japanese enterprises, on the other hand, are inclined to enhance the ability of working teams to solve production problems on their own and the ability is largely gained by the workers through learning by doing and sharing skills and expertise with each other. This comparison not only reveals the difference between two management models, but also poses a challenge to the traditional enterprise management theory. His view no doubt provides a meaningful inspiration for China’s enterprise reform and for the study on the modern enterprise management with the Chinese characteristics.

[3] In regards to the theory and method of the modern enterprise system, refer to the author’s paper “Institution, Transaction Costs and the M-type Structure” published in the No. 6 issue of *Reform*, 1994. In conjunction with the theory and practice of the establishment of China’s modern enterprise system, the article discussed the meaning and function of the institution, theory of transaction costs, the substitution of market by organization, agency problem, X-Inefficiency theory and major hierarchical structures. The second section of this paper is a summary of the main points of that article.

[4] In Japan, after the financial oligarchies were compulsorily dismantled and holding companies were prohibited by law after World War 11, there emerged a unique structure characterized by overlapping shareholding between enterprises and the so-called main banks. This structure does not belong to H-type, it also differs from U- and M-types, but seems to be a mix of the two. It has been described by some scholars as the J-type (Japanese type).

[5] Refer to this author’s article “Conglomerate Strategy” for the “large company phenomenon.” The thesis was published in the No. 3 issue of *Management World* 1993. The author is of view that the emergence of large companies was an outcome of China’s economic development and reform in the past decade. The reason why it is called a new phenomenon is that the “large companies” are not judged by their scale only, but rather by the degree to which they have broken away from the traditional planned system and entered into the market. Therefore, the “large companies” discussed in this thesis do not include the production
enterprises or more accurately production units under the planned system, the industrial companies with administrative function (most of them evolved from government ministries) nor specialized trading companies under the Ministry of Foreign Trade and Economic Relations. The large companies referred to in this paper mainly fall into two categories: first, the large industrial enterprise groups integrating production and trade, such as No. 2 Automobile, Capital Iron and Steel; the second type refers to the multifunctional, transindustrial and international conglomerates involving finance and industries, such as CITIC and Everbright Corporation. The situation has somewhat changed since 1992. As a result of foreign trade system reform, the first generation of international multifunctional trade houses such as Sinochem has emerged, which is a positive development in the rationalization of the composition of “large companies.”
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COMMENT ON "RESTRUCTURING LARGE STATE-OWNED ENTERPRISES: INTERNAL MECHANISMS FOR ALLOCATING RESOURCES AS A SUBSTITUTE FOR THE MARKET"

Yung Chul Park¹

General Comments

The main message of this paper is that the reform of China's LSEs (large state-owned enterprises) needs to focus more on internal restructuring of these firms' organization and renovation of the operational mechanism. In putting forward this message, the author borrows heavily from the existing body of literature on the theory of the firm and the economics of modern enterprise management.

The underlying theme of this paper is the substitution of the market by organization, which naturally leads to the task of minimizing organizational inefficiency in intrafirm resource allocation. By comparing the organization and operation of today's LSEs in China with those of large business firms in Western economies, the author tries to emphasize the importance of organizational restructuring and operational innovation.

The author's findings seek to shed light on this neglected but important dimension of the organization and operation of China's LSEs. This paper should contribute to further studies on reforming China's LSEs.

Efficiency Gap Between LSEs and Other Types of Enterprises in China

It is worthwhile to compare LSEs with foreign-funded enterprises and township enterprises in China. This leads to the important issue of why LSEs perform poorly on average, while other types of business firms achieve relatively high levels of managerial efficiency.

Assuming that similar competitive conditions exist for both types of enterprises in China, the apparent gap in efficiency between LSEs and other types of enterprises might be caused by differences in the nature of ownership, control, and management between

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the two groups of enterprises. Although I agree with the author’s view that the core issues are organizational structure and operating mechanisms, the issue of corporate ownership (property rights) and corporate control/governance should be treated as equally important.

While the issue of organizational structure and operating mechanisms boils down to nothing more than scientific and modern management, the author himself points out that the structural determinants of efficient management have yet to be identified.

The point is that there exist certain limitations on the organizational and operational renovations designed to maximize managerial efficiency. The LSEs in China can draw useful lessons from the experiences of public-owned enterprises in advanced market economies. The efficiency gap between the LSEs and other types of enterprises in China has a corollary; that is, the efficiency gap between private and public enterprises in many countries around the world.

Thus, it can be said that the privatization of the LSEs in China is a good complement to the author’s idea of organizational and operational reform. Efforts to improve the internal structure of the LSEs have both merits and limitations in enhancing efficiency, while privatization of both ownership and management can, under certain circumstances, ensure the introduction of efficient management. The privatization method in a socialist market economy, however, differs significantly from the usual divestiture process in market economies. One obvious condition for successful privatization lies in whether there exists a mature private sector.

China’s LSEs as “Small Societies”: A Bottleneck to Reform

It is well known that a distinct feature of China’s LSEs is their lack of clear boundaries as business firms. China’s LSEs are quite abnormal with respect to the anticipated role of a modern enterprise; that is, a modern firm is a profit-maximizing organization that combines various inputs, including labor, to produce and market its own outputs. In contrast, China’s LSEs themselves constitute “small societies,” in which the LSEs offer not only jobs to their employees but also other services such as housing, schooling, medical care, etc. Thus, China’s LSEs are at the same time both profit-seeking business firms and financial supporters of their regional society.

With LSEs structured in this manner, losses and surpluses of the LSEs cannot be treated from a purely business viewpoint. Bankruptcy of LSEs in China must thus be seen as a direct concern of the affected regional society as a whole.

This feature of the LSEs in China raises questions about the validity of the author’s argument to innovate organizational structure and operating mechanisms. Whatever the answer is to this question, it seems to me that another reform is necessary to
reduce LSEs' responsibilities to a level normal for business firms. It may be necessary to develop markets for schooling, housing, medical care, etc.

Lessons from the Korean Experience

China's LSEs can be compared in many respects with business firms in other countries. In Korea, we have big business conglomerates as well as large public enterprises. Let me summarize some of the insights or implications of comparing China's LSEs with Korean firms.

We note that the internal hierarchical structure of Korea's large business conglomerates, or so-called chaebol, is of special interest to China's LSEs. As the author pointed out, Prof. Williamson's M-type structure is the predominant organizational structure for large firms in Western economies, but large business groups in Japan exhibit a unique structure known as the J-type (Japanese type) structure, characterized by overlapping shareholding between industrial firms, main banks, and insurance companies.

Korea's chaebol, consisting of many legally independent and highly diversified subsidiaries, have certain characteristics in common with both the M-type and J-type structures.

Chaebol are M-type in the sense that they maintain a head office with extraordinarily strong functions in planning, developing strategies and coordinating transactions. Each chaebol maintains a special planning and coordination organization under the direct control of the chairman of the group. Although this organization is not an independent legal entity, it usually plays the most important role as a head office and is entrusted with the highest authority by the chairman who is usually an owner-manager.

Chaebol in Korea also have many elements in common with the J-type structure. One obvious example is the in-group shareholdings, exchange of personnel, and other important transactions between a chaebol's subsidiaries. Thus, Korean chaebol can be said to have a "K-type" structure, which is a mixture of the M-type and J-type structures. The K-type differs from the J-type in that it has strong coordinating and centralizing functions that J-type structures lack. Recent discussions in Japan on the revival of holding companies were part of an effort to strengthen the coordinating function of Japanese big business groups.

Korea's chaebol structure has proved to be a successful case of substituting markets with organization. The chaebol structure was a vehicle in overcoming many market imperfections, especially those in important input markets such as capital and managerial talent, which existed in the early phases of economic development. Chaebol in Korea have also proved to be efficient in responding to the needs of industrial restructuring in a rapidly growing economy, which was possible through the internal reallocation of resources.
The author's insightful discussions on the various structural models, determination of operational strategy, the policy-setting, human resources and development, and business plan management are all important dimensions to consider in studying Korea's big business conglomerates. In contrast to China's LSEs, Korea's business groups offer an extreme case of centralized and well-coordinated management by head offices.

Thus, both the strengths and weaknesses of Korea's chaebol carry useful implications in reforming of the organizational structure and operating mechanisms of China's LSEs.

There is one more observation on the large publicly-owned enterprises in Korea, which are thought to be closer counterparts to China's LSEs. In Korea, it is widely accepted that there exists a significant efficiency gap between firms and public enterprises, like the gap between the LSEs and township enterprises in China. The Korean government's efforts in the past to renovate the organizational structure and operating mechanism of the large public enterprises, while maintaining them as publicly-owned status, have proved to be a limited success. This observation, combined with ever-intensifying competition in those industries once monopolized by the public enterprises, has prompted a series of privatization programs whose efficiency results remain to be seen.
DEBT RESTRUCTURING OF STATE-OWNED ENTERPRISES AND THE ROLE OF BANKS

Wu Xiaoling

Introduction

An enterprise’s debt-bearing decision reflects a choice about asset-liability structure. For the purpose of cost management and strategic control, enterprises make different judgments on equity financing and debt financing. In order to reduce or diversify risk, an enterprise of a certain scale may not adopt a 100 percent equity capital structure, just as no creditor is willing to put his money in an enterprise that has no equity. There is no unified standard for debt-equity ratios since they inevitably vary according to differences in country conditions, stages of financial market development, and in peoples’ financing and investment habits. However, there does exist in the corporate world a naturally-developed debt-equity ratio, within which a certain amount of debt is considered normal. When the debt of an enterprise exceeds a certain limit, we call it “abnormal liabilities.” When an enterprise relies mainly on bank loans, its abnormal liabilities will become unhealthy claims reflected on the balance sheet of the bank.

