

The World Bank in China's State-Owned Enterprise Reform Since the 1980s

Chunlin Zhang¹

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State owned enterprise (SOE) reform has been critical to China's successful economic reform in the past four decades, which resulted in 850 million people being pulled out of poverty (World Bank, 2017). This is because at the outset of the economic reform, China's non-agriculture sector, accounting for 60-65 percent of GDP and 30 percent of employment (World Bank, 1985, pp. 40, 42), were dominated by state ownership and central planning. Even today, a large SOE sector remains a hallmark of the Chinese economy. There were over 170,000 SOEs operating in the non-financial sectors in 2017 with a total of RMB 50 trillion (around US\$ 7 trillion) state equity capital, and the financial sector is dominated by state-owned financial institution in which the state has invested RMB 16 trillion (over US\$2 trillion) equity capital². Recent information released by senior leaders of the government suggests that SOEs generate around 30 percent of China's GDP³. China's unprecedented development success would have been unconceivable without its efforts in reforming the SOE sector.

Starting from the 1980s, SOE reform has been an important component of the partnership between the World Bank and China. Over a period of more than three decades, the Bank worked closely with its Chinese partners to provide a stream of analytical and advisory services⁴. This note is intended to be a brief review of the Bank's engagement in this area in the overall context of China's SOE reform.

Corporatization as a SOE Reform Strategy

In the 1980s, China's first generation of SOE reform sought to improve performance of all existing SOEs through two sets of modification to the traditional SOE model it transplanted from the Soviet Union⁵. The first aimed to empower SOE managers by transferring to them some microeconomic decision-making rights, known as "delegation of power" (*fangquan*). The second was designed to strengthen firm-level incentives by allowing managers and workers to benefit from performance improvement of their factory, in the forms of increased bonus and welfare, known as "profit sharing" (*rangli*). In the mid-1980s when this approach peaked, a range of performance contracts were put in place between SOE managers and their government supervisors to specify the decision-making rights to be delegated and the terms of profit sharing in relation to performance.

¹ Lead Private Sector Specialist of the Finance, Competitiveness and Innovation Global Practice of the World Bank Group.

² State Council report to the National People's Congress in 2018, http://www.npc.gov.cn/npc/xinwen/2018-10/25/content_2063928.htm.

³ According to a speech in 2018 made by President Xi Jinping (<http://finance.sina.com.cn/china/2018-11-01/doc-ifxeuwwt0311614.shtml>), domestic private enterprises account for "more than 60 percent" of China's GDP, which does not include private farms and foreign invested enterprises.

⁴ The Bank also attempted to support China's SOE reform through lending operations. However, there were small in scale, with relatively limited impact.

⁵ For a comprehensive review of China's SOE reform efforts since the 1950s, see Chapter 4 of (Wu, 2005).

However, the Bank's work in the 1980s focused on the reform of the traditional SOE model itself while maintaining state ownership. The first set of reform recommendations was provided in a highly proclaimed flagship study⁶ entitled "*China: Long-Term Development Issues and Options*" published in 1985. Recognizing the need for state direct control over some "important enterprises" such as public utilities, the report argued the following with regard to the majority of Chinese SOEs (World Bank, 1985, pp. 3-4; 164-6):

- Once a suitable economic environment is created through price reform and competition, pursuit of profit should lead most state enterprises in economically appropriate direction. The fundamental problem remains of the proper relationship between the state and the enterprise.
- One approach is to give strategic decision-making authority in each enterprises to a board of directors that represent institutions with a strong interest in the enterprise's profit.
- To guard against direct government intervention, a possible solution might be to spread the ownership of each state enterprise among several different institutions, example of which would include banks, pension funds, and insurance companies. This would result in a dispersion of the ownership of SOEs, a system that the report called "socialist joint stock ownership".
- However, policy towards non-state enterprises will also be critical in China's reform of the urban economy and could indirectly contribute to reform of state enterprises.
- Some state enterprises in small-scale industries and service sectors might be contracted out or simply sold.

