University of New England

School of Economics

Institutional Constraints and Feasible Reform for State-Owned Enterprises in China

by

Xianming Meng and Brian Dollery

No. 2005-17

Working Paper Series in Economics

ISSN 1442 2980

http://www.une.edu.au/febl/EconStud/wps.htm

Institutional Constraints and Feasible Reform for State-Owned Enterprises in China

Xianming Meng and Brian Dollery**

Abstract

Efforts to transform the Chinese economy will have decisive ramifications for global prosperity and the success of these efforts hinges largely on the reform of state-owned enterprises (SOEs). The existing literature on the Chinese SOE reform program has neglected various critical institutional features of SOEs. This paper seeks to remedy this defect by describing the characteristics of SOEs in China, providing a synoptic description of the evolution of SOE reform, evaluating the magnitude of the impact of the SOE reform program, exploring key problems in Chinese SOE reform, and offering some policy suggestions for enhancing the process of reform.

Key Words: China, reform, state-owned enterprises.

** Xianming Meng is a member of the Centre for Local Government at the University of New England in Armidale NSW. Brian Dollery is Professor of Economics and Director of the UNE Centre for Local Government at the University of New England in Armidale NSW.
Contact information: School of Economics, University of New England, Armidale, NSW 2351, Australia. Email: bdollery@une.edu.au.

INTRODUCTION

State-owned enterprise (SOE) reform represents perhaps the most vital as well as the most difficult aspect of the overall economic reform process in the People's Republic of China and thus occupies a central position on the agenda of the Chinese government. Moreover, the SOE reform process has profound repercussions far beyond the borders of China. Given the rapid growth of the Chinese economy and its increasingly integral position in the global economy, development of the Chinese economy will have a decisive impact on world economic growth over the foreseeable future. It is thus not at all surprising that Chinese SOE reform has been heavily debated among economists not only in China but also in the broader international community.

The existing substantial literature about the SOEs reform in China is heavily focused on the political and social constraints of Chinese government policy on SOE reform. However, most commentators ignore various institutional characteristics unique to China. As a result, most policy prescriptions are neither feasible nor likely to be efficacious in the Chinese political economy milieu. The present paper thus attempts to incorporate the peculiarities of the Chinese economic structure into the analysis in order to generate a new perspective and offer practicable policy suggestions.

The paper itself is divided into five main parts. Section 2 seeks to outline the characteristics of SOEs in China and sketch their institutional background. Section 3 provides a synoptic description of the evolution of SOE reform in China. Section 4 attempts to evaluate the magnitude of the impact of the SOE reform program. Section 5 seeks to determine and explore the key problems in Chinese SOE reform. The paper ends in section 6 that offers some policy suggestions for enhancing the process of SOE reform in China.

STATE-OWNED ENTERPRISES IN CHINA

In line with the transformation of the Chinese economy into a centrally-planned socialist economy after the Communist takeover, there are a large number of SOEs in China that continue to play an important role in the modern Chinese economy. Prior to the present transition of China towards a market economy, all enterprises, apart from a small number of collectively-owned organizations, were owned by the Chinese state. However, with the onset SOE reform, the number of SOEs in China has decreased significantly, but nevertheless remains considerable. According to the State-owned Assets Supervision and Administration Commission (SASAC) of China (2004), the number of state-owned and state-held businesses fell from 238,000 in 1998 to 150,000 in 2003. Some idea of the rate of decline in the numbers of SOEs since 1998 can be gathered from Table 1.

Table 1 Trends in Number of SOEs in China, 1998 to 2002

Year	*1998*	*1999*	*2000*	*2001*	*2002*
No. of state-owned and state-holding enterprises	64737	61301	53489	46767	41125
No. of all state-owned and non-state-owned industrial enterprises above designated size *	165080	162033	162885	171256	181557

Note: * All state-owned and non-state-owned industrial enterprises above designated size refer to all state-owned industrial enterprises and the non-state-owned industrial enterprises with an annual sales income of over 5 million yuan.
Source: China State Statistical Bureau (2003).

The information in Table 1 requires some qualification. Despite the enormous number of SOEs in China, most are small or medium size: 147,000 out of 150,000 state-owned and state-holding businesses belong to this category. Moreover, according to the China State Statistical Bureau (2003), of the 181,557 industrial enterprises in 2002, 158, 234 should be classified as small-scale enterprises.

Given the rapidly declining numbers of SOEs, we would anticipate that their relative importance in the Chinese economy should be falling. Table 2 demonstrates that this is indeed the case.

Table 2 Percentage SOE Contribution to Industrial Output and National Retail Sales

Year	*1978*	*1985*	*1990*	*1999*
Output (%)	77.6	65	54.6	28.5
Retail sale (%)	54.6	41	39.5	24.3

Source: China State Statistical Bureau (1986, 1991, 2000); China Economic Information Network (http://www.cei.gov.cn)

Table 2 indicates that SOEs dominated Chinese economy before 1990, with total output accounting for more than half of national industrial production; but after 1999, output generated by SOEs fell to less than 30 per cent of GDP. Nevertheless, SOEs still enjoy a substantial influence on Chinese economy mainly by dominating certain vital industries and controlling 57 per cent of all industrial assets (Desvaux and Xu 2004). For instance, in the Chinese steel industry, SOEs occupied around 80 per cent of aggregate market share (Sheehan *et al.* 2001); in the insurance market, SOEs accounted for about 70 per cent of the market (Yu 2004). Similarly, China's four major state-owned banks hold more than 60 per cent of the country's banking assets (Wu, Y.C. 2001). Airlines, energy, telecommunication, metallurgy, and many other strategic industries are also monopolized by SOEs.

Notwithstanding their decline in absolute numbers, the continued significance of SOEs makes their performance important. It is well known that Chinese SOEs are inefficient, making heavy losses and generating vast bad debt to the banking system. However, the SOE reform program seems to have improved the situation. For instance, Table 3 provides various measures of the performance of SOEs in 2002 relative to foreign-funded enterprises (FFEs).