In recent years, some SOEs and state-owned banks in China have fallen into difficulties. In addition to other factors, an abnormal asset-liability structure—due to historical evolution of SOEs—is one of the main factors contributing to the decline in the asset quality of banks. For the purpose of freeing enterprises and banks out of this dilemma and reaching a new growth point for further development, it is necessary to analyze debt rearrangement between SOEs and banks.

The asset-liability ratio of China’s SOEs is on the rise. In 1980, this ratio for industrial SOEs was 18.7 percent, of which the debt ratio of current assets was 48.7 percent. In 1993, however, the asset-liability ratio for industrial SOEs was 67.5 percent, of which the debt ratio of current assets was 95.6 percent, which means that these enterprises relied virtually completely on bank loans for their working capital. The asset-liability ratios for medium-size and small industrial SOEs were 74.23 and 73.25 percent, respectively, and the ratio for SOEs in light industry was 75.54 percent. According to the findings from an assets value verification conducted by the National Administrative

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Bureau for State-Owned Property (NABSOP) on 20,000 SOEs in 1994, the asset-liability ratio was 79 percent.

Of the huge debt of SOEs, a certain proportion is abnormal. Abnormal debts can be divided into two types: fiscal liabilities and excessive liabilities.

The "fiscal liabilities" of SOEs include the following: First are the policy-related losses due to price controls. These should have been made up by public finance but have not been yet. As a result, enterprises have had to cover the losses with production capital, and this has consequently resulted in an increase in the liabilities of the enterprises. Second, various social welfare burdens have been placed on the enterprises, such as expenses on culture, education, health care and public security within the community. Enterprises also have to pay for social security for employees, such as expenses on unemployment, pension and medical care. Such expenses should be theoretically contributed by the whole society through taxation and social insurance premiums, but they actually fall on the shoulders of SOEs. In the past, advance payment was made as social insurance premiums; however, no individual account was established for employees after the collection of such premiums. This fund was actually converted into state-owned assets in a unified manner by fiscal departments, but enterprises still had to be responsible for the social security of employees. The excessive social welfare and social security expenses took away some of the enterprises' production capital, thus increasing SOE liabilities. Third, losses have arisen due to improper management and the increase in enterprises' liabilities caused by errors in policy decision-making in projects and by macropolicy changes. The debts of SOEs due to the above three causes are generally not repayable. As far as the banks are concerned, they are defined as bad loans. But this is a problem caused by the economic system and history. The state, as the owner of enterprises, should bear these debts. Therefore, we call such debts "fiscal liabilities" of enterprises.

The "excessive liabilities" of SOEs. Significant changes have taken place in the distribution of China's national income since the adoption of economic reform and the open-door policies. The percentage of central and local government revenues in national income is declining, but the notion that the state should invest and operate SOEs has not changed, and the capital market is not sufficiently open. Consequently, there have appeared many enterprises that basically or completely rely on bank loans. Some projects without any loan repayment ability also have used bank loans, which has greatly affected the circulation velocity of bank loans. The problem is not confined only to new enterprises. Some old ones that used to own considerable capital are debt-ridden now due to excessively low depreciation rates and to the fact that even the very limited depreciation funds were not completely left with enterprises. When both equipment and products are obsolete, and no fiscal support is available to renew them, enterprises have to turn to banks and often end up with "excessive liabilities."
Large abnormal liabilities impact negatively on enterprises and banks. The existence of bad and excessive debts has weakened the repayment pressure that debt normally has on a borrower, giving rise to the idea that there is no need to worry about excessive debts. This is not conducive to the establishment of a normal credit order, or to an assessment of enterprise performance.

The existence of a large amount of bad assets has increased the operational risk of banks. With so many SOEs with excessive debts, a bank cannot play its role in assisting good enterprises and restricting poor ones through the credit lever. In addition, because the bad assets were not actually caused by banks’ decisions, it is very hard to assess and examine how the banks in fact performed. Moreover, this is not conducive to establishment of a self-restraint mechanism for the banks.

Generally speaking, in a market economy bad debt is a micro problem. However, in a country with SOEs as the mainstay of the economy, a large amount of bad debts will cause aggregate credit expansion, adding to inflationary pressures.

In a market economy, if the bad debt of an enterprise increases, it will have difficulty in raising funds in the capital market, and competition will force the enterprise to deal with its bad debts. A bank, under the pressure of competition, will not extend loans to enterprises with bad debts. If bad loans occur, it will immediately deal with them so as to maintain a good asset structure and a strong competitive edge.

However, in an economy such as China’s, where SOEs constitute the mainstay and a factory is actually a small society, SOEs have to bear many responsibilities that should not be theirs. For the purpose of maintaining social stability, the banks still have to provide loans to enterprises with poor performance and bad debts, which leads to the weakening of credit constraint, and the bad debt problem becomes more and more serious.

Since credit is extended by banks, the deterioration of bank assets will inevitably cause an oversupply of credit, thus increasing inflationary pressure. In order to effectively control inflation, the debt-credit issue between enterprises and banks must be addressed and solved.

Modes of Debt Restructuring: Advantages and Disadvantages

The issue of bad debts between China’s SOEs and banks is a significant public concern. Dealing with these bad debts is not sufficient to cause the operating mechanisms of enterprises and banks to transform, but is a precondition. This historically rooted problem makes it hard to evaluate the actual performance of enterprises and banks. At the same time, it serves as an excuse for some people to shirk their responsibilities.
Debt restructuring has dual implications: the first is to write off debts that cannot be repaid; the second is to change the debt-credit relationship, change the creditor, or carry out a debt-equity swap, so as to improve the asset-liability structure.

In the course of debt restructuring, first the owners will be liable and then the creditors. The fiscal liabilities of SOEs is money that can never be recouped; such debt has to be borne by the owners since a debt-equity swap is out of the question. If the Ministry of Finance (MOF) has money, a financial allocation could be used to compensate for the fiscal liabilities. If MOF does not have the money, then bad loan provisions of the state-owned banks, the largest creditors of SOEs, will have to be used to write off the liabilities. If both the banks’ capital stock and bad loan provisions are not sufficient, the only option is to change the enterprises’ liabilities into fiscal liabilities.

A possible outcome of debt restructuring where debt is shouldered by new creditors or transformed into equity, is that through corporatization and improvement in an enterprise’s operation, such debt might be repaid and yield returns.

Various proposals have been presented for debt restructuring between China’s SOEs and the banks. We now compare these proposals from the viewpoint of “fiscal” and “excessive” liabilities.

**Debt-equity swaps.** A research group led by Mr. Zhou Xiaochuan published the first dissertation on this issue in 1993. Their analysis focuses on enterprise excessive liabilities, the slow velocity of bank credit and poor asset quality. In their view, in order to not increase the financial burden and ensure the capital adequacy of banks, the most desirable option is to conduct debt-equity swaps between enterprise and banks.[1]

Mr. Zhou divides enterprises into four categories. Starting from the bottom, the fourth category contains enterprises whose assets are not sufficient to make up for liabilities and who should go bankrupt; their debts may be written off under bad loan provisions. Enterprises in the first category, which operate efficiently, are not subject to debt restructuring. For the second and third categories, the banks may convert their debts into equity. As a first step, banks will own the equity of these enterprises. As a second step, the state specialized banks will be restructured and divided into commercial and investment sections. The commercial sections own debt claims and the investment sections own equity of the enterprises. In the third step, the state would issue equity warrants to the investment sections. The banks, with the stock warrants, would purchase equity from enterprises with good performance for the purpose of solving the problem of capital insufficiency, which is a different situation from completely relying on issuing bonds to the banks. Mr. Zhou illustrates the relationship of the conversion of debt into capital stock between enterprises and banks with the following diagram.
The prime advantage of this approach is that it solves the problem of excessive liabilities of the enterprises, and at the same time applies management experience of banks to the reorganization of enterprises and improvement of management. In a market economy, only some enterprises require help to solve debt problems. However, for China, which is in transition, the majority of SOEs have debt problems. As a result, several qualifications must be noted.

First, the amount of fiscal liabilities in China’s SOEs is large. It is beyond the capacity of banks to write off all such debts.

Second, transferring the bad loans extended to enterprises into bonds only solves the problem of liquidity and quality of the banks’ assets; the total assets of banks are not reduced. Therefore, such an approach will not ease inflationary pressures.

Third, in order to reduce the reliance on banks’ commercial sections, the plan entails issuing stock warrants, and these stock warrants are actually fiscal obligations based on the creditworthiness of the state.

Fourth, current financial laws and regulations in China permit commercial banks to invest in nonbanking financial institutions, but not to directly engage in nonbank, nonfinancial businesses. Therefore, the banks’ investment sections envisioned by the plan must become independent legal entities. Mr. Zhou does not object to transforming them into independent legal entities with banks holding the shares. This approach is
similar to that of using a commercial intermediary to perform the debt restructuring of enterprises.

**Commercial intermediaries and debt restructuring.** Commercial intermediaries include institutions with investment powers and operation and management abilities, such as investment banks, trust and investment companies and asset management companies. Such entities could purchase enterprise debt from banks and turn them into equity, and enterprises could use the newly-increased capital stock to repay bank loans. In this way, the debts and liabilities of enterprises and bank loans are reduced at the same time. This would solve the problem of excessive debts and liabilities of enterprises while also reducing bank credits. It would also help improve the operating conditions of enterprises and banks, and alleviate inflationary pressure.

Debt rearrangement by commercial intermediaries has the following two characteristics: First, the capital sources of commercial intermediaries are limited, so they need to raise capital in the market. Second, when making investments, they must maintain liquidity and earn a return on their assets. Otherwise, their financing ability would be restrained.