This was followed by another report specifically on SOE reform in 1989 with more concrete recommendations (World Bank, 1989, pp. iv-ix). The report warned that the danger that the newly created State Property Management Board⁷ attempt to become a superpower of state property. It should be a policy making and monitoring body. It recommended that the actual ownership role in SOEs can be exercised by various forms of companies such as holding companies, investment companies. In the meantime, promulgation of a company law was highlighted as an immediate priority, and a set of regulations governing the valuation of assets and enterprises and of ownership rights should be developed as a basis of enterprise ownership transfer.

The two reports were instruments of an active and continuous policy dialogue. Policy message and technical advice were disseminated to Chinese policy researchers and advisors as well as senior policy makers in various ways. Participation in workshops with Chinese policy advisors was one of them. For example, most Chinese policy advisors received the messages of the 1989

⁶ It was the second analytical product the Bank delivered to China, and was requested personally by China's top leader Deng Xiaoping and the then Premier Zhao Ziyang. See (Lin, 2002, p. 26).

⁷ Or the State Administration of State Assets Management (SASAM) . SASAM was established in 1988 as an attempt to separate state ownership function and other functions of the government, (<http://www.cser.org.cn/news/895.aspx>). It was later absorbed by Ministry of Finance. In 2003, the State Assets Supervision and Administration Commission (SASAC) of the State Council was created to act as state owner on behalf of the State Council. Some units and staff of the Ministry of Finance joined the SASAC.

report, which was never published, at a workshop held in the Diaoyutai State Guest House⁸. A second channel was the participation of Chinese counterpart team in the Bank's study⁹.

While a wide range of Bank recommendations were considered by the Chinese authorities, corporatization as a strategy for SOE reform was later recognized by many senior Chinese policy advisors as a key contribution of the World Bank. It is widely agreed that the World Bank was the first to propose that corporatization can be a strategy for China's SOE reform. For example, in reviewing enterprise reform history of the 30 years after 1978, the China Academy of Social Sciences (Chen, 2008) recognized Edwin Lin, the head of World Bank China Program in the 1980s, as the first who proposed in 1984 that China's SOEs may adopt the corporation form of western companies. Wu Jinglian, a leading advisor to the State Council on economic reform, also appraised the influence of the World Bank's two reports in 1985 and 1989 in advising China to adopt corporatization as a potential way of reforming SOEs (Wu, 1994, pp. 220-1; 234-8).

After the re-launch of market-oriented reform in 1992 by Deng Xiaoping's "Southern Speeches", China's SOE reform entered its second generation in 1993, marked by the "Third Plenum Decision" of the 14th Central Committee of the Communist Party of China (CPC). In line with an overall vision of a "socialist market economy", the thrust of the new SOE reform strategy was a transformation of SOEs into modern corporations, known as the "modern enterprise system" in the CPC document. Behind the new strategy was a recognition that the efforts in improving SOE performance within the traditional SOE model in the 1980s had reached its limit and further progress would be difficult to achieve without reforming the model itself. A Company Law was promulgated in 1994 to facilitate the reform. Today virtually all Chinese SOEs are corporatized¹⁰.

The corporatization reform in the 1990s was implemented as a component of a broader and radical program of restructuring, in which a large number of financially distressed SOEs exited the market through merger and bankruptcy (Hsieh & Song, 2015, p. 304) and small SOEs were privatized following a policy known as "grasping the big and letting-go the small". In its 15th national congress in 1997 the CPC modified its ideological position to accept the private sector as a "component" of the "socialist market economy" and established that the co-existence of public and private ownership should be China's "basic economic system". In response to the Asian Financial Crisis, improvement of SOE performance was made a top priority through the "Three-Year Turnaround Program" that was implemented in 1998-2000. The radical reform and restructuring in the 1990s came with heavy social cost: around 30 million SOE employees, nearly half of the SOE workforce, lost their jobs. However, it transformed most large Chinese SOEs from inefficient production factories of government departments with multiple political and social mandates into corporations that compete in the domestic and international markets pursuing primarily commercial objectives. As a result, SOE performance was steadily strengthened from 1998 to 2007, which helped unleash the country's growth potential and secure rapid development in the early 2000s (Lam & Schipke, 2017, p. 307).

