Meeting the Challenge of Chinese Enterprise Reform

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FOREWORD

Unlike many other countries undergoing transition to a market economy, China has experienced very fast growth; indeed, in recent years it has been the fastest in the world. In large part, China's economic performance since the advent of reform in 1978 is rooted in an industrialization strategy that has mixed competition, decentralization of economic management, and the opening of the economy to international trade and foreign investment. China's approach to enterprise reform has been a gradual and incremental one, as well as one based on experiments at the regional level before there is application nationwide. The nature of Chinese enterprise reform has progressed with increased sophistication in the last decade and a half, and a spate of reforms in the last two years, especially a 50-point program embodied in "The Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure" adopted by the 14th Central Committee of the Chinese Communist Party in November 1993, which sets out a reform blueprint for 2000, hold great promise.

Still, serious problems remain in a significant portion of China's industrial sector. These problems stem from inefficient structural attributes and poor performance of many of the country's state owned enterprises (SOEs). Among other things, China's SOEs possess ill-designed governance structures that do not delineate clearly corporate ownership and control property rights and are burdened by having to carry out a mix of productive and social functions amidst a lingering, distorted policy and regulatory policy regime and an economic environment lacking in well-developed factor markets. However, also populating China's industrial sector are collective firms and other non-state enterprises, including a nascent private sector, which are dynamic and growing rapidly. Although, in the main, these enterprises are small in scale, their increasing presence in the Chinese marketplace is having a strong, salutary competitive impact on SOEs' structure, conduct and performance.

As Harry Broadman's analysis shows, the Chinese authorities recognize that the "SOE problem" will not be fundamentally solved as a result of such competition. The challenge is to design a proactive program that intensifies SOE reform and accelerate SOEs' transformation into the commercial entities the Chinese authorities now believe they should be. The Bank and China have enjoyed a productive relationship working on enterprise reform, including a policy dialogue, economic and sector policy research and lending operations. The Bank and Chinese authorities share the common vision of the importance of the continued rapid development of the industrial sector for China's future prosperity.

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This paper is based in part on a larger study by the author of the Bank’s role in advancing the industrial development of China’s economy. In addition, it builds on insights in earlier Bank reports on Chinese enterprise reform, especially "China: Industrial Policies for an Economy in Transition," Report No. 8312-CHA (June 1990); "China: Industrial Restructuring: A Tale of Three Cities," Report No. 10479-CHA (December 1993); and "China: Enterprise Reform Strategy," mimeo (April 1994). The author is grateful to numerous Bank colleagues for helpful comments on earlier drafts, including Nick Hope, Pieter Bottelier, Eliana Cardoso, Richard Newfarmer, Richard Stern, Alan Gelb, I.J. Singh, Natalie Lichtenstein, Ishrat Husain, Jed Shilling, Peter Harrold, Tony Ody, Vikram Nehru, Ram Agarwala, Austin Hu, Shigeo Katsu, Zafar Khan, Xiaofeng Hua, and Rick Scobey. In addition, several non-Bank China experts provided useful advice, including Athar Hussain (London School of Economics), Gary Jefferson (Brandeis University), Nick Lardy (University of Washington), Tom Rawski (University of Pittsburgh), and Qian Yingyi (Stanford University).
This paper argues that despite China's impressive growth since the beginning of economic reform in 1978, inefficiencies still burden many of the state owned enterprises (SOEs) that comprise the core of the country's industrial sector. Reform of SOEs has been proceeding, including a 50-point program announced by the Government in November 1993 that contains major reforms to be introduced. In addition, competition from non-state sector firms has eroded the market share of SOEs; however, China's "SOE problem" will not simply wither away as a result of such competition. If China is to capitalize on its past successes, it must proactively restructure the overall SOE sector and intensify enterprise reform. The paper develops a diagnosis of the "SOE problem" in terms of three dimensions: (i) poor corporate internal incentive and governance systems; (ii) distortions in the policy and regulatory environment; and (iii) lack of well-developed factor markets—for labor, capital and technology. Utilizing this diagnostic perspective, an assessment is made of Chinese enterprise reform experiments, both past and planned efforts. It is suggested that the articulated objectives for future reforms hold the promise for solving many of the major problems and the challenge before the Chinese authorities is to design a program that implements these objectives.
EXECUTIVE SUMMARY

Introduction

At the heart of the seventeen year old Chinese "economic miracle" lies an industrialization strategy that has combined the introduction of market forces, gradual reduction of mandatory planning, decentralization, autonomy in economic management and opening the economy to international trade and foreign investment. While most successful development experiences feature industrialization as the key ingredient, reform in economies undergoing transition faces serious obstacles, and there is no generic model to serve as a guide. Indeed, China has yet to put in place a complete or fully consistent alternative to the earlier centrally planned model. But the transformation of China from a Soviet-style command system to a "socialist market economy" has pivoted on the skillful use of the country's economic and resource base.

China's economic performance is traceable to reforms that have transformed its industrial landscape into one where the share of state ownership in industrial enterprises has declined (but remains significant), and non-state enterprises, relatively unshackled by government policy and facing a highly competitive environment, thrive. This has occurred amidst an overall policy climate that increasingly simulates market conditions by encouraging state-owned enterprises (SOEs) to behave as commercial, profit-oriented entities. Notwithstanding this considerable progress, a significant portion of the industrial sector is still handicapped by systemic weaknesses and technological backwardness. China cannot afford to slacken the pace of reform.

Chinese Industrial Structure and Performance

Enterprise Ownership Forms and Size Distribution. There are about 9.9 million industrial enterprises in China.1/ Of these, 104,700 are "state-owned enterprises," which are generally located in urban areas; 1.8 million are "collectively owned enterprises" (COEs)—both rural, township and village enterprises (TVEs) and urban collectives; 8.0 million are "private businesses," which are family or individually owned private entities with no more than seven employees; and 32,100 are "other" types of enterprises, which include private firms employing more than seven persons, foreign-owned enterprises, and foreign-domestic joint ventures. The vast majority of enterprises in China are of relatively small scale.

Both SOEs and collectives are "public sector" enterprises. However, because of significant differences between the two in terms of location, ownership form, property rights regime, functional structure and the policy environment that governs their conduct and performance, collectives operate in a fashion more similar to competitive enterprises than to traditional public enterprises. While SOEs are mostly located in urban areas, most collectives are TVEs, located in rural areas. Functionally, SOEs not only carry out productive operations, but also are burdened with having to provide social services, including housing, education, hospitals, social security (pensions and unemployment, accident and health insurance), food services and fuel and retail outlets. COEs, on the other hand, generally perform only productive functions and thus can focus more squarely on commercial objectives. Unlike SOEs, which historically have had access to on-

1/ Unless otherwise noted, data cited in this paper generally are from the annual China Statistical Yearbook (various years) published by the State Statistical Bureau.
budget subsidies from government (at the central and sub-central levels) and off-budget subsidized credits from (the state-owned) banks, collectives have had to operate in an environment free of direct fiscal and quasi-fiscal government subsidies. However, COEs do rely on SOEs as sources of capital, labor, technology, materials and output markets. This dependence means that some of the observed superior performance COEs exhibit may be illusory.

SOEs account for about 43 percent of the country's gross value of industrial output (GVIO); COEs account for about 38 percent (TVEs account for 26 percent); "private business" account for about 8 percent; and "other" firms account for 10 percent. This pattern of industrial organization is in stark contrast to that at the beginning of reform. In 1978, the share of GVIO accounted for by SOEs was about 78 percent and collectives accounted for about 22 percent. While the non-state sector has been the major source of employment growth since the beginning of reform, SOE employment is growing, and today, among all industrial enterprises, about 70 percent of Chinese industrial workers at or above the village level are still employed in SOEs. SOEs also provide a disproportionate share of tax revenues for government at virtually all levels—the center, provinces, municipalities and counties. As a result, SOEs represent a pivotal, perhaps the pivotal, resource—acting as both a determinant and a constraint—in China's economic policy choices.

Enterprise Performance. Although small in scale and occupying relatively specialized market niches, non-state enterprises have proven to be powerful generators of employment, output and exports, and are generally efficient and dynamic. Perhaps most important, the emergence and rapid growth of these firms has done much to change the competitive market environment in which all enterprises operate, including SOEs. Notwithstanding the salutary effects of non-state firms on the degree of competition in the market, many—though by no means all—SOEs continue to have serious problems. In part, these problems are structural: (a) excessive and rigid patterns of corporate integration (e.g., extensive vertical integration and/or exaggerated diversity of product lines); (b) use of obsolete and often inappropriate technology; (c) virtual absence of multiplant economies of scale, especially across regions; (d) prevalence of plant production designs at less-than-minimum efficient scale; and (e) excessive investment in heavy industry at the expense of higher value-added activities, including services. In addition, SOEs' performance suffers because of the "social burdens" they carry.

China's economic reform program has had a strong, positive impact on SOE structure, output growth and performance. Total factor productivity growth has increased, and hundreds of otherwise unprofitable, smaller SOEs have been closed or transformed into joint ventures or collectives. A significant number of SOEs are also on the technological frontier, developing new products and processes and effectively diffusing such innovations in the markets they dominate. A growing number of SOEs are not only increasingly economically successful in the domestic market, but have also become major exporters and international investors.

Still, many large and medium sized SOEs continue to exhibit poor performance. For example, while annual total factor productivity for SOEs is rising, its growth is only about one third to one half the corresponding rate for non-state enterprises. SOE losses are sizeable, estimated at between 2.4 percent and 5.3 percent of GDP annually. As a result, many SOEs have required substantial fiscal and quasi-fiscal public subsidies, often occurring in a disguised manner through the financial system as directed credits. While explicit and implicit fiscal (i.e., on-budget) subsidies as a percent of GDP have been declining in recent years (from about 5.9 percent in 1990 to about 3.5 percent in 1993), quasi-fiscal (i.e., financial system) subsidies as a percent of GDP have been increasing (from about 3.8 percent in 1990 to about 6.0 percent in 1993). The net result is that total subsidies to SOEs are large and remain virtually unchanged. This is an unsustainable
structural situation and has obvious implications for macroeconomic performance, resource allocation and social stability.

Pollution associated with China's burgeoning industrial growth, including reliance on high-polluting heavy industry, continues to exact a sizeable toll on the Chinese people and the environment. China's industrial sector—not only SOEs but also non-state enterprises—is the major generator of massive water and air pollution in the country.

Historical Sources of China's Industrial Sector Problems

There are three main historical sources of the problems of China's industrial sector: (a) inefficient internal enterprise incentive and governance systems; (b) a distorted policy and regulatory regime; and (c) lack of well-developed factor markets. Inefficiencies in internal incentive and governance systems are rooted in the earlier regime of central economic planning, under which SOEs were generally established by administrative fiat rather than by market forces and thus suffered from poor "initial condition" decisions with respect to location, scale, product lines, capital-labor mix and technology; the linking of SOEs' productive functions with the provision of social services; and the administrative involvement of government in SOE business decision-making.

The policy and regulatory regime—comprising taxation, credit, price regulations, direct subsidies, tariff and nontariff trade barriers, foreign direct investment rules, and environmental regulations—has attempted to channel incipient market forces to serve often-conflicting policy goals. Many of these policies have been incoherent and uneven in application, causing distortions in resource allocation, both across regions and across industries. While there has been improvement in recent years on many of these fronts, problems remain; in some cases, progress has regressed, e.g., some eliminated price controls have been re-instituted. A particularly visible weakness of the regulatory regime is environmental protection.

The absence of viable and flexible factor markets has also made the transition to a market economy difficult. With capital markets still at an early stage of development, firms that are dynamic have relied mainly on internally generated savings, while money-losing firms have received subsidies from the government; bankrupt firms have been artificially kept in business. Rigidities in labor markets, due, among other things, to the absence of a free-standing "social safety net" have made it difficult for the movement of workers from areas with excess supplies of labor to areas with excess demand for labor, and for SOEs to shed labor as they have sought to become more efficient. While technology markets have emerged with much improved patent and trademark protection, immobility of scientific personnel, small production scales and restrictions on entry of certain foreign investments still impede the transformation of research and development (R&D) discoveries into marketable products and processes and technological diffusion.

The Record of China's Industrial Reforms

The Chinese authorities have recognized that the nation's pace and pattern of industrial growth must be sustained if economic development is to proceed. As a result, since the market opening of the country in 1978, a series of reforms were launched that decentralized economic decision-making, introduced market forces and competition into the industrial sector, and liberalized the external sector. Achieving even better industrial performance and sustaining high rates of economic growth have required that China accelerate the earlier reforms of its overall industrial organization, and more recent reforms have tended in that direction.
Achievements from 1978 to the Present. Throughout the 1978-92 period, numerous reforms were introduced, almost always in the Chinese gradualist and incremental style, and often first as experiments in certain regions and then replicated in other locales. The most salient policy experiments during the period included the introduction of the Contract Responsibility System (CRS), "corporatization" of SOEs, and the New Operating Mechanism (NOM) and the subsequent codification of its 14 Autonomous Management Rights. In addition, prices and production were increasingly decontrolled, and trade and foreign investment liberalized. Furthermore, labor, capital and technology market reforms were introduced. The period since late-1992 has witnessed several significant new tranches of enterprise reforms. The reaffirmation of the leadership's commitment to economic reform launched in the 1980s was first made evident in October 1992 with the change in the official economic philosophy from a "planned economy on the basis of socialist public ownership" to a "socialist market economy". In November 1993 the 3rd Plenary Session of the 14th Party Congress issued the "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure". This Decision outlines a 50-point agenda for economic reform to be attained by the end of the century across an unprecedented array of interrelated fronts, including (a) creating a "modern enterprise system"; (b) encouraging the development of diversified ownership forms of enterprises, including the "privately owned, individually owned and foreign-invested" sectors; and (c) requiring the state to provide for different ownership forms of enterprises to be able 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 program for implementation of the agenda embodied in the Decision is the challenge now being undertaken by the Chinese. The "10,000-1000-100-10" enterprise reform experiment, is the latest effort in this regard.