These characteristics of commercial intermediaries mean that implementation of such as plan in China would face the following problems:

- First, as commercial entities with long-term interests, they may purchase some debt from enterprises, bear some risks, but only within certain limits. If future returns could not exceed by a large margin the costs of the fiscal liabilities of the enterprises, they would not purchase the enterprises’ debts at the original price. Instead, they will demand a discount (Mr. Masanobo Otsuka, director of the Nomura Research Instituted Ltd., once made this proposal [2]), and there have to be persons or entities to bear such debts and liabilities with discounts. Because China encounters huge fiscal liabilities by enterprises, bad loan provisions and banks’ capital stock cannot bear them completely.

- Second, the smooth operation of these intermediaries requires a rather developed capital market. But China now has various restrictions on the transfer of shares, listing of shares and bonds. Therefore, it is virtually impossible to implement this plan on large scale.

**Debt restructuring by efficient enterprises.** At present, joint ventures and mergers are widely practiced methods for accomplishing enterprise transformation in China. These methods provide a solution to the heavy debt burden problem, providing a way for products to become competitive on the market following reorganization of the enterprise.
There are two approaches enterprises pursue to form ventures or merge with other enterprises: The first is acquisition of all SOEs in a region or a line of business in a region, or whole acquisition of individual enterprises; the second is acquisition of part of an enterprise.

Acquisition of enterprises normally solves both fiscal and excessive liabilities. A successful example of using foreign capital in this way is the acquisition of several SOEs in Quanzhou city, Fujian province by the Hong Kong Zhongce Company. A successful example of using Chinese capital in this method is the acquisition of the Beijing No. 2 Watch Factory by Beijing Dong-an Department Store.

The reason foreign firms acquire SOEs in a whole region (or a line of business) and bear responsibility for their debts and employees is that they foresee, following restructuring of these enterprises, an attractive economic return. The real estate proceeds, in particular, would be much larger than the costs and expenses they would have to bear. This mode is controversial in China and unlikely to be a widespread practice soon.[3] Sometimes an approach is followed by Chinese enterprises that results in efficient enterprises bearing all debt burdens of the enterprises to be merged. However, using future profits of efficient enterprises to digest fiscal liabilities can lead efficient enterprises to become enterprises in trouble.

Sino-foreign joint venture enterprises often follow a different approach. The foreign party usually agrees to solve the excessive debt problem and alleviate the shortage of development funds through injection of capital, but it is not willing to solve the problem of fiscal liabilities. Therefore, Sino-foreign joint ventures usually adopt the method of "one factory, two systems" or building a new plant outside the old one. While such a practice can develop the economy by utilizing the productive factors of SOEs, someone has to take care of the fiscal liabilities.

Due to these problems, some analysts have proposed establishing liquidation companies to deal with surplus labor and unpaid debts following a restructuring of a firm's productive factors. These liquidation companies are actually policy-oriented intermediaries.

**Shareholding and the role of individual investors.** One direct channel to solve the problem of excessive debts is through turning deposits of individuals into equity shareholding investment. However, the establishment of joint stock shareholding companies faces several challenges in China:

- First, it is impossible for China to develop its stock market rapidly.
- Second, there are still debates over methods of enterprise management—which is more effective, "vote by foot" or "vote by hand." That is, some people think that, when stock ownership is extremely decentralized,
enterprises are often manipulated by a few shareholders or some insiders. They therefore advocate that the shares should be held mainly by legal entities.

- Third, individuals, when making direct investment, will not bear the fiscal liabilities of the enterprises. Fiscal liabilities must be tackled during the corporatization process.

**Implementing debt restructuring by policy-oriented intermediary organizations.** The above-mentioned four approaches of debt rearrangement have all proven successful in market economies. But they all face the same problem: the inability to deal with huge fiscal liabilities of SOEs, particularly during the transition to a market economy. In order to liberate most of the SOEs and banks from their historical problems and settle their bad debts, some policy-oriented intermediaries have been established in a variety of countries. Examples are the “Trenhandanstal” after the unification of East and West Germany, and the “Union Bank” in Czech Republic. Hungary also has similar agencies.

The “Enterprise-Bank Restructuring Fund” proposed by Professors Lawrence Lau and Yingyi Qian is a policy-oriented nonbanking financial intermediary [4]. It has two basic functions. First, to take over bad debts from the banks, set them free, and commercialize them. Fiscal liabilities are treated as sunk costs. It does not matter how they are written off; it is just an accounting procedure. What is important is to minimize such liabilities through transparent fiscal channels instead of banking channels. The second role of the fund is to provide fixed-term fiscal subsidies to enterprises currently in difficulty. This will replace existing policy credits, reduce bankruptcy and maintain social stability.

The characteristics of all policy-oriented intermediaries is that they accept bad debt claims and liabilities of both enterprises and banks. They conduct restructuring and eliminate part of the bad debts. Debts that cannot be eliminated are eventually borne by the state.

If the state is to bear the liabilities, it can only be shouldered through public financing. When massive debts arise in an economy, public financing encounters difficulty as well and the liabilities are financed by issuing bonds. After reforms, if the public revenues and expenditures balance, such debts can be paid back year by year. But if deficits arise, the debts will have to be digested through inflation.

Policy-oriented intermediaries typically handle only the fiscal liabilities of SOEs. Excessive liabilities will have to be selectively dealt with by choosing from the above-mentioned four approaches. During the course of enterprise restructuring, many transitional economies have paid great attention to the role of banks. Hence the focus of
Professors Lau and Qian on reforming China’s commercial banks. The Czech Republic, Poland, Hungary and former East Germany also implemented reconstruction of their banking systems.

**Roles of the treasury, enterprises and banks.** China’s state enterprises face a different debt situation from that of the former Soviet Union and some countries that experienced economic restructuring after World War II. First, the debt problem of Chinese state enterprises is one that has arisen in the course of basically healthy economic development. China’s growing economic environment and high national savings rate will provide maneuvering room for debt restructuring. Second, China is building a socialist market economy, with public ownership as its main body, and thus state enterprises will assume an important share in the economy.

Based on these two characteristics and in light of Chinese history, Ms. Wu Xiaoling has proposed incorporating into a program of debt rearrangement within the state economy some of the suggestions by Mr. Zhou Xiaochuan and Guo Shuqing.[5]

The specific measure proposed is that the finance ministry borrows money from the People’s Bank to solve the SOEs’ problems of fiscal debts and excessive indebtedness. As the owner of the state enterprises and state banks, the state should have the treasury bear the debts. In China, the treasury does not need to issue new bonds to finance SOEs’ historical abnormal debts because the banks’ bad claims have already led to the current inflation. What should be done now is simply to make an accounting change by turning the debts undertaken by the treasury from secret ledgers into open ledgers. A new operating mechanism should be established while the balance sheets of enterprises and banks are improved in a bid to intensify the restriction over enterprises’ budgets and credit. The establishment of a bank risk control mechanism should provide a new impetus for growth of state enterprises and banks.

The process of dealing with the historical liability is: the treasury borrows 300 billion yuan from the People’s Bank (the numbers here are all hypothetical), which shall be allocated to SOEs. The enterprises return the loans of 300 billion yuan to the specialized banks (state-owned commercial banks), which shall, in turn, return the People’s Bank’s loan of 300 billion yuan. After this process, the treasury’s liability to the People’s Bank increases 300 billion yuan and at the same time it receives a certain amount of share ownership. But this amount will be far less than 300 billion yuan because part of the 300 billion yuan shall be used to offset the enterprises’ fiscal debts. On the one hand, the assets of the People’s Bank increases by 300 billion yuan when it extends the loans. On the other hand, the People’s Bank’s assets decrease by 300 billion yuan when it reduces loans made to specialized banks. Overall, the total amount of assets has not changed. The assets of the specialized banks decrease by 300 billion yuan when they recover the bad loans from SOEs. Their liability decreases by 300 billion yuan when
they pay back the loans to the People’s Bank. As a result, their assets and liabilities reach a new balance.

**Balance Sheet of the People’s Bank**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Billion yuan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans to Treasury</td>
<td>120 (+300)</td>
</tr>
<tr>
<td>Gold and Foreign Exchange Reserves</td>
<td>110</td>
</tr>
<tr>
<td>Loans to Specialized Banks</td>
<td>670 (-300)</td>
</tr>
<tr>
<td>Others</td>
<td>40</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>940 (940)</td>
</tr>
</tbody>
</table>

**Liabilities**

| Fiscal Deposits               | 90           |  
| Deposits of Specialized Banks | 340          |  
| Currency Issued               | 460          |  
| Own Capital                   | 50           |  
| **Total**                     | 940 (940)    |  

*Note:* The numbers in the brackets are the ones after debt restructuring.

**Balance Sheet of Specialized Banks**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Billion yuan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>2,200 (-300)</td>
</tr>
<tr>
<td>Deposits in the Central Bank</td>
<td>340</td>
</tr>
<tr>
<td>Others</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,550 (2,250)</td>
</tr>
</tbody>
</table>

**Liabilities**

| Deposits                    | 1,750        |  
| Borrowings from the Central Bank | 670 (-300) |  
| Own Capital                  | 130          |  
| **Total**                    | 2,550 (2,250) |  

*Note:* The numbers in the brackets are the ones after debt restructuring.

This kind of debt rearrangement could simultaneously solve both the fiscal indebtedness and excessive indebtedness of SOEs. Meanwhile, it could guarantee that
the actual share of SOEs in the economy will not decline. But the greatest risk of this
approach is that it encourages SOEs to ignore their obligations to pay back debts. After
the new balance sheet is established, they would not work hard to improve management,
and expect another debt rearrangement. In carrying out this approach, measures must be
taken to ensure that it is being applied to solve a historical problem before a certain year.
After that year, the problems shall be solved only through the new market mechanism.
Thus, this approach will be “the last supper” from the big rice pot of a planned economy.
There will be no more such meal. A series of supplementary reform measures shall be
taken to ensure that this is the real “last supper.”

Implementing the State Enterprise-Bank Debt Program

The effectiveness of the above six approaches varies from case to case. China is a
big county. Different areas and different industries can have different situations.
Therefore, it is impossible to adopt only one approach. We should choose the approach
according to a specific situation.