Table 3 Efficiency Comparison between SOEs and FFEs in 2002

Enterprises	*Ratio of value-added to gross industrial output value(%)*	*Ratio of total assets to industrial output value(%)*	*Assets liability ratio(%)*	*Ratio of profits to industrial cost(%)*	*Overall labor productivity (yuan-person-year)*	*Proportion of products sold*
State-owned and state holding enterprises	35.27	8.71	59.30	5.93	65749	98.98
Foreign funded enterprises	26.41	10.46	54.38	6.40	81313	98.28

Source: China State Statistical Bureau (2003).

Table 3 shows that in some respects SOEs seem relatively inefficient compared to FFEs. For instance, SOEs have lower profit-cost ratios, but the difference is not significant.

However, Desvaux and Xu (2004) has argued that only in protected industries, such as telecommunications, are most Chinese SOEs profitable. By contrast, in deregulated or competitive industries, SOEs yield, on average, a return on assets of 3 per cent - well below the 7 per cent that generated by the private sector.

From the perspective of employment, SOEs still play a critical role in the national economy. For example, Desvaux and Xu (2004) has estimated that SOEs employed half of China's 750 million workers in 2003. This is consistent with the data provided by the China State Statistical Bureau (2003), which is replicated in Table 4; SOEs accommodated around half of all industrial employment in 2002.

Table 4 Number of industrial staff and workers (million persons)

Year	*1998*	*1999*	*2000*	*2001*	*2002*
State-owned	27.21	24.12	20.96	18.24	15.46
Collective-owned	8.02	6.73	5.63	4.64	3.83
Others	12.30	13.43	14.43	15.50	18.00
National Total	47.53	44.28	41.02	38.38	37.29

Source: China State Statistical Bureau (2003).

Finally, several other features of SOEs in China are noteworthy. In particular, although the national company law passed in 1993 legally enshrined the notion that all business enterprises all equal in the eyes of the law, in reality, the policy environment faced by SOEs and non-SOEs is different. On one hand, Chinese SOEs enjoy several distinct advantages provided by central government, such as priority for bank loans and government subsidies, first claim on natural resources, and most importantly, less competitions (i.e. the private sector is forbidden to operate in some industries, and in China every company is permitted only restricted scope for business activities). On the other hand, SOEs suffer more from government intervention and socially imposed obligations. For example, some large SOEs in China run schools and hospitals and provide housing for their employees.

HISTORY OF STATE-OWNED ENTERPRISE REFORM IN CHINA

The SOE reform program was initiated in December 1978 by the Communist Party of China (CPC). It can be divided into three distinct stages.

Initiating Stage (1978-1984)

Prior to the SOE reform program, SOEs received production quotas from the state, and sold all output to the state, which allocated and distributed any profits generated by their operations. Moreover, senior executives of SOEs were both appointed and dismissed by government. These executives enjoyed the same treatment as government officials, and their achievements were evaluated by reference to government economic plans rather than by financial performance *per se*. In essence, SOEs were not separate enterprises, but rather production units under the direct control of the CPC and thus the government. This *modus operandi* was extremely inflexible and severely inhibited performance, thus contributing to the very low economic efficiency of SOEs.

In 1979, Chinese government initiated a SOE reform program by 'delegating power and sharing profits' with enterprises, aiming at reducing stultifying bureaucracy and giving more autonomy to enterprises. The main elements of the reform program ensured that once the scheduled production quota was met, SOEs could determine supplementary plans according to market conditions. They also now possessed some independent financial resources to use as they saw fit. In May 1984, the State Council announced that SOEs could enjoy autonomy in numerous crucial aspects including production and operations programming, product sales, pricing, material procuring, use of funds, disposition of properties, restructuring, personnel and labour, and the distribution of wages and bonuses. This phase of the SOE reform program was characterized as 'delegating power and sharing profits'. In effect, managers now had more freedom to manage and the performance of the enterprise directly affect the benefits of all employees.

Exploratory Stage (1984-1991)

In October 1984, the *Resolution on Reforming the Economic System* was adopted by the CPC, which encouraged all sectors of the economy to cooperate in increasing economic growth. In early 1987, the 'contract responsibility' system was initiated by the central government. Under this system, executive managers of all SOEs signed contract (typically for three years) with the relevant government agency and hence forth acted as the legal representatives of SOEs. The contract stipulated performance indicators such as profit and tax targets, asset appreciation levels, debt repayment, product and technology innovation, and the utilization of retained profits. In April 1988, the *SOE Law* was enacted. According to this law, executive managers assumed overall responsibility for enterprise control, with public agencies prohibited from direct intervention in enterprise management.

During this period, the contract responsibility system was adopted national wide. The main goal of this phase of the SOE reform program was to distinguish the role of government and the role of the enterprise, and thereby separating the right to own SOEs from the right to run them.

Standardizing Stage (1992-)

In October 1992, the CPC made it explicit that the objective of China's economic reforms was to establish a ‘socialist market economy’. State-owned enterprises, collectively owned enterprises and other types of enterprises were all requested to compete in the market economy where only the ‘fittest would survive’. State-owned enterprises were to become modern business enterprises with ‘clearly established ownership, well-defined power and responsibility, separation of enterprises for administration and scientific management’.

In 1993, legislation was adopted by the National People’s Congress to assist SOEs in developing modern business systems. In September 1999, the CPC passed *The Decisions of the Central Committee of the CPC on Several Important Issues in the Transformation and Development of State-owned Enterprises* which required that the shareholding of state-owned enterprises was to be spread and organizations with diversified investing bodies were encouraged to turn into regular commercial companies. In April 2001, the State Economic and Trade Commission, the Ministry of Personnel and the Ministry of Labour and Social Security jointly issued *The Opinions on Deepening the Reforms of the Internal Personnel, Labour and Distribution Systems of State-owned Enterprises* by which the administrative ranks in enterprises were cancelled. Thereafter, managers of SOEs were no longer entitled to treatment according to their administrative rank. In essence, this stage of the transformation of SOEs featured the establishment of modern enterprise system and the joint-stock system as the preferred method of ownership.

EMPIRICAL ASSESSMENT OF THE REFORM PROGRAM

The Chinese SOE reform program has clearly come a long way. But has it been a success or a failure? The answer depends to a large extent on the method to evaluate SOE reform. In this paper, we will use two different benchmarks to evaluate the efficacy of the program: past performance of SOEs and concurrent performance of non-SOEs.