Remaining Problems to be Addressed. Notwithstanding the real progress of China's industrial reforms to date, these efforts have not resolved several problems. First, reforms have not appreciably squeezed out economically wasteful resource use in most SOE operations, let alone raised to technologically feasible levels the productivity of resources employed in economically efficient uses. Second they have not provided for sufficiently market-based governance autonomy and risk-reward incentive structures for SOE management. Third, reforms have not effectively reduced on a broad scale certain distortions in the policy regime governing enterprise conduct and performance. Finally, the reforms have not engendered self-sustaining factor markets, without which the efficient performance of industrial enterprises is ultimately constrained. Dealing with "the SOE problem" is still central. What is required is to modify the existing proactive policy regime into one that combines (a) a program for phasing out SOE fiscal and quasi-fiscal subsidies; (b) a nurturing environment that allows for autonomy of management, recombinations of corporate assets and open exit and entry; (c) the shedding of redundant labor and enterprise social service responsibilities while simultaneously ensuring the existence of a government-sponsored "social safety net"; (d) creating employment growth conditions, particularly in high value-added services industries; and (e) development of an independent, viable financial system.

The Agenda for Further Reform of China's Industrial Sector

China's government has charted an ambitious agenda for the continued development of the country's industrial sector. It generally reflects the objectives articulated above and seeks to modernize enterprise incentive and governance systems and diversify corporate ownership; improve further the policy and regulatory regime; and develop factor markets.
Modernizing Enterprise Incentive and Governance Systems

Separating the Government and Productive Sectors. Building on past reforms, efforts must continue the process of delegating business decision-making to SOEs, imposing hard budget constraints, and creating a market-oriented institutional framework for the state to exercise its ownership rights over its assets. In particular, SOE governance structures, property rights and managerial control mechanisms are sorely in need of realignment with principles of economic efficiency and greater specificity. The role, function and structure of the system of state asset administration also need significantly greater refinement.

Restructuring SOEs. Because of their continued critical role in the economy and the absence of fully developed factor markets, many SOEs require a proactive policy of restructuring. Ignoring the problems posed by this risks incurring unnecessary resource costs and social reversals that could delay the transition to a market economy. Further reform efforts must focus on (a) creating a nationwide market-driven restructuring capability that would have a multiplier effect across many industries and allow enterprises to consolidate, diversify, divest, exit and engage in asset sales and purchases so as to recombine capital and labor in new ways; (b) establishing mechanisms for enterprises to pass many of their social service burdens to government such that they are financed through public revenues (or in the case of housing, passed to newly developed markets); (c) creating credible and politically viable mechanisms to shed redundant labor, ease the adjustment of displaced workers into the labor market and create new employment opportunities, particularly in high value-added services activities; and (d) increasing the pace of corporatizing enterprises.

Enhancing the Policy Environment for the Non-State Sector. The Third Plenum’s Decision calls for a policy context that moves from "benign neglect" to active encouragement and development of non-state enterprises. Implementation of this policy objective will necessitate the establishment of (a) clearly and well-defined property rights for non-state enterprises and the management autonomy and obligations that go with them; (b) broad policy neutrality across enterprise ownership forms; and (c) equal access to factor markets, especially the financial system, for state and non-state enterprises.

Improving the Policy and Regulatory Regime

Reducing Distortions in the Policy Framework. Further reforms are needed regarding (a) prices, to completely decontrol lingering price ceilings and further rationalize relative prices (e.g., in the energy, grain and cotton sectors); (b) investment policy, to eliminate directed credit allocation schemes and rationalize and limit on- and off-budget financing and investment approval plans; (c) competition and regulatory policy; (d) foreign trade policy, to continue the liberalization of import tariff and nontariff barriers, especially the import license regime, the elimination of remaining indirect export subsidies and the further granting of direct export and import rights to enterprises (of all ownership types); (e) foreign direct investment policy, to streamline the regulatory apparatus governing screening of foreign direct investment as well as to further open the sectors in which such investment is permitted; and (f) tax policy, to establish greater neutrality among economic activities and across income groups.

Mitigating Industrial Pollution and Environmental Damage. There remains considerable scope for improvements in integrating environmental management effectively into economic policies. The pollution management system still relies heavily on administrative command rather than market-based mechanisms. There is thus a need to improve economic incentives to adopt
clean production techniques and waste disposal, which includes the imposition of fees, fines and compensation payments on any enterprise that fails to meet environmental standards. Enforcement of penalties and collection of levies are currently weak. Further reforms must focus on (a) pricing policies that encourage excessive energy and materials consumption, (b) the implementation of regulatory incentives/disincentives that internalize the costs of pollution and (c) strengthening regulatory institutions for pollution control, including monitoring and enforcement capabilities.

Developing Factor Markets

Enhancing the Labor Market. Development of a labor market is hampered because SOEs remain burdened with social service functions, notably the provision of housing, education, hospitals, and social security—pensions and unemployment, accident and health insurance. Moreover, notwithstanding the gradual introduction of the labor contract system, SOEs are burdened with the obligation of providing permanent employment to their workers. There is an urgent need to design implementable programs to accelerate the establishment of (a) government sponsored education, labor retraining, job information networks and unemployment compensation; (b) employer-employee funded portable pensions; and (c) commercial housing markets.

Capital Market and Financial Sector Reform. Restructuring of "real sector" enterprises requires that commercial banks, investment and merchant banks, and nonbank financial institutions have an incentive to intermediate funds so that firms can afford new investments in technology and machines. The government believes creating the mechanisms for monetary control is a top priority. Reforms being planned or already underway include (a) development of indirect monetary policy instruments, such as open market operations, gradual liberalization of interest rates, development of government securities markets, and creation of a modern payment system; (b) institutional restructuring of the People's Bank of China (PBC) to facilitate centralized monetary policy management; (c) the transformation of the state specialized banks into commercial banks; and (d) the establishment of a system of policy banks, including a state development bank, an agricultural policy bank, and an export-import bank.

Promoting Diffusion of Technology. The government is now committed to speeding technological innovation through (a) improving enforcement of recently implemented intellectual property legislation; (b) providing for the mobility of technical personnel from academic research institutions into the productive sector; (c) creating market-driven engineering agents to adapt international and domestic technology to local inputs and conditions; and (d) fostering the transfer of technology from abroad through foreign investment, licensing and "build-operate-and transfer" (BOT) or turnkey contracts.

Conclusion

China's economic growth has been sustained because the economy has been decentralized and there has been increased autonomy ceded to state-owned enterprises and opportunities for growth in the non-state sector. Consolidation of the successes engendered by that strategy requires further fundamental reforms: changes in the internal incentive and governance systems of SOEs, such as through clearer definition of property rights, and greater ownership diversification. At the same time, the overall market environment needs to be enhanced through: greater price competition, development of bona fide markets for labor, capital and technology, and reducing inter-regional and international barriers to entry and exit. The SOE-based social welfare system also needs to be reformed. Imposition of a "hard budget constraint" will require phasing out subsidies, collecting taxes, eliminating inter-enterprise debts and soft bank loans.
Achieving China's goal of industrial modernity will require farsighted policies backed by resource mobilization on a scale equivalent to the recent past. China cannot afford to slacken the pace of change. It must continue down its path of incremental implementation of reforms. In no small way that has been part of the secret of China's economic success and its ability to maintain growth.
1. INTRODUCTION

At the heart of the seventeen year old Chinese "economic miracle" lies an industrialization strategy that has combined the introduction of market forces, gradual reduction of mandatory planning, decentralization and autonomy in economic management and opening the economy to international trade and foreign investment. While most success stories of economic development feature industrialization as the key ingredient, reform of socialist economies undergoing transition to a market-oriented system faces especially formidable obstacles, and there is no generic model to serve as a guide. Indeed, China has yet to put in place a complete or fully consistent alternative to the centrally planned model. But the transformation of China from a Soviet-style command system to a "socialist market economy" has pivoted on the skillful use of the country's economic and resource base.

Since the advent of economic reform in 1978, China's real annual growth rate has averaged close to 10 percent, and in 1993 it exceeded 13 percent--the fastest in the world. This performance is traceable to policies that have transformed the country's industrial landscape; between 1979 and 1992, China's gross value of industrial output increased rapidly, at 13.2 percent a year in real terms. The share of industrial output accounted for by state owned enterprises (SOEs) has declined significantly since reform began, although SOEs still produce somewhat less than half of the nation's industrial products and employ the majority of industrial workers. At the same time, "non-state" enterprises--collectives, foreign funded firms, and private businesses--relatively less affected by direct government intervention or support and facing a more competitive environment and harder budget constraints, have been thriving. This transformation has occurred amidst an overall policy environment that increasingly simulates market conditions. Growing numbers of SOEs have been given autonomy over production, purchase of inputs, output sales, pricing, and internal profit distribution. Actions have also taken place on important fronts such as the use of labor contracting and formation of group and shareholding companies. Policy-makers have also drafted a plan to create a market-oriented banking system to allocate credit more efficiently.

However, important features of a modern, market-oriented enterprise system are still lacking in China. SOEs cannot freely dispose of assets, labor markets are just emerging, and direct export/import rights of individual firms are not widespread. Losses by SOEs continue to be pervasive, as reported by more than forty percent of them. Mandatory investment planning remains extensive; in some cases, price controls still prevail or have been re-introduced. Because SOEs are rarely allowed to go bankrupt, their losses are met through budget subsidies and soft loans, which are financed by the central bank. Deficit finance creates money more quickly than the amount people want to hold and thus produces inflation.

To be sure, reform of China's SOEs is proceeding, and in some cases producing great advances. But China remains a relatively poor country, with a per capita income of $470,3/ and close to 100 million people living in absolute poverty. Empirical evidence discredits the notion that the problems faced by China's SOEs will disappear gradually with the growth of the non-state sector: SOEs accounted for 70 percent of total industrial investment in 1993, an increase from 61 percent in 1989.4/ On the other hand, China's leadership has refrained from a policy of transforming the state's dominant ownership of SOEs, although a few sales of small SOEs into private hands has occurred. A significant portion of the state-owned industrial sector is still handicapped by systemic weaknesses and technological backwardness. The services sector, an area that holds great promise for employment growth in high value-added activities and which will become increasingly important as inefficient manufacturing industries continue to turn around and shed redundant labor, is severely underdeveloped.

China's economic growth has been sustained because the economy has been radically decentralized and there has been increased autonomy ceded to enterprise management. Beginning at the time economic reforms were introduced, when, by central fiat, there was a shift from collective to family farming as a way to unleash the productive talents of the overwhelming bulk of Chinese living in the countryside, the center has retained less control than it once did over the economy. While the center may have relinquished control in pursuit of efficiencies engendered by regional specialization that it ultimately would mediate, in fact, such interregional mediation has not effectively occurred. The result has been increasing amounts of local autonomy in economic decision-making. Lower level governments view enterprises under their jurisdiction as revenue sources. They allow some of these enterprises to operate in an entrepreneurial fashion. Indeed, in recent years, under a setting of increasingly insecure local property rights over state-owned enterprises' operations, particularly in advanced regions, there has arisen some degree of "collusion" between municipal governments and enterprise managers in facing the central government regarding disposition of assets and cash flow. The countervailing force to this collusion is that the central government and the Party maintain strong control over local government and SOE personnel appointments.

Decentralization and local autonomy have also resulted in uneven regional patterns of economic development, with coastal provinces exhibiting growth rates in multiples of interior provinces. For example, in the first quarter of 1994, seven provinces in the East and the South—Anhui, Fujian, Guandong, Jiangsu, Jiangxi, Shandong and Zhejiang contributed to 12.2 percent to the nation's 18.6 percent industrial growth.5/ A similarly uneven development pattern exists between the urban and rural areas. For example, amid

3/ The dollar GDP per capita figure used here is based on the atlas method rather than on purchasing power parity. Discussion of measuring China's GDP per capita on the basis of purchasing power parity is contained in World Bank, "China: GDP Per Capita," Report No. 13580-CHA, September 30, 1994.


13 percent economic growth in 1993, average annual rural per capita income grew only 3.2 percent to about Y 900, compared to income growth of 10.2 percent in urban areas, where the average annual per capita income is around Y 2300.6/ To be sure, the absence of strong central control has given rise to significant problems for management of fiscal and monetary policy. But the tension that has arisen between the central authorities and those at the provincial, municipal and county levels also has been an economically propelling force.

The "open door" policy of international trade and foreign investment liberalization has also helped the dramatic development of China's economy. Chinese foreign trade in industrial goods is now sizeable and has increased significantly over the last decade. Manufactured exports grew from $9.1 billion in 1980 to $72.1 billion in 1993, and manufactured imports grew from $5.4 billion in 1980 to $57.3 billion in 1993.7/ China now ranks as the 11th largest global exporter. Today, China is also one of the most attractive destinations for foreign direct investment (FDI). With $25.8 billion FDI inflows in 1993, China is the largest developing country recipient of FDI and accounts for more than 30 percent of such investment in developing countries.8/ The opening of the economy to international trade and foreign investment has led to the emergence of private and quasi-private enterprises, both domestic and foreign, through the establishment of foreign funded enterprises and joint ventures. Important, this has brought into the Chinese marketplace new forms of competition, modern management skills, and the transfer of innovative technologies.

Within the framework of a "socialist market economy" and an enterprise system that retains a high degree of public ownership, China is committed to pursuing a strategy of SOE ownership diversification. Beyond the transformation of increasing numbers of SOEs into shareholding companies, including cases where the state holds only a majority share, the authorities have provided for the leasing of SOEs to managers, other enterprises and workers, as well as for SOE mergers and consolidations, including mergers with other types of enterprise ownership forms. It has also permitted divestiture of small-scale SOEs into private hands.

One of the central challenges facing China's authorities in furthering enterprise reform is to devise, within the "socialist market economy" framework, an efficient system of corporate governance.2/ It is well known that in an economic system of private

9/ Governance generally refers to the set of relationships that link ownership and control of firms, the institutions through which these relationships are mediated (e.g., monitoring and evaluation mechanisms) and the nature of incentives, risks and constraints that affect how the actions of a firm's principals and agents (i.e., owners, managers and workers) influence the firm's conduct and performance.
enterprise and where competition prevails, the integration of corporate ownership and control provides for optimal governance. Even where there is some separation of corporate ownership from control, the granting of sufficient managerial autonomy can result in relatively efficient firm performance. This is true as long as the lines of authority between owners and managers are clearly delineated, are based on market principles, and are devised in line with the relevant parties' attitudes and abilities to bear risks as well as their comparative advantage in carrying out their respective tasks. Of course, when the "owner" of enterprises is the state, devising an efficient governance system requires use of non-conventional mechanisms to be effective. Since at this time China's leaders have chosen to place limits on more ambitious private asset divestitures to solve enterprise governance problems, the authorities have focused on pursuing efficient corporate performance through "corporatization," imposition of hard budget constraints and competition.