Debt restructuring should be combined with reform of the state-owned asset
management system. Debt restructuring should not be conducted directly between the
state treasury and an SOE. The main body responsible for debt restructuring should be
the one managing the enterprise in the future. Therefore, selection of the executive
agencies is critical.

In China, both trust and investment companies and state-owned asset operating
companies can serve as the executive agencies. Personally, I am more inclined to the
latter companies because:

- First, at present, the state does not want to generally convert SOEs into
shareholding companies held by individuals. Most will be reorganized into
limited liability companies owned by state-sector legal entities. The state
asset operating companies, which manage state-owned properties, shall be the
beneficiaries of the reorganization of limited liability companies owned by
public legal entities.

- Second, government management of the economy in China cannot be changed
within a short period of time. Some special economic departments, which
need to be trimmed in the course of the transformation of the government’s
function, can be turned into asset operating companies. This is the trend of
the reform.

In order to prevent state asset operating companies from using governmental
administrative measures to manage enterprises, state asset operating companies may not
be set up under one single economic department, but should be comprised of personnel
from several departments. Special legislation should be established for state asset
operating companies to define their rights and responsibilities. The key is to hold these companies responsible for maximizing the value of state properties.

Given the fact that there exist central, provincial, city and county departments of finance in China, the property rights of state assets should be shared by these different levels of government. However, to ensure management efficiency of state assets, state asset operating companies should not be set up according to the principle of administrative subordination, but rather entrusted by the various levels of finance departments.

**State enterprise-bank debt rearrangement should be conducted alongside the restructuring of the national economy.** To ensure a leading position of the state-owned sector in the national economy while the state faces financial constraints, some measures have to be taken regarding the national economy; that is, to adjust the balance of the national economy, minimize risk exposure and optimize sectoral structures.

Firstly, the state should make a choice on the industry distribution of the national economy. The state should keep control over industries fundamental to the national economy, as well as industries that generate genuinely low economic returns and hence lack commercial investment. The state should allocate its limited funds among these sectors and guide social funds to invest in competitive industries.

The state cannot take care of all enterprises. Selection should be based on economic returns. The state should minimize the number of enterprises suffering from industrywide policy-related losses. Those with good management and less losses can be retained. Most industries can be reorganized according to these respective categories.

State enterprise can be divided into the following categories. The first category includes enterprises with marketable products, reasonable asset-liability structures, good operations and higher profit margins. The second category includes those with good operations and management, good market prospects and good profit, but are in trouble due to shortage of capital. The third category includes those with inadequate capital, average market prospects and operations, with little profit or loss. The fourth includes those with a serious shortage of registered capital, doomed market prospects, ineffective operations and management, huge debt and are on the verge of bankruptcy.

The enterprises in the first category generally do not need to take part in a debt rearrangement. They should be mainly supported by developmental credits and become purchasers of enterprises when necessary. The enterprises in the fourth category should be declared bankrupt. The second and third categories take part in the debt rearrangement scheme. Firms in the third category should generally be auctioned. Funds collected would be partly used to set up a social security system for workers and partly invested as capital into the second category of firms, focusing the state’s limited funds into firms that are economically efficient to improve the quality of state enterprises.
Establish an accounting mechanism for enterprises and banks, and gradually cancel verified financial debts. Enterprises’ debt rearrangements should be conducted in sequence:

- First, the scope of the debt rearrangement by state asset operating companies must be defined. Enterprises can be divided into two categories according to their respective holding companies/departments and geographic location. Central-level state asset operating companies should conduct debt rearrangements within the important sectors the state has selected. Local state asset operating companies should conduct the rearrangements at the provincial and prefectural levels.

- Second, the state shall decide upon the amount of capital to invest in state asset operating companies with reference to the results of relevant sample surveys. Part of the capital should come from treasury loans from the People’s Bank. This shall be converted to treasury stock rights. The rest of the capital should come from provincial bonds (local governments are not allowed to issue bonds) and shall be transferred as stock rights of local governments.

- Third, state asset operating companies shall, together with banks, conduct asset-liability and economic performance analyses of the SOEs in their respective areas in order to decide which enterprises should go bankrupt, be auctioned or injected with capital. For those that should be injected with new capital, the state asset operating companies should divide the assets and liabilities of the enterprises into old and new accounts. The banks should also split their balance sheets into two accounts so that both enterprises and banks may operate on the same basis of new accounts. Interest and tax calculations should be verified with the old accounts. After defining the nature of enterprises’ old accounts, proportional gains of new accounts should be used to make up for the debt. The rest of the debt shall be written off according to the shares of enterprises’ owners.

Supplementary reforms are needed to create a favorable economic environment for enterprises.

- Create a class of professional managers and entrepreneurs. The state asset operating agencies and managers of enterprises should change their status from cadres to professional managers. Their compensation and promotions shall be determined by their performance. Operational guidelines and an incentive mechanism should be established.
• Separate the social burdens from state enterprises and set up a social security system so that workers can flow freely and enterprises live or die by the market.

• The debt rearrangement program should be integrated into the establishment of a modern enterprise system and banks’ commercialization. Banks and enterprises should have their property rights defined and infused with scientific management and advanced production technology. The roles and duties of government and enterprises should be clearly specified. The state shall hold limited liability over enterprises and banks. Internal management structures of enterprises and banks should be rationalized.

• The state’s guiding principle of direct interference in economic activities should fundamentally change.

To avoid new problems after clearing the historical debts, the state should adhere to the principle of “working within its means.” New projects should receive adequate capital. If the state does not have the money, it should mobilize society and transfer residents’ savings deposits into investment capital to reduce fiscal and inflation pressure. Developing a capital market is a fundamental way to solve the problem of enterprises’ excessive indebtedness as well as an important measure to curb credit inflation.

The most practical method for China to pursue strengthening its capital market is to develop nonbanking financial institutions and foster institutional investors. Residents’ savings deposits can be converted to investment capital through investment banks, trust and investment companies and investment foundations.

The healthy development of a capital market has to be coupled with financial system reforms, especially the marketization of interest rates, strengthening of the legal system regarding the securities market, as well as operational standardization of nonbanking financial organizations.
REFERENCES


COMMENT ON “DEBT RESTRUCTURING OF STATE-OWNED ENTERPRISES AND THE ROLE OF BANKS”

Robert D. Hormats

Ms. Wu’s paper provides a very interesting and thoughtful analysis of two interrelated sets of issues: the large fiscal liabilities of SOEs (related to various kinds of policy-induced loans and other factors) and the excessive liabilities of those enterprises (that is, due to a generally high reliance by Chinese enterprises on debt financing). Ms. Wu’s ideas provide a constructive basis for a discussion of this subject and for developing policies to resolve these problems.

In this paper I discuss a few of the main points contained in Ms. Wu’s paper. I hope that Ms. Wu will be able to discuss some of the points in greater detail and correct me if I have not fully understood all aspects of her proposals.

As a foreigner with experience in China and in other countries undergoing financial and corporate restructuring, I have tried in this paper to view China’s debt rearrangement requirements and excessive liabilities problems in light of similar types of problems elsewhere in the world and to identify some concepts used in other countries that might be useful to China’s authorities in addressing these matters.

In discussing these subjects, five major points appear to me to be particularly important:

- first, solutions to the SOE debt problem should avoid large-scale closing of enterprises in conjunction with the restructuring process;
- second, the financial cost to the state of restructuring nonperforming loans should be kept as low as possible and inflationary financing of any debt write-downs should be avoided; although state funds or guarantees will likely be required to some degree, a portion of the burden should also be borne when possible by banks, potential private investors and the enterprises themselves

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1 Robert D. Hormats is Vice Chairman, Goldman, Sachs (International) and former US Undersecretary of State for Economic Affairs.
when viable in order to reduce that of the Ministry of Finance and the People’s Bank of China;

- third, enterprises should be treated on a case-by-case basis because debt structures and ability to service and repay debt differ considerably among companies;

- fourth, any plans for debt restructuring should create strong incentives for banks and SOEs to avert a repetition of this problem; it must have strong provisions to prevent another large buildup of fiscal liabilities and excessive debt and to avoid the risk that Ms. Wu correctly identifies—that debt restructuring could encourage companies to ignore paying debts in the future in anticipation of another restructuring;

- fifth, the expertise of the banks should be utilized in the restructuring because they know the companies involved and because they should be under pressure to come up with restructuring plans that avoid shifting too such of the burden directly to the state.

Ms. Wu’s Analysis

Ms. Wu very effectively describes the reasons for the large buildup of debt by China’s large SOEs. She analyzes both the fiscal liabilities and the excessive liabilities of those enterprises. In the former group (fiscal liabilities), she includes: policy-oriented losses due to price controls; social welfare burdens shouldered by the enterprises; and losses due to improper operations of enterprises and errors in policy-making in the operations of projects and changes in macroeconomic policies. In the second category (excessive liabilities), she points out that the problem results from a general overreliance on borrowing by Chinese enterprises for new projects and modernization.

Ms. Wu points out that the problem of nonperforming debt owed to the banks was not entirely the fault of banks, which in many cases have had to make loans to SOEs for a variety of noneconomic policy reasons. She also correctly notes that the large amount of loans extended by the banks has caused them to accumulate massive amounts of nonperforming assets and that new lending adds to inflationary pressures. To maintain social stability, banks in China frequently have to provide new loans to inefficient enterprises that already have large amounts of bad debt on their books.