Past SOE Performance

Considerable work has been undertaken on evaluating SOE reform in China in terms of improvements in total factor productivity (TFP) including Chen *et al.* (1988), Gordon and Li (1989), Dollar (1990), Jefferson *et al.* (1992), McMillan and Naughton (1992), Groves *et al.* (1994, 1995). According to these studies, the annual increase in TFP has been in the range 2 per cent to 4 per cent since 1979 - much higher than in the pre-reform period.

Other measures can also be invoked. For instance, according to the SASAC, in 2003 SOEs and state holding companies generated aggregate profits of around 495 billion yuan, which increased some 30.8 per cent over the previous year or 22.2 times greater than in 1998. Along similar lines, the gross state-owned assets rose to 19.7 trillion yuan in 2003 from 14.9 trillion yuan in 1998. Moreover, there are now 15 Chinese companies in the world's top 500, 14 of which are SOEs.

Table 5 provides various additional measures of the improvement in SOEs efficiency over the recent past.

Table 5 Efficiency Indices of State-owned and State-holding Enterprises

Year	*Ratio of value-added to gross industrial output value(%)*	*Ratio of total assets to industrial output value(%)*	*Assets liability ratio(%)*	*Ratio of profits to industrial cost(%)*	*Overall labor productivity (yuan-person-year)*	*Proportion of products sold*
1998	32.95	6.51	64.26	1.61	29054	97.41
1999	34.11	6.77	61.98	2.89	35741	98.15
2000	33.97	8.43	60.99	6.15	45998	98.88
2001	34.55	8.17	59.19	5.75	54772	98.65
2002	35.27	8.71	59.30	5.93	65749	98.98

Source: China State Statistical Bureau (2003).

Table 5 clearly illustrates the steady increase in both the asset-output ratio and labour productivity. Furthermore, the profit-cost ratio improved dramatically from 1998 to 2002. In sum, it is thus possible to demonstrate that SOE reform appears to have been successful.

However, these data only show the overall success of Chinese SOE reform. More disaggregated work suggests a somewhat different picture. For instance, the econometric study by Groves *et al.* (1994) concluded that, in 769 SOEs from 1980 to 1989, the increased enterprise autonomy raised workers' incomes but tended not to increase profits or lower state subsidies. In an analogous finding, the World Bank (1997) established that SOEs with management contracts tended to have lower capital and labour productivities.

Non-SOE Performance

Notwithstanding the comparatively rosy picture that emerged from using the past performance of SOEs as the *numeraire*, compared with non-SOEs, SOEs seem to have lagged (see, for example, Jefferson and Rawski 1994; Woo *et al.* 1994). The 'efficiency gap' between SOEs and non-SOEs is shown in Table 6.

Table 6 Estimated Percentage Rates in Annual Productivity Growth in Chinese Industry

	1980-84	*1984-88*	*1988-92*
Total factor productivity			
State sector	1.8	3.0	2.5
Urban and township	3.4	5.9	4.9*
Township-Village	7.3*	6.6*	6.9*
Labor productivity			
State sector	3.8	6.2	4.7
Urban and township	8.6	7.0	13.8

Notes: * Preliminary results
Source: Jefferson and Rawski (1994).

Chinese Industrial Censes also suggest a very poor comparative performance of Chinese SOEs. Relevant data is provided in Table 7. On the basis of this data, Nakagance (2000) has argued that the profit-tax ratio of SOEs is far below that of non-SOEs. If we consider the increasing wage share shown in Table 7, it seems that SOE reform process benefited SOE employees substantially, which apparently indicates that SOEs paid employees at the price of lower profitability. Put differently, SOEs still bear a significant social burden.

Table 7 Profitability of SOEs and Non-SOEs

	Wage share (%)		*Profit-tax ratio (%)*	
	1985	*1995*	*1985*	*1995*
SOEs	22.02	37.08	32.94	13.45
Collective-owned enterprises	34.84	33.15	46.96	22.26
Private industry		16.83		50.71
Joint industry	21.08	32.79	64.44	18.45
Share-holding industry		26.22		25.63
Foreign founded industry	23.16	17.80	31.90	20.29
Total	25.14	33.10	35.06	15.64

Source: Calculated from Chinese State Statistical Bureau (1985, 1995).

In addition to the evidence presented in Table 7, it is widely believed that one third of SOEs make explicit losses, another one third make implicit losses, while only one third are slightly profitable (Zhang, W.Y. 1998). This view appears to have been borne out in a survey of 100,000 medium and large SOEs undertaken by the Asian Development Bank, with more than one third of the sample SOEs making losses (Kokko *et al.* 2001).

These empirically based arguments seem to contradict our earlier conclusions drawn from Table 2. The primary reason for this ostensible paradox may lie in the differentiation between state-owned enterprises and state-holding enterprises. State-owned enterprises are undoubtedly SOEs, whereas state-holding enterprises imply that state owns the majority share of the enterprise, and they are thus mixed organizations or hybrid SOEs. Although the number of hybrid SOEs is smaller than pure SOEs, the output value and performance of the former outweigh the latter greatly, as Table 8 shows.

Table 8 State-owned enterprises and State-holding Enterprises

	Number of Enterprises (unit)		*Gross Industrial Output Value (100 million yuan)*	
	2001	*2002*	*2001*	*2002*
State-owned Industry	34530	29449	17229.19	17271.09
State-owned and State-holding Enterprises	46767	41125	42408.49	45178.96

Source: China State Statistical Bureau (2003).

Given that state-holding enterprises are only partly state owned and consequently have much better performance, if the performance of state-owned and state-holding enterprises as a whole is used to analyze the overall performance of SOEs, then the aggregate performance of SOEs will be overstated. This can partly explain the jump in profit-cost ratio in 2000 in Table 5, when SOEs started to diversify their ownership. However, it should immediately be added that if state holding enterprises are excluded in the comparative evaluation of SOEs, the performance of SOEs would be understated since the only best SOEs became state holding companies.[1]

[1] The China State Statistical Bureau (2003) only provided the efficiency data for state-owned enterprises and state holding enterprises as a whole; it was used to estimate the efficiency of SOEs in the second section of the paper.

