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China
Facilitating Investment and Innovation:
A Market-Oriented Approach to Northeast Revitalization

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Executive Summary

While the Northeast has significant potential, its economic growth has steadily lagged behind China's more rapidly growing Southeast provinces. While history and geography play a part, so do government policies and programs. The Northeast's lagging growth reflects both a lack of private sector development and an inadequate transformation of Northeast industry away from state control.

The government's current program to "revitalize" the Northeast includes a mix of measures – including direct interventions, some public-private partnerships, and some initiatives to encourage market investment.

In general, Northeast revitalization would benefit from less emphasis on government direction and intervention, and more emphasis on private-sector investment and innovation supported by appropriate public-private partnerships.

Since dominance of Northeast economies by state-owned enterprises (SOEs) "crowds out" private sector development, it is important to transform this sector. Different "segments" of the Northeast SOE sector warrant different approaches.

- Corporate governance of large or strategic SOEs should adhere to international best practices – including "hard budget" constraints, commercial financing, and a "level playing-field" vis-à-vis private businesses.
- The sale or liquidation of any small/medium enterprises that are still state-owned should be accelerated. Such measures as an open and competitive sales process and adequate information are the best way to maximize sales proceeds and "avoid the loss of state assets."
- The restructuring of distressed SOEs might best be accomplished through specialized entities, owned by local governments, that focus on "operational restructuring" and are empowered to borrow, manage financial and real estate resources, and settle worker claims.
- Efficient SOE transformation will require support from legal reforms (e.g., a more open approach to cross-border mergers and acquisitions), from further development of social protection programs, and from general improvements in the investment climate to encourage private investment.

Investment climate improvements are needed to attract both more domestic and more foreign private direct investment and to make the Northeast more competitive vis-à-vis China's Southeast provinces.

- While recent updating of China's Company Law is a major improvement, there is still much that both the central government and local governments could do to reduce licenses, permits, and other impediments to new businesses.
- Barriers to business entry by foreign investors, both into industrial sectors and into transport/logistics, could usefully be lowered.
- More transparent approaches to land use, taxes, and administrative fees would help.

- Access to finance, especially by small private enterprises, is a particular issue in the Northeast. Key reforms would include measures to attract more foreign banks into the Northeast; training for local banks in international best practices in micro/small/medium enterprise (MSME) lending; and legal/procedural changes to increase protections for creditors and create more opportunities for MSMEs to use inventory and receivables as collateral.

Finally, the government needs to change its own approach, and move from directing economic activity to facilitating private-sector investment and innovation. To make needed rapid progress on all these investment climate issues, close coordination is needed – among local authorities in the Northeast, between the central authorities and Northeast local authorities, and between the public sector and the private sector. Reforms are needed at both the central and local government levels.

The private sector needs more effective means for organizing itself and representing its interests and views if it is to fulfill its potential contribution to Northeast investment climate improvements. Old-style industrial associations should be replaced with new-style business associations that genuinely represent stakeholders. Global experience provides numerous models of consultative forums to facilitate ongoing dialogues among the business community, government, labor, and civil society. These also warrant careful study. As the Northeast's investment climate improves, investment promotion will have a more realistic chance of effectively attracting inbound investment – both foreign and domestic.

Table 1 presents recommended priorities for local and central government action to improve the investment climate in Northeast China. (Priority recommendations are in **bold**.)

Table 1. Recommended Priorities for Local and Central Government Action To Improve the Investment Climate in Northeast China

Reform Category/Item	Primary Responsibility	Secondary Responsibility
1. Management of Northeast SOEs according to commercial best practices.		
a.) Develop plans based on "segmentation" of SOE portfolios: corporate governance for large and/or strategic SOEs; sale of small/medium SOEs; restructuring of distressed-but-viable SOEs; and liquidation of non-viable SOEs.	Central SASAC; local SASACs	
b.) **For large and/or strategic SOEs, adopt international best practices in corporate governance.**	Central SASAC	Local SASACs
c.) On a pilot basis, sell a majority shareholding in several large Northeast SOEs, either through trade sale or public offering. Rely on innovative approaches (e.g., blocking minority shareholding, "golden shares") to safeguard national economic interests.	Central SASAC	

d.) **Accelerate the sale or other ownership transformation of small/medium SOEs. Rely on process (e.g., open and competitive sales, information, warranties) to maximize sales proceeds and avoid "loss of state assets."**	Local SASACs	Central SASAC
e.) Adopt more open policies on cross-border mergers and acquisitions (M&A) – including more transparent regulation, and an international-standard competition law.	Central Government (e.g., MOFCOM; and State Administration of Industry and Commerce)	
f.) Establish specialized Entities to raise the necessary financing, manage the operational restructuring or liquidation of local SOEs, and manage associated "costs of SOE reform."	Local governments and local SASACs	
g.) **Develop complete and detailed financial projections and identify transition arrangements for completing the transformation of Northeast SOEs (including the transfer of social services now provided by SOEs) within 5-7 years.**	Local governments; central government	
h.) **Achieve further near-term refinements in unemployment insurance, urban *dibao*, and pensions.**	Local governments and central government	
2. Business entry		
a.) **Lower formal barriers to business entry, for instance by dramatically reducing the number of industries in the "restricted" category.**	Central government (e.g., MOFCOM and NDRC)	
b.) Review local administrative decrees and practices and eliminate remaining intra-China barriers to trade and investment.	Local governments	Central government
d.) Liberalize entry by foreign and domestic service providers into national/local transport/logistics sector.	Central government	
d.) **Simplify national-level laws and regulations on business start-up**	Central government	
e.) Simplify unique local regulations on business start-up.	Local governments	
f.) Pass a law on cooperatives to allow rural producers to form cooperatives that can respond to members' business needs, levy user fees, and support joint investments in common-use supply chain assets.	National People's Congress	
g.) Fully implement the new Administrative Licensing Law. Set up ombudsmen to monitor implementation and resolve complaints.	Local governments	Central government and NPC
h.) Reduce business inspections. Use a risk-based approach to	Local	

eliminate needless inspections.	governments	
i.) **Verify that local land-use policies conform to rules by the central government. Make the implementation of land-use quotas more transparent. Base land-use quotas solely on conformance with broad land-use categories (e.g., "commercial" or "industrial") and end requirements for detailed business/economic/financial information on planned investment projects.**	Local governments	
3. Taxes, tax administration, and administrative fees.		
a.) Reduce and simplify administrative fees. Base administrative fees on objective measures.	Local governments	
b.) Simplify and standardize taxes and tax administration. Make tax administration easier and more transparent, for example, through encouraging more use of e-filings.	Central government	Local governments
4. Customs		
a.) Continue to standardize, formalize, and simplify customs procedures. Increase the use of remote electronic clearances. Rely more on risk-based management in order to reduce the frequency of physical examinations. Facilitate customs clearances at in-land destinations.	Customs authorities in the Northeast	
5. Court-based resolution of commercial disputes		
a.) Increase the timeliness with which courts in inland Northeast cities resolve commercial disputes. Provide more resources and/or streamline procedures, as appropriate. Assess fairness – i.e., whether firms enjoy a "home court advantage" in commercial or investment disputes.	Local authorities	National People's Congress
6. Access to finance		
a.) **Encourage foreign investors to consider strategic investments in local financial institutions (e.g., city commercial banks), for instance, by presenting financial statements according to International Accounting Standards and retaining internationally-recognized accounting firms to audit financial standards according to international audit standards.**	Local financial institutions	
b.) Make it easier for foreign banks to open branches in Northeast cities.	CBRC	
c.) **Provide training for credit officers in international best-practices in lending to micro/small/medium enterprises (MSMEs) and in loan administration.**	Local financial institutions	
d.) **Pass new market-oriented bankruptcy laws and other civil code changes to facilitate SME use of receivables/inventory as collateral; and encourage development and use of nationwide**	NPC; PBOC; and CBRC	

collateral and credit registries to facilitate MSME access to credit.		
e.) Develop laws, regulations, and institutions to support non-bank financing: e.g., leasing, venture capital, initial public offerings (IPOs) of shares, and private equity.	Central government	
7. Labor flexibility		
a.) Bring labor laws/regulations and their implementation into alignment, by tightening implementation where necessary to improve worker protections and by loosening labor rules where possible to address legitimate business needs for labor flexibility.	Local governments	
8. Infrastructure and urban quality of life		
a.) **Continue investments in urban infrastructure to improve urban quality of life.**	Local governments	
b.) Attract schools and health care facilities oriented toward serving expatriate families. Provide financial subsidies during start-up, if needed.	Local governments	
9. Skills and technology		
a.) Develop incentives for research universities and institutes to commercialize their findings and build relationships with industry.	Local governments and institutions	
b.) Support local programs for "life-long learning" and movement toward a "knowledge economy."	Local governments and universities	
10. Institutions to achieve, sustain, and promote investment climate improvements		
a.) **Encourage (e.g., through dismantling of old-style industrial associations) the development of new-style market-oriented business associations that genuinely represent stakeholder (member) interests.**	Local governments	
b.) **Establish consultative forums to promote regular dialogue on economic, business, and private sector development issues among government, business, and other key stakeholders.**	Local governments	
c.) Develop the institutional capacity of investment promotion agencies seeking to attract direct investment in the Northeast.	Local governments	MOFCOM

I. Introduction

Northeast China has the conditions to support a more dynamic economy. Its population of 107 million and GDP of RMB1,500 billion make the Northeast a large market. In purchasing power parity (PPP) terms, the Northeast China market is almost twice the size of Poland, Thailand, or Turkey. Other key advantages include an educated and trained workforce, mineral deposits, fertile soil, relatively good transport and infrastructure, and coastal access and modern seaports.

The Northeast should be able to achieve a "vision" of economic development that includes the following:

- High levels of domestic and foreign private investment;
- Efficient industry supported by clusters of small and medium enterprise (SME) suppliers and service providers;
- Abilities in research, development, organization, and management that support product innovation and branding, worldwide industry standard-setting, integration of global supply chains, and value-adding post-sales services; and
- An agricultural sector that utilizes efficient supply chain linkages with domestic and export markets to achieve high profits.

Actual economic performance, however, has so far failed to approach the Northeast's full potential. The problem is not that the Northeast isn't growing. Annual GDP growth averaged 8-10 percent for all three Northeast provinces during 1980-2004 and exceeded 10 percent in all three during 2000-2004 (Table I-1). Rather, the problems are that the Northeast's main competitors (e.g., the Southeast provinces of Jiangsu, Zhejiang, and Guangdong) are growing more rapidly[1] and that the Northeast's growth has been insufficient to meet public expectations and generate employment for urban workers laid off from the Northeast's state-owned enterprises (SOEs).[2]

Table I-1. Five-Year Average Annual GDP Growth Rates
(percent)

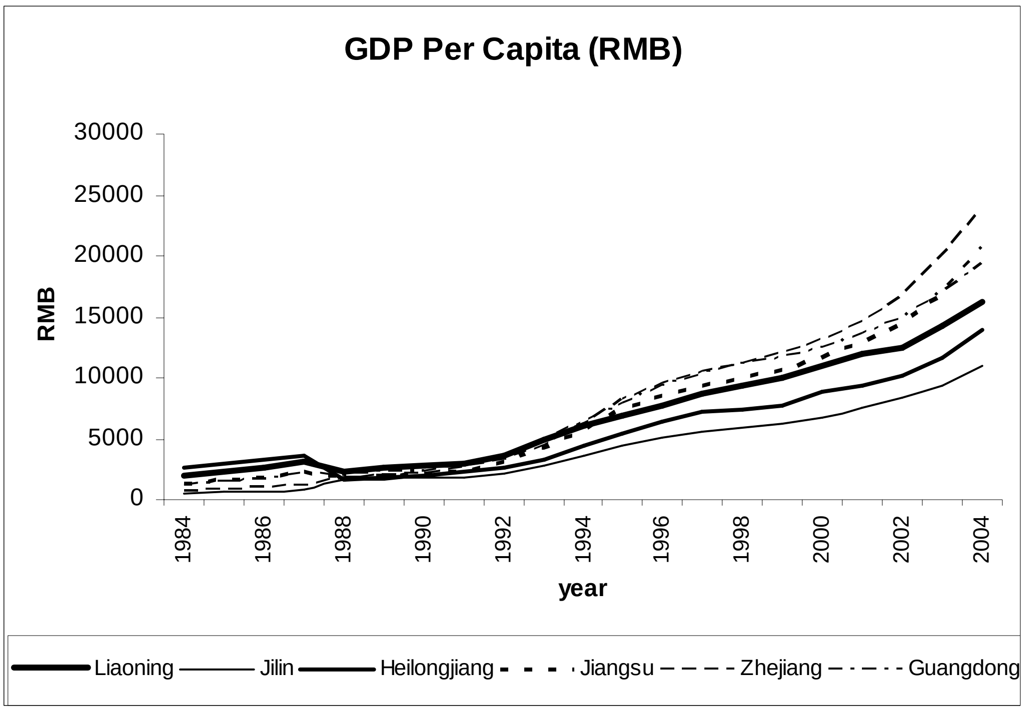
Period	Northeast provinces			Selected Southeast provinces		
	Liaoning	*Jilin*	*Heilongjiang*	*Jiangsu*	*Zhejiang*	*Guangdong*
1980-1984	8.6	10.8	8.0	10.7	13.8	12.1
1985-1989	10.1	9.3	6.6	12.6	11.2	14.7
1990-1994	9.1	9.7	7.2	15.0	16.5	18.4
1995-1999	8.2	9.9	9.2	12.1	12.1	11.2
2000-2004	10.5	10.1	10.0	12.2	12.5	12.1
Average	*9.3*	*10.0*	*8.2*	*12.5*	*13.2*	*13.7*

Source: www.cei.gov.cn; provincial statistical yearbooks; and staff calculations.