Ms. Wu describes a number of proposals for addressing the debt problem. The first four of these are aimed primarily at the problem of excessive liabilities and the second two are aimed primarily at rearranging debts between SOEs and the banks. But the two groups are interrelated and some of the suggestions in the first group can be helpful in the second and some in the second group can be helpful in the first.
Debt-Capital Stock Conversion

In the first group of proposals, a research team led by Mr. Zhou Xiaochuan has made suggestions for a debt-capital stock conversion between enterprises and banks. Mr. Zhou usefully divides enterprises into four categories. This division is important because it underscores the point that there are real differences among enterprises with respect to their ability to service and ultimately repay debt. This point suggests that any restructuring scheme should avoid treating all enterprises the same.

This same point has been made by Ms. Wu, where she also divides enterprises into four types. Professors Lawrence Lau and Yingyi Qian do not suggest categories but do point out that the restructuring of debt should recognize the differences among companies; they classify companies according to the quality of their balance sheets and net operating accounts, pointing out that the positive or negative net worth of an enterprise should be a key factor in determining the proper solutions to its debt problem. Their proposal is also important in that it applies the management experience of the banks to the reorganization of enterprise debt and to the improvement of enterprise operations and management. Mr. Zhou makes a similar point about the importance of bank involvement in restructuring enterprise debts.

Commercial Intermediaries Rearrange Debt

Other proposals noted by Ms. Wu include arrangements whereby commercial intermediaries implement the debt rearrangement for enterprises. This would promote the establishment of commercial intermediary organizations such as trust and investment companies and investment banks to purchase the enterprise debts from the banks and turn them into share ownership; the enterprises then would use the newly-increased capital stock to repay bank loans. The result would be that the debts and liabilities of the enterprises and the banks would be reduced at the same time.

This concept could work to a limited degree. But as Ms. Wu points out, such investment companies would need to raise a lot of capital for this purpose through stock and bond markets; and that would be difficult to do if the enterprises in which they invest are likely to be in poor financial condition.

Moreover, in many cases the value of the enterprise debt would be very low since much of it would be nonperforming, so the receipts of the enterprises will not be enough to repay the bank debt, and the state therefore will have to write part of it off in any case. And if investors believe the enterprises will not perform well because they can obtain additional funds from state banks in the future without improving efficiency, they also will be reluctant to hold stock. Alternatively, some enterprises could service the debts sold at a discount to investors through new borrowing from state banks. Nonetheless, the idea of selling shares in SOEs has important benefits, even if it does not mean that equity
sales will significantly reduce the enterprise debt to the banks. I shall discuss the benefits of the sale of shares later in this paper.

**Enterprise-Enterprise Reorganization**

Another idea noted by Ms. Wu—that could proceed in parallel with the others—is for the more efficient enterprises to help reorganize the debt of the less efficient enterprises. General acquisition of one enterprise by another can solve the problem of excessive and fiscal liabilities, although the acquiring enterprise investor is not likely to be willing to assume all the debts of the heavily indebted SOE, so some write-off of enterprise debt by the banks and a broader plan to clean up bank balance sheets will be required. In China, as Ms. Wu notes, the efficient enterprise normally bears all the burdens of the enterprises to be merged, but if the debts incurred are too large, the newly created enterprise could be badly weakened in the process.

Foreign enterprises that buy the old SOE, as Ms. Wu points out, could purchase some of the debt of the enterprises. In other countries, foreign investors have agreed to take on a portion of enterprise debt and/or inject new funds, but they usually are not willing to solve the problem of the enterprise's fiscal liabilities incurred as the result of their former operations that were made less efficient because of the need to fill orders from or comply with uneconomic directives from state authorities. The recent experience of Germany with enterprises from the former East Germany can be instructive. In the early 1990s, most East German companies were in need of major restructuring. Many had large debts and work forces larger than appropriate for efficient operation.

But Germany did not want to engage in a major shutdown of such industries or cause a higher level of unemployment than already anticipated. It succeed in “corporatizing” most of the state sector and sold SOEs to private companies, many of which were foreign; there were no public market flotations of stock. In many cases, the debts to the old East German State Bank were canceled as part of corporate restructuring. A new state institution assumed responsibility for such obligations. One agency, the Trouhand, coordinated the entire process; the process was flexible and the state was often willing to accept “negative receipts” from purchasers as part of the process of selling off companies.

The purchasing company was required to give commitments regarding the number of workers it would retain in order to avoid large-scale layoffs. And many had to give similar assurances regarding new infusions of capital. But in order to induce companies to make such commitments, the German government frequently had to write off much or all the enterprise’s debt and to protect it from environmental liabilities. Government revenues, through higher taxes and some borrowing, helped to pay for the process and were used to subsidize a number of companies for a time.
Joint Stock Companies

Ms. Wu describes the option of organizing in a massive way joint-stock companies in order to turn deposits by individuals into investments so as to solve the excessive debts of enterprises. This, of course, presupposes that individuals will want to hold stock in such companies, that there will be a liquid market for such stock holdings and that fiscal liabilities will be absorbed in another fashion, because without this absorption, stock of previously highly indebted companies will not be attractive to potential investors.

The concept of creating joint stock companies should be a part of any restructuring strategy. In some cases, the process will lead to such companies remaining in the hands of the state; in other cases, the process should be a prelude to sale of stock to the public.

Public Sale of Shares

If the objective is to sell the shares to the public, there are a variety of options: sell only to state-organized funds, sell only to state-established investment companies or banks, sell to employees, sell through an initial public offering to domestic and/or foreign buyers.

For heavily indebted companies, a strategy for sale of shares will need to be combined with a strategy for writing off a part of the debt of the SOE. To make such a strategy successful, restructuring will frequently be required before stock is offered to investors; restructuring often involves managerial reorganization, reducing the labor force, a revised financial structure rebalancing debt and equity. In parallel, social safety nets need to be created to assist workers who lose their jobs by providing retraining, transitional unemployment compensation and health care. The social responsibilities (hospitals and schools) of enterprises are usually also separated off and picked up by local authorities. In most cases, a clearly articulated regulatory regime will be required before selling shares both to provide assurance to investors against regulatory surprises and to ensure that the new private owners do not utilize monopoly or oligopoly positions to keep prices artificially high for industries such as electric power or phone service or other items.

In the effort to avoid a recurrence of a debt buildup, such sales of shares can reduce chances of enterprises having to respond to political pressures that interfere with efficiency, require managers to comply with more rigorous financial standards and avoid new calls on the state’s budget or directed credits from state banks.

Although concerns that there will be major layoffs make some countries reluctant to engage in the sale of shares to private investors, studies cited by the World Bank demonstrate that companies can improve their performance without major layoffs,
although some programs to absorb and assist the unemployed will be necessary as a precaution.

Financial Reorganization of Debts and Enterprises

Ms. Wu then discusses the proposal of Professors Lau and Qian (noted above) to deal with the problem of massive nonperforming loans on the balance sheets of the banks and associated problems of their undercapitalization. They propose a method of financial reorganization of SOEs that avoids massive and immediate bankruptcy. They make an important distinction between a one-time cleaning up of bank balance sheets (the stock problem) and avoiding a future buildup of large nonperforming debt (the flow problem). They want to be certain, as does Ms. Wu, that new debt problems can be avoided by any new scheme proposed and to prevent the emergence of a situation in which cancellation of bad debts and recapitalization of banks creates a “moral hazard” that leads to future debt problems.

Their plan involves creation of an Enterprise and Bank Reconstruction Fund (EBRF). It would serve as an intermediary to issue bonds to the banks; those bonds would partially offset the losses created by the nonperforming loans as a first step toward cleaning up the bank balance sheets. And it would provide subsidies for a fixed period through a special facility for loss-making enterprises to avoid mass layoffs; these would be in lieu of new policy loans by the specialized banks.

After creation of EBRF, their plan proposes a sequence of financial reorganization under which reorganization of banks comes first. In financial reorganization of banks, their proposal would have the banks mark their loans to market rates; corporatize into joint stock companies with control still in the hands of the state but with removal of bank responsibility for extending policy loans. They would recapitalize the banks through a contribution of nontransferable bonds by the state (and the issuance of bank common stock to the state), and the issuance of preferred stock by the banks (with no voting rights) to the public. The nonperforming loans would be written down to zero on the banks’ balance sheets, but 50 percent across-the-board interest in such loans will be transferred to the EBRF so that it would benefit if a portion of them were to be recovered. The allocation of bonds, preferred stock and common stock would depend on whether the banks had a positive or negative net worth before restructuring.

In financial reorganization of enterprises, their proposal would have the enterprises revalue their assets and liabilities under the supervision of the banks (their major creditors). All enterprises then would be classified into three categories according to their restated balance sheet and their net operating account: normalizable if they have nonnegative net operating profit; potentially normalizable if they have nonnegative net worth and negative net operating profit; and probationary if they have negative net worth and negative net operating profit. Recognizing the complexity of debt reorganization, the
government would not mandate a unified rule, and the banks and enterprises would negotiate the details themselves. The government would, however, provide general guidelines to treat the three categories differently.

For normalizable enterprises, the bank and the enterprise would be given broad latitude to devise a reorganization. The potentially normalizable enterprise would be restructured to become more viable and the banks would closely monitor its new activities. Fiscal subsidies from the EBRF would only be given to probationary enterprises that would see their operations restricted and borrowing capacity severely limited. The above proposal of classification and restrictions is aimed at providing a mechanism to grant the maximum flexibility and at the same time to prevent bad debts from reoccurring.

Among the advantages of this idea are: that the total amount of government bonds issued would be smaller than under a plan for the government to take over all nonperforming loans, the banks would still maintain a 50 percent interest in nonperforming loans and thus have an interest in helping enterprises to restructure and in pressing them to repay their loans, and issuance of preferred stock would constitute a new source of funds for the banks.

One problem that comes to mind is that the preferred stock, which is envisaged to be part of the bank balance sheet restructuring, might not be appealing to Chinese investors unless it is clear that the bank in question can service the dividends on the stock, that the bank can transfer itself into a profitable operation and that all future bank loans will be strictly based on economic merits. Moreover, the new EBRF will still be issuing credit to the banks in the name of the state, so the state will be, in effect, issuing new bonds to help recapitalize the banks. This adds to state debt, although by less than a complete state-financed write-off.