Commercialization of State Ownership Function

⁸ Some participants later referred it as the "Diaoyutai Meeting".

⁹ For example, the Chinese economist who was appointed to work with the Bank's industry team for the 1985 flagship report was Zhu Rongji, who became China's Premier a decade later (Lin, 2002, p. 35).

¹⁰ According statement of SASAC in early 2018, http://www.xinhuanet.com/fortune/2018-01/15/c_129791416.htm.

In the 1990s, the exercise of state ownership rights in SOEs became an issue of increasingly high priority. As explained by a Chinese senior policy maker in a joint conference with the World Bank (World Bank, 1995) in 1995, the challenge was how to 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. This was not surprising, because corporatization of SOEs requires an entity to act as shareholder on behalf of the state. In the absence of a well-functioning institutional framework of state ownership, many SOEs transformed themselves into “enterprise groups” where one traditional SOE was split into two entities: one wholly state-owned parent company acts as state shareholder, and another an operational subsidiary held by the former. The operational subsidiary was then opened up to non-state investors, including those in the stock market through initial public offering (IPO). In addition, in an attempt to further curtail government intervention in SOEs to make them independent market players, a range of line ministries and departments of the government at both the national and subnational levels were abolished in late 1990s. Again, due to the absence of a well-functioning institutional framework of state ownership, the role of the state as owner was weakened as government intervention in SOEs was scaled down, leading to an “emerging corporate governance vacuum” of “insider control” (World Bank, 1997, p. 50).

The World Bank’s supports in the 1990s maintained a strong focus on the exercise of state ownership. In 1995 the Bank and the then State Economic and Trade Commission (SETC), which was charged to lead SOE reform efforts nationwide, organized a joint conference on issues and options of China’s SOE reform, in which Chinese policy makers presented their views and raised questions, to which international experts responded with comments and discussions. Among the important policy options discussed were proposals of Jiang Qiangui, Director General of the then Enterprise Reform Department of SETC, of the creation of separate "managing institutions for state-owned assets" as corporate entities that replace line bureaus and ministries to oversee the performance of individual enterprises, and proposal of Wu Jinglian, Research Fellow of the Development Research Center of the State Council (DRC), that pension funds are allowed to hold shares in SOEs.

The conference was followed by a report in 1997 (World Bank, 1997) that advised China to strengthen the state's ownership interest through several organizational reforms including, e.g., simplifying present structures and their component bodies and eliminating layers wherever feasible; reorienting state asset management institutions toward financial instead of administrative management of assets; introducing professional managers and “outsiders” into the system. The report recognized that in China, the state carries out "shareholder" functions performed by private owners in market economic systems, and in doing so, it faces a tradeoff between maintaining control of SOEs and enhancing their asset values. Fundamentally reorienting SOEs' incentives toward the market may well require reducing the state's involvement to passive minority ownership of SOEs.

In the meantime, the Bank also expanded its engagement into areas related to SOE financial performance and restructuring shortly before the Asian Financial Crisis. Two reports were completed in 1996. One, based on missions in 1994 and 1995, focused on SOEs and looked at the need to reduce the borrowing requirement of the SOE sector, so as to contribute to macroeconomic stability. The report recommended a two-pronged strategy: reforming SOEs to improve

profitability which can be expected to increase the share of investment financed by retained earnings, and transferring SOEs to the non-state sector, together with the risks, through merger and other ways (World Bank, 1996 B, p. vii). Another put SOE issues in an overall analytical framework that has the SOE sector, the state owned financial sector and the public finance as three components of the overall government finance (World Bank, 1996 A). Such a framework made important contribution to the policy deliberation in China when the ongoing SOE restructuring was frustrated by a huge amount of non-performing loans that had the potential to drag state-owned commercial banks into crisis, and pension obligations of the state to SOE employees that could destabilize public finance. The impact of the Asian Financial Crisis proved it to be a particularly timely discussion. Shortly after the Crisis, China created four assets management companies to dispose non-performing loans of state-owned commercial banks, and the Bank provided its technical advice to some of them. In 2000 the Bank further engaged with the Chinese clients in this area and provided technical advice on SOE bankruptcy, supporting China's efforts in drafting a new bankruptcy law (World Bank, 2000).