[1] Annual GDP growth in these three Southeast provinces averaged 12.5-13.7 percent during 1980-2004 and exceeded 12 percent in all three during 2000-2004.
[2] Despite GDP growth, urban employment growth during 1999-2003 has been *negative* 2 percent in Liaoning province, *negative* 21 percent in Jilin province, and *negative* 13 percent in Heilongjiang province.

This prolonged growth differential has had a dramatic effect on per capita GDP (Figure I-1). As of 2004, per capita GDP for Jiangsu, Zhejiang, and Guangdong averaged RMB 21,286, or 55 percent above the RMB 13,703 average for Liaoning, Jilin, and Heilongjiang.

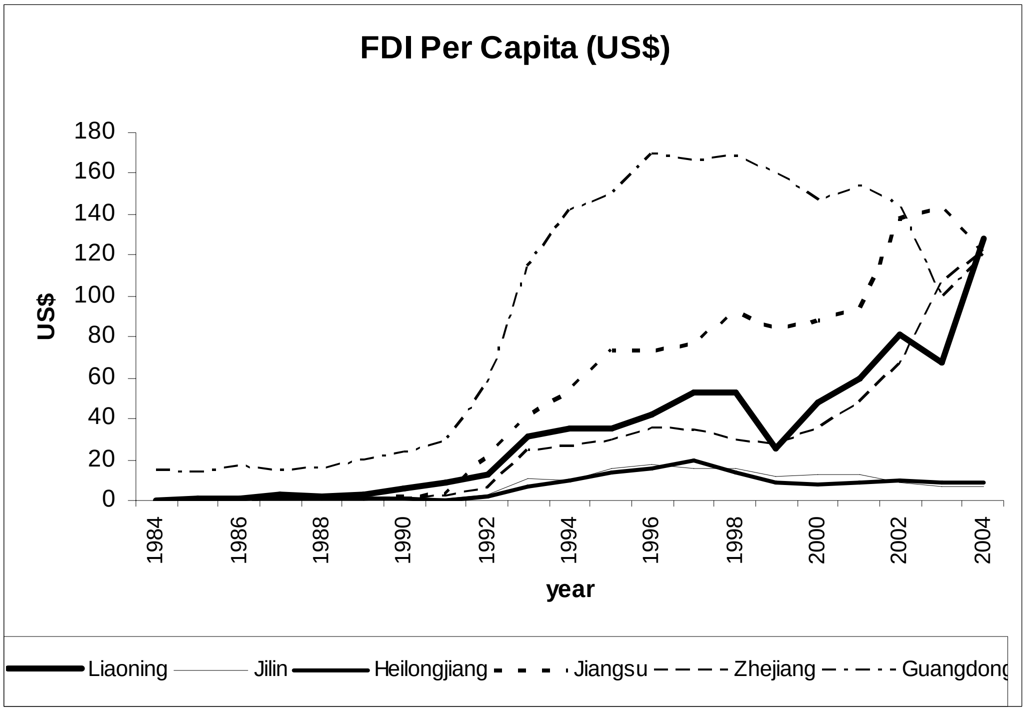
Figure I-1.



Source: www.cei.gov.cn; provincial statistical yearbooks; and staff calculations.

These differences in GDP growth partly reflect differences in foreign direct investment (FDI). Starting about 1991, per capita FDI in the Southeast (especially in Guangdong and Jiangsu) surged ahead (Figure I-2). During 1985-2004, FDI totaled $80.2 billion for Jiangsu and $137.6 billion for Guangdong – versus $38.0 billion for all three Northeast provinces.[3]

Figure I-2.



Source: www.cei.gov.cn; provincial statistical yearbooks; and staff calculations.

There are also striking differences between the Northeast and Southeast in terms of total factor productivity (TFP)[4] and state (versus private) ownership of industry. Among the twenty-one cities shown in Figure I-3, TFP averaged about 80 percent higher for surveyed firms in the Zhejiang and Guangdong cities than for surveyed firms in the Northeast cities of Shenyang, Changchun, and Ha'erbin.[5] The proportion of industrial

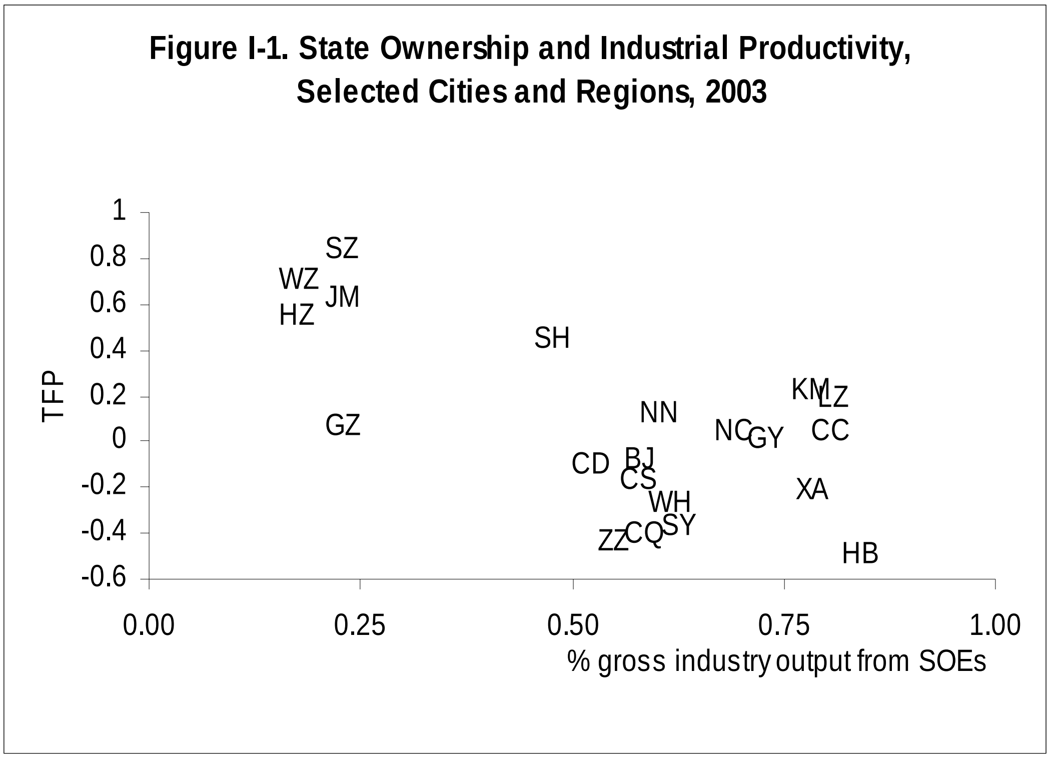
[3] Notably, during 1979-2004, almost 70 percent of all FDI in Guangdong came from or through next-door Hong Kong.

[4] Total factor productivity (TFP) attempts to measure contributions to output beyond those made by the number of workers, their skill level, and the machinery they use. Recent work on TFP has expanded beyond differences in technology to reflect differences in institutional setting or "investment climate" that influence the opportunities and incentives to adopt new technologies and operate efficiently. Rather than being measured directly, TFP is the residual growth in output not explained by differences in other factor inputs (i.e., labor, education, equipment). World Bank, *World Development Report 2005: A Better Investment Climate for Everyone*, (WDR2005), 2004, p. 28.

[5] World Bank (2004), pp. 47-8; World Bank (2005), p.39. For the Northeast city of Dalian, however, which has attracted substantial foreign investment, TFP for surveyed firms was comparable to the productivity level of Shanghai.

output from SOEs ranges from about 25 percent in the Southeast provinces of Guangdong and Zhejiang (cities of Shenzhen, Wenzhou, Jiangmen, Hangzhou, and Guangzhou) to 60-80 percent in the Northeast provinces (cities of Shenyang, Changchun, and Ha'erbin). TFP and state control of industrial output appear to be negatively correlated, with a coefficient of correlation of 43 percent. Thus, lower TFP is associated with higher state control of industrial output, while higher TFP is associated with lower state control (or higher private control) of industrial output.

Figure I-3.



Sources: *China Statistical Yearbook, 2004,* p. 514; World Bank (2003, 2004).
Note: Total factor productivity estimates are for surveyed firms in cities indicated. Output from state-owned industrial enterprises is for associated region (e.g., province).
SZ = Shenzhen, WZ = Wenzhou, JM = Jiangmen, HZ = Hangzhou, SH = Shanghai, KM = Kunming, LZ = Lanzhou, NN = Nanning, GZ = Guangzhou, CC = Changchun, NC = Nanchang, GY = Guiyang, BJ = Beijing, CD = Chengdu, CS = Changsha, XA = Xi'an, WH = Wuhan, SY = Shenyang, CQ = Chongqing, ZZ = Zhengzhou, HB = Harbin

The Southeast has some significant geographical and historical advantages over the Northeast*.* The Pearl River Delta (PRD), for instance, benefits from easier access to ocean transport, closer proximity to Southeast Asia, and a network of inland waterways that have facilitated low-cost intra-regional transport. Perhaps because of a lack of natural resources other than land, Guangzhou emerged several hundred years ago as a center for light industry and trade. This gave rise to traditions of entrepreneurship, production for market, and business initiative, which many migrants from the region carried overseas to Southeast Asia, the U.S., and elsewhere. Overseas Chinese are now providing important benefits to the PRD, including capital investment, business opportunities, skills and technology, and technical services. While the PRD has come to dominate many areas of light manufacturing over the last two decades, FDI is now also bringing in heavier and high-tech industries (e.g., petrochemicals, IT, autos).[6]

By contrast, the Northeast remained sparsely populated and un-developed during the Qing era. While Japan developed coal and iron ore mining, steel, engineering, and chemical industries after 1905, these basically served Japanese industry. After liberation, the pre-existing industrial structure was revived under state ownership. Nearby neighbors provided little or no trade or investment benefits, at least until the development of links with Japan and South Korea in the 1980s, and there has been no overseas migration. The resource-rich Northeast has been relatively inward-looking and dependent on domestic markets. Lacking centuries-long commercial traditions, the Northeast's economic development was jump-started when heavy manufacturing was grafted onto a backward rural economy. Thus, the industries that now exist in the Northeast are largely state creations that are ill-equipped to cope with market competition.[7]

But neither the Southeast's rise nor the Northeast's eclipse was inevitable. As a result of heavy state investment during the 1950s, by 1957 over one-quarter of China's entire industrial capital stock was concentrated in Liaoning province. By contrast, investment in the Southeast and growth were below-average during 1950-1980. Until about 1988, per capita GDP in the Southeast lagged behind Liaoning and Jilin (Figure I-1).