Debt Rearrangement Within The State-Owned Economy

Ms. Wu has made a proposal that starts from the perspective that the Ministry of Finance will provide funds to enable banks to wipe out their debts and that, to do so, it would borrow significant amounts from the People’s Bank of China. Ultimately, the proposal would result in clean balance sheets for the banks and for the SOEs. The Ministry of Finance would end up with a large amount of debt owed to the People’s Bank of China.

This large-scale role for the Ministry of Finance is either explicitly or implicitly contained in other proposals described earlier as well, because even the most market-oriented of those proposals would force the state to take some of the responsibility for debt restructuring. All of these would put added strains on the fiscal budget of China.
It is clear from Ms. Wu’s analysis that the concept of bank financing for enterprises rather than financing from the budget has not solved many of the structural problems of financing these enterprises, but in many cases only shifted the burden from one state institution to others. But this does not mean that the Ministry of Finance would want to take on the burden of restructuring all or even a large portion of SOE debts; if it does, I assume it would want strong assurances that the structural problems of state enterprises—that could require new infusion of policy loans and excessive reliance on debt financing—are being resolved once and for all. There could be inflationary risks in such a proposal, although these are manageable if this is a “one-off” event; if not, it would merely allow enterprises that benefit from restructuring to resume borrowing, which puts new demands on state finances. There is the risk, which Ms. Wu correctly identifies, that enterprises would not manage themselves rigorously in anticipation of yet another debt restructuring down the road.

Other facets of Ms. Wu’s proposal would permit the state to decide on the amount of capital it will put into the enterprises and then distribute it to the state property agencies. Part of the funds that the state provides for this purpose would be converted to stock rights of the finance ministry. Another part of the funds would be kept in reserve and transferred to stock rights of local governments. Ms. Wu also stresses that this rearrangement of SOE debt should be conducted along with the structural adjustment of the national economy.

Part of this effort should involve improved governance structures clarifying the relationship between owners and managers, applying market-oriented incentives and disincentives for managers and workers and moving toward commercially oriented boards of directors. Also, more work is needed to separate an enterprise’s commercial functions from its social functions, with the latter being shifted to local or regional governments or new enterprises. Such changes are extremely important in avoiding a repetition of the debt problem as discussed above. Equally important is that SOEs in the future must operate under tight budgetary constraints and be required to pay the full cost for inputs while charging a market-oriented price for their output and that, where there are subsidies required, they be transparent so that their cost to the state’s budget or the provincial budget can be assessed clearly.

An important part of Ms. Wu’s proposal is for state-owned property operation companies to serve as executive agencies in this process. This is a good idea and in many ways complements the proposals of Professors Lau and Qian. Ms. Wu has suggested that the state property operations agencies, working with the banks, conduct analysis of asset-liability situations and economic performance of banks and SOEs to decide which shall go bankrupt, which shall be auctioned (which could be done in line with the share offering ideas suggested above) and which shall be injected with new state funds.
Ms. Wu's significant focus on restructuring loans owed to banks—and the focus of other writers discussed above—is appropriate given the size of the debt owed to the banks. But as Ms. Wu notes toward the conclusion of her paper, issues such as social security for workers also need to be addressed. And there are large nonbanking creditors, namely other enterprises that are owed money by the SOEs. Debt rescheduling plans should also address these "triangular" debt issue.

It is also important to have a process for determining optimal capital structure for firms. Ms. Wu correctly points out that this can differ among enterprises. Some methodology should be identified to determine such ratios because that is key to calculating how much debt should be written off in a given enterprise under any of the schemes proposed.

**Integrating Debt Restructuring with Corporate Reorganization**

Dr. Shan Li of Goldman Sachs and Professor David Li of the University of Michigan are currently developing a proposal (described in greater detail in Annex A) that integrates debt restructuring with corporate reorganization and can complement Ms. Wu's proposal. Where restructuring is required, all debts would be canceled in the initial step in the process and employees would receive 100 percent of the new shares in the reorganized enterprise. Creditor enterprises would have the option to buy the equity from the workers with a cash transfer to pay off the social security debt to workers if they are laid off.

The bank would have the option to buy the equity from the workers and the enterprises for a given amount going to the enterprises and a cash transfer to pay the social security debt if workers are laid off. And the original owner of the SOE, the government agency, has the option to buy the equity from the above enterprises, banks and workers.

The government would set up a Debt Restructuring Fund to ensure that workers obtain the full value of their social security benefits if these benefits exceed the value of the enterprise and pay the creditor enterprises if their debt plus the social security costs of the workers exceed the value of the company. And it would provide funds to the banks if their debt plus social security costs and the debt of the enterprises exceed the value of the SOE.

**Conclusion**

Ms. Wu's excellent paper makes a significant contribution to the discussion and resolution of China's complicated and very large SOE debt problem. There are many important aspects of Ms. Wu's proposal. Her proposal, those that she discusses and others I have commented on in this paper can be drawn on and to varying degrees incorporated in a plan for addressing the issue of China's SOE debts.
A vital dimension, which Ms. Wu emphasizes, is to integrate debt restructuring with corporate reorganization. Ms. Wu points out that rearrangement of debts should truly be the "last supper" so that such an exercise does not have to be replicated again. This could be done in the context described by Ms. Wu: the intermediaries could be the banks themselves supported by the EBRF of Professors Lau and Qian or the Debt Restructuring Fund of Dr. Li and Prof. Li.

However it is done, this restructuring of enterprises and banks to stop the accumulation of nonperforming loans in the future is an imperative of the restructuring process. Any solution that does not include strong disincentives that avert a recurrence of this problem merely invites it to recur.
ANNEX A: PROPOSAL OF DR. SHAN LI AND PROFESSOR DAVID LI

We view our proposal as a complement, rather than substitute, of Ms. Wu’s. Our very preliminary proposal consists of six steps:

(1) The trigger of debt restructuring. The debtor firm is obliged to file for debt restructuring when it has at least one major debt (say over Y 100,000) overdue for a certain period of time (say 6 months).

(2) All of the firm’s debts are automatically canceled and will be replaced by a set of securities determined in step (3).

(3) A committee is appointed to supervise the reorganization process. It has two immediate tasks:

First, to draw up a plan (or plans) for the future of the company, to be presented to equity holders at the end of a prespecified period of time, say three months. The plan might be to reorganize the company—maybe with new management and/or a new financial structure; to sell it as a going concern; or to close the company down and sell off its assets piecemeal. The committee may also invite outsiders, other companies, to submit bids. Thus, plans should, of course, be consistent with the government’s policy guidelines. (The government may also need to set up an Enterprise Reorganization Fund, when necessary, to support the reorganization plan that is finally adopted in step (5) below.)

The committee, which may or may not include the old management, should be appointed by the largest creditor of the firm. In China’s case, it is most likely to be a bank.

Second, allocating rights to the equity in this company. This task could be carried out in parallel with the first task within the same time frame.

To simplify the illustration, suppose there are only two classes of creditors, an enterprise (triangular debt) and a bank (bad loan). They are owed debts in the amounts of Y 100,000 and Y 200,000, respectively. There is also a potential creditor, the worker, who would be owed Y 10,000 (social security debt, which represents the minimum
amount of money the worker is entitled to receive simply because he has been an employee of the company) should he is laid off after the restructuring.

The worker is allocated 100 percent of the company's equity. The enterprise is given the option to buy the equity from the worker with a cash transfer of 10,000 to the company. The money will be used to pay the worker if he is laid off after the restructuring, and will become a part of the company's assets if the worker stays in the company. The bank is given the option to buy the equity by paying 10,000 to the company and 100,000 to the enterprise. Finally, the original owner of the company (for example, the government agency in charge of the enterprise's assets, or, in the case of a shareholding company, the shareholder) is given the option to buy the equity from the worker, the enterprise and the bank for 10,000+100,000+200,000=310,000.

(4) Once the three months are up, the reorganization committee reveals its plan(s) and everyone can make an assessment of its worth (possibly with the help of some outside expert, such as an investment bank). At this point, the enterprises, the bank and the original owner are given some period of time, say one month, to examine their options under the committee's supervision and assistance (disclose relevant information regarding the reorganization plan). During this period, there can be a market in equity and options, although the process does not depend on this. (When outside investors are allowed to participate in this market, they may become the final owner of the company. In some circumstances, this could be the optimal solution. However, to simplify the illustration, we assume this will not happen here.)

(5) The company's equity holders (that is, those who hold equity in the company at the end of month 4) vote on which of the various proposals to select.

(6) A Debt Restructuring Fund will be set up by the government to do the following:

Case 1: The best plan is perceived to value the company at less than 10,000, say 8,000. Then no one will want to exercise their options, and the worker will end up with all the equity. The fund should provide 10,000-8,000=2,000 to the worker to maintain his minimum living standard. Without subsidies from the fund, neither the enterprise nor the bank would get any payoff. To partially compensate their losses, the fund should make a cash transfer equals to a portion of their debt claims. For example, the fund can pay 80 percent of 100,000 to the enterprise, and 80 percent of 200,000 to the bank. (The government should punish creditors for making wrong lending decision by not fully compensating their losses.)

Case 2: The best restructuring plan is perceived to be worth more than 10,000, but less than 110,000, say 50,000. Then the enterprise will choose to buy out the worker, but the bank and the original owner will not want to exercise their options. Then the enterprise becomes the final owner of the firm. Without subsidies from the fund, the
enterprise would only get a payoff of 40,000, which equals to the value of the company (50,000) minus the enterprise’s cash transfer to the company (10,000). The enterprise would incur a loss of 100,000-40,000=60,000. To partially compensate the enterprise’s loss, the fund should make a cash transfer of 0.8x60,000=48,000. As a result, the enterprise’s final payoff will be 40,000+48,000=88,000. The fund should also provide 0.6x200,000=120,000 to the bank. Notice that the enterprise, who is now the owner of the firm, should have incentive to vote for the optimal plan since its payoff is positively correlated to the firm’s value, while it should have no incentive to make bad loans again because the payoff 88,000 is less than the full value of its loan 100,000.