If China is to capitalize on its past successes, it must restructure the overall SOE sector because it bottles up most of the country's resources. The challenge before China's authorities is to design a program that intensifies SOE reform.
2. CHINESE INDUSTRIAL STRUCTURE AND PERFORMANCE

Enterprise Ownership Forms and Size Distribution

Industry is China’s largest productive sector, accounting for about half (51.8 percent) of its gross domestic product (GDP) and employing approximately a fifth of the country's total social labor force.10/ Gross industrial output, which amounted to $908 billion equivalent in 1993, is divided almost equally between heavy (56 percent) and light (44 percent) industries.

There are about 9.9 million industrial enterprises in China. Of these, 104,700 are "state-owned enterprises," which are generally located in urban areas; 1.8 million are "collectively owned enterprises" (COEs)—both rural, township and village enterprises (TVEs) and urban collectives; 8.0 million are "private businesses," which are family or individually owned private entities with no more than seven employees; and 32,100 are "other* types of enterprises, which include private firms employing more than seven persons, foreign-owned enterprises, and foreign-domestic joint ventures.11/ The vast majority of enterprises in China are therefore of relatively small scale.

Both SOEs and collectives are "public sector" enterprises. However, because of significant differences between the two in terms of location, ownership form, property rights regime, functional structure and the policy environment that governs their conduct and performance, collectives operate in a fashion more similar to commercial enterprises than to traditional public enterprises. While SOEs are mostly located in urban areas, most collectives are TVEs, located in rural areas.

SOEs are owned by the state ("the people," represented by the State Council—the Chinese equivalent of the U.S. cabinet—in the central government), while COEs are generally owned by local governments (e.g., TVEs are owned by township and village authorities). This gives rise to an important difference in terms of property rights: Even if SOEs' control rights (and residual income) have been delegated to municipal or other sub-central governments (which is the case), the state (central government) retains the ultimate rights over SOEs' assets. The state has no such rights vis à vis collectives, and the relationship between local government officials responsible for COEs and COE

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10/ China’s total social labor force in 1993 was 602.2 million persons. The industrial sector employed about one-fifth of the total, depending on how "industrial worker" is defined. "Secondary industry" workers totaled 135.2 million (22.5 percent). Workers employed in the three industrial sectors "manufacturing, excavation, and power generation, gas and water production and supply" totaled 104.7 million (17 percent).

11/ The "other" ownership category also consists of a variety of permutations of hybrid ventures between the aforementioned categories. In addition, the "other" category includes "labor service companies" (LSCs), which typically are formed by family members of SOE employees or SOE redundant workers themselves. LSCs tend to be initially financed heavily by SOEs, which in many cases own an LSC's assets. LSCs generally sell their output to SOEs as well as to other firms.
managers is characterized by direct and simplified interaction and a strong commonality of interests. Functionally, SOEs not only carry out productive operations, but also are burdened with having to provide social services, including housing, education, hospitals, social security (pensions and unemployment, accident and health insurance), food services and fuel and retail outlets. COEs, on the other hand, generally perform only productive functions and thus can focus on traditional corporate financial objectives. Unlike SOEs, which historically have had direct access to on-budget subsidies from government (at the central and sub-central levels) and off-budget subsidized credits from (the state-owned) banks, collectives generally have operated in an environment without easy access to direct fiscal and quasi-fiscal government subsidies and a bankruptcy safety net. SOEs rely heavily on bank credit--some estimates place the reliance as high as 80 percent--whereas COEs mostly utilize retained earnings.\footnote{At least 70 percent of bank lending in China goes to SOEs.} While SOE bankruptcies have been relatively rare, bankruptcies, layoffs, closures and restructurings occur regularly in the COE sector. Importantly, however, COEs do rely on SOEs as sources of capital, labor, technology, materials and output markets.

Although all SOEs are owned by the state at the central level, the overwhelming majority of the 104,700 industrial SOEs are controlled by municipal (and to a lesser extent) provincial or county governments: all but the 2,000-3,000 "very large" SOEs are under the control of sub-central authorities. Moreover, about 74 percent of SOE employees work in enterprises controlled by sub-central governments. Approximately 14,200 of the 104,700 SOEs (13 percent) are classified by the authorities as "large and medium" enterprises. These "large and medium" SOEs, which are defined on the basis of production capacity and asset value, produce more than 35 percent of the country’s total industrial output and account for more than 80 percent of SOE industrial output.

In general, SOEs concentrate on heavy industry (heavy industry accounts for about 70 percent of the gross value of SOE industrial output) and produce mostly important raw materials, capital goods, and strategic commodities. Non-state enterprises—urban collectives, TVEs, private firms, foreign funded enterprises and joint ventures—give greater attention to producing light industry manufactured and downstream consumer products (for example, 50 percent of the gross value of TVE industrial output is in light industry).

\textit{SOEs account for about 43 percent of the country’s gross value of industrial output (GVIO); COEs account for about 38 percent (TVEs account for 26 percent); "private business" account for about 8 percent; and "other" firms account for 10 percent.} Thus although SOEs account for only about 1 percent of the number of Chinese enterprises (see above), they account for more than 40 percent of China’s industrial production. Moreover, these data suggest that, strictly speaking, about 80 percent of China’s industrial output is produced by the public sector, i.e., SOEs and COEs. However, inasmuch as collectives tend to operate under conditions more akin to that of competitive firms, it is arguable that only somewhat less than half of China’s industrial output is produced by
traditional public enterprises. On the other hand, the contribution to GVIO of a genuine Chinese private sector, although difficult to measure accurately, is at maximum 20 percent.

This pattern of industrial organization is in stark contrast to that at the beginning of reform. In 1978, the share of GVIO accounted for by SOEs was about 78 percent and collectives accounted for about 22 percent; at that time the "private business" and "other" ownership enterprise forms effectively did not exist. Clearly there has been sizeable growth of the non-state sector, including private enterprise. In fact, since the advent of reform, in terms of industrial output, the collective and private sectors have exhibited the most rapid growth. In 1993, growth of industrial output by SOEs was 6.4 percent; in contrast, COE industrial output grew 28.6 percent, including 41.3 percent growth for TVEs; joint venture and solely foreign-funded firms registered output growth of 46.2 percent.13/

However, the core of China's industrial sector is still dominated by SOEs. A critical perspective on this point is provided by data on the important population of industrial enterprises that the authorities classify as "independent accounting units." An industrial enterprise is classified as an independent accounting unit if it possesses an independent administrative organization, the ability to account independently for its profits and losses and prepare independent financial balance sheets, the power to sign contracts with other units, and control of an independent bank account. This classification of enterprises is important from the perspective policy-making. For example, the corporate income tax is germane only to independent account unit enterprises. Similarly, assessment of enterprise losses depends on the existence of balance sheet accounting. Of the 9.9 million industrial enterprises in China, 449,000 are independent accounting units, and these enterprises account for 75 percent of the country's gross value of industrial output. Of the 104,700 SOEs, 80,586 (77 percent) are classified as independent accounting units. Importantly, SOEs that are independent accounting units account for about 72 percent of the country's industrial net fixed assets. Moreover, in contrast to the 43 percent share of industrial output accounted for by SOEs within the general population of enterprises, among all independent accounting unit enterprises—SOEs, COEs, private businesses and "other" firms—SOEs account for approximately 56 percent of China's industrial output.

In addition, while non-state firms have been the major sources of employment growth since the beginning of reform, employment in SOEs has continued to grow significantly—about 20 percent from 1985 through 1993. Today, about 70 percent of Chinese workers in the industrial sector at or above the village level—or 76.4 million persons—are employed in SOEs.14/ Moreover, SOEs provide a disproportionate share

13/ State Statistical Bureau, "Communique on Economy and Society for 1993," February 1994. The particularly slow growth of SOEs is traceable to the Government's anti-inflation policy of tighter money and credit, including restrictions on new fixed investment, as well as to a policy of reducing SOE fiscal and quasi-fiscal subsidies. Preliminary data for 1994 show that the value of SOE industrial output grew 5.5 percent, collectives' industrial output grew 21.4 percent and private and foreign-funded firms' industrial output grew 27.9 percent; see China Daily, January 12, 1995.

14/ These data refer to "staff and workers" employed in industrial SOEs.
of tax revenues for government at virtually all levels—the center, provinces, municipalities and counties: 65 percent of 1993 government revenues came from SOEs (in all sectors). Also significant is the fact that the majority of fixed investment in China is in the SOE sector: 61 percent of total fixed investment went to SOEs in 1993.15/ Taken together, these data suggest that SOEs represent a pivotal, perhaps the pivotal, resource—acting as both a determinant and a constraint—in China's economic policy choices.

Inter-enterprise Competition

In contrast to SOEs, non-state enterprises tend to operate at small scales. But non-state enterprises have proven to be powerful generators of employment, output and exports, and are generally efficient and dynamic. For example, for private enterprises alone, between 1992 and 1993 employment in cities and towns increased from 8.4 million to 11.2 million (33 percent). TVEs' exports increased tenfold between 1985 and 1990, and their share in national exports is estimated to have increased from 4.4 percent in 1985 to over 25 percent by 1992.16/ Perhaps most important, the emergence and rapid growth of non-state firms have done much to change the competitive market environment in which all enterprises operate, including SOEs. This is confirmed by the fact that in markets where TVEs are present there is (a) convergence of factor returns between SOEs and TVEs, (b) declining SOE profit rates and (c) a positive relationship between TVE market share and SOE productivity. In short, TVEs' contestable behavior has had a beneficial impact on SOE conduct and performance.

However, TVEs and urban collectives are dependent on resources from SOEs. The precise nature and extent of this dependency are not systematically documented. But the "free ridership" of these non-state enterprises and thus their perhaps significantly illusory cost advantages over SOEs raise doubts that some of these firms, particularly in light of their relatively small scales and the specialized market niches they occupy, can meet the market test of "sustainability" and hold the key to provide the ending competitive discipline necessary for efficient SOE performance. Owing to China's historical command economy system, which resulted in a bias towards regional autarky and thus "duplication of facilities" (e.g., where every region—or even every province—has its own set of steel-making factories, machine tool manufacturers, and so on), the degree of producer concentration in many industrial sectors in China is very low relative to what prevails internationally, as determined by technical economies of scale and scope. This suggests that with increased marketization of the Chinese economy, including further reduction of barriers to interregional trade, competition waged by large firms in each market—typically SOEs—will become more intense and there will be consolidation of enterprises.

Notwithstanding the salutary effects the entry of non-state firms has had on the degree of competition in the market, many—though by no means all—SOEs continue to have serious fundamental problems. In part, these problems are structural: (a) excessive


and rigid patterns of corporate integration (e.g., extensive vertical integration and/or exaggerated diversity of product lines); (b) use of obsolete and often inappropriate technology; (c) virtual absence of multiplant economies of scale, especially across regions; (d) prevalence of plant production designs at less-than-minimum efficient scale; and (e) excessive investment in heavy industry at the expense of higher value-added activities, including services.

In addition, SOEs' performance suffers because of the "social burdens" they carry: (f) providing to workers lifetime employment, resulting in an average SOE redundant labor force of 30 to 40 percent; and (g) providing an array of social services, such as housing, education, hospitals, social security (pensions and unemployment, accident and health insurance), food services and fuel and retail outlets. On average, SOEs provide housing for 93 percent of their employees and 51 percent of all urban residents. Taken together, these social obligations are sizeable, amount to a significant drag on enterprise expenses and distort labor costs. It has been estimated that the social services amount to about 6 percent of a typical urban SOE's total costs and 40 percent of its wage-bill. Particularly problematic are the pension costs. The age structure of the SOEs' workforce is old, and SOEs already have a large percentage of retirees. China's practice has been to adopt a "low wage / high welfare benefit payment" regime, where such welfare payments as pensions are paid out of SOE current revenues.

Impact of Reforms on SOE Performance

China's economic reform program has had a strong, positive impact on SOE structure, output growth and performance. Although difficult to estimate with great precision, annual total factor productivity growth in SOEs was just under about 2 percent from 1980 to 1984, accelerated to about 3 percent from 1984 to 1988, and was about 2.5 percent from 1988 to 1992. Hundreds of otherwise unprofitable, smaller SOEs have been closed or transformed into joint ventures or collectives. Some SOEs have divested the majority of their assets into private hands. In fact, the private divestiture of small-scale SOEs has been sanctioned by the authorities. Auctions where majority or full private ownership of (loss-making) SOEs has been the outcome, have occurred in Shanghai, Sichuan and Fujian. SOE enterprise groups, specialized sector holding companies and portfolio holding companies (like mutual funds in other countries) are also being

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17/ There has been a gradual introduction of a labor contract system to replace the "job-for-life" system; see below.


20/ There is a well-known case of a large-size SOE that is listed on the Shanghai stock exchange whose majority stake by the state was reduced below 50 percent when additional shares were issued and purchased by (foreign) institutional investors. Discussions with the Chinese authorities and anecdotal evidence strongly suggest there are other, similar cases.
formed at a rapid pace. At the end of 1994 there were 55 sanctioned large enterprise
group companies.21/

In addition, there has been a significant amount of leasing of enterprises currently
under state ownership to managers, other enterprises, or even to workers. Merger and
diversification strategies are also being pursued as ways of rationalizing and consolidating
(geographic and product-wise) segmented operations and achieving economies of scale and
scope. In recent years, as many as 10,000 enterprises (usually SOEs and COEs) have been
involved in mergers or acquisitions.22/ There are 36 "property rights transaction"
markets throughout the country, and the establishment of a national one in Beijing is being
planned.

Some SOEs are also on the technological frontier, developing new products and
processes and effectively diffusing such innovations in the markets they dominate. A
growing number of SOEs are not only increasingly economically successful in the domestic
market, but have also become major exporters and international investors. For example,
from 1985 to 1990, SOE exports grew at an average annual rate of as much as 20
percent.23/ Some of China’s large SOEs are adopting strategies to compete in the
international marketplace. For example, Sinochem, the state oil company, is one of
China’s most active firms abroad. The People’s Insurance Company of China (PICC) has
established two regional group companies in Hong Kong and London, and has plans to
establish group companies in New York and Singapore. The Bank of Communications
(BoCom)—one of a dozen state commercial banks established in the mid-1980s—has two
overseas branches in Hong Kong and New York, as well as two offices in Tokyo and
London; it has plans to open representative offices in Singapore and Frankfurt. Shougang
Steel Company purchased an iron mine in Peru and a steel mill in the United States.

Moreover, many SOEs are becoming shareholding companies. Indeed, there
currently are about 170 SOE listings on the Shanghai Stock Exchange, and about 110 SOE
listings on the Shenzhen Stock Exchange. More than thirty SOEs have received approval
for listing on foreign stock exchanges. To date, a dozen are listed on the Hong Kong
Stock Exchange; four are listed on the New York Stock Exchange, with three more to be
added as a result of a recent cooperation agreement signed between U.S. and Chinese
securities regulators;24/ see Box 2.1.