Differences between the Southeast and Northeast in economic growth, foreign investment, and productivity also reflect differences in industrial policy, infrastructure development, economic policy, and business orientation.

The Southeast has benefited from a largely *laissez faire* approach to industrial development. Rapid and largely unplanned and uncontrolled industrialization has encouraged the development of more efficient urban agglomerations and industrial clusters. This led to some strains on infrastructure (e.g., power), urban services, and environmental quality, however, which now need to be addressed. Basically, however, this *laissez faire* approach represented a reasonable alignment with market forces and allowed the Southeast's comparative advantage to determine the composition of industry – initially light industry, with increasing recent FDI in heavy industry. This permitted rapid growth with minimal investment of state funds.[8]

By contrast, a *dirigiste* approach to industrial development in the Northeast has left a troubled legacy. It is inherently more difficult and expensive to graft capital- and skill-intensive heavy industry onto a newly settled (basically rural) area that lacks much of an industrial past. Northeast heavy industry had backward linkages to mining, but there

[6] Barry Naughton, "The Economic Trajectory of Northeast China: Implications for Development Strategy," background paper, January 2005; Shahid Yusuf, "Two Tales of Regional Development in China: The Pearl River Delta vs. the Northeast," September 2005.
[7] Ibid.
[8] Ibid.

were relatively few forward linkages.[9] Sparse linkages and limits on labor mobility discouraged organic development of industrial clusters, supporting services, and efficient urban agglomerations able to sustain high-quality services and amenities. In localized cases where mineral resources or capital stock have been depleted or worn out, a spiral of decline may ensue as employment falls, fiscal resources shrink, physical infrastructure crumbles, and diminution of public services worsens the local business climate. Because it went against the momentum of comparative advantage, Northeast industrial policy could be no more than marginally successful – if successful at all – once the supporting structures of the command economy (e.g., directed resource flows, captive markets, controlled prices) disappeared. Due to the overwhelming preponderance of SOEs, no other engines of growth managed to emerge even as reforms continued in the 1980s and 1990s.[10]

The Northeast and Southeast have faced different infrastructure challenges. In the Northeast, resource depletion or diminished competitiveness have challenged cities that are essentially focused on a particular enterprise, making it difficult or impossible for these cities to modernize urban infrastructure and address environmental degradation. By contrast, the Southeast's rapid growth has strained infrastructure, social services, and the local environment. The post-1979 establishment of five special economic zones (SEZs) in the Southeast[11] sought to combine modern infrastructure with low rents, inexpensive services and utilities, tax concessions, and cheap labor.

While the Southeast had potential as a result of its geography, history and traditions, and the SEZ initiative, one long-time observer maintains that the Southeast's potential would have remained dormant without three complementary policies – i.e., trade reforms, decentralization of fiscal responsibility, and liberalization of rules on enterprise ownership. With increased trade, FDI, and the entry of thousands of township and village enterprises (TVEs) into the market, Chinese enterprises in the Southeast were exposed to intense competition that gave an immediate boost to productivity, product quality, and reliability.[12]

Lastly, the Southeast's history and recent 25 years of rapid growth have established a virtuous circle, featuring a business-friendly receptivity toward private enterprise and (compared with the Northeast) less excess capacity, less over-staffing, lower taxes and fees, and better access to finance. While the Southeast's rapid growth created some infrastructure problems, especially in power supply,[13] this growth has also provided the financial wherewithal to address such problems.

In response to the Northeast's lagging growth, in October 2003, the State Council launched a program to "revitalize" Northeast China and other old industrial bases. Especially since then, the central government and Northeast provincial governments have

[9] First Auto Works (FAW) was an exception.
[10] Naughton, Yusuf.
[11] Shenzhen, Zhuhai, and Shantou in Guangdong; Xiamen in Fujian; and Pudong in Shanghai.
[12] Yusuf, pp. 24-5.
[13] Dollar, et al, (2004), p.20.

undertaken many initiatives, including some measures to liberalize markets and encourage public-private partnerships.

In general, however, the program for Northeast revitalization emphasizes continued direct government intervention in directing support to favored sectors and firms, especially to SOEs (Box I-1).

Box I-1. Government Initiatives for Northeast "Revitalization"

Direct government intervention:

- The central government is providing direct support, in the form of financing from treasury bonds, for numerous projects to establish equipment manufacturing bases and a raw materials production bases in the Northeast. About 100 such projects were approved in 2003 and another 197 in 2004. In 2005, as of end-February, 40 additional projects with total treasury bond investment of RMB 429 million had been approved. During 2004-2005, 103 industrial projects in Heilongjiang province received treasury bond financing.
- The central government has financed 160 projects (worth RMB 60 billion) since 2003 to restructure and upgrade traditional Northeast industries with an aim of supporting high-tech exports and FDI.
- Eight Northeast industrial sectors – equipment manufacturing, petroleum and pharmaceuticals, metallurgy, ship-building, automotive production, agricultural products, military goods, and high-tech industry – were selected for a pilot reform of value-added tax (VAT) in July 2004. By replacing "production-based" VAT with "consumption-based" VAT, the costs for capital investment in these sectors were greatly reduced. Enterprise income tax has also been reduced, including through faster depreciation of fixed assets and faster amortization. Resource-depletion taxes have been reduced for some Northeast mines and oil fields.
- China's four large state-owned commercial banks (SOCBs) and 3 policy banks have been given greater flexibility to restructure or write-off non-performing loans to SOEs. By end-2004, about RMB 34 billon loans classified as "loss" had been written off and RMB 50 billion in "doubtful" loans had been transferred to asset management companies (AMCs) affiliated with China's four large state-owned commercial banks.
- The State Development Bank (SDB) has been encouraged to provide extensive supports for the restructuring of large SOEs, establishment of SME "credit management agencies, and additional loans for SMEs. The People's Bank of China is promoting loan guarantees for loans to laid-off workers.
- In November 2000, Liaoning's Economic and Trade Commission (ETC) formulated measures to establish a credit guarantee system to support SME financing and to encourage municipal governments to provide business development services to SMEs.
- In 2002, Liaoning's ETC organized a 3-year "SME Technology Innovation Flying Dragon Program." More than 200 enterprises deemed to have advantages in products, technologies, or management systems were given priority in project approvals, policy support and technological service.
- According to a June 2004 agreement between Liaoning government and SDB, SDB will issue loans to an SME Service Center in Yingkou city (one of 8 nationwide pilots) that will on-lend to SMEs and repay loans to the SDB.
- In 2004, Heilongjiang government announced a strategy to establish bases in six "pillar" industries: equipment manufacturing, petrochemicals, energy, food processing (including tobacco and soft drinks), pharmaceuticals, and forestry.

Public-private partnerships:

- The pilot reforms in social security were launched in Liaoning in July 2001 and subsequently in Heilongjiang and Jilin in May 2004. During 2003-2005, the central government provided RMB 66.2 billion to the three provinces for pension support, subsidies for laid-off workers, minimum urban subsistence payments (*dibao*), and social security subsidies.
- During 2004-2005, an administrative bankruptcy program to facilitate the sale or liquidation of distressed SOEs resolved 122 Northeast SOEs, writing off RMB 22.4 billion in bad debts.

- Pilot reforms were launched, starting in March 2004, to relieve large centrally-administered SOEs in the Northeast from the burden of providing social services. By end-2005, 23 SOEs had spun off 408 schools and other social service units.
- Since January 2005, SMEs Service Centers are established in 24 universities or colleges in Liaoning to improve SME access to technology resources.
- Ha'erbin, Changchun, Shenyang, and Dalian agreed in June 2005 to simplify customs clearance and treat the three interior cities as inland ports.

Encouragement of market investment:

- Northeast rural credit cooperatives have begun to pilot reforms to reduce non-performing loans (NPLs), improve productivity, and improve access to finance.
- In October 2004, People's Bank of China (PBOC) removed remaining ceilings on interest rates for most commercial loans, a crucial step toward facilitating SME access to credit through market-based lending.
- A State Council circular in February 2005 proposed policies to boost non-State (i.e., private) investment in natural resources, air transport, power, telecommunications, petrochemicals, media, and public utilities. It also called for more legal and policy reforms to improve investment climate.
- The three provinces have announced abolition of discriminatory rules and policies on market access, to eliminate inter-provincial trade barriers.
- In November 2000, the Liaoning authorities formulated measures to facilitate business entry and exit by SMEs.
- In March 2002, a Liaoning government directive sought to promote a level playing-field for private firms by confirming that private investment is allowed in all sectors except those prohibited by law or regulation; by permitting installment payments of required minimum capital for manufacturing and technology enterprises; encouraging private investment in SOE ownership transformation; and implementing proactive fiscal support and credit support. Project initiation was also to be facilitated by a switch from requiring actual government approval of projects to a simple project record-filing system for most projects.
- Following June 2004 identification of 100 problem areas in government behaviors, policies, institutions, market development, and human resources, the Liaoning government issued a September 2004 circular providing for some immediate actions (e.g., elimination of some approval procedures, abolishment of some administrative offices, reduction of various annual inspections) and development of follow-up policies.
- As of January 2005, Jilin has sought to facilitate new business entry and SOE ownership transformation. Efforts include shorter processing times for business registration and licensing; opportunities to treat unpaid salaries as worker equity in cases of SOE restructuring; and opportunities to treat investment by new investors in SOEs as registered capital even if the enterprise is insolvent.

Sources: selected speeches; press reports.

Initiatives to liberalize market entry and promote public-private partnerships are very positive. But the program for Northeast "revitalization" so far seems to place greater emphasis on continued government direction – e.g., designation of "pillar" industries and priority firms; financing development of raw materials and equipment production bases; and direct involvement in financial and business services support for SMEs. Five decades of government interventions have resulted in a Northeast economy somewhat lacking in vitality. The lesson from the contrast with the Southeast seems clear: *Northeast development would benefit from less government direction and more emphasis on market-led investment supported by appropriate public-private partnerships.*

The earlier comparison of local firm productivity and state control of industry (Figure I-3) raises a question. Is the Northeast's problem more that it never developed a vibrant private sector or that prolonged state control of industry has constrained productivity and crowded out private sector development? As with many "chicken or egg" questions, the answer is *yes*.

Since it does appear that SOE dominance of the Northeast economy "crowds out" development of a vibrant private sector – e.g., by discouraging new business entry and impeding access to finance – this topic is addressed first. Section II focuses on the issues associated with SOE dominance of the Northeast economy and recommendations for fixing the problem.

The transformation of Northeast SOEs seems necessary, but not sufficient in itself to spur more rapid economic development.[14] Hence, Section III assesses Northeast investment climate issues of particular relevance for new (e.g., "greenfield") investment by a domestic or foreign investor. What do we mean by "investment climate?" Definitions and emphases vary.[15] Investment climate factors of particular relevance to the Northeast, and therefore to this paper, include ease of business entry and exit; tax rates and tax administration; corruption; court-based resolution of commercial disputes; access to finance; labor flexibility; infrastructure; and skills and technology.

Section IV provides some cross-country perspective on the government's role in economic development and discusses institutional arrangements for facilitating private investment and business innovation.

[14] This view is also shared by a recent analysis of Northeast SOE performance since 1995. Xiao Geng and John Weiss, "Development in North East People's Republic of China: An Analysis of Enterprise Performance, 1995-2002," September 2005, ADB Institute discussion paper no. 34. The analysis indicates that changing an enterprise's ownership away from state ownership would, other things being equal, increase value-added per worker by 37-81 percent and the implied rate of return on capital by 3.8-8.2 percentage points.