Case 3: The best restructuring plan is perceived to be worth more than 110,000, but less than 310,000, say 250,000. Then the bank will choose to buy out the worker (by making a 10,000 cash transfer) and the enterprise (by paying 100,000 cash), but the original owner will not want to exercise its option. Then, the bank becomes the final owner of the firm. Without subsidies from the fund, the bank would only get a payoff of 140,000, which equals to the value of the firm (250,000) minus the bank’s cash transfer to the company (10,000) and the enterprise (100,000). The bank would incur a loss of 200,000-140,000=60,000. To partially compensate the bank’s loss, the fund should make a cash transfer of 0.6x60,000=38,000. As a result, the Bank’s final payoff will be 140,000+38,000=176,000.

However, because the Chinese banking regulation does not allow banks to hold equity shares in nonfinancial companies, the fund should buy out the bank’s equity interest in the company. Therefore, instead of making a 38,000 compensation, the fund should make a cash transfer, which equals the bank’s payoff 176,000 when it is allowed to own the company, to recapitalize the bank, while taking away the bank’s ownership in the company. Notice that under the scheme, the bank will have incentive to pick the best plan while it has no incentive to extend bad loans again.

Case 4: The best plan is perceived to value the company at more than 310,000. Then the original owner will choose to buy out the worker, the enterprise and the bank. The fund should do nothing.
CLOSING REMARKS

Chen Qingtai

Ladies and Gentlemen,

The two-day conference is coming to an end. I would like to thank all the authors, consultants, and commentators—from home and abroad—for your hard work, which has made this conference a great success. The papers, comments and discussions of the participants covered a number of major issues faced by SOE reform in China, and the conference achieved positive results in many areas.

Here I'd like to especially mention the comprehensive report presented by the World Bank, which systematically introduced international experiences in SOE restructuring and put forward 10 suggestions in three areas for China's SOE reform. We have reported the main points of the suggestions to Vice Premier Wu Bangguo. We consider it a good proposal with many fundamental ideas that are consistent with what we are carrying on in this field. We also hope to continue our cooperation with the World Bank after this conference, to turn the results of this conference and the currently feasible parts of the Bank's proposal into policies, and according to Mr. Hope's advice, to select some municipalities or enterprises for experimental implementation. We believe that through the joint effort of central and local governments, technical experts, banks and enterprises, by bringing to bear their expertise and financial support, significant contributions will certainly be made to promote China's enterprise reform.

As a brief summary, I'd like to point out the following areas where this conference has achieved positive results.

Coordination of SOE Reform with Other Economic Reforms

The paper by the World Bank was rich in content and raised a number of issues of interest to all participants. One of its important points was the significance of the internal incentive and external incentive mechanisms to ensuring the efficient operation of a modern corporation. In his speech, Mr. Iskander stressed the importance of the external incentive mechanism. Professor Wu Jinglian, the commentator for the paper, shared this view. The Bank's analysis contains explicit policy recommendations. Clarifying the property rights

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1 Chen Qingtai is Vice Minister, State Economic and Trade Commission.
relationship, separating the functions of government from those of enterprises, designing a
mechanism for the owner's function, reorienting the relationship between enterprises and
banks, building up the social security system, separating social responsibility from
enterprises, strengthening external market pressure, enhancing mechanisms for bankruptcy,
and fostering labor force mobility, all of these are necessary conditions for the internal
incentive mechanism to be in place and for the external incentive mechanism to play its
role. Enterprise reform involves more than improving the businesses of enterprises per se.
To some extent, many of the difficulties that need to be overcome for enterprise
restructuring involve improving other facets of the economy. This requires us to view SOE
reform as a systematic project and to carry out other economic reforms in coordination with
top enterprise reform. Our Commission proposed a policy of "RRTS," that is, to combine
reform, restructuring, technological transformation and strengthening of enterprise
management, and to create the necessary external conditions for improvement of SOEs by
stressing both enterprises' own effort and complementary reforms.

Efficiency of a Holding Company Structure

As pointed out by Madame Jiang Qiangui in her paper, one of the difficulties
encountered by Chinese SOEs in the process of transforming to the modern enterprise
system is establish agencies that will represent the owner of state-owned assets in SOEs,
and how to find an efficient way for the ownership rights of the state to be realized. A
holding company is one of the devices proposed for resolving this problem. The
effectiveness of this structure was discussed by conference participants. Those who support
this notion argue that, in a developed market economy, many multinational companies take
on the structure of a holding company. In China, the State Council may authorize some
large enterprises and enterprise groups to exercise ownership rights on behalf of the state,
and transform sectoral companies and industrial ministries into state asset management
institutions. Those who oppose the idea, including the authors of the Bank's paper, give
examples of Italy and other countries where this type of corporate structure failed to solve
the problem. Some participants stressed that it is important to distinguish between state
asset management at the enterprise level and at the state level. The holding company
structure, they argue, may work well for internal management in enterprises, but is not
suited to management of state assets in general. Moreover, in a developed economy,
holding companies face market competition. I personally think that all arguments—both
pro and con—are valuable for further study of the issue.

The Role of Pension Funds in Enterprise Reform

In his comments on the Bank's paper, Professor Wu Jinglian repeated a suggestion
he has made in other fora of turning part of an SOE's assets into a pension fund. This drew
a great deal of attention from conference participants. Professor Wu believes that by
holding shares of SOEs, pension funds will both improve their shortage of capital, speed up
the establishment of a social security system, and form a new investment institution. This is
like “getting two birds with one stone.” While many participants agreed with Professor Wu, others doubted the feasibility of the suggestion. The main reason lies in the fact that the safety and quality of the assets of pension funds would be affected by poor performance of some SOEs, which could cause uneasiness of the pension beneficiaries. The discussion on this issue is expected to lead to further studies.

**Governance Structure Suitable for China’s SOEs**

The modern corporation has a long history of hundreds of years, and over time, a set of basic norms related to governance structure has emerged. The first step of China’s SOE reform is to thoroughly understand and learn from these norms. But that is not all. China’s SOEs have their own peculiarity because of the inheritance of centralized planning for decades. How international norms can be adopted in China to guarantee both the feasibility of reform and effectiveness of governance is an urgent problem. Mr. Jia Heting’s paper discussed the essence of this issue. In the comments and discussions about his paper, the participants expanded on such issues such as the selection mechanism for managers and the status of trade unions, which provide valuable reference for deeper research.

**Reducing the Social Burden of Enterprises and Establishing a Social Security System**

Mr. Hu Xiaoyi submitted a comprehensive and detailed paper to this conference on establishing a social security system and reducing the social burden of enterprises. As noted by his commentator, governments in developed economies spend a lot of time and energy on these issues. This demonstrates the troublesome nature of the “social responsibility” of China’s SOEs and the significance of Mr. Hu’s paper. The discussions referred to a number of issues. I am interested in two of them. One is the inherent relationship between the operation of capital markets and the reallocation of a redundant labor force. It is important to place the issue of reallocation of redundant labor in such a wider analytical framework in order to provide insights for policy-making. The other point is about the possible role of housing, a significant financial asset, in solving the problems of redundant labor and retired workers. As discussed by Mr. Bottelier of the World Bank and other participants, developing mortgage instruments provides an opportunity for workers to accumulate capital and develop the financial service industry; also, repair of houses could provide an important channel for employment opportunities for redundant labor, and so on. These suggestions will be helpful for policy-making.

**Internal Organizational Structure of Large Enterprises**

Mr. Qin Xiao, General Manager of a large Chinese company, bring a special advantage to the study of internal organization reforms of large SOEs. His paper indeed raised great interest among participants. Since reform began, there has been much debate as to the best methods for changing the internal structure of large enterprises, centralization vs. decentralization, and transforming the operation mechanism. In the discussion on
Mr. Qin’s paper, both the commentator and participants touched on the fundamental issue of what is the optimal relationship between the market and a firm’s internal organization as a means of resource allocation. On the one hand, as some participants pointed out, an enterprise, as a resource allocation mechanism that substitutes for the market, has its own value; yet it is not recommended to replace the enterprise organization with the market mechanism in all areas. On the other hand, some participants stressed that a clarified property rights system and a strong external incentive mechanism, as called for by the World Bank paper, are necessary preconditions for enterprises to run efficiently. As I said before, the essence of enterprise reform lies in the interrelationship of the internal incentive mechanism and the external incentive mechanism. I believe these discussions will help reform the internal structure of large SOEs.

Debt Restructuring in SOEs

One might say that the first day of the conference was more focused on the role of state assets in improving the operation of China’s SOEs and seeking representative institutions to realize the state’s property rights in SOEs. This afternoon, Madame Wu Xiaoling’s paper led the discussion to another part of the capital structure of SOEs, that is, capital invested in form of credit by the banks. Wu’s distinction between fiscal indebtedness and overindebtedness is a good conceptual framework both to theoretical study and policy-making. Her proposal, both its general ideas and its technical details, is worth careful study.

The issues raised by Mr. Hormats about debt restructuring are very important. It is necessary to take into account many factors when actually implementing financial restructuring, such as how to prevent the bad debt from getting worse; keeping fiscal costs to the minimum; how to prevent large-scale bad debt from recurring; combining debt restructuring with the reorganization of enterprises; preventing bankruptcy on a large scale in the process of reorganization; combining debt restructuring with the transformation of the management mechanism; dealing with each enterprise on a case-by-case basis; etc. It would be dangerous without careful consideration of all these factors to implement SOE debt restructuring.