ANALYSIS OF THE SOE REFORM PROGRAM

The synoptic empirical survey conducted above confirmed that SOEs still exhibit poor performance in comparison with non-SOEs. Accordingly, what is the problem with the SOE reform program? Several schools of thought have sought to answer this question and develop remedial measures. In this section we will examine extant work on the SOE reform program, various dilemmas that have been identified in the literature, and some of the central problems associated with then SOE reform program.

Chinese SOE Reform Perspectives

The literature on SOE reform in China can be roughly divided into two schools of thought: the ownership (or property rights) focused paradigm and the market focused paradigm.

Ownership focused paradigm

This school of thought contends that an unclear definition of ownership lies at the root of the problem (see, for instance, Zhang, W.Y. 1995, 1998; Qian 1996; Nakagance 2000; Shleifer and Vishny 1986, 1994, 1997). According to this view, the state (as owner of the SOE) has failed to effectively supervise management in

SOEs and this insufficient monitoring has allowed managers to pursue their private interests at the expense of the profitability of these enterprises. It is argued that residual claims and the control rights should be matched as closely as possible (see, for example, Harris and Raviv 1988, 1990; Dewatripont and Tirole 1994); and the optimal corporate governance should be characterized by a state-contingent control structure (see, for instance, Ahgion and Bolton 1992; Dewatripont and Tirole 1994). Scholars in the ownership camp attack the market focused school by maintaining that non-SOEs perform much better than SOEs even though they are all operate in the same market in China. Moreover, the performance of SOEs will not improve without first solving the principal-agent problem. Accordingly, to improve the corporate governance of SOEs, they advocate the corporatization and privatization of SOEs through mechanisms such as the introduction of a shareholding system, management and employee buyouts, joint ventures with foreigners, international listing of SOEs, outside control through bank or non-bank financial intermediaries, and separating the role of government as owner and as administrator.

Following the arguments advanced by this school of thought, Chinese government introduced the joint-stock system in 1987 and established both Shenzhen and Shanghai stock markets in 1990. Moreover, from September 1999 SOEs were encouraged to diversify their stock rights and to list abroad. As financial intermediaries, asset management companies (AMCs) have also been set up. To separate the role of government as administrator and owner, SASAC was established. These measures improved the performance of SOEs to some extent, but the outcomes are still not adequate. For instance, consider the operation of the shareholding system. According to Tam (1999), 74 per cent of chairmen, 80 per cent of directors and 90 per cent of supervisors in listed SOEs claimed that they were elected to their appointments - the election occurring during the custodianship of the enterprise by central government ministries. As a result, private shareholders can do very little to improve corporate governance.

Market focused paradigm

This school of thought attributes causes of the poor performance of the SOE sector to the lack of a competitive market environment (see, for example, Lin 1998; Rawski 1995; Steinfeld 1998). Exponents of this view assert that price distortions, soft-budget constraints, and the high costs attendant upon monitoring SOE management impair the SOE performance, and that these conditions are generated by the 'immature' nature of the current Chinese market system. They disagree with the ownership-focused school that the introduction of the shareholding system would improve the SOE efficiency without existence of an effective competitive market, and that property rights reform would function efficaciously only when institutions regulating and enforcing property rights became firmly established. Moreover, market mechanism will naturally create necessary institutions in any event. From a policy perspective, they contend that Chinese government should further develop a competitive capitalist market system, including removing the 'social burden' from SOEs, 'hardening' budget constraints on SOEs, restricting the role of SOE management, and constructing well-functioning markets for goods, capital and managerial and entrepreneurial talent.

Some SOE reform policies in China have indeed taken up some of these policy prescriptions. For example, Chinese authorities broke up many monopoly SOEs (like China Telecom) to encourage competition, wrote off some SOE debt, and reduced the 'social burden' borne by SOEs through housing reform, health insure reform, etc. Some of these policies were effective, such as encouraging more competition, but others were less successful, like writing off SOE debt, which many SOEs simply regarded as the equivalent of a new interest free loan!

How should we evaluate the debate between the property rights school and the market focused paradigm? Both schools seem to present reasonably convincing arguments, but none of them can solve the problems in Chinese SOE reform. Otherwise Chinese SOE reform should be very smooth and need not take so long time. The failure of both schools of thought lies in that they failed to fit in the political and social situation in China. For instance, when privatization is a taboo in Chinese political circle, full privatization of SOEs suggested by property right school of thought will be rule out at the beginning of policy making. Given the high entry barriers maintained by Chinese government in most of industries, developing a mature competitive market suggested by market school of thought has a long way to go. On the other hand, if the political and social constraints are released, two schools of thought are in fact two sides of a coin: if Chinese market became competitive, the corporate governance of SOEs should be improved. Otherwise, SOEs will be bankrupt, or privatized; if ownership of SOEs were diversified, or privatized, which meant no entry barriers in industries, the mature market would be formed thanks to competition.

Dilemmas in Chinese SOE reform

A second way of thinking about SOE reform in China is to construe the process in terms of a series of six main 'dilemmas':

Market economy vs. political control

The CPC seems agreed that Chinese economy reform is geared towards the creation of a fully-fledged market economy. But in the transition period between socialism and capitalism, there are nevertheless ongoing conflicts between market and government. For instance, a market economy requires allocation of resources through a price system in order to achieve allocation efficiency, but presently the vast preponderance of the resource allocation is mainly conducted by public agencies through administrative fiat (Wu, J.L. 2000). Similarly, the development of a market economy requires freedom within an established legal system, but the Chinese government is still unwilling to relinquish economic control. In this context, it must be stressed that currently the Chinese government retains substantial control over economy through SOEs, which still dominate in key industries.

Encouraging competition vs. entry barriers

Robust and competitive markets are essential to a thriving market economy. Bearing this in mind, the Chinese government encourages competition among enterprises (e.g. Chinese government has split most of monopoly SOEs). However, the Chinese authorities deliberately maintain many entry barriers to major industries. (Qian and Xu 1993) Indeed, in many industries non-SOE are forbidden. This promotes monopoly and oligopoly rather than competition.