[15] Cross-country comparisons of investment climate often consider macroeconomic policies and political/social stability. For example, see World Bank, *World Development Report 2005: A Better Investment Climate for Everyone* (WDR2005), pp. 246-7. These factors tend to be uniform within a particular country and, hence, irrelevant for cross-city comparisons. A survey by the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) of foreign investors highlights some additional factors, including market access, labor costs, and availability of technically-trained staff and local managers as key considerations in choosing a direct investment destination. Indeed, a World Bank survey of 14 cities in Liaoning Province found that local market factors (i.e., local income) seem to explain 45-60% of the variation in firm productivity. Some observers question the long-term importance of labor factors and skill endowments, given the possibilities of labor migration (e.g., to Shenzhen in the 1980s) or effective management of low-skilled labor. Given findings from the MIGA survey, however, these factors are included along with other obvious factors in this investment climate assessment.

II. Curing the Northeast's "SOE Syndrome"

The problems of Northeast SOEs are so deep-seated and their impact on the Northeast's economy so harmful that it is reasonable to characterize the Northeast as suffering from an "SOE syndrome."

The key issues are low SOE productivity, limited incentives for reform within SOEs, market distortions, financial losses and opportunity costs, social stability concerns, and the short-term "costs of SOE reform."

Turning to recommendations, this section suggests that the Northeast's SOE syndrome can be cured through a commercial approach to transformation of the SOE sector. Key elements of this commercial approach include segmentation of the overall portfolio of Northeast SOEs; adoption of corporate governance or ownership transformation measures appropriate to each portfolio segment; and development of necessary financing mechanisms, both long- and short-term.

A. Issues

Northeast SOEs remain heavily burdened by requirements to provide social services. As of end-2002, Northeast SOEs ran 7,183 child care centers, primary and middle schools, hospitals, public security and judicial organs, recreational facilities, etc. that employed 491,000 and annually drained RMB 15.4 billion from these enterprises. Of this, centrally administered SOEs accounted for 1,667 social organs, which employed 140,000 and cost RMB 6.8 billion. Thus, locally administered SOEs assumed most of the burden: 5,516 social organs, employing 351,000 and costing RMB 8.6 billion.[16] Costs in 2003 were roughly the same.[17]

Northeast SOEs still maintain excessively large workforces. The State sector workforce in the Northeast has been halved from 17.1 million in 1993 to 8.4 million in 2003.[18] Despite these reductions, compared with international peers, output per employee is far lower among Northeast SOEs in such key industries as steel, machine tools, autos, and petrochemicals.[19]

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[16] Of these, centrally-administered SOEs accounted for 1,667 social organs, which employed 140,000 and drained RMB 6.8 billion. Shao Ning, Vice Chairman of the State-Owned Assets Supervision and Administration Commission (SASAC), "The Reform and Transformation of Central SOEs in Northeast China," International Conference on Revitalizing Northeast China, Dalian, 25 September 2004.

[17] An earlier, February 2004 SASAC source indicates that costs for Northeast SOE social organs totaled RMB 15.3 billion as well for 2003, but that centrally-administered SOEs accounted for RMB 12.9 billion. Cited in Naughton, p. 16.

[18] By contrast, the State sector workforce in the rest of China saw a more modest 37 percent reduction, from about 92 million to almost 58 million. Naughton, p. 14.

[19] For example, 2002 steel production was 1450 tons per employee at South Korea's POSCO, 1206 tons per employee at China Steel (Taiwan, China), and 851 tons per employee at Baosteel, versus just 140 tons per employee at Angang. In machine tools, 2002 sales per employee amounted to $18,000 to $23,000 for Liaoning's two foremost machine tool manufacturers, versus $193,000 to $374,000 for international peers. Booz, Allen & Hamilton, briefing, "SOE Restructuring in China's Northeastern Provinces," 2004, processed. In autos, General Motors (GM) of North America produced 104 vehicles per worker in 2003,

Northeast SOEs produce too many parts in-house, instead of relying on more efficient "clusters" of private small and medium enterprise (SME) suppliers. This results in higher costs and lower quality for parts and components.[20] The auto industry probably epitomizes this issue. A 2004 study study found that automobile manufacturing costs were 150-190 percent higher at Chinese state-owned auto assemblers than at European, U.S., and Japanese joint ventures.[21] As noted above, FAW seems to rely excessively on in-house production, in contrast to European and North American car makers.[22] The "organic" development of auto parts/components clusters in the Southeast provinces of Guangdong and Guangxi is worth noting.[23]

Logistics costs are high, both nationally and in the Northeast. A McKinsey study identifies major cost and service quality problems:

- The lack of effective transport networks increases distribution costs. In China, transport and warehouse costs can amount to 30-40 percent of total costs for manufactured goods and around 70-80 percent for certain chemical products.
- On average, both inventory and delivery times exceed 30 days, "a striking divergence from the most advanced practices."
- Manufacturers face a lack of reliability in pick-up and delivery times and a lack of transparency during shipment. "Until goods show up at their destination, manufacturers have almost no information about their whereabouts."
- Rail and truck transport now involves a lot of human handling, and perhaps transfers of the goods between different transport companies, which results in excessive loss, damage, or theft.[24]

These cost and service problems reflect a lack of entry by international third party logistics (3PL) providers into Northeast markets and tendencies by large manufacturers to (inefficiently) meet their logistics needs with in-house assets rather than buying logistics services from more efficient outside specialists.[25]

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versus 7.3 vehicles per worker for First Automobile Works (FAW), headquartered in Changchun, Jilin province. Source: annual reports for GM and FAW, 2004. For a broader discussion of over-staffing in China's oil/petrochemicals and aerospace sectors, see Peter Nolan and Jin Zhang, "The Challenge of Globalization for Large Chinese Firms," *World Development*, 30:12, 2002.

[20] Peter Marsh, "A Little Local Difficulty in the Supply Chain," *Financial Times*, 23 June 2004.

[21] Japanese Auto Manufacturers Association, 2004, cited in K. Hiratsuka, "Northeast China Supply Chains for Automotive Components," June 2005, processed, p. 32.

[22] Following programs to shed in-house producers and outsource production, European carmakers Renault and Fiat outsourced 75-80% of their 2000 production. F. Veloso and R. Kumar, "The Automotive Supply Chain: Global Trends and Asian Perspectives," Asia Development Bank working paper, January 2002, p. 9. GM "spun off" (i.e., sold via public share offering) its captive in-house parts producers in the 1990s.

[23] Around Liuzhou, in Guangxi province, for example, 100 SME parts producers supply a joint venture jointly owned by General Motors and Volkswagen. World Bank, *Investment Climate for Small and Medium Enterprises (SMEs) in Southwest China*, 2004, p. 34. See also Naughton, pp. 10-12

[24] Jonathan R. Woetzel, *Capitalist China: Strategies for a Revolutionized Economy*, (John Wiley, 2003), pp. 82-94.

[25] Logistics costs represent 5% of sales for Japan's auto companies, 8% for American and European, and 15% for China's. In order to utilize excess labor, large Northeast enterprises like FAW have relied on internal assets to meet logistics needs. This has resulted in barriers to entry by specialized logistics providers (both international and domestic) and added to manufacturing, logistical, and management

Inadequate capital investment has left Northeast SOEs with technologically obsolete equipment and facilities. For example, according to one analysis of industrial enterprises in Jilin province, only 15-20 percent use equipment that is internationally advanced; 25 percent use equipment that conforms with China's domestic average; the remaining 60 percent use equipment that is below-average by China's domestic standards.[26]

Enterprises also appear to have under-invested in "value-adding" activities. For example, expenditures on research and development (R&D) are well below R&D expenditures by international peers.[27] More generally, while mastering low-cost modular manufacturing techniques that have enabled them to fit into the global supply chains of global multinational companies, Chinese enterprises have not invested enough in "soft assets" to boost profits from such higher value-added activities as proprietary R&D, brand development, industry standard-setting, and supply chain management.[28]

SOEs are constrained in their ability to attract and retain top technical and managerial talent. While the compensation of top SOE managers has improved, it still lags behind management compensation at private companies.[29] Issues include whether management compensation should be capped, for example, by minister-level salaries in the Government or as a multiple (e.g., 12x or 14x) of the minimum salary in any particular SOE. While some countries with highly successful and efficient SOE sectors (e.g., Singapore, New Zealand) have de-linked SOE compensation from civil service pay scales and/or provide market-competitive compensation to civil servants, such reforms are not on China's horizon. China's SOEs have experimented with various forms of equity incentives.[30] Experience in other countries suggests that equity incentives – especially purchases or awards of "restricted" stock that must be held for several years – can be a powerful tool for aligning the interests of managers/directors and shareholders. In China, however, corporate governance issues work to undermine share prices and, hence, the value of such equity incentives.

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inefficiencies. Jilin Development Research Center, "Study on Automobile Transport/Logistics/Supply Chain in Jilin Province," March 2004, pp. 14, 20-1.

[26] Li Jiange, "Propelling SOE Restructuring With Foreign Investment," International Conference on Revitalizing Northeast China, Dalian, 25 September 2004.

[27] In electronics, for example, R&D expenditures in 2002 by two Dalian companies, Dalian Daxian and Hualu represented 1.4% and 4.8%, respectively, of sales versus 9.5-15% for international companies Phillips, NEC, and Intel. BAH, 2004, p. 98. Comparable figures for 2003 were still low, 4.1% for Dalian Daxian and 3.6% for Hualu. Jun Kurihara, "Economic Development Strategies for Northeast China: A Study of the Electronic Components Industry," March 2005.

[28] Edward Steinfeld, "Chinese Enterprise Development and the Challenge of International Integration," in Shahid Yusuf, *et al*, editors, *Global Production Networking and Technological Change in East Asia*, World Bank, 2004, pp. 255-65.

[29] According to one international specialist in compensation, fewer than 1% of China's SOE paid more than RMB 200,000 to top managers during 1999-2001 versus about 12% of private firms in China. In 2004, the central State-Owned Assets Supervision and Administration Commission (SASAC) unveiled a plan to pay senior managers of centrally-administered SOEs anywhere from RMB 100,000 to RMB 1,000,000, depending on performance, with average compensation of RMB 250,000. This range, however, is just 40-65% of the compensation for comparable jobs at private firms in China. Watson Wyatt, *Study on SOEs Performance Management and Compensation*, April 2005, processed, pp. 7, 38.

[30] Ibid.

Since its founding, SASAC has focused much attention on SOE performance measurement and incentive compensation. In a pilot program, central SASAC has signed management contracts whereby the management and directors at selected large SOEs commit to increase net assets (book value) by 10.5 percent and revenues by 8.5 percent within two years. The impact of such efforts on the long-term competitiveness of SOEs is unclear. A pre-SASAC survey of 400 SOEs concluded that performance contracts did not on average improve the productivity of SOEs in China and may even have hurt productivity.[31] The use of such performance metrics as gains in net assets and revenues may indeed encourage SOE managements to cut costs (e.g., for social services, redundant staff). But such metrics may also discourage investments (e.g., in R&D, in newer and larger fixed assets, and in less-tangible supply chain assets) needed to enhance long-term competitiveness.

By tending to depress Northeast markets and "crowd out" private businesses, low SOE productivity hurts the region's investment climate.

Northeast industry suffers from overcapacity. The World Bank's 2002/2003 survey of 23 cities found that excess capacity tended to be lowest in coastal cities and highest in the west and northeast.[32] Financial data (see Table II-1) indicate that many less-competitive SOEs with high excess-capacity are kept on financial "life support."

Northeast SOEs rely too much on price competition. Over-capacity is one factor. Distressed SOEs may be overly willing to sell at low prices in order just to cover variable costs (e.g., suppliers, labor, and utilities). In addition, SOEs are constrained by under-investment in R&D, modern facilities and equipment, product development, or supply chain management. Hence, SOE manufacturers are less able to compete in terms of product quality, "brand recognition," flexible production, responsive delivery, or after-sales service. Especially if buyers are less-discriminating, excessive price competition will tend to depress profit opportunities for other more-competitive firms.[33]

Private sector access to finance is also crowded out by non-competitive SOEs. Nationwide, SOEs still absorb up to two-thirds of all credit even though the share of

[31] Mary Shirley and Lixin Colin Xu, "Empirical effects of Performance Contracts: Evidence From China," World Bank research note, October 17, 1997.