As large SOEs were corporatized and some of them listed in the nascent stock market, and small ones were privatized, corporate governance quickly arose as a reform priority, to which the World Bank Group responded with a study jointly completed by the International Finance Corporation (IFC) and the World Bank in 2001 (Tenev & Zhang, 2002). The study, formally launched by the then President James Wolfenson in early 2002, focused on short- to medium-term corporate governance issues that were arising during the course of transformation of ownership in the Chinese state enterprise sector, covering companies participating in the two main forms of ownership diversification: listed companies and small and medium enterprises whose ownership structure is dominated by insiders. It looked at the new mechanisms and stakeholders emerging during the process of ownership diversification and their role in corporate governance. Recommended priorities for policy action include: (a) alleviating the negative impact of dominant state ownership on market discipline and on the regulatory capacity of the state; (b) building an institutional investor base; and (c) strengthening the role of banks in corporate governance. Many of the specific recommendations were consistent with recommendations made in previous World Bank studies, particularly the reports in 1997 and 2000 (World Bank, 1997) (World Bank, 2000). The study was completed in collaboration with the DRC, a partner that the Bank has closely worked with since then in its engagement on SOE reform.

In the fall of 2002, when the Chinese authorities made the final decision to create a centralized ownership agency, the Bank contributed to its design. The decision was made in the CPC's 16th national congress in 2002 and the creation of the entity, later named as "State Assets Supervision and Administration Commission" (SASAC), was approved by the National People's Congress in March 2003. In a policy note completed in September 2002 (Mako & Zhang, 2002) that addressed the question of how the Chinese state could exercise its ownership rights in a more effective way, the Bank advised China to focus on large SOEs and make the efficient use of state capital a central objective. It went further to recommend two specific instruments to this end: the concept of economic value added and statement of SOE that specifies its performance goals. In view of global experience and the fragmentation of authority and diffusion of responsibility for Chinese SOEs, the note argued in favor of the creation of a single government agency that specializes in exercising state ownership rights. It further emphasized a number of key requirements that would make the ownership agency work, including, for example, that it should

be commercially-focused and professional, and exercise its rights through normal means available to shareholder such as annual shareholder meetings and SOE board appointments. The messages of the policy note were disseminated to the authorities in the second half of 2002 through a partnership with the DRC and the note itself was delivered to a task force that was responsible to set up the structure of SASAC in early 2003. In September 2003, a follow-up policy notes (Mako & Zhang, 2003) provided more detailed technical advice on implementation of a “modern capital management system” as well as “ownership transformation”, or privatization, of some SOEs.

The establishment of SASAC in 2003 marked the end of China’s second generation of SOE reform. SASAC adopted a strong focus on efficiency of state capital use, in the name of “state assets value preservation and appreciation”. Corporate performance agreements with SOE management were employed as instruments to set clear and measurable performance targets, on which a monitoring and evaluation system was established that linked managerial performance with remuneration and appointment. A great deal of efforts was also made through pilots to promote board governance and market-based recruitment of senior executives.

Dividend Policy

After the establishment of SASAC, the Bank provided further support to China’s SOE reform on a specific issue: dividend policy. In essence, this involves an unfinished reform on the financial relationship between the government and SOEs. Since the taxation reform in 1994, in which a decision was taken that the government would not collect profit from SOEs for an unspecified period of time, most SOEs had not submitted any significant profit/dividend to the government. The issue was brought to the reform agenda by the establishment of SASAC as well as the steadily improving profitability of SOEs. Non-financial SOEs earned a total profit of RMB 759 billion in 2003, equivalent to 6.5 percent of GDP and 35 percent of fiscal revenue. In 2005, the Bank prepared a quick policy note (World Bank, 2005) advising the Chinese government to start formulating and implementing a dividend policy for SOEs. Drawing on international experience, the note discussed three key questions: why SOEs should pay dividend, how much to pay, and to whom.