Political costs vs. agency costs

Prior to the reform program, Chinese SOEs were exclusively run by government bureaucrats. In particular, both the quantity and price of products made by SOEs were determined by public agencies and simply set for SOEs. This had various deleterious effects to endemic government failure. For example, SOEs were obliged to use resources inefficiently because of the high cost of enforced information collecting and slow decision-making (i.e. political costs). After the onset of reform, and especially after the implementation of the contract responsibility system, the efficiency of SOEs was then impeded by severe principal-agency problems (i.e. agency cost) (Qian 1996). To minimize these agency costs, government agencies intervened more frequently, thus raising political costs. Accordingly, Chinese SOE reform has subsequently been hampered by an intertwined spiral of political costs interacting with agency costs.

Privatization vs. limited liquidity in the capital market

On ideological grounds, the Chinese state continues to hold a majority share in corporatized SOEs. But even granting the political concerns of the authorities, the state share is unnecessarily high. For instance, in most of listed companies, the government retains a two-thirds ownership through state and legal-person entities. In fact, the government only needs 51 per cent ownership or even less to effectively control a company. In principle, public agencies are free from political constraint if they want sell state shares. However, when (former) Prime Minister Zhu Ronji decided to sell state shares to finance the public social-security fund, the market reacted sensitively. For instance, the announcement by the China Securities Regulatory Commission (CSRC) in June 2001 that the state would sell shares equal to 10 per cent of public offerings led to 30 per cent decline in the Shanghai index, losing around US$ 72.5 billion in value over four months. When information emerged that CSRC would shelve any plan for the sale of state share, the market rapidly responded with a 10 per cent increase in value. The logic behind the sensitive market appears to be that liquidity in Chinese stock market is insufficient, so the sale of substantial state shares would flood the market due to insufficient demand.

Harder budget constraint vs. social burden borne by SOEs

The gross inefficiency of Chinese SOEs caused heavy financial burden to government, especially through large bad bank loans. Some economists criticized the soft budget constraint to SOEs as a primary reason for their inefficiency, but when public policy followed their policy prescriptions to harden budget constraints, SOE managers complained that they not only had too many extraneous employed workers, but also had to bear the tremendous burden of funding retired employees, and accordingly threatened to lay off more workers. Concerned by potential political unrest as a consequence of high unemployment, the government has to continue to subsidize SOEs or alternatively ordered banks to provide soft loans to SOEs.

'New boards' vs. 'old boards' in SOEs

During the corporatization of SOEs, new boards were set up within SOEs according to Chinese Corporate Law, which required shareholder's meetings, a board of directors and supervisory boards. A shareholder's meeting is similar to those of western companies. A board of directors is elected by at a shareholder's meeting. The supervisory board is composed of representatives of shareholders and a proportion of employee representatives. However, the 'old boards' in SOEs, such as a CPC board, trade unions, and a staff representative board still exist since the 'old boards' are still legal because no law or rule exists to dismiss them, and the CPC worries about losing control of reformed SOEs. Thus, the 'new' and 'old' boards are in conflict with each other for the right to control the enterprise. This also obviously leads to low productivity.

Key reasons for problematic SOE reform in China

Political considerations and 'spiritual shackles'

Given its communist background, Chinese government still adheres (at least in rhetorical terms) to socialism, for which state ownership is a critical foundation. Prior to economic reform, the CPC held that the quality of the socialist state is directly proportional to the size of its state sector. Accordingly, the more SOEs and the higher the state ownership in these SOEs, the better. This belief was further modified by Deng Xiaoping through his ‘white cat, black cat’ policy to the notion that SOEs must be efficient. The underlying philosophy was further revised to advocate a ‘leading role’ for government through state-owned enterprises by former president Jiang through his ‘hold the bigger, release the smaller’ policy, which meant that state ownership should be dominant in key industries and in large SOEs. It follows that state ownership of dominant SOEs should remain through the prohibition of full privatization and by forbidding private sector control of key industries.

A second political imperative that prevented the full privatization of SOEs resides in the proposition that ‘people should become rich together’. In the early stages of SOE reform, the increasing differences in income and wealth worried Chinese communists, which led then to question the policy. However, Deng Xiaoping met this concern be arguing that the aim of reform is to ‘let some become rich first and then help others’, with the final result that ‘we become rich together’. Nevertheless, in order to prevent the income and wealth gap between workers and managers from increasing, Ministry of Labor in China issued a decree that prohibits senior managers of SOEs from receiving more than three times the average income of employees. Bearing this in mind, the wages in foreign-funded enterprises are far higher than SOEs, so too is the differential between the salaries of managers and workers. It is thus rational to anticipate that the gap will become even larger if SOEs are fully privatized.

Aside from these ideological considerations, another practical political reason for Chinese government to retain control over so many SOEs is that dominant state ownership is essential for communists to remain in power. By controlling the economy through SOE ownership, it seems less likely that the authority of CPC will be challenged. In November 1993, the Third Plenary Session of the Fourteenth National Congress of the CPC passed *Decision on Several Issues for Establishing a Socialist Market Economy System by the Central Committee of the CPC*, which stated that the ‘market was to play a fundamental role concerning the resources under the macro control by the State’. It is thus made explicit that Chinese government wants to retain control of the national economy.

Finally, after considerable experience with socialist centrally planned economy, Chinese government has grown accustomed to controlling economic development. Moreover, despite 27 years since the genesis of market-orientated economic reform, the planned economy is far from over. To communist Chinese leaders, developing economy still appears to be one of most important national tasks. Indeed, economic development plans are still announced when the National People’s Representative Congress is held every five years. In essence, it remains true that the Chinese economy is a market economy at the micro level, but planned economy at macro level.

Social considerations

The Chinese government has made it explicit that social stability is one of its top priorities. A famous slogan initiated by former president Jiang held that 'stability is above everything'. Indeed, a stable society is vital for leading position of CPC and crucial for Chinese economic development as well. However, at least three problems associated with SOE reform may affect societal stability: income polarization, vulnerability of the social security system, and unemployment.