[32] Surveyed firms reported excess capacity of 14-22% in Shenzhen, Hangzhou, and Jiangmen; 27-28% in Dalian, Guangzhou, Wenzhou, Shanghai, Wuhan, Tianjin, and Changchun; 30-33% in Beijing, Zhengzhou, Nanchang, Chongqing, and Chengdu; 34-39% in Ha'erbin, Kunming, Changsha, Xi'an, and Nanning; and 40% or more in Lanzhou, Guiyang, and Benxi. Firms in Benxi, in Liaoning, reported excess capacity of almost 80%. World Bank, 2004. More recent economic growth may have absorbed some of the Northeast's excess capacity. A subsequent survey of 14 cities in Liaoning province found that excess capacity typically ranged from 15-25 percent. Firms in two cities, however, reported substantially higher excess capacity: Fuxin at 30 percent and Benxi at 55 percent. World Bank, 2004b.

[33] While there is also a possibility that less-competitive SOE manufacturers may be more inclined to infringe on intellectual property rights (e.g., trademarks, patents) in order to compete, some observers suggest that IP problems arise more from small and medium enterprises.

SOEs in industrial GDP has declined to one-fifth.[34] The problem seems especially severe in the Northeast, whose provinces rank first, second, and third in terms of highest ratios of non-performing loan (NPL) ratios.[35] In addition to being very expensive, as detailed below, the preservation of non-competitive Northeast SOEs absorbs capital that could be used more productively by newer and more-dynamic private firms.

The direct cost of financial "life support" for Northeast SOEs is extremely high. Table II-1 summarizes the recent status of locally-administered SOEs in the Northeast provinces.[36]

Table II-1. Financial Results for
Locally-Administered SOEs in Northeast China
(RMB in 100 million)

	Liaoning			Jilin			Heilongjiang		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Number	5,462	5,157	3,934	3,325	3,105	2,845	6,323	5,926	5,178
Sales	1790	1872	1776	628	654	686	705	751	784
Profits	-39	-36	-29	-14	-25	-34	-33	-27	-39
Assets	5159	5196	4213	2210	2371	2194	3179	3227	2968
Average assets	0.94	1.01	1.07	0.66	0.76	0.77	0.50	0.54	0.57
Liabilities/Assets	0.795	0.818	0.759	0.914	0.925	0.896	0.913	0.906	0.838
Liabilities	4101	4250	3198	2020	2193	1966	2902	2924	2487
Equity	1058	946	1015	190	178	228	277	303	481
Bad assets/Equity	0.910	1.073	1.305	2.593	2.920	3.521	1.878	1.869	1.965
Bad assets	962	1015	1325	493	519	803	519	567	945
Bad assets/Total assets	19%	20%	31%	22%	22%	37%	16%	18%	32%
Adjusted equity, Worst case (1)	95	-69	-310	-303	-341	-575	-243	-264	-464
Adjusted Liabilities/Assets (1)	0.977	1.017	1.107	1.176	1.184	1.414	1.091	1.099	1.229
Adjusted equity, Best case (2)	576	438	353	-56	-82	-174	17	20	8
Adjusted Liabilities/Assets (2)	0.877	0.907	0.901	1.029	1.039	1.097	0.994	0.993	0.997

Source: *Finance Yearbook of China, 2004*, pp. 374-7, 380; and staff calculations.
(1) Assumes 0% recovery on bad assets.
(2) Assumes 50% recovery on bad assets.

The number of industrial SOEs in the Northeast has declined, from about 15,000 at end-2001 to about 12,000 at end-2003. This presumably reflects the sale, merger, acquisition, or administrative bankruptcy of distressed SME SOEs, as indicated by the increase in average assets. *Net losses* for 2001-2003 totaled RMB 27.5 billion.[37] Despite these losses, equity increased between end-2001 and end-2003, probably mainly as a result of

[34] Patrick Honohan, "Finance in China: Removing Ambiguity Over the Government's Role," paper prepared for the Report on the 11th Five-Year Plan, World Bank, 2004.
[35] Du Yi, "CBRC investigates the true rate of non-performing loans in the Northeast," in *21 Shiji Jingji Baodao*, 19 January 2004, cited in Naughton, p. 21.
[36] This excludes a smaller number of larger SOEs administered by the central government's State-Owned Assets Supervision and Administration Commission (SASAC).
[37] Since this figure is net of profits by profitable SOEs, *gross losses* were higher (by an unknown amount).

asset revaluations, free asset transfers, and sale or bankruptcy of insolvent SOEs accompanied by debt write-offs.[38]

Portfolios of locally-administered SOEs are deeply distressed. Official statistics attempt to identify "unhealthy" SOE assets, which can include un-collectible receivables, un-saleable inventory, and outmoded fixed assets. As indicated in Table II-1, bad assets represent a high percentage of SOE industrial assets in the Northeast: 31 percent in Liaoning, 37 percent in Jilin, and 32 percent in Heilongjiang.[39] Comparable percentages of bad assets for industrial SOEs are much lower for small state-sector coastal provinces, for example, 4 percent for Zhejiang and 14 percent for Guangdong.[40] The accumulation of bad assets would represent an additional deferred loss beyond the negative income of RMB 27.6 billion for 2001-2003. According to the data summarized in Table II-1, bad assets of industrial SOEs in the Northeast totaled RMB 307 billion as of end-2003. The realizable value of these bad assets is unknown. If these bad assets have no realizable value, designated the "worst case" in Table II-1, the portfolios of locally-administered industrial SOEs would have been insolvent in all three Northeast provinces as of end-2003, with RMB 135 billion of *negative* equity. If it proved possible to recover 50 percent of the book value of the negative assets (the "best case"), the ensuing write-off of RMB 153 billion would have resulted in liabilities/asset ratios of 0.90 for Liaoning, 1.10 for Jilin, and 1.00 for Heilongjiang.

Moreover, the real financial performance (or cost) and financial position of Northeast SOEs is obscured by outmoded accounting standards. While SOEs with publicly-listed shares or foreign partners use the new Accounting Systems for Business Enterprises (ASBE), which is reasonably close to international accounting standards (IAS), the great majority of SOEs continue to follow traditional accounting standards. Compared with IAS, these traditional standards are sometimes much less conservative (e.g., no accounting for foreseeable liabilities, such as restructuring or redundancy costs) and sometimes much more conservative (e.g., cost basis instead of market value for granted land use rights).[41]

Opportunity costs are also high. It is reasonable to conclude that SOE dominance of Northeast industry diminishes firm productivity and growth. This, in turn, results in lower tax revenues (e.g., business tax, company income tax) for the local authorities. The good news is that fixing the Northeast's investment climate should significantly increase

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[38] The bulk of debt/equity swaps occurred before 2001. There does not appear to have been much new cash equity investment into Northeast SOEs during the period. All this suggests that asset revaluations, free asset transfers, and debt write-offs during 2002-2003 could have amounted to as much as RMB 35 billion. As noted earlier (Box I-1), as of end-2004, banks had written off RMB 34 billion in "loss" loans to Northeast SOEs.

[39] Bad assets jumped dramatically in all three Northeast provinces in 2003. The data do not indicate whether this reflected a real increase in bad assets or simply more realistic reporting. If the latter, this hopefully might signal preparations to resolve distressed SOEs in the Northeast.

[40] Staff estimates, based on *Finance Yearbook of China, 2004*.

[41] William Mako and Chunlin Zhang, "Management of China's State-Owned Enterprises Portfolio: Lessons from International Experience," September 2003, pp. 15-7.

local tax revenues and that rising tax revenues would make it easier to finance the "costs of SOE reform," as discussed below.

Given the prospect of additional SOE workforce reductions, further near-term refinements in social safety nets are important.

- For laid-off workers, the shift from the *xiagang* system – whereby the SOE, local government, and unemployment insurance program all contributed – to reliance just on unemployment insurance in all three Northeast provinces has been a positive step. While it is too soon to draw definitive conclusions, several additional reforms warrant consideration: e.g., pooling at the provincial, rather than municipal, level; reducing maximum duration of unemployment benefits; and providing more effective support for worker training.
- Expansion of minimum subsistence payments in urban areas (*dibao*) spread rapidly in the early 2000s. The Northeast provinces now spend significant amounts on *dibao*, with substantial subsidies from the central government. While urban *dibao* played an important role in sustaining households during the height of SOE retrenchment, some changes seem warranted, including greater efforts to improve re-entry to employment among urban beneficiaries able to work.
- Pensions in the Northeast suffer from the same issues as in the rest of China, for example, age demographics, fewer workers in the urban formal sector, and fragmentation. Reforms are needed, including measures to restore financial viability and improve pension administration, investments, and governance.[42]

Detailed projections of the "costs of SOE reform" are needed. Only partial estimates are available for the main costs of SOE reform: transfer of SOE social services; worker claims; and settlement of non-performing loans (NPLs).

- As noted earlier, Northeast SOE expenditures on social services amounted to more than RMB 15 billion as recently as 2003. Financing from local or central government sources would presumably need to be arranged before local governments could take responsibility for providing such social services. Some pilot projects are underway.[43]
- Looking just at Liaoning Province and excluding resolution of non-performing loans owed by SOEs, researchers at the Development Research Center of the State Council (DRC) have estimated that costs of SOE reform would involve a one-time cost of RMB 3.03-4.26 billion and annual recurring costs of RMB 2.1-2.6 billion for five years.[44] It seems reasonable to assume that inclusion of the other two provinces would roughly double costs (to RMB 6-8.5 billion one-time and RMB 4-5 billion annually recurring). Some costs (e.g., bankruptcy subsidies) have already been paid (Box I-1).

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[42] Xiaoqing Yu *et al*, "Background Notes on Social Protection," World Bank, June 2005.

[43] For example, an agreement between PetroChina and Heilongjiang provincial government on transfer of compulsory education schools run by Daqing oil field; 408 of 7,183 Northeast SOE social service units had been spun off as of end-2005.

[44] Liu Shijin and Lai Youwei, "Pay Essential Reform Costs, Promote Transformation of State-owned Enterprises," A Development Strategy for Northeast China: Background Report, Development Research Center of the State Council, December 2003.

- Government support for NPL resolution in the Northeast has amounted to at least RMB 100 billion in the form of NPL write-offs, transfer of doubtful loans to AMCs, and bankruptcy subsidies from the central government (Box I-1). Remaining NPLs among Northeast SOEs, however, may be substantially larger. As of end-2003, bad assets of locally-administered SOEs in the Northeast amounted to RMB 307 billion while their liabilities totaled RMB 765 billion (see Table II-1), which could include RMB 500 billion or so of bank debt.[45] The implications are that perhaps 60 percent of loans to these SOEs were non-performing as of end-2003 and that perhaps another RMB 200 billion of Northeast SOE NPLs awaits resolution.

The Northeast's own financial resources should be sufficient to finance most, if not all, of the costs of SOE reform. Three main types of financial resources are available to Northeast governments:

- First, the sale or liquidation of loss-making SOEs would end any need for continuing financial support. Gross losses of Northeast SOEs are unknown, but likely large.
- Second, proceeds from the sale of SOE assets (especially land use rights) or shares could be substantial. The most valuable asset of distressed Northeast SOEs is likely to be the underlying real estate. This real estate (mainly land use rights) has not been properly valued, however, which precludes any precise estimate of final recovery (or residual loss) on remaining Northeast SOE NPLs. Recoveries on the underlying assets (especially real estate) could be substantial, especially if asset recovery and management follow international commercial best-practices.
- Third, and perhaps most importantly, projected increases in local business taxes (mainly the business revenue tax and the company income tax), resulting from improvements in the investment climate, could support up-front borrowing to finance SOE reforms and other measures needed to improve the Northeast's investment climate (Box II-1).

Box II-1. Up-Front Financing for Investment Climate Improvements

The relationship between reduced state ownership and greater private ownership of industry on the one hand, and higher total factor productivity (TFP) on the other hand, is reasonably strong. Hence, reduced state control of industry and greater private sector development in the Northeast should lead to higher sales and income for firms and to higher tax revenues for the local authorities.

In anticipation of future improvements in the investment climate, it may make sense for the local authorities to borrow against the incremental tax revenues expected to result from future improvements in the investment climate. These could be substantial. As noted earlier, TFP for survey firms averages about 80 percent higher in Southeast cities than in Northeast cities (Figure I-3).