21/ A 56th large enterprise group company is currently being formed.


23/ This rapid growth—an estimate that is subject to considerable uncertainty—is in part likely attributable
to direct export subsidies. In the last few years, however, such subsidies have been removed,
although indirect export subsidies (e.g., low interest loans for some export categories) remain.

Data on the number of SOEs that have become shareholding companies are sketchy. As of year-end 1993, there were approximately 3,800 shareholding companies—of all ownership forms—in China. Other than 100-plus SOEs that are listed on the stock exchanges, it is not known with precision how many other SOEs are limited liability shareholding companies. There is also inadequate information on the number of SOEs that are limited liability companies. The State Planning Commission decides on an annual quota for listings on the domestic stock exchanges. For 1993, the national quota was Y 3 billion, which was divided among 14 cities and 30 provinces, with most jurisdictions getting about a Y 100 million quota. There is a minimum threshold of Y 50 million par value for each firm listed, thus effectively limiting the number of actual listings to two enterprises per jurisdiction. There are two types of shares listed on the two Chinese stock exchanges. "A" shares are for domestic investors only and paid for in renminbi. "B" shares are restricted to foreigners and paid for in hard currency. At most, 25 percent of a listed company's "A" shares can be held by the public, with a maximum of 10 percent held by employees. As of year-end 1994, there were about 140 "A" and 30 "B" listings on the Shanghai exchange, and about 90 "A" and 20 "B" listings on the Shenzhen exchange; generally "B" share companies also list "A" shares. "H" shares are issued for the Hong Kong Stock Exchange. The Hong Kong listings include Beiren Printing Machinery, Guangzhou Shipyard, Kunmin Machinery, Maanshan Iron and Steel, Shanghai Petrochemicals and Tsingtao Breweries. "N" shares are issued for the New York Stock Exchange (NYSE). The four SOEs currently listed on the NYSE are Shanghai Petrochemicals, Shanghai Rubber Tyre, Shandong Huaneng Electricity, and Huaneng International Power Development. The three additions will be China Eastern Airlines, China Southern Airlines, and Tianjin Steel Pipe. There are also several American Depository Receipts (ADR) listings of Chinese companies on the NYSE, which provide indirect instruments to raise equity in that market (because the companies' shares are already being traded on another stock market.)

SOE Losses and Subsidies

Still, many large SOEs continue to exhibit poor performance. For example, while annual total factor productivity for SOEs is rising, its growth is roughly estimated to be only one third to one half the corresponding rate for non-state enterprises, even after accounting for differences in the mix of productive and social functions carried out by the different enterprise forms.25/

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25/ See G.H. Jefferson and T.G. Rawski, "Enterprise Reform in Chinese Industry," The Journal of Economic Perspectives, vol. 8, no. 2, Spring 1994, p. 56. Comparisons between SOEs and COEs with respect to levels of productivity are more ambiguous. Some studies find little, if any, statistically significant difference in productivity levels, and some find that while at the beginning of the reform period SOE and COE productivity levels were roughly equal, by the late 1980s the average productivity level for COEs exceeded that for TVEs by as much as 16 percent.
Moreover, SOE financial losses are sizeable; see Table 2.1. Although measures of SOE losses are highly imprecise (for technical reasons and because firms have a tax incentive to under-report profits), Chinese authorities estimate that, in all sectors of the economy—industry, agriculture and services—the number of loss-making SOEs under the budget has increased from 26.4 percent in 1992, to 30.3 percent in 1993, to 41.4 percent in the last quarter of 1994. It is estimated that, in all sectors, the annual losses for SOEs under the budget were ¥93.3 billion in 1990, ¥93.1 billion in 1991, ¥75.7 billion in 1992 and ¥75 billion in 1993. These all-sector SOE losses amount to between 2.4 percent and 5.3 percent of GDP. For industrial sector SOEs under the budget, annual losses were estimated to be ¥34.9 billion in 1990, ¥36.7 billion in 1991, ¥36.9 billion in 1992 and ¥45.3 billion in 1993. These industrial sector SOE losses amount to between 1.4 percent and 2 percent of GDP.

Table 2.1: LOSSES OF CHINA'S STATE-OWNED ENTERPRISES (¥ billion)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>SOEs in all sectors</td>
<td>93.3</td>
<td>93.1</td>
<td>75.7</td>
<td>75.0</td>
</tr>
<tr>
<td>Losses as a % of GDP</td>
<td>5.3%</td>
<td>4.6%</td>
<td>3.2%</td>
<td>2.4%</td>
</tr>
<tr>
<td>SOEs in the industrial sector</td>
<td>34.9</td>
<td>36.7</td>
<td>36.9</td>
<td>45.3</td>
</tr>
<tr>
<td>Losses as a percentage of GDP</td>
<td>2.0%</td>
<td>1.8%</td>
<td>1.5%</td>
<td>1.4%</td>
</tr>
</tbody>
</table>

**Memo item**

GDP at current prices

|                  | 1,768.0 | 2,018.0 | 2,402.0 | 3,138.0 |


A significant portion of SOE losses have been due to policy factors (e.g., controlled sales prices set below cost) and concentrated in the grain, coal, petroleum and natural gas, and imported timber and wool sectors; as most price controls are being eliminated (although recently some have been re-introduced) these losses should disappear. However, SOE losses have also been present in other sectors, notably textiles, heavy engineering and metallurgy, materials, commerce (wholesaling and retailing), food processing and tobacco.

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26/ SOEs "under the budget" refers to SOEs that have been historically treated by the central authorities as independent accounting units and have directly received capital or financial subsidies from the central government—regardless of whether a sub-central government entity maintains operational control of the enterprise. In the industrial sector, approximately 38,200 SOEs—generally including the 14,200 "large and medium" SOEs—are under the budget.

27/ It has been reported that the losses for the first quarter of 1994 were ¥15.7 billion; see International Herald Tribune, April 27, 1994.
Measured losses are also a function of business cycle conditions. Moreover, the increase in reported losses within the last year is due to the adoption in July 1993 of the new, modernized accounting rules, which have the effect of converting otherwise invisible, implicit losses into visible, explicit losses.

The aggregate data on SOE losses pertains to the country as a whole and thus masks regional differences; see Table 2.2. Certain areas, particularly those with high concentrations of heavy industry, exhibit pronounced SOE losses. A senior government official in Beijing who recently visited Liaoning province in the Northeast, a region where heavy industry is dominant, estimates that only 12 percent of the more than 1,200 large and medium-size SOEs located there are operating "on a sound basis," another 18 percent are "operating reasonably well but apparently lacking staying power," and "all of the remaining 70 percent have major problems." In Chongqing, another of China's centers of heavy industry, located in the interior Southwestern province of Sichuan, about 45 percent of the SOEs were unprofitable in 1994, compared with 35 percent in 1993.21/

As a consequence of the large SOE losses, many of these firms have required substantial fiscal and quasi-fiscal public subsidies, often occurring in a disguised manner through the financial system; see Table 2.3. It is difficult to assess accurately the extent to which the government provides direct and indirect assistance to SOEs. Explicit subsidies paid out of the central budget to all unprofitable SOEs have been decreasing and amounted to Y 57.9 billion in 1990, Y 51.0 billion in 1991, Y 44.5 billion in 1992 and Y 41.0 billion in 1993.29/ These explicit fiscal subsidies to all SOEs amounted to 3.3 percent of GDP in 1990 and declined to 1.3 percent in 1993. For industrial sector SOEs, estimates of explicit fiscal subsidies are Y 11.8 billion in 1990, Y 14.5 billion in 1991 and Y 15.4 billion in 1992. These data indicate that although as a share of GDP explicit fiscal subsidies to all SOEs is declining, industrial SOEs account for a rising share of these explicit fiscal subsidies—from one fifth in 1990 to more than a third in 1992. Together with the data on losses, these data suggest that for industrial SOEs, the share of losses covered by explicit fiscal subsidies has been increasing over time.

However, a significant proportion of budgetary allocations are also made for SOE fixed investments that are in fact implicit fiscal subsidies to cover SOE operating expenses. About half of these funds are channeled through the People's Construction Bank of China (PCBC) as interest rate subsidies, and about half are channeled through the State Planning Commission (SPC) for special development projects. For all SOEs, the amount of such implicit fiscal subsidies has increased from Y 46.0 billion in 1990, to Y 48.4 billion in 1991, to Y 55.2 billion in 1992, and to Y 69.0 billion in 1993. However, as a share of GDP, implicit fiscal subsidies have declined, from 2.6 percent in 1990 to 2.2 percent in 1993.

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29/ The 1994 China Statistical Yearbook presents the central government's 1993 "balance sheet of revenues and expenditures" with about half of the 1993 Y 41.0 billion subsidies (Y 20.2 billion) going to "lossmaking nonproductive enterprises" and the other half (Y 20.8 billion) going to "lossmaking productive enterprises."
Table 2.2: **Regional Distribution of Industrial SOE Losses** (1993)

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of Firms</th>
<th>Gross Value of Industrial Output (Y billion)</th>
<th>Total Losses (Y billion)</th>
<th>Share of Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>80,586</td>
<td>2,208.7</td>
<td>45.3</td>
<td>100.0%</td>
</tr>
<tr>
<td>Beijing</td>
<td>1,575</td>
<td>76.0</td>
<td>0.7</td>
<td>1.5%</td>
</tr>
<tr>
<td>Tianjin</td>
<td>2,632</td>
<td>62.8</td>
<td>1.5</td>
<td>3.3%</td>
</tr>
<tr>
<td>Hebei</td>
<td>4,304</td>
<td>102.1</td>
<td>1.7</td>
<td>3.8%</td>
</tr>
<tr>
<td>Shanxi</td>
<td>2,630</td>
<td>53.7</td>
<td>1.7</td>
<td>3.8%</td>
</tr>
<tr>
<td>Inner Mongolia</td>
<td>2,097</td>
<td>36.7</td>
<td>1.0</td>
<td>2.2%</td>
</tr>
<tr>
<td>Liaoning</td>
<td>4,034</td>
<td>179.8</td>
<td>4.0</td>
<td>8.8%</td>
</tr>
<tr>
<td>Jilin</td>
<td>2,583</td>
<td>67.1</td>
<td>2.6</td>
<td>5.7%</td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>3,711</td>
<td>102.0</td>
<td>4.0</td>
<td>8.8%</td>
</tr>
<tr>
<td>Shanghai</td>
<td>2,166</td>
<td>155.9</td>
<td>0.7</td>
<td>1.5%</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>3,962</td>
<td>159.9</td>
<td>1.4</td>
<td>3.0%</td>
</tr>
<tr>
<td>Zhejiang</td>
<td>3,294</td>
<td>79.4</td>
<td>0.6</td>
<td>1.3%</td>
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<tr>
<td>Anhui</td>
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<td>69.8</td>
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<tr>
<td>Fujian</td>
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<td>38.5</td>
<td>0.6</td>
<td>1.3%</td>
</tr>
<tr>
<td>Jiangxi</td>
<td>3,768</td>
<td>47.8</td>
<td>1.5</td>
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<tr>
<td>Shandong</td>
<td>4,111</td>
<td>164.7</td>
<td>4.7</td>
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<tr>
<td>Henan</td>
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<td>101.1</td>
<td>1.6</td>
<td>3.5%</td>
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<tr>
<td>Hubei</td>
<td>4,069</td>
<td>110.1</td>
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<td>Hunan</td>
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<td>Guangdong</td>
<td>5,074</td>
<td>137.2</td>
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<tr>
<td>Guangxi</td>
<td>2,614</td>
<td>48.1</td>
<td>0.7</td>
<td>1.5%</td>
</tr>
<tr>
<td>Hainan</td>
<td>585</td>
<td>6.9</td>
<td>0.1</td>
<td>0.2%</td>
</tr>
<tr>
<td>Sichuan</td>
<td>5,289</td>
<td>126.0</td>
<td>3.1</td>
<td>6.8%</td>
</tr>
<tr>
<td>Guizhou</td>
<td>1,737</td>
<td>27.2</td>
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</tr>
<tr>
<td>Yunnan</td>
<td>2,049</td>
<td>50.3</td>
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<td>0.9%</td>
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<tr>
<td>Tibet</td>
<td>141</td>
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<td>0.01</td>
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<td>Shaanxi</td>
<td>2,555</td>
<td>49.6</td>
<td>1.7</td>
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<td>Gansu</td>
<td>1,489</td>
<td>37.3</td>
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<tr>
<td>Qinghai</td>
<td>524</td>
<td>7.8</td>
<td>0.4</td>
<td>0.9%</td>
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<tr>
<td>Ningxia</td>
<td>417</td>
<td>9.3</td>
<td>0.2</td>
<td>0.4%</td>
</tr>
<tr>
<td>Xingjiang</td>
<td>1,524</td>
<td>31.1</td>
<td>1.5</td>
<td>3.3%</td>
</tr>
</tbody>
</table>

Note: Pertains to industrial SOEs with "independent accounting systems."
Source: Author's calculations from *1994 China Statistical Yearbook.*
Table 2.3: Fiscal Subsidies to China's SOEs
(Y billion)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Explicit Fiscal Subsidies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SOEs in all sectors</td>
<td>57.9</td>
<td>51.0</td>
<td>44.5</td>
<td>41.0</td>
</tr>
<tr>
<td>Subsidies as a % of GDP</td>
<td>3.3%</td>
<td>2.5%</td>
<td>1.9%</td>
<td>1.3%</td>
</tr>
<tr>
<td>SOEs in the industrial sector</td>
<td>11.8</td>
<td>14.5</td>
<td>15.4</td>
<td>n.a.</td>
</tr>
<tr>
<td>Explicit subsidies to industrial SOEs as a share of total explicit subsidies</td>
<td>20.4%</td>
<td>28.4%</td>
<td>34.6%</td>
<td>n.a.</td>
</tr>
<tr>
<td><strong>Implicit Fiscal Subsidies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SOEs in all sectors</td>
<td>46.0</td>
<td>48.4</td>
<td>55.2</td>
<td>69.0</td>
</tr>
<tr>
<td>Subsidies as a % of GDP</td>
<td>2.6%</td>
<td>2.4%</td>
<td>2.3%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

**Memo item**
GDP at current prices 1,768.0 2,018.0 2,402.0 3,138.0


While the sum of explicit and implicit fiscal subsidies to SOEs as a share of GDP has been decreasing, from 5.9 percent in 1990 to 3.5 percent in 1993, quasi-fiscal subsidies—mainly low cost policy loans provided by the People's Bank of China (PBC) to the financial system to generally finance the short-term working capital needs of SOEs—have been rising as a share of GDP. Calculating these quasi-fiscal subsidies is even more difficult than (explicit or implicit) fiscal subsidies. It is estimated that as a share of GDP, quasi-fiscal subsidies amounted to between 3.2 and 4.3 percent in 1990 and rose to between 5.1 and 6.8 percent in 1993.\(^{30/}\)

\(^{30/}\) Not all "policy loans" are financed by PBC. Some are financed by the state banks supported by their own deposits and not borrowing from PBC resources; however, the loans are extended essentially as subsidies upon the direction of the central and local governments and are often non-performing. Still, it is generally believed that PBC lending supports the bulk of all policy loans. It is estimated that PBC policy loans range from 60 to 80 percent of total annual PBC lending to the financial system. The bulk of this lending has maturities of one to two years, and the rest is short-term lending, mostly for working capital loans made to loss-making SOEs. All PBC loans are subsidized to different degrees below the base of administered interest rates for bank loans, and it is estimated that more than half are not paid back. For a full discussion see World Bank, "China: Country Economic Memorandum," Report No. 13399-CHA (October 1994).
China’s above-average national saving rate has made providing these subsidies tolerable in the short run. But this is an unsustainable structural situation and has obvious implications for macroeconomic performance, resource allocation and social stability. As the authorities attempt to reduce inflationary pressures by adopting a policy of monetary restraint, the need to deal with SOE structural losses deprives the government of precious degrees of freedom in adopting such a policy stance. All other things equal, monetary restraint exacerbates the "SOE problem" not only by restricting unhealthy SOEs' cash flow and thus limiting their wage and other factor payments, but also curbing, on the margin, investments necessary for sound SOE restructuring.