In the first place, widening income differences are a major concern for the Chinese government. According to Jian *et al.* (1995), China's income disparity has grown significantly since 1990. Income polarization due to SOE reform, and especially privatization, may lead to social unrest, especially in a communist country. As we have seen, income inequality conflicts with core communist values and thus may inflame 'losers' in the reform process. As a result, these people may rise up against society.

Secondly, reform may let the already vulnerable social security system unworkable. At present, the Chinese social security system is underdeveloped and incomplete. Moreover, most of its responsibilities are borne by SOEs. For example, SOE provides pensions for retired people, organizes childcare, delivers healthcare, and even arranges housing for their employees. If these social obligations are removed from SOEs through reform, and at the same time government cannot provide these services, then social unrest may arise.

Finally, and perhaps most importantly, unemployment associated with SOE reform that can spark civil unrest. For instance, fully privatized SOEs may lay off numerous superfluous workers, leading to possible disturbances.

Table 4 shows that SOEs employed around 20 million people in the period from 1998 to 2002 - roughly half of the total industrial staff and workers. The reform of SOEs may thus involve considerable increased unemployment. According to Hu (1998), laid-off workers from SOEs accounted for 64.3 per cent of laid off persons in 1996, and 68.4 per cent in 1997. Table 9 provides a statistical picture of registered urban unemployment over the period 1985 to 1997.

Table 9 Registered Urban Unemployment

Year	*No. of Unemployed*	*Unemployment Rate*
1985	2,385,000	1.8%
1986	2,644,000	2.0%
1987	2,766,000	2.0%
1988	2,962,000	2.0%
1989	3,779,000	2.6%
1990	3,832,000	2.5%
1991	3,522,000	2.3%
1992	3,639,000	2.3%
1993	4,201,000	2.6%
1994	4,764,000	2.8%
1995	5,198,000	2.9%
1996	6,528,000	3.0%
1997	5,700,000	3.1%

Source: China Statistics Summary (1998).

Although the aggregate unemployment rate in 1997 was 3.1 per cent, which is not high compared with western countries, it is nonetheless unsustainable in China. One reason for this observation is the huge absolute population of China; a small increase in the unemployment rate means a massive increase in absolute unemployment. Secondly, the social security system is incomplete and poorly financed in China; unemployment thus means extreme hardship. The third factor is that youth unemployment accounts for a very high proportion of total unemployment (60 per cent – 85 per cent), as shown in Table 10.

Table 10 Rate of Youth Unemployment

Year	*No. of Unemployed Youth*	*Youth Unemployment/ Total Unemployment*
1985	1,969,000	82.6
1986	2,093,000	79.2
1987	2,351,000	85.0
1988	2,453,000	82.8
1989	3,090,000	81.8
1990	3,127,000	81.6
1991	2,884,000	81.9
1992	2,998,000	82.4
1993	3,318,000	79.0
1994	3,010,000	63.2
1995	3,102,000	59.7

Source: China Industry Union Statistics Almanac (1998).

Given its concerns about increasing unemployment, the Chinese government established a reemployment project and a minimum living security system in May 1998. This effort mitigated the pressure of unemployment to some extent. However, much remains to be done.

Absent principals

The ownership of SOEs in China resides notionally in 'the whole people', which theoretically means all Chinese people. This interest in their efficient functioning is diluted across the entire population - SOEs become 'free goods'. Of course, in practice it is Chinese Government, or more precisely the bureaucratic agencies in government, that acts as the representative of the SOE owner. In other words, bureaucrats are the 'first order agent'. (Tylecote and Cai 2004; Zhang, W.Y. 1998) But the relationship between these 'owner' and 'agent' is peculiar: representative has all rights of ownership to select and supervise enterprise managers, but legally bears no responsibility nor enjoys any defined benefits from these rights. It should be stressed that in China, the salary and rank of public bureaucrats is decided through political alignment and bears no relationship with economic performance.

This situation gives rise to a very severe principal-agent problem. Given their lack of accountability, bureaucrats are not obliged to perform their oversight functions well. Moreover, because they receive no benefit, most bureaucrats have little incentive to select qualified managers and supervise their management adequately. In fact, patronage flourishes in the selection of managers, and rent seeking is rife. Indeed, according to Dunfee and Warren (2001), in 1998, out of 84 countries, China ranked 33rd most corrupt country. Because of these bureaucratic proclivities, many Chinese economists have come to the unusual conclusion that the principal-agent problem surrounding SOEs resides mainly in the principal rather than the agents (Zhang, W.Y. 1995, 1997; Fan 1995; Zhang, C.Y. 1995; Zhang, C.L. 1995, 1997)!

Given bizarre principal-agent problem between state (as SOE owner) and its bureaucratic agents, the second principal-agent problem between bureaucrats and SOE managers is amplified. Since bureaucrats are unaccountable, there is little *de facto* supervision of managers. The economy thus suffers from managerial 'insider control' (Wu, J.L.1994, 1995). This corporate structure has been summarized as 'a strong middle (top manager), and weak top (bureaucrats) and bottom (employees)' (Lee and Hahn 2001). This accounts for rampant corruption within SOEs, including widespread fraud and expense account abuse.

POLICY IMPLICATIONS FOR SOE REFORM

Based on this analysis, what should be done to improve the SOE reform program? Two policy options appear feasible: the establishment of a sound macro-economic environment and resolution of the acute principal-agent problems.

Establishment of a sound macro-economic environment

This would require at least two decisive policy measures:

Removal of entry barriers

As we have seen, for political reasons the Chinese government has forbidden the privatization of key industries. This is not only 'unfair' to non-SOE investors, but also leads to gross inefficiencies in SOEs due to lack competition in these industries. As a result, it impedes the overall development of the Chinese economy. It is thus obvious that a strong case exists for the removal of entry barriers.