For 2003, business tax and company income tax for the three Northeast provinces amounted to about RMB 30 billion. The following table illustrates the capitalized value – and, hence, potential borrowing capacity – of a range of increases in local tax revenues resulting from improved investment climate. For example, assuming that investment climate improvements would result in a 30-50 percent increase in local tax revenues, it should be possible to borrow RMB 112-187 billion up-front, to invest in measures (e.g., SOE reform, better infrastructure) needed to achieve a better investment climate.

[45] Typically, bank debt accounts for 60-70% of SOE liabilities.

Increase in annual business taxes	Capitalized new borrowing capacity (in RMB billions)
60%	224
50%	187
40%	150
30%	112
20%	75
10%	37

Source: *Finance Yearbook of China*, *2004*; and staff estimates.
Assumptions:
1. Current business tax revenues of RMB 30 billion for the three Northeast provinces.
2. 5 percent interest on borrowing.
3. 20-year repayment of borrowing and accrued interest.

B. Recommendations

The transformation and reform of Northeast SOEs (both local and central) should proceed efficiently according to commercial best practices. Key elements of a commercial approach include "segmentation" of the overall SOE portfolio; adoption of corporate governance or ownership transformation measures appropriate to each portfolio segment; and development of financing projections and arrangements, both short- and long-term.

The portfolio of Northeast SOEs should be "segmented" and appropriate principles applied to each segment:
1. *Large and/or strategic SOEs, which are healthy and destined to remain in the State portfolio, should follow international best practices in corporate governance.* The great majority (and perhaps all) of these would be administered by central SASAC.
2. *Small and medium enterprises that are viable as "going concerns" should be sold, using procedures to maximize sales proceeds and "minimize the loss of State assets."*
3. *Non-viable SOEs should be liquidated, while distressed-but-probably-viable large SOEs may be restructured.*

Such a segmented approach is consistent with the 4th Plenum Decision of the 15th Central Committee of the CCP in 1999 to "grasp" large SOEs and "let go" the small and medium.

Central SASAC would act as shareholder for all (or almost all) of the large Northeast SOEs that remain in the state portfolio. Local SASACs would be responsible for sales of small/medium SOEs and most liquidations. Local SASACs and central SASAC might all play a role in SOE restructuring.

Corporate governance of large Northeast SOEs should be consistent with international best practices. These have recently been codified (Box II-2).

Box II-2. OECD Guidelines on the Corporate Governance of State-Owned Enterprises

The legal and regulatory framework for SOEs should ensure a level playing field in markets where SOEs and private sector companies compete in order to avoid market distortions. E.g.,
* The legal form for SOEs should allow creditors to press their claims and initiate insolvency procedures.
* Non-standard requirements for SOEs to provide public services should be clearly mandated by laws/regulations, disclosed, and compensated for in a transparent manner.
* SOEs should have to compete for access to finance. Their relations with state-owned financial institutions should be based on purely commercial grounds.

The state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that SOE governance is transparent, accountable, professional, and effective. E.g.,
* SOE management should have full operational autonomy to achieve their defined objectives.
* The state should let SOE boards exercise their responsibilities and respect their independence.
* The ownership entity should be held accountable to representative bodies.
* The ownership entity should set up reporting systems that allow regular monitoring and assessment of SOE performance.

The state and SOEs should recognize the rights of all shareholders in accordance with OECD Principles of Corporate Governance and ensure their equitable treatment and equal access to information.

State ownership policy should fully recognize SOE responsibilities toward stakeholders and request SOE reporting on relations with stakeholders.

SOEs should observe high standards of disclosure. E.g.,
*The ownership entity should develop consistent and aggregate reporting on SOEs and publish annually an aggregate report on SOEs.
*SOEs should develop an internal audit function that reports directly to the SOE's board.
*SOEs, especially large ones, should be subject to an annual independent audit based on international standards. The existence of specific state control procedures does not substitute for an independent external audit.
* SOEs should be subject to the same high-quality accounting and auditing standards as listed companies.
* SOEs should disclose material matters, including any financial assistance (including guarantees) from the government and any material transactions with related entities.

SOE boards should have the necessary authority, competencies, integrity, and objectivity to provide strategic guidance and monitor management. They should be held accountable. E.g.,
* SOE boards should be assigned a clear mandate and ultimate responsibility for SOE performance. The board should act in the best interest of the company and treat all shareholders equitably.
* An SOE's board should have the power to appoint and remove the SOE's chief executive.
* When necessary, SOE boards should set up specialized committees (e.g., audit, risk management, remuneration, nomination).
* SOE boards should carry out an annual evaluation to appraise their performance.

Source: OECD, 2005b

Applying these principles to China's large SOEs, especially those in the Northeast, promises many benefits. For instance, hard budget constraints and threat of insolvency would preclude open-ended loss-making operations. Private businesses would enjoy same access as SOEs have to credit. SOEs would no longer be obliged to provide social services free charge. SOE boards and management would have both greater autonomy and greater accountability. Representative bodies (e.g., the National People's Congress) and the public would receive regular reports on the financial performance (or cost) and position of remaining SOEs. Minority (public) shareholders would be better-protected.

Central SASAC and other relevant authorities (especially the China Securities Regulatory Commission, CSRC) are clearly attempting to reform corporate governance at China's as-yet state-majority enterprises. Key reforms since 2003 include requirements for independent directors to approve "connected transactions" and major asset sales, mergers, or acquisitions by listed companies; initial efforts to convert non-tradable shares into tradable shares and empowerment of public shareholders to approve such conversions; efforts to appoint boards of directors for 100 percent state-owned enterprises; and new arrangements for performance monitoring and incentive compensation. Continued implementation of such reforms should improve SASAC's ability to exercise its State shareholder function over remaining shares in large Northeast enterprises.

Given the need of large Northeast SOEs for additional capital investment and performance incentives, it makes sense for central SASAC to explore a more market-oriented balance between State and non-State ownership and corporate governance. SOEs in highly-sensitive sectors (e.g., military production) may naturally remain 100 percent state-owned. For other large enterprises, however, greater "ownership diversification" is a useful way to achieve both market financing and market discipline. While pursuing ownership diversification for some large SOEs since about 1990, China's government has typically retained majority control. The governments of other social-market and developing OECD economies, however, have been more willing to accept minority state-ownership of strategic enterprises (Box II-3).

Box II-3. Minority State Ownership for Strategic Enterprises: Cases from OECD Countries

Korea: Increasingly since the late 1990s, South Korea's government accepted minority state ownership of such strategic enterprises as Korea Telecom and POSCO, a world-leading steel company. In POSCO's case, 2nd tier shareholders such as Korea Development Bank and other state-owned banks remained major shareholders for a while. Since 2001, however, foreigners have owned 62 percent of POSCO's shares.

	Government 1st tier	Government 2nd tier	Other domestic	Foreign
Korea Telecom				
Dec-92	100%	--	--	
Dec-98	71%	--	24%	5%
Dec-99	59%	--	22%	19%
Dec-01	40%	--	23%	37%
May-02	--	--	51%	49%
POSCO				
Dec-68	56%	44%	--	--
Dec-87	32%	68%	--	--
Jun-88	20%	43%	37%	--
Dec-92	20%	30%	42%	8%
Dec-97	20%	22%	33%	25%
Dec-99	--	18%	39%	43%
Dec-01	--	10%	28%	62%

Austria: Since the mid-1990s, the government has sought to enhance capital market financing and supervision of strategic enterprises by reducing the OIAG state shareholding fund's shareholdings toward a level that would allow OIAG to block fundamental changes in these strategic companies.

	Government 2nd tier OIAG Fund
VA Stahl (steel)	
1993	75%
1995	43%
2000	35%
OMV (oil refining/distribution)	
1993	75%
1997	35%
2005	31.2%
Austrian Airlines	
1997	52%
2000	40%
Telekom Austria	
1997	100%
1998	75%
2000	47%
2005	30%
Boehler Udenholm (steel)	
1994	73%
1996	25%

Source: Lim (2002); www.oiag.co.as

In cases where OECD countries have accepted minority state ownership of strategic enterprises, they have used other methods to guard against major changes in the enterprises (e.g., ownership transfer) that might affect national economic interests. The main methods have been (1) blocking minority shareholdings; (2) "golden shares"; and (3) special legislation.

In Austria, while reducing state shareholdings to minority ownership, the OIAG state shareholding fund has retained enough shares to block fundamental changes in key companies. According to Austria's Company Law, ownership of 25 percent of a company's shares *plus 1 share* is enough to block fundamental changes in a company (e.g., merger, acquisition, dissolution). If this "blocking minority" model were applied to large SOEs in China, according to China's Company Law, ownership of 33 percent of a company's shares *plus 1 share* would give the SASAC the power to block amendments to articles of association; an increase or decrease in registered capital; or merger, split, dissolution, or restructuring of the company.[46]

"Golden shares" may give governments special post-sale powers to approve or veto major initiatives, such as the sale of a majority of an enterprise's shares to a third party; sale of major assets; or reorganization or liquidation. First introduced in the U.K. to prevent newly privatized enterprises from being taken over, golden shares have been used in many additional OECD countries (Box II-4). The disadvantages are that golden shares may facilitate undue government interference or undermine the market for corporate

[46] Company Law, as amended 27 October 2005, article 104.

control. By increasing uncertainty or restraining the enterprise's post-sale commercial freedom of action, golden shares may diminish an enterprise's value and sales price. Worldwide experience suggests that the potential drawbacks from golden shares can be mitigated by narrowly focusing the scope of golden share powers, limiting the duration of golden share powers (e.g., to 3 years after sale), and specifying circumstances under which golden share powers may be invoked.[47]

Box II-4. Use of "Golden Shares": Selected Cases

U.K.: While varying among industries, golden share powers have tended to be time-limited. A typical prohibition has been on one person or group acting together to control more than 15% of a company's equity. For defense industries, golden shares have no time limit and additional powers are included, e.g., nomination of directors, disposal of major assets. As a matter of policy, the retention of a golden share has been treated as an exceptional matter, one that does not allow government interference in the business affairs of the company. Over the years, the government has been relinquishing its golden shares in most sectors, except for defense. In the case of British Telecom, the government relinquished its golden share to dispel investor uncertainty during merger discussions with MCI. Except in defense industries, golden share powers have never been invoked.

France: Golden shares ("action specifique") were introduced in 1986. There is now no time limit, but the government may elect to convert golden shares into regular shares. Typically, golden shares give government powers to require authorization from the Ministry of Economy and Finance for any concentration of control above a certain percentage; to appoint two non-voting directors to the board; and to block the sale of any assets (e.g, shares, real estate, intellectual property) to protect national interests.

Italy: A 1994 law provided broad powers to protect public order, safety, health, and defense. Golden share powers were more narrowly specified in 1999, in part due to European Union action and to a hostile takeover bid for Telecom Italia and its proposed defensive merger with Deutsche Telecom. Since then, golden share powers could be invoked only under specified conditions: e.g., non-transparency in the ownership of privatized shares, over-riding public interest, proportionality, and non-discrimination.

Portugal: Golden share powers have limited participation by non-nationals in insurance, banking, transport, and energy.

Poland: The government used golden shares in some privatized companies to ensure control and supervision of post-sale commitments by the buyer.

OECD, pp. 64-5 and 84-5.

In South Korea, according to an enabling decree of the Securities and Exchange Act, the Minister of Finance and Economy retained the authority to designate as a "public nature corporation" any corporation engaging "in an important industry for the national economy" so long as the state retains at least 15 percent of the corporation's shares. For any such "public nature corporation," the Act would restrict proxy voting and allows the corporation's articles of association to cap the voting rights of other individual shareholders at 3 percent.[48]

In cases where viable small/medium SOEs are to be sold, minimizing the "loss of State assets" in the sale of SOE shares or assets will mainly depend on (1) openness and

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[47] OECD, 2002, pp. 64-5 and 84-5. It is worth noting that the European Union has steadily moved to scrap "golden shares" on the grounds that these restrict capital flows within the EU. Hence, the UK, Ireland, the Czech Republic, and Spain have given up some golden shares in recent years, leaving Italy and Hungary as the only EU members with wide-ranging golden share regimes for former SOEs. *Financial Times*, 26 November 2005.