Ladies and Gentlemen,

The Chinese economy has greatly impressed the world by its fast growth with vitality and vigor and its success in rapid reform in fiscal, financial, foreign exchange and foreign trade systems since Mr. Deng Xiaoping made his well-known speech in southern China in 1992. In the Fourth Plenum of the Fourteenth Party Congress of the CPC, it was decided that reform of SOEs will be the focal point of economic reform in China. At this moment, reform of SOEs is deepening in many areas, and positive results are being realized gradually. I believe that the deepening and success of the reform of SOEs will fundamentally accelerate the Chinese economy. At the same time, Chinese SOE reform
will result in tremendous and far-reaching impacts on the world economy. In this sense, there will be a very bright future for cooperation between the World Bank, experts and scholars and the State Economic and Trade Commission, the Ministry of Finance and other government departments on the reform of SOEs. What makes me and my colleagues in SETC, the Ministry of Finance and other government departments happy is that this conference, as a good beginning of this cooperation, not only achieved fruitful results in discussions of reform of SOEs, but also increased mutual understanding, established trust and friendship and paved the road for further cooperation. Here, please accept my heartfelt thanks to you all for your brilliant research, candid remarks and specific suggestions that contributed to reform of SOEs in China. May I look forward to more pleasant and fruitful cooperation with the World Bank, experts, professors and friends.

Thank you!
CLOSING REMARKS

Nicholas C. Hope

Distinguished authors, discussants, colleagues, ladies and gentlemen, let me thank you very much indeed for your insightful papers, comments, and frank discussions. It is a real pleasure to summarize the main findings and recommendations of this excellent Conference.

Let me start by saying that this Conference has fully confirmed our conviction that the government is entirely right in giving high priority to the reform of SOEs in the years ahead. These major institutional and system reforms at the enterprise level, together with the pilot reforms and financial system reforms at the macro level that were started last year, are the key building blocks for completing China’s transition to a socialist market economy with a modern enterprise system. This Conference has demonstrated that the thinking in Government on such complex and often controversial issues as internal and external enterprise governance, the management of state assets in a competitive environment, labor mobility and labor market development, the reorganization of the social security system, housing reform and debt restructuring, has advanced and sharpened significantly.

The discussion at this Conference was so rich and suggestions so detailed that it would be impossible for me to reflect all covered ground fairly. Let me simplify my task by taking one by one each of the five key questions raised in my opening remarks yesterday. Recognizing the wisdom of Minister Wang’s statement that “China must find solutions that are uniquely appropriate to China,” let me briefly summarize what I heard in response to each of them while pondering on the principles that should guide action in reforming China’s state-owned enterprises.

How should the assets of the state be managed to ensure that society receives adequate return on capital, natural resources and labor?

The problem of ensuring that managers work in the interest of the owners was found to be particularly acute in SOEs because many bureaucratic layers—with distinct interests—separate the population (owners) from SOE managers. Although there is no easy solution to this principal-agent problem, two conclusions did emerge in the last two
days: First, the fewer intervening layers that separate owners from managers, the less likely it is that management will operate with a purpose different from owners. In this regard, international experience suggests that holding company structures entail certain risks that may retard reform of SOEs. China needs to review its current state asset management administration, and abandon large group companies and multilayer management bureaus in cases where it is clear that such structures reduce efficiency, accountability and transparency. In such cases, the interests of the state as owner may be better represented at the enterprise level through simple board structures.

Second, our discussion in the last two days has also made clear that SOE reform should focus on not only refining organizational structures, through improved internal governance systems, but also on promoting ownership diversification.

**What changes will create better incentives for the managers of China’s enterprises to strive for superior enterprise performance?**

There was considerable agreement on the best external incentives: the end of fiscal and quasi-fiscal subsidies and the establishment of a strong competitive environment.

For reform to be effective and enduring, competition in the marketplace is a must. There is much to be done in this area. Although SOEs account for only 1 percent of all Chinese enterprises, they produce close to 43 percent of the country’s industrial output. Moreover, economic and institutional barriers to entry and exit among SOEs remain high. State enterprise bankruptcies have been rare, although many SOEs have liabilities that exceed their assets. Bankruptcies have been avoided because of the adverse effect on workers, who risk losing their social security, and because the banking system is not yet motivated to deal effectively with overdue loans.

Further price liberalization and growth of nonstate distribution firms, especially at the wholesale level, can also increase competition and promote SOE efficiency. In addition, liberalization in foreign trade can be accelerated as planned. Government-controlled Foreign Trade Corporations still manage exports and imports; they handle more than 90 percent of China’s imports and at least 80 percent of its exports. Only a minority of SOEs have direct trading rights. Although China has reduced import tariffs, significant nontariff barriers are still in place. The result is that many SOEs are shielded from global competition. The best performing SOEs in China are generally those that operate in a genuinely competitive environment, be it domestically or internationally.

Our discussion also focused on designing policies that separate social services and housing from enterprises in such a way as to create appropriate incentives for SOE reform. Some progress was made in this area, to which I will return soon. We were less successful, however, in suggesting market-driven ways to eradicate poor management—something that occurs automatically in economies with well-developed capital markets.
Clearly, a starting point is corporatization, adoption of international accounting standards, and regular, required publication of balance sheets of SOEs.

**How can heavily indebted enterprises be helped to restructure their finances and regain profitability?**

The different proposals to restructure the debt of SOEs discussed during the conference had many points in common. Let me begin by repeating two guiding principles:

- Priority should be given to shutting off the flow that adds to the *stock* of bad debt each year.

- Subsequently, there should be a one-time cleanup of both SOEs and banks' balance sheets and an introduction of market-based incentives so as to instill self-sustaining commercial business practices.

With these two principles in mind, any plan will have to start by classifying the enterprises with respect to their ability to service and repay debt. State agencies working with banks should conduct an analysis of asset-liability situations and economic performance of banks and SOEs. Based on this analysis, they then have to decide which shall go bankrupt, which shall be sold, and which shall undergo financial restructuring.

Financial restructuring can include debt-equity conversion between enterprises and nonbanking creditors. Commercial intermediaries (such as trust and investment companies) in some cases could assist in implementing debt rearrangements for enterprises. Further initiatives would include general acquisitions of one enterprise by another; creating joint stock companies; and public sale of shares. Whatever the process, old mistakes must be avoided. SOEs have to operate under real budget constraints, and be required to pay the full cost for inputs while charging a market price for their outputs. Any remaining subsidies should be transparent and accounted for in central, provincial, and municipal budgets.

Much discussion was devoted to the question of whether accumulated social welfare debts of state enterprises—not always fully reflected on the liability side of their balance sheets—could be converted into equity shares paid to pension funds. This idea should be explored more fully. But it is clearly inadvisable to transfer to pension funds anything but high-quality assets that are readily tradable in secondary securities markets.

**How best can the social needs of the enterprise work force be supplied without impairing enterprises' ability to compete efficiently?**
Our two-day deliberation focused on both of the important factors that shape the response to this question. The first is labor redundancy, and the second is the separation of social services from enterprises.

Labor redundancy remains a serious problem in SOEs, despite the contract system and the redeployment program. With an estimated 15 million redundant workers in industrial SOEs, labor redeployment will be a task for many years—even if China manages to keep growing at 8 or 9 percent per year. To facilitate the process, a well-functioning unemployment insurance system will have to be put in place. An unemployment insurance system that provides protection but also encourages active job search is a better alternative than job guarantees. Unemployment insurance is less costly than job guarantees and, in contrast with job guarantees, it helps labor mobility.

Labor mobility is also hindered by enterprise-based social services. In addition, these enterprise-based social services obstruct enterprise performance. The largest component of these social costs is housing. As long as housing remains linked to jobs, labor markets cannot develop.

Housing subsidies should be phased out—either by converting them into wages and raising rental prices at least to cover the cost of construction plus interest forgone, or by selling real property rights to workers.

Private housing offers the opportunity to reduce fiscal burdens through the mechanism of reverse mortgage payments. Generally, an imaginative use of existing assets in the state sector, not only housing but also land and SOE assets not needed for productive processes, can facilitate the financial restructuring of overindebted enterprises while protecting social needs.

Divestiture of state enterprise social burdens is beginning to take place with municipal pension pooling, and the idea of a payroll tax earmarked for pension, unemployment and health benefits is gaining prominence. The ultimate goal of the pension reform process is to establish a public redistributive pension that guarantees a minimum income based on some poverty criterion and mandatory savings for retirement incomes above this minimum that reduces dependency of the old on the government.

**How should the production of state enterprises be reorganized?**

In many profit-making enterprises, the profits earned on one product subsidize the losses incurred from another. Redundant labor is partly paid through these internalized losses. Restructuring of China's SOEs calls for narrowing product lines, streamlining management, establishing effective financial controls, and introducing new production technologies.
Modernizing the organization of China's SOEs will have limited success unless the enterprises face hard budget constraints. It is true that real fiscal subsidies have been declining. But subsidies have not disappeared. They are now hidden in the banking system in the form of cheap credit. Money travels from state banks to state enterprises and many times does not return. As a result, otherwise bankrupt SOEs are able to maintain lines of subsidized credit and roll over nonperforming bank loans.

Negative real interest rates encourage excessive capital investment by SOEs. Making state enterprises efficient will depend significantly on financial reform. Reducing policy-directed credit and subsidies should be a chief aim of the reform of the financial sector in China. Over time, China should reduce the role of the credit plan and liberalize interest rates.

In closing, let me reiterate a major point from the opening session of the Conference. The news on the economy has been encouraging in recent months. This gives China the opportunity to push ahead with the reform of SOEs, and the associated reforms in the financial and social security systems. China can pursue reform from a position of strength. The World Bank has been proud to cooperate with the Government of China in organizing this Conference; we hope to extend that cooperation through active support to the Government as it implements its reform of SOEs.

Thank you.
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