In any event, it can be argued that high entry barriers to private sector involvement in key industries are not necessary to maintain China as a socialist country and thus removal of entry barriers is feasible even if with this political objective. In the first place, in complete contrast to 'small' SOEs which can be dominated by private enterprises, 'big' SOEs may continue to dominate in designated key industries without entry barriers, since they enjoy considerable advantages, such as guaranteed access to natural resources, significant economies of scale, and an experienced labor force. Secondly, facilitating the growth of the private sector should increase aggregate employment. Private sectors may employ more workers, thereby mitigating the financial pressure of unemployment on government and thus allowing the authorities to 'harden' budget constraints on SOEs. Thirdly, some of workers employed by private sectors may be from SOEs, which will decrease the number of employees in SOEs and improve their efficiency. Fourthly, competition will increase the efficiency of SOEs as well as non-SOEs. Fifthly, competition will provide more information on SOE performance that is vital for improving the agency problem, Finally, if SOEs are to survive in the long run, they will in any event have to be capable of competing with the private sector or they will represent a permanent obstacle to economy development. After all, there is surely scant reason to protect SOEs at the price of economy development and attendant improvement of in living standards.

Even without these arguments, the Chinese government may still be forced to remove entry barriers due to China's membership of the WTO. At the request of WTO, China will have to open the door to foreign companies. There is thus no reason for the Chinese government to permit foreign company to enter designated industries while simultaneously prohibiting entry for domestic Chinese private enterprise.

Reduce SOE's 'social responsibilities'

The existing extensive 'social responsibilities' of SOEs represent a critical barrier to SOE reform. In the first place, social obligations impose a heavy burden on SOEs. It is thus unfair for SOEs to compete with private firms that have no corresponding social burden. Secondly, given their social burden, SOEs have goals other than profit maximization and the pursuit efficiency, which serve to weaken their viability. Finally, social obligations have become an excuse for extensive government intervention and as well as enabling SOEs to bargain for bigger budget. By removing social responsibilities from SOEs, profit becomes the only goal of SOEs. 'Hard' budget constraints and less government intervention therefore become possible. Provided they adopt adequate corporate governance institutions, the efficiency of SOEs should improve.

However, the implementation of this policy objective is problematic since it involves reforming the entire Chinese social security system - a complicated project that will need vast public resources. Nevertheless, it is worth pursuing since the efficiency of SOEs must be improved and more efficient SOEs can generate more profits to finance the social security reform.

Solving the agency problem

Three main avenues suggest themselves:

Establishing adequate corporate governance of SOEs

In order to reduce the severity of the existing agency problem, many measures have been suggested and some have been adopted by Chinese government, such as a shareholder system, outside control by banks or other financial intermediates, and separating the roles of SOE owner and administrator. But none of these seems to function well. For instance, the introduction of a shareholder system has improved corporate governance of SOEs very little since the government as owner continues to dominate listed SOEs. Similarly, outside control by banks or other financial intermediates does not work simply because they are also Chinese SOEs and thus have acute agency problems themselves. Moreover, separating the roles of SOE owners and administrators has had scant impact on SOE performance, because it does not solve the principal-agent problem between state and bureaucrats in the first place: From the perspective SOE managers, a new department such as SASAC simply means a different but similar principal.

As we argued earlier, the acute first principal-agency problem resulted from the fact that bureaucrats in government are not responsible representatives for the SOE owners. Accordingly, to solve this problem, we should find appropriate and accountable representatives for the state as the owner of SOEs.

It can be argued that government should not constitute these representatives because SOE is owned by the public at large rather than government *per se.* In practice, a mechanism already exists for selecting suitable representatives of the people as a whole. These representatives of SOE owners could be chosen from the National People's Congress (NPC) side. NPC representatives are popularly elected by voters across China, and they in turn elect the Standing Committee of NPC (SCNPC) every five years, which is formally supposed to act on the behalf of the people of China. Numerous committees under SCNPC standing already exist. It thus seems feasible to establish an SOE committee under SCNPC that is responsible for selecting managers for SOEs and then supervising the management of SOEs. If this standing committee does not perform its role adequately, then it can be replaced in the next election. Through this mechanism, the performance of SOE committee will affect its own future composition thus ensure that members of the committee strive to excel.

Under this proposal, the Chinese government will be formally separated from SOEs. Relieved of this time-consuming microeconomic role, it is hoped that the authorities can concentrate fully on building a better macroeconomic environment.

Risk funds

A core ingredient of the agency problem in SOEs resides in the fact that managers enjoy all the rights given by the SOE owner but bear no corresponding risk. Accordingly, if managers are asked to bear some risk (i.e. by purchasing SOE stock), the agency problem should be reduced. This method correlates risk and responsibility and thus should improve corporate governance. However, it does require managers to possess adequate personal funds or have access to commercial bank loans funds.

Accurate information collection

SOE are quintessential public sector organizations. Like any other public sector agencies, they will try to take advantage of information asymmetries in an attempt to maximize their budget. At present, the Chinese government only collects information through official government channels, most of which is provided by

SOEs themselves. An obvious agency problem thus arises. In order to facilitate more accurate information gathering, it is argued that other ‘outside’ sources of information on SOE performance should be sorted.

REFERENCES

Aghion, P. and Bolton, P. (1992) ‘An incomplete contracts approach to financial contracting’, *Review of Economic Studies* 59: 473-94.

Chen, K., Wang, H.C., Zheng, Y.X., Jefferson, G.H. and Rawski, T.G. (1988) ‘Productivity change in Chinese industry, 1953-1985’, *Journal of Comparative Economics* 12: 570-91.

China Industry Union (1998) *China Industry Union Almanac*, Beijing: Chinese labor publishing company.

China State Statistical Bureau (1985) *Chinese Industrial Censes*, State Statistical Publishing House.

China State Statistical Bureau (1995) *Chinese Industrial Censes*, State Statistical Publishing House.

China State Statistical Bureau (1986-2003) *China Statistical Yearbook*, Beijing: State Statistical Publishing House.

China State Statistical Bureau (1998) *China Statistic Summary*, Beijing: State Statistical Publishing House.

Desvaux, G.. W. M. and Xu, D. (2004) *Spurring Performance in China's State-owned Enterprises,* Mckinsey Quarterly, http://www. mckinseyquarterly.com

Dewatripont, M. and Tirole, J. (1994) 'A theory of debt and equity: diversity of securities and manager-shareholder congruence', *Quarterly Journal of Economics* 109: 1027-54.

Dollar, D. (1990) 'Economic reform and allocative efficiency in China's state-owned industries', *Economic Development and Cultural Change* 39: 89-105.