[48] Mako and Zhang, 2002, pp. 9-10, citing W. Lim, 2002.

competitiveness of the sales process; (2) management of risks to prospective buyers; and (3) incentives for sellers to maximize sales proceeds.

An earlier World Bank report on management of state-owned equity concluded that China needed to replace reliance on management/employee buyouts with a more open approach (e.g., auctions, public tenders) to ownership transformation.[49] This study noted that worldwide experience conclusively demonstrates the great advantages to the State shareholder/seller and individual enterprises from an open process. An open process is more likely to maximize sales proceeds for the seller and to attract more highly qualified managers and additional investment for the enterprise. Since its establishment in early 2002, central SASAC has indeed issued a number of regulations to promote a more open approach to ownership transformation, mainly through greater reliance to "property rights transactions centers" to publicize opportunities to purchase SOE shares or assets.

The World Bank report further concluded that pre-sale restructuring of SOEs should be minimized. Any pre-sale restructuring should focus on reductions in redundant staff. In cases of SOEs designated for sale, SASACs should avoid any additional capital investment. Additional capital investment should be left to the new owner.

Rigidity in adhering to minimum values for SOEs should be avoided. An SOE is worth only what a ready and willing buyer will pay for it. Thus, rather than emphasizing estimates of "enterprise value," SASACs should instead focus on procedures to maximize competition among potential buyers, for instance, by providing adequate information on SOEs offered for sale, giving qualified investors opportunities for due diligence, and advertising. Due diligence can be difficult in China (Box II-5). The biggest issues are unclear ownership, unreliable financial statements, hidden social welfare liabilities, and incomplete tax compliance resulting in hidden tax liabilities. *Throughout the SOE sector, international standards for accounting, auditing, and financial disclosure are needed.*

Box II-5. Typical Due Diligence Problems

- Land use rights not converted from allocated land to granted land, thereby precluding the target company from transferring the land use rights;
- Activities beyond the target company's permissible business scope;
- Lack of documentation supporting legal title to assets or their book value;
- Incomplete documentation of loans to shareholders or related parties;
- Improper registration of foreign currency loans or payables with the State Administration of Foreign Exchange (SAFE), which could impede payment;
- Lack of proper registration of intangibles, such as patents and trademarks, with the proper authorities;
- Non-use of employment contracts;
- Unreliable financial statements;
- Unrecorded purchases, guarantees, commitments, tax, illegal, or semi-legal agreements;
- Manipulation of results through improper end-period sales cut-offs;
- Failure to convert financial information into International Accounting Standard (IAS) format, which is more understandable to foreign buyers;
- Under-statement of social welfare costs;

[49] This section draws extensively on W. Mako and C. Zhang, *Management of China's State-Owned Enterprises Portfolio: Lessons from International Experience*, World Bank, September 2003.

- Future business projections based on unrealistic assumptions;
- Aggressive tax minimization schemes and undocumented agreements with local tax authorities;
- Weak tax compliance; and
- Inadequate funding of social welfare contributions.

Source: PricewaterhouseCoopers, 2001, cited in OECD, 2005b.

Since uncertainty tends to reduce the amount that buyers are willing to pay for an SOE, SASACs and other government authorities may also wish to consider measures to reduce buyer uncertainty, for example:

- Readiness to transform SOEs through asset sales/liquidations or joint ventures (JVs), instead of through mergers or acquisitions (M&A), in order to eliminate or lessen buyer exposure to hidden liabilities;
- Warranties or indemnities by the seller for specific risks – e.g., hidden liabilities, security of land tenure;[50] and
- Additional clarity on SOE and buyer exposure to any environmental liabilities.

More open policies on cross-border mergers and acquisitions (M&A) are also needed to encourage foreign investment in SOEs. According to the OECD, "the regulatory framework for cross-border M&A remains fragmentary, over-complex, and incomplete." Issues include a lack of clarity as to strategic sectors closed to foreign M&A; remaining foreign ownership restrictions, which are not wholly transparent; cumbersome and time-consuming approval procedures for cross-border M&A; idiosyncratic valuation procedures; a closed A-share market, which precludes hostile takeovers; and a lack of competition law conforming with international best practices for substantive standards and review procedures. Hence, the OECD suggests further relaxation of foreign ownership restrictions; greater regulatory transparency; adoption of international-standard and transparent merger notification procedures; and full opening of equity markets to participation by foreign investors.[51]

Liquidation can be an efficient sales method for SOEs that are insolvent, or risky from a due diligence perspective. Liquidation involves the sale of SOE assets and the use of asset sale proceeds to pay off enterprise debts. The buyer assumes none of the SOE's debt and avoids exposure to hidden or contingent liabilities. This may be highly desired by the potential buyer of an insolvent SOE or an SOE (or enterprise group) with an overly-complex capital structure (e.g., cross-shareholdings, cross-guarantees on debt). Liquidation has been an important transformation method in other transition economies.[52]

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[50] These would, of course, need to be enforceable.

[51] OECD, 2005b, Preliminary findings, *China's Mergers and Acquisition Policies 2005 Project*, September 2005, p. 3.

[52] In Poland, for instance, liquidation permitted firms (without passing through a court-supervised insolvency system) to sell assets, lease out assets, enter into joint ventures, and merge with other firms. This became a principal method for providing former small SOEs and new start-up small businesses with the real estate and assets they needed. Between end-1990 and end-1996, 3,373 of Poland's 8,441 medium/large SOEs (i.e., 40 percent) entered a liquidation or insolvency process. By 1996, 2,073 liquidation cases (61 percent) had been completed. This exceeded the 1,898 completed privatizations of medium/large SOEs by other methods. For a nation with no practical experience in insolvency, the liquidation of medium/large SOEs proceeded relatively quickly. Liquidations proceeded most quickly

It* may *make sense for a specialized entity(ies) to raise the necessary financing, manage the restructuring or liquidation of local SOEs, and minimize the associated "reform costs." International experience provides valuable lessons in how to organize and operate specialized entities for resolving distressed assets and enterprises (Box II-6).

Box II-6. Specialized Entities for Resolving Distressed Enterprises & Assets, Selected Cases

South Korea: Originally organized in 1962 as a subsidiary of Korea Development Bank (KDB), the Korea Asset Management Company (KAMCO) is now owned 43% by the South Korean government, 29% by KDB, and 28% by other South Korea Banks. During 1997-1999, KAMCO issued $18 billion in 3 to 7-year bonds to fund the acquisition of NPLs. Bond funding, other financing, and NPL/asset sales enabled KAMCO to spend $35.6 billion on NPLs (with face value of $86.6 billion) between November 1997 and April 2001. Resolution methods included auction, securitization, sale to private investment vehicles, foreclosure, and redemption. As of end-March 2001, KAMCO had resolved half its assets, receiving $19.6 billion for NPLs purchased for $19.8 billion with a face value of $42.8 billion. KAMCO has a two-tier board. An executive board of 9 is overseen by an outside board of 11. Appointees to the "supervisory" board, chaired by KAMCO's CEO, include 4 from the government, 3 from KDB and other banks, and 3 from academia and the legal and accounting professions.

Malaysia: The Danaharta asset management company was established by a special law in 1998 to acquire, manage, and resolve NPLs from Malaysian banks. Its planned capital structure was the equivalent of $789 million equity from Ministry of Finance, $526 in borrowing from the national employee pension fund, and $3,947 million in bond financing. Danaharta actually issued $2.932 million in 5-year bonds between November 1998 and March 2001. Its capital and ongoing asset sales enabled Danaharta to buy $5.216 billion in NPLs as of end-2001. On a commercial fee basis, Danaharta managed another $7.353 in NPLs as of end-2001. Danaharta expects to cease operations at end-2005, by which time it expects to have collected $7.895 billion and achieved a loan recovery rate of 59%. Malaysia's Ministry of Finance (MOF) appoints 11-person Board, which includes a non-executive director from the private sector, Danaharta's managing director, 2 MOF representatives, 2 central bank representatives, 3 private sector representatives, and 2 foreign representatives from the international banking sector. The full Board meets 4 times a year to set policy and strategy; approve plans, targets, and budgets; and approve major strategic decisions for Danaharta. The Board is assisted by an Executive Committee, a sub-set of the full Board, which met 10 times in 2004; a Remuneration Committee, assisted by outside experts, which met 3 times in 2004; and an Audit Committee, which met 4 times in 2004. Board members have unrestricted access to Danaharta's records and information. Most of Danaharta's staff are professionals hired on a contract basis from the private sector. Danaharta provides the public with a full set of financial statements, which are prepared according to international accounting standards and audited by an international accounting firm.

Sweden: Assets with a face value of SEK 6.7 billion (4.4% of Swedish banking assets) were transferred to the Securum AMC. Of these assets, 80% were related to the real estate market and 91% were real loans. Securum sold 98% of transferred assets within five years. Factors contributing to Securum's success included private management and strong governance mechanisms that ensured the entity's independence; prompt valuation; transparent financial management; strong laws; and adequate funding and staffing.

Germany: Between July 1990 and end-1994, the Treuhandanstalt resolved 13,815 SOEs, including through 6,546 privatization transactions and 3,718 liquidations. Privatization transactions generated DM 66.6 billion in sales proceeds, employment guarantees for 1.5 million workers, and capital investment

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under the special-purpose privatization law (98 percent completion rate) and more slowly under Poland's SOE law (34 percent completion). Further study of Poland's use of liquidation for ownership transformation and its potential applicability to China seems worthwhile W. Mako and C. Zhang, *Management of China's State-Owned Enterprises Portfolio: Lessons from International Experience*, pp. 52-3.

commitments of DM 211.1 billion. In the process of resolving its SOE portfolio, the Treuhand accumulated debts of DM 200 billion that were eventually transferred to the central government budget. The Treuhand was governed by a 21-person board, which included representatives from industry, the provincial governments in East Germany, trade unions, and the central government.

United States: During 1989-1996, the Resolution Trust Corporation (RTC) resolved 747 savings banks with total assets of $465 billion, most of which were real estate-related. The RTC's overall recovery rate was 87%. Key factors in the RTC's success included adequate governance structures; professional management; and extensive use of private sector contractors for asset disposition. Detailed internal directives and guidelines minimized the possibility of fraud and increased the transparency of policy and cost evaluation, which expedited the resolution process.

Sources: KAMCO (2001, 2002 & 2004); Danaharta (2005); Klingebiel (2000); Treuhandanstalt (1994); and Czada (1996).

If such a specialized entity to resolve the Northeast's distressed SOEs were established, international best practice suggests that it should have the following characteristics:
- A limited life of 5-7 years;
- Reliance on fixed-term recruitment of qualified professionals from the private sector;
- Prompt valuation of assets;
- Professional management and staffing;
- Adequate internal controls, financial management systems and disclosure; and
- Adequate public oversight and governance, perhaps through a board consisting of directors chosen by local Northeast governments and the central government.[53]

The actual ability of such an entity to raise debt financing on capital markets and harness local tax revenues to service such debt would depend on a number of factors, including the adequacy of the entity's equity capital; the existence of any guarantee from the central government; and its financial management system and internal controls.

A specialized entity(ies) for distressed Northeast SOEs should be different from the four asset management companies (AMCs) set up to resolve the NPLs of the state-owned commercial banks (SOCBs). These four AMCs have faced two limitations. First, AMCs affiliated with China's financial sector have had little or no incentive or capacity to pursue the "operational restructuring" of distressed firms.[54] These AMCs have instead focused on getting cash back, usually through financial market transactions (e.g., NPL sales). Second, bank-affiliated AMCs have little or no capacity for dealing with labor and other social issues that have impeded SOE restructuring.