The factor payment limitation is especially serious on two counts. First, it results in a growing number of SOEs unable to pay full wages to workers (and presumably full retirement and other benefits), raising the risk of social unrest. While the official urban unemployment rate in 1994 was 2.8 percent (4.4 million urban workers) and authorities estimate that it will increase to about 3.0 percent in 1995 (5 million urban workers), these data do not include workers "waiting for work." A recent survey by the Chinese Academy of Social Sciences estimated that the actual urban unemployment rate is at least 7 percent (10 million urban workers).31/ The survey predicts that 8 million urban workers will become unemployed as SOEs restructure in the future; it also estimates that up to 100 million rural workers are currently idle.

Second, the limitation on factor payments also fuels inter-enterprise "triangular" (or "chain") debt, estimated to be greater than Y 600 billion (19 percent of GDP).32/ Moreover, most of the SOEs' liabilities—estimated to be about Y 2 trillion, after deducting for the "triangular" debt—are credits of the (state-owned) banks. It has been estimated that already Y 300 billion to Y 400 billion of these liabilities (or approximately 15 percent of the country's bank loans) will never be recovered, although the precision of such estimates is subject to great uncertainty.33/ A recent government survey of SOEs in several cities reveals that the average debt-to-asset ratio is more than 70 percent.34/

31/ Japan Economic Newswire, May 16, 1994. Some Chinese economists quoted in government newspapers believe that adding all idle workers, including those who still have an employer of record but receive only a portion of their former wage and don't report to work, to the official unemployment rate brings the rate to at least 15 percent; see Wall Street Journal, February 6, 1995.


33/ There is wide fluctuation in available estimates of non-performing SOE bank loans. For example, the Secretary General of the China Monetary Society, a non-governmental organization, was quoted in the official Economic Information Daily in December 1994 as saying these "dead" debts may be as big as Y 1 trillion (or 40 percent of the country's bank loans); see International Herald Tribune, December 13, 1994.

34/ The same report estimates that on a nationwide basis the total asset value of SOEs (excluding land) on a replacement cost basis is roughly Y 3 trillion.
Industrial Pollution

Pollution associated with China's burgeoning industrial growth, including reliance on high-polluting heavy industry, continues to exact a sizeable toll on the Chinese people and the environment. China's industrial sector—not only SOEs but also non-state enterprises—is the major generator of massive water and air pollution in the country. In 1991, for example, 11 trillion cubic meters of waste gases and 16 million metric tons of soot were emitted. China ranks third in the world in emissions of greenhouse gases, behind the United States and the former Soviet Union; it is the fastest-growing source of such gases. China's industrial pollution problems are made more difficult to solve by its dependence on coal as the major energy source, the scarcity of water in much of the country, and reliance on administrative environmental controls. Both the desire for local self-sufficiency and certain elements of the planned nature of the Chinese economic system have introduced economic inefficiencies that have hampered efforts at abatement of industrial pollution.

On the other hand, China has not been ignoring its industrial pollution difficulties. Unlike many developing countries, China has a comprehensive set of laws based on reasonable concepts to guide environmental policy development, a range of command-and-control as well as economic incentive approaches to implement the law, and an impressive network for administering, monitoring and enforcing environmental policy. However, while past efforts have reduced pollution per unit of output, these gains unfortunately have been mostly canceled by population growth and rapid industrialization. Environmental management should be viewed as a part of the larger process of reforming China's economy and restructuring its industry. In general, until enterprise reforms are more extensively undertaken, neither pollution fees or fines nor administrative regulations are likely to carry sufficient force or be systematically applied to encourage the most cost-effective means of reducing environmental degradation.
3. HISTORICAL SOURCES OF CHINA'S INDUSTRIAL SECTOR PROBLEMS

The principal historical sources of the problems associated with China's industrial structure and performance today are rooted in the legacy of (a) an inefficient system of enterprise internal incentive structures and governance in which ownership of business assets, firm management and social service functions have been woven into a common bureaucracy; (b) lingering distortions in the policy and regulatory regime as manifested in various policies affecting business decision-making with respect to investment, input purchases, production and sales as well as the environment; and (c) the lack of well-developed factor markets for labor, capital and technology.

Inefficient Enterprise Incentive and Governance Systems

The historical problems associated with enterprise incentive structures and governance are rooted in (a) the earlier regime of central economic planning, under which SOEs were generally established by administrative fiat rather than by market forces and thus suffered from poor "initial condition" decisions with respect to location, scale, product lines, capital-labor mix and technology; (b) the sheltering of SOEs from the discipline of "hard budget constraints"; (c) the linking of SOEs' productive functions with the provision of social services and lifetime employment and, as a result, the slow pace with which SOEs have been able to alter capital and labor combinations in response to changes in relative prices and business cycles; (d) the administrative involvement of government in SOE business decision-making; and (e) the partial insulation of SOEs from domestic as well as international competition.35/

Today, Chinese authorities are increasingly poised to allow for the development—in China's own unique style of marrying public ownership with market competition—of a "market for firms," in which there would be free entry by acquisition, divestitures, exit, changes in management, and market-driven access to infusions of capital from both domestic and foreign sources. These are all key elements of a flexible, dynamic industrial organization. It should be noted, however, that mergers involving SOEs—even limited liability or limited liability shareholding companies—pose major problems from the

35/ Although the prices firms can charge—both for inputs and outputs—have been greatly liberalized, domestic trade in consumer and producer goods is still heavily controlled by state-owned distribution entities. Prior to 1993, the allocation of producer goods was handled by the municipal Material Supply Bureaus of the former Ministry of Materials and Equipment, and consumer goods were allocated through the Ministry of Commerce, via large state-owned (domestic) trading enterprises in municipalities, and through the network of All China Supply and Marketing Cooperatives in rural areas. In 1993, these two distribution systems merged, forming the Ministry of Internal Trade, which has a network of twelve sector bureaus in each locality. There has been growth in non-state distribution entities, especially in retail distribution, but the bulk of distribution entities overall are still state owned. Also, there is still separation of foreign from domestic trade, as virtually all foreign trade is conducted through Foreign Trade Corporations (FTCs), and FTCs do not have their own domestic distribution networks; FTCs are discussed in more detail below. Further analysis of barriers to China's internal trade is contained in World Bank, "China: Internal Market Development and Regulation," Report No. 12291-CHA, March 17, 1994.
perspective of formal control rights, absent further reform in state asset administration and
delineation of property rights. Since the state owns all SOE assets, when two (or more) SOEs merge one company can use the other's property but cannot own it. Formal approval from the State Council is required to alter the configuration of actual property rights. Without such approval the merged enterprise may engender some technical efficiencies, but not corporate governance efficiencies. In fact, the authorities' concern over "asset stripping", potentially engendered by mergers and other forms of corporate reorganization, has been increasingly pronounced. The State Council in April 1994 issued a circular to regulate more stringently and more consistently nationwide in the various property transaction markets SOE property transfers in order to prevent loss of state asset values.

Distortions in the Policy and Regulatory Regime

Over time, China's incentive and regulatory regime--comprising policies and other measures regarding taxation, credit, price regulations, direct subsidies, tariff and non-tariff trade barriers, foreign direct investment rules, and environmental regulations--has attempted to channel incipient market forces to serve often-conflicting policy goals. Many of these policies were incoherent and uneven in application, causing distortions in resource allocation, both across regions and across industries. While there has been improvement in recent years on many of these fronts, problems remain. For example, artificially low (indeed negative, in real terms) interest rates have encouraged excessive capital investment, particularly in heavy industry. Lingering price controls--and recently, re-introduced ones--have depressed energy and other commodity costs, resulting in distorted investments, excessive consumption and resource misallocation. Effective tax rates have not been uniform across regions, with variations due in part to relative bargaining strengths of local authorities.

A particularly visible weakness of the regulatory regime is in the area of environmental protection. Industrial pollution--of atmospheric, water and other natural resources--has risen to levels that cause widespread environmental degradation and health hazards, particularly in urban industrial centers. Much has been accomplished in putting in place systems for industrial pollution control, but the government recognizes that the effectiveness of regulation is weak: pollution levies (penalties for exceeding national or local standards) are considerably below the marginal cost of treatment, the levy system has structural deficiencies, there is over-reliance on self-reporting by enterprises, monitoring capability is poor, and the disposal of toxic and hazardous waste is largely unregulated. Overall, environmental policies have largely failed to induce firms to internalize the "hidden costs" of pollution that their activities impose on society and industrialization has proceeded without regard to environmental externalities. This not only results in increasingly severe environmental degradation, but also in enterprise output levels and product mixes that are socially sub-optimal.

Lack of Factor Markets

The absence of viable and flexible factor markets--evident in weaknesses in the financial system, restrictions on labor mobility, and inadequate development and diffusion
of technology—has also made the transition to a market economy difficult. With capital markets still at an early stage of development, firms that are dynamic have tended to be compelled to rely mainly on internally generated savings, while money-losing firms have continued to receive subsidies from the government; bankrupt firms have been artificially kept in business and their reorganization for subsequent merger has been often delayed. While there are estimated to have been about 2000 applications for bankruptcy filed since the bankruptcy law was implemented in November 1998—by firms of all ownership forms, but few large SOEs—a relatively small number of enterprises, approximately 100, have been declared bankrupt. In Chongqing, for example, there have been only two SOE bankruptcies, a shoe manufacturer and a knitting mill, the latter involving the layoff of 2000 workers—one of the largest bankruptcies in China. In August 1994, Wuhan experienced a rare bankruptcy of a major SOE—a textile firm employing almost 4,000 workers. In addition to the potential deleterious impact on workers, a major reason why bankruptcies have been infrequent is that banks have often refused to declare their clients insolvent because this would reduce the value of the banks’ assets. This raises the important issue of devising policies to deal with bad bank debts, including debt for equity swaps.

Rigidities in labor markets, due, among other things, to the absence of a free-standing "social safety net"—comprising pensions, worker retraining, unemployment compensation, and health insurance—have made it difficult for the movement of workers from areas with excess supplies of labor to areas with excess demand for labor, and for SOEs to shed labor as they have sought to become more efficient. For example, Fujian province in the South has recently had chronic excess demand for labor, whereas Heilongjiang in the Northeast has had a chronic labor surplus.

From the founding of the PRC in 1949, the government has promoted technology as a tool for economic development. Until the late 1970s, the institutional structure for technology development was patterned after the Soviet model, characterized by heavy state control, an absence of competition and inflexibility. R&D was conducted in centralized, academic institutions in isolation from the productive sector. With the advent of reform, the government began an overhaul of the R&D system, including exposing technology development to competitive forces (both domestic and foreign), reforming the R&D institutional framework to be more responsive to market incentives and promoting diffusion and assimilation of new technology into the productive sector. While technology markets have emerged, the restrictions on internal labor mobility of scientific personnel and on entry of certain foreign investments still impede the transformation of R&D discoveries into marketable products and processes and technological diffusion.

4. CHINA'S INDUSTRIAL REFORM ACHIEVEMENTS TO DATE

The Chinese authorities have recognized that the nation's pace and pattern of industrial growth must be sustained if economic development is to proceed. As a result, since the market opening of the country in 1978, a series of reforms were launched that decentralized economic decision-making, introduced market forces and competition into the industrial sector, and liberalized the external sector. Reforms introduced in the 1980s doubled the industrial sector's average annual growth rate of total factor productivity in the second half of the decade relative to the first half. Achieving even better industrial performance and sustaining high rates of economic growth have required that China accelerate the earlier reforms of its overall industrial organization, and more recent reforms have tended in that direction. Figure 4.1 depicts the pace and pattern of Chinese enterprise reform.

Reforms in the 1978-92 Period

Throughout the 1978-92 period, numerous reforms were introduced, almost always in the Chinese gradualist and incremental style, and often first as experiments in certain regions and then replicated in other locales. Within the area of enterprise incentive structures and governance, the most salient policy experiments included (see Box 4.1):

- the introduction of the Contract Responsibility System (CRS), which, on the basis of five generic types of negotiated multiyear contracts, SOE managers' (and sometimes as well workers') control rights and obligations to the state were determined by certain (firm-specific) performance parameters;

- the introduction of "corporatization" of SOEs, wherein the state's ownership rights are reflected through its disposition of shares, as exercised through State Asset Administration Bureaus and State Asset Investment Companies, and the firm, organized as a limited liability or limited liability shareholding company with a governing board of directors, is granted management autonomy from line ministries; and

- the introduction (following the visit of Deng Xiaoping to the South of China in early spring 1992) of the New Operating Mechanism (NOM) and the subsequent codification of its 14 Autonomous Management Rights, which give to SOE managers broad "authority to use and dispose of the property entrusted to them by the state for management and business purposes," including autonomy in production, price-setting and input purchase decisions, enterprise accountability for profits and losses, the separation of profit remittances from tax payments and discretion to close-down and/or declare bankruptcy.