Dunfee, W.T. and Warren, D.E. (2001) 'Is Guanxi ethical? A normative analysis of doing business in China', *Journal of Business Ethics* 32(3): 191–204.

Fan, G.. (1995) 'On ongoing reform of property rights of state enterprises', *Journal of Reform* 1: 7-24.

Gordon, R. and Li, W. (1989) *The Change in Productivity of Chinese State Enterprise, 1983-1987: Initial Results,* Manuscript. Ann Arbor: University of Michigan, Department of Economics.

Groves, T., Hong, Y., McMillan J. and Naughton, B. (1994) 'Autonomy and incentives in Chinese state enterprises', *Quarterly Journal of Economics* 109, 183-209.

Groves, T., Hong, Y., McMillan J. and Naughton, B. (1995) 'China's evolving managerial labor market', *Journal of Political Economy* 103, 873-892.

Harris, M. and Raviv, A. (1988) 'Corporate governance: voting rights and majority rules', *Journal of Financial Economics* 20: 203-235.

Harris, M. and Raviv, A. (1990) 'Capital structure and the informational role of debt', *Journal of Finance* 45: 321-49.

Hu, A. (1998) 'An analysis of Chinese unemployment conditions', *Management World* 4: 11-19.

Jefferson, G.., Rawski, T. and Zheng, Y. (1992) 'Growth, efficiency and convergence in China's state and collective industry', *Economic Development and Cultural Change* 40: 239-66.

Jefferson, G. and Rawski, T. (1994) 'Enterprise reform in Chinese industry', *Journal of Economic Perspective* 8(2): 56.

Jian, T.L., Sachs, J. and Warner, A. (1995) *Trends in Income Inequality in China*, Development Discussion Paper No. 518, Harvard Institute for International Development, October.

Kokko, A., Cheng, Y., Qian, S., Senosliain, G. and Wepf, C. (2001) *SOEs and TVEs: The Pillars of the Chinese Industry*, available at http://www.nhh.no/geo/chinese/2001/papers/public-private.pdf.

Lee, K. and Hahn, D. (2001) *From Insider–outsider Collusion to Insider Control in China's SOEs,* April, available at: http://ideas.repec.org/p/snu/ioerwp/

no44.html.

Lin, J. (1998) *State-owned Enterprises Reform in China*, Hong Kong: Chinese university of Hong Kong.

McMillan, J. and Naughton, B. (1992) 'How to reform a planned economy: lessons from China', *Oxford Review of Economic Policy*. 8(1): 130-143.

Nakagance, K. (2000) *SOE Reform and Privatization in China: a Note in Several Theoretical and Empirical Issues,* Tokyo: University of Tokyo.

Qian, Y. and Xu, C. (1993) 'Why China's economic reform differ: the M-form hierarchy and entry/expansion of the non-state sector', *The Economics of Transition* June: 135-70.

Qian, Y. (1996) 'Enterprise reform in China: agency problems and political control', *Economics of Transition* 4(2): 427-447.

Rawski, T. (1995) 'Chinese industrial reform: accomplishments, prospects and implications', *American Economic Review* 84(2): 271-75.

State-owned Assets Supervision and Administration Commission [SASAC] (2004) 'China's SOE reform on the right track and to make headway'*, People's Daily,* 29 September, available at: http://www.chinastudygroup.org/newsarchive/7186/

Sheehan, J., Hassard, J., Morris, J. and Xiao, Y. (2004) *State Enterprises Reform and Industrial Restructuring in China,* ICCS/IAPS seminar paper, Nottingham University

Shleifer, A. and Vishny, R. (1986) 'Large shareholders and corporate control', *Journal of Political Economy* 94: 461-488.

Shleifer, A. and Vishny, R. (1994) 'Politicians and firms', *Quarterly Journal of Economics* 109: 995-1025.

Shleifer, A. and Vishny, R. (1997) 'A survey of corporate governance', *Journal of Finance* 52: 737-87.

Steinfeld, E. (1998) *Forging Reform in China-the Fate of State-owned Industry,* Cambridge: Cambridge University Press.

Tam, O.K. (1999) *The Development of Corporate Governance in China,* Cheltenham: Edward Elgar.

Tylecote, A. and Cai, J. (2004) 'China's SOE reform and technological change: a corporate governance perspective', *Asian Business and Management,* available at: http:www.palgrave-journals.com/abm.

Woo, W.T., Hai,, W., Jin, Y.B. and Fan, G. (1994) 'How successful has Chinese enterprise reform been?', *Journal of Comparative Economics* 18: 410-437

World Bank (1997) *China's Management of Enterprise Assets: The State as Shareholder,* Washington, D.C.: World Bank.

Wu, J.L. (1994) *Modern Corporate and Enterprise Reform*, Tianjing: Tianjin Renmin Press.

Wu, J.L. (1995) ‘Hard problems and policy options of large- and medium- sized SOE reform’, *Economic Daily*, 26 February, Beijing.

Wu, J.L. (2000) *China's Economic Reform: Past, Present and Future,* available at: http://www.oycf.org/Perspectives/5_043000/china.htm

Wu, Y.C. (2001) *Banking Industry in China: Problems and Prospect*, Beijing: China International Economic Consults.

Yu, C. (2004) ‘Insurance industry makes strides in reforms’, *China Daily*, 7 October, available at: http://www.chinadaily.com.cn/english/doc/2004-10/07/content_380111.htm

Zhang, C.L. (1995) ‘Reform of SOE's corporate governance: a financial perspective’, *Journal of Reform* 3: 3-11.

Zhang, C.L. (1997) ‘State enterprise reform and state financing’, *Economic Research Journal* 4: 18-24.

Zhang, C.Y. (1995) ‘Insider's control and Chinese enterprises reform’, *Journal of Reform* 3: 12-22.

Zhang, W.Y. (1995) ‘Rational thinking of China's SOE reform’, *China Business Time,* 13 January.

Zhang, W.Y. (1997) ‘Decision rights, residual claim and performance: a theory of how the Chinese state enterprise reform works’, *China Economic Review* 7(1):68-82.

Zhang, W.Y. (1998) *China's SOE reform: a Corporate Governance Perspective, Working paper,* No. 1998E004, Institute of Business Research, Peking University.