Reform action was soon taken by the government. In 2007, the No. 26 Document of the State Council (State Council, 2007) launched a reform that aimed to collect dividend from SOEs in the portfolio of SASAC of the State Council and put it into a State Capital Management Budget (SCMB) on a pilot basis. In 2008, the first SCMB was formulated and implemented. However, some issues remained. First of all, there was a consensus that the dividend ratios of 5 percent and 10 percent were too low. Second, the approach of setting uniform ratio by the government was questionable. Third, one of the key principles of State Council Document No. 26, namely, the “interconnection” of the SCMB with the general budget, was not implemented.

In this context, and at the request of the Ministry of Finance, a second policy note was prepared in 2009 (World Bank, 2009). It argued that a sound dividend policy must generate effective discipline against insiders and leave adequate managerial autonomy to them in the meantime. In light of China’s challenges and relevant international experience, it recommended three actions to deepen the reform started by State Council Document No. 26 of 2007. The first was to raise the flexibility of SOE dividend ratio by adding a dividend ratio determination

mechanism to the existing system of state ownership function. The second involves government monitoring and adjustment of the average dividend ratio of all SOEs in the portfolio of State Council SASAC. The third was to start integrating SCMB with the general budget. In 2013, China made further decision (CPC, 2013) to raise the dividend ratio to 30 percent by 2020 and have the revenue submitted to public finance. Contribution of the SCMB to the general budget remains limited but has been increasing. In 2016, 21.6 percent the SCMB revenue was transferred to the general budget, although the amount was only RMB 55 billion¹¹, insignificantly small compared with the magnitude of the general budget.

In addition to dividend policy, the Bank also supported the government’s “Northeast Revitalization” initiative by providing advices from the perspective of SOE reform. The three Northeast provinces, Helongjiang, Jilin and Liaoning, are China’s “rust-belt” that had a high concentration of SOEs and lagged significantly behind the rest of the country in economic performance. A 2006 study (World Bank, 2006 A) found that dominance of Northeast economies by SOEs crowded out private sector and recommended that the SOE sector be categorized into different segments to apply different transformation strategies. In addition, investment climate improvements were recommended to attract private investment of both domestic and foreign origins. Finally, the government was advised to move from directing economic activity to facilitating private-sector investment and innovation. In a separate study in 2006 on social security reform of Liaoning province (World Bank, 2006 B, p. 41), the Bank also assessed the financial implication of the payroll tax that SOEs were required to pay for pension, health, and unemployment insurances.

State Capital Management and Competitive Neutrality

While the establishment of the SASAC model represented a major step forward in China’s SOE reform from where it stood in the 1990s, as the economic context changed, however, the SASAC model encountered various problems. On the one hand, there has been a tendency for SASAC to become increasingly involved in the business operation of SOEs. On the other hand, it made little progress in downsizing the SOE sector, withdrawing state capital from non-strategic sectors, and improving the efficiency of state capital use. In this context, the joint flagship study of the World Bank and the DRC published in 2012, “*China 2030: Building a Modern, Harmonious, and Creative High-Income Society*” (World Bank and DRC, 2012), provided further advice to the Chinese government on SOE reform in general and state capital management in particular. Recognizing that government ownership was widespread and varied, covering most sectors and ranging from outright ownership to controlling interest to minority shareholder, the report identified a two-fold challenge: How can public resources best be used? And how can China best transition from its current approach to managing its portfolio of state enterprises to an approach that is best suited for its long-term development objectives?

The report provided answers to both questions. On the first, the report stated that public resources should be used solely or mainly for the provision of public goods and services, the production or consumption of which result in unremunerated positive externalities, ranging from defense at one end to infrastructure, social protection, and basic R&D at the other. On the second, the report recommended to securitize state ownership in SOEs and consider establishing one or

¹¹ Data released by the Ministry of Finance, http://yss.mof.gov.cn/2016js/201707/t20170712_2647803.html.

more state asset management companies (SAMCs) that would represent the government as shareholder and would professionally manage and trade these assets in financial markets where feasible. The dividends of state enterprises would need to be paid to the SAMCs who, in turn, would transfer them to the budget. Finally, a portion of state assets could be transferred to the national pension fund with the flow of returns being used to help meet future pension obligations. The report saw it critical that SASAC confine itself to policy making and oversight, leaving asset management to the SAMCs. (World Bank and DRC, 2012, pp. 26-7).