Within the area of the regulatory and policy regime, significant policy changes during this period included (a) upward ceiling adjustments or decontrol of prices for most consumer, producer, and agricultural goods; (b) the phasing out of mandatory production
### Figure 4.1: The Pace of Chinese Enterprise Reform

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>CPC denounces &quot;Cultural Revolution&quot;; formulates general principles for economic reform</td>
</tr>
<tr>
<td>1979</td>
<td>Law on joint ventures promulgated; price liberalization in agriculture begins</td>
</tr>
<tr>
<td>1980</td>
<td>Urban individual enterprises encouraged</td>
</tr>
<tr>
<td>1981</td>
<td>CPC calls for increasing industrial output; price liberalization of consumer goods begins</td>
</tr>
<tr>
<td>1982</td>
<td>Opening up of 14 coastal cities; SOE Director Responsibility System and &quot;above-plan&quot; production and pricing autonomy provisions introduced; TVEs created</td>
</tr>
<tr>
<td>1983</td>
<td>Regulations issued on mergers, joint-stock companies and commercialization of banks</td>
</tr>
<tr>
<td>1984</td>
<td>Deng Xiaoping tour of South; New Operating Mechanism and 14 Autonomous Rights to SOEs; phasing out of production targets and price controls</td>
</tr>
<tr>
<td>1985</td>
<td>Adoption of principle of &quot;socialist market economy&quot;; Decision of Third Plenum on establishing Modern Enterprise System</td>
</tr>
<tr>
<td>1986</td>
<td>Foreign exchange reform; fiscal and tax reform; implementation of company law</td>
</tr>
<tr>
<td>1987</td>
<td>Delegation of direct trade rights to SOEs; pension and Housing Reform begin; encouragement of enterprise groups and corporatization</td>
</tr>
<tr>
<td>1988</td>
<td>CPC Law on Urban CPC calls Opening up Regulation Deng Adoption of principle of &quot;socialist market economy&quot;; Decision of Third Plenum on establishing Modern Enterprise System</td>
</tr>
<tr>
<td>1989</td>
<td>Law passed on Xiaoping of principle exchange</td>
</tr>
<tr>
<td>1990</td>
<td>Cultural &quot;Cultural Revolution&quot;; formulates general principles for economic reform</td>
</tr>
<tr>
<td>1991</td>
<td>Law on joint ventures promulgated; price liberalization in agriculture begins</td>
</tr>
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<td>1999</td>
<td>Delegation of direct trade rights to SOEs; pension and Housing Reform begin; encouragement of enterprise groups and corporatization</td>
</tr>
</tbody>
</table>
Box 4.1: Three Major Chinese Reform Experiments in Enterprise Governance

Contract Responsibility System (CRS). The five types of contracts under the CRS were the (a) general quota responsibility contracts for all types of enterprises (principally ceding to managers (and sometimes the entire workforce) control over enterprise operations, including retention of excess profits, in return for meeting profit remittance targets); (b) leasing contracts for collectives and small SOEs (tying leasing fees paid by managers to various measures of enterprise performance); (c) management responsibility contracts for large and medium-size SOEs (tying management teams’ autonomy, pay and excess profit retention to the meeting of profit and tax remittance targets); (d) enterprise management responsibility contracts for large and medium-size SOEs (similar to (c) but covered enterprise directors (and sometimes workers)); and (e) asset management responsibility contracts for small and medium-size SOEs (tying directors’ and managers’ autonomy, pay and retention of excess profits to enhancement of enterprise asset value). The two most common contract forms were (c) and (d). By early 1988 the CRS covered 90 percent of SOEs. Beginning in January 1994 no new CRS contracts were being initiated in light of the now company law and the corporatization reforms; existing CRS contracts will remain in force until their terms expire, estimated to be in 1996 or 1997.

State Asset Administration. The government’s ownership representation function—“state asset administration” (sometimes referred to as “state asset management”)—is carried out at the center by the National Administrative Bureau of State-Owned Property (NABSOP) and State Investment Corporations (SICs). The former entity manages the overall administration of the state’s ownership interests, as implemented through the latter entities’ direct or indirect participation on corporatized SOEs’ boards of directors and valuation of SOE assets, financial performance, etc.; the SICs are analogous to western-style mutual funds, holding shares in multiple SOEs. For SOEs under local control, there are analogous municipal level State Asset Administration Bureaus (SAABs) and State Asset Investment Companies (SAICs). The two-tier framework is still nascent and many municipalities have not yet established SAABs or SAICs, or do not possess adequately trained staff to oversee their functions. Center-directed regulations on state asset administration procedures were released in July 1994.

New Operating Mechanism (NOM). The NOM is formally called the "Regulations on Transforming the Management Mechanisms of State-Owned Industrial Enterprises," promulgated by the State Council in July 1992. The complete set of the 14 Rights is (a) production and management decision-making power; (b) the right to determine prices for output and inputs; (c) the right to sell output; (d) the right to purchase goods and materials; (e) import and export rights; (f) the right to make investment decisions; (g) the right to decide on the distribution of retained earnings; (h) the right to dispose of assets; (i) the right to enter into joint ventures and to engage in mergers or acquisitions; (j) the right to hire workers; (k) the right to manage personnel; (l) the right to determine wages and bonuses; (m) the right to decide on the enterprise’s organization structure; and (n) the right to refuse to pay unauthorized charges by the government for physical, financial and human resources. As of February 1995 while most of these rights have been ceded to a large number of SOEs, only a relatively small number have been given all 14 rights. For example, for most SOEs, export and import rights are exercised indirectly through Foreign Trade Corporations (FTCs), which are under the control of central or lower level governments, and only a minority share of SOEs have direct trading rights; importantly, however, whereas in 1978 all of China’s trade was monopolized through 12 FTCs and their branches, today there are 3,600 FTCs. The number of FTCs actually peaked at 6,500 in 1989; the downward trend since then reflects the growing number of SOEs obtaining direct trading rights.

targets; (c) the introduction of substituting bank loans for budgetary appropriations as the chief source of SOEs’ external funding; (d) reduction of import tariffs; (e) liberalization of the regime governing foreign direct investment; (f) introduction of "swap" foreign exchange markets and the initiation of a phased movement toward a single floating
exchange rate; (g) initiation of development of unfair competition laws; (h) development of laws regarding the protection of intellectual property;37/ (i) tax reform, including introduction of an enterprise income tax (EIT); and (j) environmental policy reforms, including establishment of an extensive legal and institutional regime for pollution control.

Regarding factor market development, significant reforms included (a) initiating the transformation of the People's Bank of China into a nationwide central bank, with the phased separation of its governmental functions from its commercial functions; (b) encouragement of the nation's four state specialized banks—Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China (BOC) and People's Construction Bank of China (PCBC)—to function as commercial intermediaries;38/ (c) establishment of stock and bond markets; (d) introduction of a labor contract system, as a replacement for the "iron rice bowl," with the result that employers and workers had greater discretion to negotiate over terms of employment, work description, and job tenure; (e) initiating the establishment of cross-enterprise pension and medical insurance pools, unemployment compensation systems,39/ and worker retraining and employment information services, and moving towards the creation of commercial housing markets; and (f) reform of the science and technology system, including encouraging the development of a technology market and enhancing the linkage between research and production.

Reforms from 1993 to the Present

The period since late-1992 has witnessed several significant new tranches of enterprise reforms. The reaffirmation of the leadership's commitment to economic reform launched in the 1980s was first made evident in the positions taken by the newly elected

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37/ China enacted a patent law in 1984 and revised it in 1992; the law and its regulations are now generally in line with international standards. A copyright law was enacted in 1990 and became effective in 1991; subsequently, China has acceded to the Berne, Geneva and Universal Copyright Conventions and implemented regulations in line with international norms for the protection of artistic and literary works, computer software and phonograms. The current trademark statute was enacted in 1982 and revised in 1992 and again in 1993, and China is a member of the World Intellectual Property Organization (WIPO) and of the Paris and Vienna Conventions governing trademarks; as a result, the basic principles of China's trademark law are in conformity with international practice. While China's laws on intellectual property generally meet international norms, the enforcement of these laws needs to be strengthened; see below.

38/ In 1984 the prevailing mono-bank system was broken up, with the beginning of the transformation of the People's Bank of China into a central bank and the establishment of the four state specialized banks. Also in the mid-1980s, a dozen national and regional commercial banks—typically owned by local governments and enterprises and operating without policy lending responsibilities—were established; the largest one is the Bank of Communications, but it is only about one-tenth the size of ICBC. Nonbank financial institutions (NBFIs) began in the second half of the 1980s and their growth has been pronounced; these include trust and investment corporations (TICs), finance companies, securities companies, financial leasing companies, and insurance companies. Rural and urban credit cooperatives have also grown at a rapid pace since the mid-1980s.

39/ In addition, central and provincial funds are used to supplement local-based unemployment insurance systems when local unemployment rates exceed certain levels.
the Fourteenth Party Congress in October 1992, including the symbolic, but critical step in March 1993 of changing the official economic philosophy from a "planned economy on the basis of socialist public ownership" to a "socialist market economy."

In November 1993 the Third Plenary Session of the Fourteenth Party Congress issued the "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure." This Decision outlines a 50-point agenda for economic reform to be attained by the end of the century across an unprecedented array of interrelated fronts, including:

- creating a "modern enterprise system" of corporate structure, governance and management, based on the principle of corporatization and providing for full separation of the state's exercise of ownership rights from the enterprise's exercise of legal person property rights;

- encouraging the development of diversified ownership forms of enterprises, including the "privately owned, individually owned and foreign-invested" sectors;

- requiring the state to provide for different ownership forms of enterprises to be able to compete on "equal terms" in the marketplace;

- improving macroeconomic and monetary policy management, including authorizing the People's Bank of China to operate fully as an independent central bank, managing the supply of money and credit and interest rates through open market operations;

- creation of an expanded capital market and banking and finance system, including the conversion of the specialized banks into commercial banks and the establishment of three policy banks;

- enhancing labor market and human resource development as well as creating a national social security system;

- fostering the development of the services sector;

- ensuring an equitable and efficient system of income distribution and taxation;

- further liberalization of foreign trade and investment;

- enhancing science and technology; and

- establishment of a market-oriented legal system.

The Decision of the Third Plenum of the Fourteenth Party Congress 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 important to emphasize that it is only a blueprint statement of principles
and does not contain a detailed plan for implementation. Establishing a program for implementation of the agenda embodied in the Decision is the challenge now being undertaken by the Chinese.

Several components of an implementation program for the Decision are already emerging. Indeed, at about the same time the Decision was issued, and in the intervening months, the following reforms have been announced:

the "10,000-1000-100-10" enterprise reform experiment, which will provide for:

- 10,000 large SOEs to adopt completely within 2 years the new accounting standards (introduced in July 1993), new asset evaluation techniques and the full set of the "14 autonomous management rights";

- 1,000 large SOEs to adopt within 2 to 3 years the new state asset administration regulations (promulgated in July 1994) and to delegate within 2 to 3 years their assets to a state assets supervisory committee, charged with deciding on methods to enhance asset value;

- 100 large and medium-size SOEs (within 2 years) to be fully "corporatized" as limited liability or limited liability shareholding companies under the Company Law; and

- 10 municipalities to undergo comprehensive urban enterprise, economic and social policy reform, including SOE restructuring, technology upgrading, mergers and consolidations, bankruptcy and divestiture of social services. In fact, 18 rather than 10, pilot municipalities have been chosen for "comprehensive urban reform;" see Box 4.2.2.

the promulgation of a Company Law (effective July 1994), which, among other things, provides rules for the incorporation of all ownership mixes of enterprises into limited liability and limited liability shareholding companies; specifies

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40/ There is a fourteen agency group overseeing this reform, with the State Commission on Restructuring Economic Systems (SCRES) and the State Economic and Trade Commission (SETC) playing the leadership roles.

41/ The 100 SOEs were selected in November 1994. In December 1994 it was decided that SETC would have responsibility for 70 of the firms, and SCRES would have responsibility for 30 of the firms. As outlined in a December 20, 1994 China Daily opinion article by SETC Minister Wang Zhongyu, the components of the "100 program" include: (i) conversion of the enterprises into limited liability and limited liability shareholding companies (some of which will be listed on the stock exchanges); (ii) "settlement of debts;" (iii) 15 percent refunds on income taxes and "concessions on bank loans;" and (iv) "lifting of social burdens."

42/ Box 4.2 outlines the 18 cities undergoing "comprehensive reform" under the jurisdiction of the SETC. SCRES also has an 18-city "comprehensive reform" program, but the list of cities under the SCRES experiment is a slightly different one than SETC's.
Box 4.2: China's Experiments in Urban Economic Reform

Comprehensive Economic Reform. Eighteen municipalities have been earmarked by the State Economic and Trade Commission (SETC) to undergo "Comprehensive Economic Reform." This program will focus on the SOEs controlled by the respective municipal governments and implement reforms dealing with, among other things, the divestiture of SOEs' social burdens to local governments or new entities; corporatization of the SOEs; creation of new municipal state asset administration institutions to carry out the new regulations in this area; etc. Chinese officials have called for this reform to be accomplished within a three year timeframe. The SETC selected cities are: Changchun (Jilin), Harbin (Heilongjiang), and Qiqihar (Heilongjiang) and Shenyang (Liaoning) in the Northeast region; Baoji (Shaanxi), Qingdao (Shandong), Taiyuan (Shanxi), Tangshan (Hebei), Tianjin, and Zibo (Shandong) in the North region; Bengbu (Anhui), Changzhou (Jiangsu), and Shanghai in the East region; Wuhan (Hubei) in the Central region; Chengdu (Sichuan) and Chongqing (Sichuan) in the Southwest region; Liuzhou (Guangxi) and Zhuzhou (Hunan) in the South region.

Urban SOE Bankruptcy Reform. In addition to this municipal portion of the "10,000-1,000-100-10" reform experiment, another center-directed reform—on "Urban SOE Bankruptcy"—was recently announced by Chinese authorities. Two cities, Chongqing and Tianjin, have been selected to participate in this experiment, which will focus on accelerating bankruptcies of nonviable firms.

governance structures (e.g., size and composition of boards of directors and boards of supervisors); rules regarding transfer and sales of shares; and procedures for mergers and bankruptcy;43/

the promulgation of a Competition Law (in September 1993), which provides for safeguards and penalties against unfair methods of competition, including price fixing and collusion;

foreign exchange reform, including the unification of exchange rates, the elimination of the foreign exchange quota retention system, the phased-in establishment of an interbank foreign exchange market, and the announced intention of preparing for a fully convertible currency on, or before, the year 2000; 44/ and

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43/ It was reported in December 1994 that new regulations to implement the bankruptcy law enacted in November 1988 are being drafted.