Reform actions since 2013 have moved broadly toward the direction suggested by the report's second recommendation. The CPC Decision in 2013 called for establishment of “state capital operation companies” (SCOCs) and “state capital investment companies” (SCICs). The implementation of the reform progressed with 142 SCOCs and SCICs being set up at the provincial level as of 2017 (Shanghai State Assets Research, 2017), together with additional 11 at the national level. While SASAC remains involved in SOE management, a reform plan has been released in April 2017 (State Council, 2017) in which SASAC committed itself to a reduction of its intervention in SOEs with regard to 43 specific actions/areas. The State Council issued a more detailed implementation plan (State Council, 2018) in July 2018 for the introduction of SCOCs and SCICs into the current system, where it was clarified, among others, that SCOCs would take a position of portfolio investors while SCICs take controlling stakes in “strategic business lines”.

The fundamental structural changes that have taken place in the Chinese economy since late 1990s and the new development challenges China is facing today call for a new generation of SOE reform that not only improves the performance of SOEs themselves but also redefine the role of the SOE sector in the economy vis-à-vis the non-SOE sector and creates a level playing field between them. In partnership with the DRC again, a new World Bank study was completed in 2017. In addition to state capital management, the study emphasized that a level playing field between SOEs and non-SOEs is crucial to China's economy system because the notion of socialist market economy is viable only when a level playing field between SOEs and non-SOEs is achieved. It argued that China could benefit from an acceptance of the globally recognized principle of “competitive neutrality”, the spirit of which is the same fair or equal competition that has been advocated in China for a long time and widely accepted. The report encouraged China to develop a “neutrality standard” that fits its particular challenges at home and its changing role in the global economy and move further to conduct a competitive neutrality gap analysis to identify gaps and come with a specific reform action plan. In December 2018, the State Council required that businesses of all sizes and all types of ownership be treated as equals in tendering, land use and other respects “following the principle of competitive neutrality”.

Concluding Remarks

China's SOE reform is an area where a productive partnership between China and the World Bank worked well for more than three decades. In retrospective, a clear reason why the Bank managed to stay relevant has been its willingness to adapt to China's own reform strategy. As the Bank's 1997 report pointed out (World Bank, 1997, p. vii), China insisted to maintain state ownership of the key enterprises and improve their performance by establishing market-oriented incentives, even when most other countries in transition had turned to systemic, widespread privatization. It was remarkable that, instead of recommending to China the same prescriptions it

offered to other countries, the Bank was humble enough to concentrated on helping China find its way to improve and implement its own reform strategies. Thus, for more than three decades the main theme of the Bank's analytical work has been the reform of state ownership.

The 1985 report laid the foundation for the partnership. A key premise of the 1985 report was that SOE could perform reasonably well when two conditions are provided: a competitive market environment outside and profit motives inside, which were often referred to as the “external” and “internal” incentives in the Bank's reports in the 1990s (World Bank, 1997, p. viii). This comes with a fundamentally important implication: SOEs are “reform-able” and systemic, widespread privatization is not the only pathway to success. The main challenge is, instead, a “proper relationship between the state and the enterprise”, a subject on which the Bank maintained a focus since then. Of course, this does not deny the importance of the development of private enterprises, it only says that economic performance can be improved by reforming SOEs within the framework of state ownership.

Despite the contribution of China's SOE reform to its overall development success, the questions the Bank tried to address in 1985 remain relevant and open. If China is to achieve success in the next round of its economic transformation, what must happen to the state ownership? Does China stand a better chance by “converging” with the internationally recognized model as boosted by western advanced economies, or “diverging” from it based on the belief that a single best practice model does not exist, and its past success justifies no need for convergence? Or rather the pathway to success is to be found at some mid-point along the spectrum of “convergence-divergence”? The relevance of the questions goes beyond China. China's rising importance in the global economy has meant that the direction of its SOE reform has significant implications to its trading partners. For countries working on their own SOE reform, especially where SOEs are run in a system close to the one China started with in the 1980s, China's experience may serve as one of the potentially useful case studies.

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