44/ The national interbank foreign exchange market, the China Foreign Exchange Trade System (CFETS), opened its Shanghai-based operations in April 1994. Over time the CFETS will replace the regionally-based swap markets. Chen Yuns, head of the PBC, was quoted as predicting the renminbi would be freely convertible in 1998, two years earlier than the previously announced target date of 2000; see China News Summary, January 13, 1995.
fiscal and tax reform, including the unification of enterprise income tax (EIT) rates on domestic enterprises into a single 33 percent rate; the consolidation of individual income tax regimes into one personal income tax (PIT) system; establishment of a nationwide value added tax (VAT) as well as a consumption tax (on luxury items); institution of a new regime (replacing the contract-based tax sharing system) for tax administration and revenue-sharing between the central, provincial and municipal governments, organized as a National Tax Service (NTS) and a Local Tax Service (LTS); and the promulgation of a budget law, which establishes sound principles and rules governing the budgetary process.

Taken together, these recent reforms—as well as the underlying Third Plenum’s Decision—offer clear evidence that China has established a well-defined path for its future industrial sector reform program. Still, transforming a centrally planned, socialist economy into a decentralized market economy will continue to require implementation of whole new sets of policies and institutions, and fundamentally redrawing the boundaries between government and the productive sectors. These endeavors will necessarily require time to implement effectively, and China’s authorities have acknowledged that much remains to be done.

Remaining Problems to be Addressed and Options for Restructuring

Notwithstanding the real progress of China’s industrial reforms to date, these efforts have not resolved several problems. First, reforms have not appreciably squeezed out economically wasteful resource use in most SOE operations, let alone raised to technologically feasible levels the productivity of resources employed in economically efficient uses.

Second they have not provided for sufficiently market-based governance autonomy and risk-reward incentive structures for most SOE management. For example, the general lines of authority over property rights between government and management remain vague. In some respects the government-enterprise institutional relationship remains fundamentally unaltered. Indeed, it is arguable that while the formal institutional government-enterprise relationship has not effectively changed, the old system of center-directed government oversight of SOE management has eroded. Without a market-based incentive system taking its place, this could give rise to delays in implementing reforms, asset stripping and collusion between local governments and SOE managers vis-à-vis the center regarding tax revenues, etc. There is only anecdotal evidence on this score at this time so it is difficult to gauge its significance. The Party still retains discretion over SOE managerial appointments at the local level, and this could act as a countervailing force to such collusion.

45/ Previously, nominal tax rates varied according to enterprise ownership type: for example, the maximum book rate was 55 percent for SOEs; 35 percent for COEs, and 15 percent for joint ventures.
In general, the historic pattern of decentralization is still manifest. But in some respects, a trend towards centralization of authority is emerging; this is true, for example, in the case of tax reform and in the design of state asset administration policy and institutions. There is also a risk-reward asymmetry in that under the contract responsibility system (CRS), managers have gotten rewarded for increased profits but not correspondingly penalized for losses, which they have credibly believed the state will absorb. In the past year, as part of the government's inflation-fighting program, credit restrictions have in fact inflicted losses on SOEs. The Contract Responsibility System was effectively eliminated in January 1994. As of that date no new contracts will be signed; while existing contracts will continue, once they expire they will not be renewed.

Third, reforms have not effectively reduced on a broad scale certain distortions in the regulatory and policy regime governing enterprise conduct and performance. For example, economic and institutional barriers to entry and exit remain high. There also is evidence of sporadic regulation, which is emerging in lieu of the removed command style regime, particularly as new legislation requires implementing measures. These distortions give rise to risk and uncertainty, producing negative effects on investment behavior. In some cases, previously eliminated price controls have been re-introduced.

Finally, the reforms have not engendered the development of bona fide factor markets—for capital, labor and technology. Without such markets the efficient performance of industrial enterprises is ultimately constrained—particularly a financial system that operates independent of the state's budgetary process and can exercise discipline of SOEs, perhaps whereby banks take equity stakes.

Dealing with "the SOE problem" is still central. In principle, there are three potential ways to address the problems in the SOE sector: (a) continue to allow the more dynamic firms to out-compete the inefficient SOEs, resulting in SOE market shares to continue to shrink; (b) immediately and radically apply the discipline of hard budget constraints (both fiscal and quasi-fiscal) and bankruptcy laws to hasten unprofitable SOEs' exit; or (c) strengthen the existing market-based, proactive policy regime, which combines the disciplining measures with supportive mechanisms to restructure potentially competitive SOEs and to foster non-state enterprises to thrive and serve as a countervailing competitive force to SOEs.

During the 1980s, policy relied primarily on the first approach, and indeed, as noted above, the SOE share of national gross industrial output fell from almost four fifths in 1978 to somewhat less than half today. The authorities, however, realize this approach is insufficient since so much capacity and resources remain bottled up in, and continue to flow into, the SOE sector. It is also clear, however, that an immediate and radical application of SOE disciplining measures without supportive policies would engender enormous economic costs and not be politically viable; potentially competitive firms, labor skills and otherwise productive assets might be unnecessarily removed from production and
become idle. High levels of unemployment could even threaten the process of reform itself. China is unlikely to politically tolerate high levels of open unemployment.46/

What is required is to modify the existing proactive policy regime into one that combines (a) a program for phasing out SOE fiscal and quasi-fiscal subsidies; (b) a nurturing environment that allows for autonomy of management, recombination of corporate assets and open exit and entry; (c) the shedding of redundant labor and enterprise social service responsibilities while simultaneously ensuring the existence of a government-sponsored "social safety net"; (d) creating employment growth conditions, particularly in high value-added services industries; and (e) development of an independent, viable financial system.

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46/ The Labor Ministry announced in 1994 a series of measures to deal with the inevitable increase in unemployment, including an "early warning system" for firms to declare ex ante that large layoffs will be forthcoming and "penalties for enterprises when they conduct illegal layoffs." Labor service companies (LSCs) can obtain tax exemptions and priority in obtaining bank loans if 60 percent of their jobs are given to the jobless or the temporarily laid off. See China Daily, May 16, 1994.
5. OBJECTIVES FOR FURTHER REFORM OF CHINA’S INDUSTRIAL SECTOR: THE DEVELOPMENT AGENDA

China’s government has charted for itself an ambitious agenda for the continued development of the country’s industrial sector. Overall, the agenda reflects the objectives articulated above of fostering SOE reform, particularly the areas of modernizing enterprise incentive structures and governance systems and diversifying corporate ownership to introduce added flexibility into the country’s industrial organization; improving further the regulatory and policy regime to continue to reduce distortions and negative externalities; and the development of factor markets to enhance productivity and fluidity in capital, labor and technology markets. In particular, the Government’s development agenda, as summarized in Box 5.1, focuses on the following elements:

Modernizing Enterprise Incentive and Governance Systems and Diversifying Ownership

Separating the Government and Productive Sectors. Building on past reforms, recent efforts have continued the process of delegating business decision-making to SOEs and begun to break up some of the line ministries that have historically managed them, as well as to create the institutional framework required for the state to exercise its ownership rights over its assets through state asset administration entities. However, (a) SOE governance structures, property rights and managerial control prerogatives are sorely in need of both realignment with principles of economic efficiency, to maximize firm performance (subject to the constraint of majority state ownership), as well as greater specificity, so as to be practically implementable; (b) the role, function and structure of the system of state asset administration, including the two-tier central and local state asset administration bureaus and state asset investment companies, are not only inadequately defined but also need to be greatly simplified; and (c) a significant number of SOEs still maintain privileged access to funds through the fiscal system and cheap capital via the financial system and thus escape the discipline of “hard budget constraints,” making imperative the need to make all types of subsidies to SOEs transparent and phased out.

Restructuring SOEs and Fostering Ownership Diversification. Because of their continued significant role in the economy, many SOEs require a proactive policy of restructuring to further facilitate the transition to a market economy. Ignoring the problems posed by this risks incurring unnecessary resource costs and social reversals that could delay the transition. Business discipline—through both imposition of hard budget constraints and openness to domestic and international competition—is the linchpin to any restructuring program. Further reform efforts must focus on (a) creating a nationwide market-driven restructuring capability that would have a multiplier effect across many

47/ For example, recall from above that the problem of poorly delineated property rights and control mechanisms can effectively prevent the realization of economies of scale and scope that are intended from mergers. In this regard, a State Asset Dispute Arbitration Body has been established to adjudicate SOE property rights disputes.
Box 5.1: Agenda for Further Reform of China's Industrial Sector

I. Modernizing Enterprise Incentive and Governance Systems and Diversifying Corporate Ownership

- Separate government from enterprise operations, including the introduction of "hard" budget constraints and market-based governance systems
- Restructure SOEs in terms of their social burdens, financial and employment structures, physical plant and equipment and managerial systems
- Enhance the enabling environment for non-state enterprises to participate in the market

II. Improvement of the Regulatory and Policy Regime

- Reduce distortions in the policy framework as regards prices, investment, competition, taxes, trade and foreign direct investment
- Create incentives for further development of traditional and nontraditional services industries
- Reduce policy distortions giving rise to regional inequities
- Modernize policies and institutional frameworks to mitigate industrial pollution and environmental damage

III. Development of Factor Markets

- Enhance the functioning of the labor market
- Accelerate capital market development
- Intensify reform of the financial sector
- Promote diffusion of technology and modernize R&D institutions

Industries and allow enterprises to consolidate, diversify, divest, exit and engage in asset sales and purchases so as to recombine capital and labor in new ways; (b) establishing mechanisms for enterprises to pass many of their social service burdens to government such that they are financed through public revenues 48/ (or in the case of housing, passed to newly developed markets); (c) creating credible and politically viable mechanisms to shed redundant labor, ease the adjustment of displaced workers into the labor market and create new employment opportunities, particularly in high value-added services.

48/ The structural characteristics of China's development pattern make it critical that such social safety nets be established at the provincial or municipal level, rather than based on a centralized system, without ruling out a central mechanism that provides for some redistribution of funds from rich areas to poor areas.
activities; and (d) increasing the pace of corporatizing enterprises within the framework of the Company Law, providing for the formation of limited liability and limited liability shareholding companies.

Chinese authorities have decided to establish a "socialist market economy" and therefore retain an enterprise system that has a high degree of public ownership. Within this framework, the government is pursuing a strategy of SOE ownership diversification. It is transforming increasing numbers of SOEs into shareholding companies—both limited liability companies and limited liability shareholding companies—including cases where the state holds only a majority share; providing for the leasing of SOEs to managers, other enterprises and workers; and fostering SOE mergers and consolidation, including mergers with other types of enterprise ownership forms. It has also permitted divestiture of small-scale SOEs into private hands. There is growing recognition that these trends should be intensified. In November 1994 the Government issued provisional guidelines regarding the minimum amount of state ownership required for state control: for certain sectors, only "relative" control by the state, with a minimum of 30 percent state ownership, will be required; for some sectors, "majority" control, with a minimum of 51 percent state ownership, will be required; and for other sectors, "absolute" control, with 100 state ownership, will be required. Determinations of which sectors fall into each of these three categories are still being finalized.

Improving the Policy Environment for the Non-State Sector. The Third Plenum's Decision calls for a policy context that moves from "benign neglect" to active encouragement and the enduring development of non-state enterprises—whether TVEs, urban collectives, private enterprises, foreign invested enterprises, or domestic-foreign joint ventures. Implementation of this policy objective will necessitate the establishment of (a) clearly and well-defined property rights for non-state enterprises and the management autonomy and obligations that go with them; (b) broad policy neutrality across enterprise ownership forms; and (c) equal access to factor markets, especially the financial system, for state and non-state enterprises. A practical policy regime is evolving that brings into reality a "market for different corporate ownership forms"—one that enhances the degree of competition among various firm types in order to continue to redress the historical imbalance between state and non-state enterprises.

In fact, collectively owned enterprises (COEs) are corporatizing. As a transitional mechanism to forming limited liability companies or limited liability shareholding companies, they are transforming into cooperative shareholding companies (CSCs). Although a national law for CSCs has not been promulgated (one is under draft), the practice being followed by CSCs is as follows: A CSC has a board of directors and other corporate governance mechanisms similar to LLCs and LLSCs. The collective owns a portion of the shares and the remainder (as a fixed amount) is held by the collective's employees. The employees' shares can be traded among employees but are not transferrable outside the work unit; hence there is no market for the shares. If a worker leaves the CSC, his or her shares must be transferred back to the collective or to the

49/ See South China Morning Post, November 18, 1994.
remaining employees. In Chongqing, for example, 20 percent of the COEs are CSCs, and these CSCs account for 40 percent of COE output.

**Improvement of the Policy and Regulatory Regime**

**Eliminating Distortions in the Policy Framework.** Although much progress has been made in recent years, the stance of the country's incentive and regulatory regime still requires improvement. Consensus is emerging—in part, reflected in a June 1994 National Industrial Policy statement—that policy needs to focus on reforms regarding (a) prices, to completely decontrol lingering (and re-introduced) price ceilings and further rationalize relative prices (e.g., in the energy, grain and cotton sectors); (b) investment policy, to eliminate directed credit allocation schemes and rationalize and limit on- and off-budget financing and investment approval plans; (c) competition and regulatory policy, beyond the recently promulgated Competition Law, to establish measures providing for freedom of entry and exit for new competitors (both domestic and foreign) and to enforce fully against monopolistic enterprise behavior on price gouging, collusion and other forms of anticompetitive conduct; and (d) foreign trade policy, to continue the liberalization of import tariff and nontariff barriers, especially the import license regime, the elimination of lingering indirect export subsidies and the granting of direct export and import rights to enterprises (of all ownership types); (e) foreign direct investment policy, to streamline the regulatory apparatus governing screening of foreign direct investment as well as to further open the sectors in which such investment is permitted; and (f) tax policy, beyond the new tax reforms, to establish greater neutrality among economic activities and across income groups.

The Chinese authorities have recently devised an industry taxonomy for the purpose of drawing boundaries between government and enterprise activities (this is related to the November 1994 provisional guidelines on levels of state ownership required in various sectors discussed above). Three categories have been defined: (a) "strategic" industries—defense firms, rare material mining and production and currency minting; (b) "public good" industries—utilities, communications, transportation, education, the arts, sports and public health; and (c) "commercial" industries—all other industries. A new policy regime has been established based on the taxonomy: (a) "not-for-profit" projects in the public good sector are to be funded on-budget; (b) "for-profit" projects in the public

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50/ The State Council's "Framework for National Industrial Policy in the 1990s" focuses on four key areas: (i) to solidify the status of agriculture as the country's fundamental industry and increase farmers' incomes; (ii) to strengthen the development of and foreign investment in infrastructure; (iii) to improve financing for five 'pillar' industries (electronics, machinery, petrochemicals, automobiles and construction); and (iv) to adjust foreign trade systems to boost China's competitiveness in the international market.

51/ Recently Chinese authorities announced their intention to begin drafting an anti-monopoly law. In addition, a Department of Fair Trading, under the State Administration for Industry and Commerce (SAIC), was recently established.

52/ The existing 3,600 Foreign Trade Corporations (FTCs), which are under central or lower level government control, handle over 90 percent of China’s imports and at least 80 percent of exports; see Box 4.1.
good sector, as well as all projects in the "strategic" sector are to be financed by a state
development bank (see below) at below-market interest rates, or in special cases through
grants; and (c) "commercial" sector projects are to be financed through commercial banks,
who are to be given autonomy from government in decision-making. To be sure, this
taxonomy and policy regime reveal a policy orientation of the Chinese authorities that is
more market-driven and less administratively determined than was previously the case.
However, further progress is required on this front; for example, for-profit projects should
not enjoy below-market factor costs.

Developing Services Industries. The development of a bona fide services sector
in China is of relatively recent origin. Historically, socialist economies labeled services
"nonproductive." National policies in such countries favored producers of goods over
producers of services. Nontraditional services activities, such as informatics, computer
software and processing, management consulting, accounting, legal practice, and
construction and engineering, as well as traditional services, such as insurance, banking,
telecommunications, trucking, and aviation, were stunted in their development, either
through hobbling regulatory policies or state-run monopolies. With the advent of reform,
growth in China's services industries has been rapid in recent years, but it has lagged
considerably behind more market-oriented developing countries, such as Brazil, Indonesia,
Malaysia, Thailand, and Korea. Yet both traditional and nontraditional services industries
are not only increasingly high value-added activities in China (as elsewhere), but are also
likely to hold significant promise for absorbing workers laid off by restructured industrial
SOEs. The Third Plenum's Decision recognizes the importance of developing the services
sector for the creation of a modern enterprise system. However, given the newness of the
sector for China, an identifiable constituency for designing and pushing through a set of
coherent development policies for the sector is lacking.

In the dynamic area of telecommunications services China has, in fact, begun to
develop a more articulated services policy, including the recent approval by the State
Council for the establishment of two new telecommunications firms to compete with the
Ministry of Posts and Telecommunications (MPT) monopoly service. Liantong (also
known as Unicom) will build on the dedicated networks of the Ministry of Railways and
Ministry of Electric Power. It has the goal of becoming the country's second nationwide
basic and value added services operator in both local and long distance markets; it is
especially aggressive in cellular telephone services. Jitong is being formed by a consortia
of 30 SOEs and research institutes allied with the Ministry of Electronics Industries (MEI)
and the China International Trust and Investment Corporation (CITIC) and will be under
the control of MEI. It will generally focus on the information services market. However,
there exist obstacles to the successful introduction of these service competitors into the
marketplace; for example, absent an independent regulatory authority in China for
telecommunications services, the fees that MPT can charge the two competitors to connect
to its network could threaten their economic viability.

China could be well poised to take advantage of the global market for services
exports, which has been growing rapidly and will accelerate now that the Uruguay Round
General Agreement on Trade in Services (GATS) has entered into force under the auspices
of the World Trade Organization (WTO). Many of the internationally tradeable services activities, e.g., accounting and management consulting, are necessary inputs or "intermediate goods" for the implementation of an enterprise restructuring capability. Indeed, international trade and FDI in the services sector will be increasingly important for China's enterprise reform progress. In the accounting sector, for example, as of late 1994, overseas accountants passing China's qualifying exam will be accorded "national treatment," i.e., be treated in a similar fashion as domestic certified public accountants (CPAs), if their home countries accord the same treatment to Chinese accountants. This reciprocal certification practice has become increasingly common worldwide under the auspices of the GATS.

Reducing Regional Inequities. The remaining distortions in the regulatory and policy regime are manifested not only within and across sectors, but also across regions. Growth in industrial output in the southern and eastern provinces has outpaced the rest of the country. This is due not only to the center's deliberate emphasis on reforming these regions first, for example, through the creation of Special Economic Zones, which now encompass 32 coastal cities, but also because under the regime of economic decentralization, where greater regional autonomy has flourished, industrial reforms were implemented by these provinces' authorities early on. The result is that the interior provinces are at an economic disadvantage. Thus, there is a pressing need to further the implementation of reforms to these areas so as to help redress regional imbalances. One reform program in this regard is the "Yangtze Dragon Economic Development" zone. Special economic incentives (e.g., tax and tariff exemptions) exist for interior cities, such as Chongqing and Wuhan, that are located along the Yangtze River, whose "dragon head" lies in Shanghai and whose "dragon tail" lies in Chongqing. However, the uneven spatial development is also due to inadequate growth of infrastructure industries—China's key bottleneck sectors. Improvements in rate, or tariff, structures have begun to help generate internal resources for development in railways and the power sector, and some ports are undergoing commercialization. Still, more needs to be done, including promoting corporatization in infrastructure services that can be supplied competitively.

Mitigating Industrial Pollution and Environmental Damage. Industry is the largest single source of pollution in China. The Chinese authorities are increasingly aware of the need to address environmental problems in the industrial sector, and recent official policy pronouncements call for economic development to proceed in tandem with environmental protection. The government's good intentions notwithstanding, there remains considerable scope for improvements in integrating environmental management effectively into economic policies. The pollution management system still relies heavily on administrative command rather than market-based mechanisms. There is thus a need to improve the economic incentives approach, which includes imposing fees, fines and compensation payments on any enterprise that fails to meet environmental standards.

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54/ It was announced in January 1995 that all of China's inland provincial capitals will be allowed to establish Special Economic Zones.
Enforcement of penalties and collection of levies are currently weak. The Environmental Protection Bureaus (EPBs) face challenges in adapting to the reform process due to the gradual demise of the industrial line bureaus, which have been responsible for ensuring much of the self-reporting and planning for pollution control for their enterprises, and to the more adversarial relationship that is likely to develop as the provinces and municipalities distance themselves from operational control of enterprises. Such challenges are already apparent in the problems of ensuring compliance from non-state firms. There are ample opportunities for policy reforms that meet both environmental and industrialization objectives. Further reforms must focus on (a) pricing policies that encourage excessive energy and materials consumption, (b) the implementation of regulatory incentives/disincentives that internalize the costs of pollution and (c) strengthening regulatory institutions for pollution control, including monitoring and enforcement capabilities.

China's leadership recognizes that much more will need to be done to significantly improve the environment, and that a "lack of money" will probably slow further progress on pollution control for at least a decade. The real issue, therefore, is how to make the funds that are available be productive; how to allocate the money cost-effectively to priority problems; and how to improve environmental policy, the economic system and government bureaucracy to maximize pollution prevention and control efforts. Most important, China needs to consider the reorientation of its industrial sector away from basic heavy industry, which is technologically outdated and highly polluting, toward more economically dynamic and less polluting manufacturing and service sectors.

Development of Factor Markets

Enhance the Functioning of the Labor Market. SOEs remain burdened with social service functions, notably the provision of housing, education, hospitals, and social security—pensions and unemployment, accident and health insurance. Moreover, notwithstanding the gradual introduction of the labor contract system, SOEs are burdened with the obligation of providing permanent employment to their workers. By the end of 1994, approximately 26 percent of the workers in industrial SOEs were covered by the contract system.\(^5\) Overall, these social burdens prevent SOEs from acting like the commercial entities the Chinese authorities now believe they should be, and hamper the development of a freely functioning and flexible labor market, a necessary condition for the full development of China's modern enterprise system. As mentioned earlier, particularly problematic in this regard is that the age structure of the SOE workforce is quite old, and the SOE sector already has a large percentage of retirees. China's practice has been to adopt a "low wage / high welfare benefit payment" regime, where welfare payments such as pensions are paid out of SOE current revenues. The result is that the present level of social welfare funds on a national level is grossly inadequate. It has been

estimated that 20 percent of SOEs’ payrolls goes to pay pensions for retired workers.56/ In the wake of the Third Plenum’s Decision, there is now the need to design implementable programs to accelerate the establishment of (a) government provided or sponsored education, labor retraining, medical care, job information networks, and unemployment compensation; (b) employer-employee funded portable pensions; and (c) self-standing commercialized housing markets. The link of the development of human capital resources and labor markets to enterprise restructuring is worth underscoring. Nearly all restructured enterprises will have to shed labor in large quantities. However, this can be done on a widespread scale only if the economy continues to grow rapidly and thereby create jobs—notably in the services sector—and labor markets are created with adequate public support as well as some form of geographic mobility.

Accelerating Capital Market Development. Capital market development, including the creation of an intermediation capacity to channel effectively national saving into investment capital, is necessary to facilitate restructuring of the real sector. Restructuring requires that commercial banks, investment and merchant banks,57/ and nonbank financial institutions have an incentive to extend credit or to mobilize funds so that firms can afford new investments in technology and machines, as well as the cost of severance for workers. The financial sector should also play a key role in spearheading the hands-on measures that are required in the initial phases of restructuring. But if industrial restructuring requires the development of a capital market, the reverse is also true. When the real sector as a whole is both highly leveraged and losing profitability and competitiveness, the absence of bold real sector restructuring may vitiate the establishment of a vibrant capital market. Indeed, the presence of a significant number of ailing SOEs without a policy regime for writing off non-performing loans, allowing for socially cushioned bankruptcies or sanctioning equity for debt swaps will delay banking reform. Notwithstanding such a regime, banks operating according to commercial standards will be wary of either lending to unprofitable enterprises or declaring them insolvent because it will only exacerbate further their balance sheet problems. In general, achieving the objective of enterprise ownership diversification will depend significantly on development of the capital market. Broad-scale corporatization and the transformation of SOEs into shareholding companies will necessitate creating venues for the disposition of shares. Some venues already exist, such as sales to the public through the stock exchanges, specialized sector holding companies, portfolio holding companies (like mutual funds in other countries) and the leasing of SOEs to managers, other enterprises, or workers. Creation of other mechanisms, such as pension fund and insurance company purchases of


57/ What is being billed as the establishment of China’s first investment bank—China International Capital Corporation (CICC)—was announced in October 1994. Press reports indicate CICC will be a joint venture between the People’s Construction Bank of China (42.5 percent) and Morgan Stanley Group (35 percent); the remaining 22.5 percent will be split evenly between a Hong Kong holding company, the Government of Singapore Investment Company and China National Investment & Guarantee Corporation. In the short-run, CICC will have to rely on the Chinese partners to deal in local currency transactions. See Wall Street Journal, October 11, 1994.
shares and the exchange of shares for existing bank debt will require promulgation of regulations.

**Furthering Financial Sector Reform.** The government is now committed to creating the mechanisms for monetary control as a top priority. As outlined in the Third Plenum's Decision, reforms being planned or already underway include (a) development of indirect monetary policy instruments, such as open market operations, gradual liberalization of interest rates, development of government securities markets, and creation of a modern payment system; (b) institutional restructuring of the People's Bank of China (PBC) to facilitate centralized monetary policy management, including possibly the creation of regional PBC branches along the lines of the U.S. Federal Reserve System; (c) the transformation of the specialized banks into commercial banks; and (d) the establishment of a system of policy banks, including the State Development Bank of China, the Agricultural Development Bank of China, and the Export-Import Bank of China. Spurred on by recent concerns about sudden, excessive and potentially destabilizing shifts of financial savings into speculative securities and real estate investments, the authorities have accelerated work on the legal and regulatory (prudential and supervisory) framework for the financial sector. Notwithstanding the articulation of these various policy objectives, as a practical matter, many of these reforms are far from the implementation stage. Thus, PBC's institutional reform remains unclear; the sequencing of interest rate liberalization in the macroeconomic stabilization cycle has not been defined; the architecture for reforming the specialized banks is still being designed; and the sources of finance, the organization and credit policies of all the development banks—as well as how they relate to the commercial banking sector—are still unclear.

**Promoting Diffusion of Technology.** In the mid-1980s China undertook a major effort to transform its R&D system, from a highly centralized system isolated from the real economy into one that was more decentralized and better tied to productive activities. As outlined in the Third Plenum's Decision, the government is now committed to speeding technological innovation through (a) improving enforcement of recently implemented intellectual property legislation; (b) providing for the mobility of technical personnel from academic research institutions into the productive sector; (c) creating market-driven engineering agents to adapt international and domestic technology to local inputs and conditions; and (d) fostering the transfer of technology from abroad through foreign investment, licensing and "build-operate-and-transfer" (BOT) or turnkey contracts. The detailed provisions implementing these reform objectives will take time to be designed, and should require careful consideration being given to international best-practices in this area.

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58/ The State Development Bank (SDB), effectively a consolidation of the six investment groups under the SPC, began operations in April 1994. The SDB will provide low-interest loans primarily to projects in the "strategic" and "public good" industry sectors; some "commercial" sector SOEs apparently will also be able to get such loans.

59/ Financial sector laws currently being drafted include a central bank law, a commercial banking law, a negotiable instruments law and an insurance law.

60/ In addition, some sectors, such as biotechnology (new plant varieties), are still without intellectual property protection under China's patent law.
6. CONCLUSION

China's economic growth has been sustained because the economy has been decentralized and there has been increased autonomy ceded to state-owned enterprises and opportunities for growth in the non-state sector. Consolidation of the successes engendered by that strategy requires further fundamental reforms: changes in the internal incentive and governance systems of SOEs, such as through clearer definition of property rights, and greater ownership diversification.

At the same time, the SOE market environment needs to be enhanced through: greater price competition, development of bona fide markets for labor, capital and technology, and reducing inter-regional and international barriers to entry and exit. The SOE-based social welfare system also needs to be reformed. Imposition of a "hard budget constraint" will require phasing out subsidies, collecting taxes, eliminating inter-enterprise debts and soft bank loans.

Achieving China's goal of industrial modernity will require farsighted policies backed by resource mobilization on a scale equivalent to the recent past. China cannot afford to slacken the pace of change. It must continue down its path of incremental implementation of reforms. In no small way that has been part of the secret of China's economic success and its ability to maintain growth.
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