Desirable attributes for a Northeast SOE restructuring entity ("Entity") include the following:

[53] Since such an entity would mainly resolve locally-administered SOEs, it would seem to make sense for local Northeast authorities and relevant central authorities (e.g., Ministry of Finance) to act as owners.
[54] Some operational restructuring measures (e.g., discontinuing less-profitable or loss-making businesses, laying off excess labor, reducing other costs) are intended to increase a company's earnings and debt service capacity. The sale of non-core businesses and assets (e.g., real estate) is another form of operational restructuring intended to pay down debt. W. Mako, "Emerging-Market and Crisis Applications for Out-of-Court Workouts," in M. Pomerleano and W. Shaw, eds., *Corporate Restructuring: Lessons From Experience,* World Bank, 2005.

- *Each Entity should be substantially owned by the local government.* While it would be useful to have a single entity for the Northeast, this may not be practicable.
- *An Entity's equity capital would mostly be provided by the local government.* Other parties (e.g., the central government, foreign investors) would also be free to invest.
- *An Entity would be able to borrow, with a government guarantee.*
- *Policies would be established to specify fiscal subsidies,* which an Entity would use for such purposes as settling workers and facilitating transfers of SOE social assets to local governments.
- In developing its portfolio, *an Entity would purchase the debts of target SOEs from AMCs and SOCBs.* If not itself a SASAC, an Entity would also take over all assets, liabilities, equity, and management of target SOEs from the relevant SASAC(s).
- *As part of its overall responsibility for operational restructuring, an Entity would manage worker layoffs and settle associated labor claims.*
- *An Entity would liquidate non-viable SOEs, using assets to settle associated claims.*
- *Firms considered viable after restructuring could be sold*.

Prototypes for such a restructuring entity exist in a few cities in China. In Wuhu, the municipal government arranged a "win-win" deal with the local bank to settle outstanding SOE NPLs and redundant workers and to recover its costs through development of the SOEs' real estate. In Chongqing, the local SASAC established its own AMC to finance the purchase of SOE NPLs and pursue restructuring (Box II-7).

Box II-7 . Recent Innovations in SOE Restructuring/Liquidation in China

Wuhu: In April 2003, Wuhu municipal government (Anhui province) did a deal with China Construction Bank (CCB) to settle RMB 389 million in non-performing loans (NPLs) owed to CCB by 26 locally-administered SOEs. Only 6 of the 26 were still operating, the others having been closed for years. The Wuhu municipal government (WMG) paid RMB 37 million in exchange for CCB's agreement to cancel the other RMB 352 million. CCB had estimated that legal action would have recovered only RMB 19 million, at a cost of RMB 13 million. While the 26 SOEs had assets with a book value of RMB 704 million, the WMG believed that the market value of these assets was only about RMB 206 million (i.e., 29 percent of book value). In addition, the WMG expected to pay RMB 224 to settle almost 9,000 SOE employees. WMG paid no cash to acquire the NPLs. Rather, it mortgaged the land and some physical assets of the 26 SOEs to WMG's Construction Investment Company, which promised to pay CCB on behalf of the WMG. WMG expected to get recover most of its expenditures through sale/rental/development of the real estate acquired from the 26 SOEs.

Chongqing: In 2004, the Chongqing SASAC established the Yufu Assets Management Company (AMC) as a subsidiary. Using two loans from China Development Bank, Yufu AMC acquired two batches of debts owed to Industrial and Commercial Bank of China (ICBC) by 667 local enterprises. After purchasing these debts, which had a total face value of RMB 10.7 billion, for the discounted price of RMB 2.2 billion, Yufu has had a free hand to pursue both financial and operational restructuring of these enterprises.

It makes sense to rely on public-private partnerships and to "outsource" the management of SOE shares/assets as much as possible. This approach reflects both the urgency of the Northeast's turnaround challenge and the lack of operational restructuring experience within government entities (e.g., SASACs). During its 1997-2001 financial crisis, South Korea passed laws to enable the establishment and operation of private investment "vehicles" to restructure distressed companies and to buy and manage surplus real estate (Box II-8). In some cases, private investors partnered with government entities, such as the Korea Asset Management Company (KAMCO) or Korea Development Bank. In other cases, private investors acquired assets (e.g., corporate shares, distressed corporate debt, or corporate real estate) on their own in order to pursue or facilitate enterprise restructuring. *These experiences from South Korea seem relevant for the Northeast and warrant further study and consideration.*

Box II-2. South Korea's Experience with Private Partnerships To Support Enterprise Restructuring

KAMCO joint ventures: As of late 2002, the Korea Asset Management Company (KAMCO) had entered into two joint ventures to manage pools of NPLs and other distressed assets. One $452 million NPL pool was owned 60/40 by a U.S. real estate investment fund and KAMCO. The other $166 million NPL pool was owned 40/60 by a U.S. investment bank and KAMCO. Both pools were managed by the international JV partner. Following due diligence by potential investors, valuation of each pool was determined through international bidding.

Corporate Restructuring Companies (CRCs) specialize in restructuring distressed companies. The first CRCs were established in 1999. As of end-2003, 54 CRCs had been formed with total capitalization of about $2.67 billion. In 80% of the cases, the majority shareholder of the CRC was a domestic manufacturer or other company, an individual, or a foreign company. Enabling legislation allowed CRCs to borrow up to 10x their capital from sources other than banks. Through end-2002, CRCs and CRC funds had invested in $3.59 billion in 130 distressed companies. A survey of 19 of these 130 companies showed post-CRC investment improvements in revenue, returns on equity, and debt/equity ratios.

Corporate Real Estate Investment Trusts (CR-REITs) buy and manage real estate from distressed companies, which must account for at least 70% of a CR-REIT's assets. Between July 2001 and January 2004, 8 CR-REITs have been established – 3 by Korean insurance companies, 3 by other Korean banks or companies, and 2 by foreign financial institutions. Total equity is about $575 million. To control risk, except for assuming the mortgages associated with acquired real estate, CR-REITs may not borrow. Through sales of surplus real estate to CR-REITs, distressed corporations have acquired additional funds to support capital investment, operational restructuring, and financial restructuring.

Corporate Restructuring Funds (CRFs): Four CRFs were created in 1998 to support the financial restructuring of distressed small and medium enterprises (SMEs) by investing in their equity and/or debt. Korea Development Bank and 11 commercial banks owned 80% of the KRW 1.6 trillion (about $1.5 billion) equity of these 4 CRFs, with remaining shares held by insurance companies and other financial institutions. Three funds of KRW 333 billion each could invest in debt or equity, while the remaining KRW 600 fund could only buy debt. The funds were each managed by leading global asset managers – Rothschild, State Street, Templeton, and Scudder Kemper. During their first few years, CRFs significantly contributed to the financial restructuring of distressed SMEs. With the return of economic growth from 2000 and the apparent success of CRCs, the government moved to liquidate the CRFs in September 2004.

Source: Kim (2004); KAMCO (2002, 2004).

More detailed analyses of financial projections and transition arrangements are needed. Detailed projections of the costs of SOE reform (including NPL resolution), expected proceeds from SOE share and asset sales, local tax revenues, and debt service capacity should be developed. While the relationship between investment climate improvements, tax revenue increases, and debt service capacity seems strong, dramatic improvements in the Northeast's investment climate would not be instantaneous. Hence, plans would need to provide for short-term and temporary financing of measures (e.g., SOE reform, infrastructure investment) to improve Northeast investment climate.

III. Encouraging Private Investment

SOE transformation alone is not sufficient to spur Northeast development and, hence, should be accompanied by additional reforms and programs to facilitate private investment. Several studies indicate that business entry (and exit); tax rates, tax administration, and administrative fees; customs; corruption; court resolution of commercial disputes; access to finance; labor flexibility; infrastructure and urban quality of life; and local skill and technology endowments pose issues for business investment in the Northeast.[55]

A. Business Entry

Business entry encompasses actual regulatory limitations, business registration, licensing, access to premises, and inspections.

Regulatory limitations. The government has continued to liberalize limitations and procedures for domestic and foreign investment. New guidance (effective January 2005) lists many sectors in which FDI is encouraged, including opportunities for wholly-owned foreign-invested enterprises (WOFIEs).[56] However, there remain some significant requirements for encouraged sectors and some restrictions or prohibitions for other sectors (Table III-1). A July 2004 State Council decision would replace government approval with confirmation for any substantial FDI or record-filing for most domestic investment.[57]

Table III-1. Selected Limits on Foreign Investment, Of Particular Relevance to Northeast China

Category/Sector	Additional Guidance
Encouraged:	
• Oil/gas exploration and production	• Requirement for local partner
• Enhanced oil recovery	“
• New technologies for exploration/prospecting	“
Restricted:	
• Grain development and production	• Local majority shareholder
• Foreign brand soda beverages	
• Processing of fats or oils	
• Cigarette production	
• Construction or management of oil refineries	
• Selected pharmaceuticals (e.g., antibiotics)	
• Various vitamins (e.g., Vitamin C) and supplements	
• Selected chemical fibers	

55 World Bank (2004) and FIAS (2005a).

56 National Development and Reform Commission and Ministry of Commerce, *Catalogue for the Guidance of Foreign Investment Industries*, amended 2004.

57 State Council, “Decision by the State Council on Reform of the Investment System,” 19 July 2004. This decision would eliminate the previous requirement for a feasibility study and project start-up report. The new State Council decision would require NDRC confirmation for (i) any FDI of $100 million or more in an encouraged or permitted sector and (ii) any FDI of $50 million or more in a restricted sector.

• Manufacture of containers	
• Manufacture of small/medium bearings	
• Some specialized construction equipment	
• Construction/operation of <300,000 kW coal power plants	
• Rail freight transport	• WOFIEs allowed in 2007
• Telecommunications and value-added services	• Foreign ownership limited to 25-49%
• Some wholesale, retail, and logistics distribution	• Limits on oil, chemical fertilizer, >30 store chains (e.g, autos, pharmaceuticals) until end-2006
• Freight-forwarding	• WOFIEs allowed end-2005
• Banking	
• Insurance	
• Financial leasing	
• Real estate development	• Joint ventures only
• Construction/operation of high-grade hotels	
• Construction/operation of gas, heat, water, or waste water distribution	• Local majority shareholder
• Law firms	
• Advertising	• WOFIEs allowed end-2005
• Market research	• Joint ventures only
• Medical treatment establishments	• Joint ventures only
• High schools	• Joint ventures only
Prohibited:	
• Some traditional medicines	
• Basic education	

Source: NDRC and MOC, 2004.

However, further liberalization of limits on entry seems warranted. For example, permission for WOFIEs in oil/gas exploration, production, and recovery might serve to extend the life of Daqing oil field. Other sector restrictions serve no obvious strategic purpose, but may simply serve to protect local industry. Restrictions on FDI in some industrial products (e.g., bearings) and consumer products (e.g, pharmaceuticals, vitamins) may impede development of local supply bases for manufacturing or efficient supply chain linkages with markets in coastal China and overseas. Restrictions on foreign entry into banking, insurance, financial leasing, and related services would tend to reduce competition in financial services and access (especially by SMEs) to financing. Limits on professional business services (e.g., law firms, market research), telecommunications, medical services, and educational services may impede FDI that would make Northeast businesses more efficient or make assignment to Northeast China more attractive to foreign investors (and their families).

Further simplification and clarification of investment procedures may also be warranted. The new investment confirmation process would require only a project application report, which the government would "review and verify…from the perspective of safeguarding economic security, rational development and utilization of resources, protecting the eco-environment, optimizing important geographic distribution, safeguarding public interests, and preventing emergence of a monopoly." Moreover, foreign-invested projects "shall be further examined by the government in respect to market access and capital account management." This is a broad set of considerations for the government to "review and verify." The State Council's decision leaves undefined the timeframe and criteria for opposing a project. Instead, it mandates that "government departments concerned shall establish a strict and standardized confirmation system with clearly defined scope, contents, application procedures and processing timeframe…." These implementing systems may warrant closer review.

The may also be some remaining issues with local protectionism. It is difficult to measure local protectionism in China because protectionism arises not from tariffs or quotas, but rather from administrative decrees designed ostensibly for other purposes. A study of 32 industries in 29 provinces for the period 1985-1997 found evidence of local protectionism, especially for industries with heavy state ownership or that had shown high profit-plus-tax margins.[58] Some local enterprises may also enjoy favored access to some services, such as transport of products via China Rail.[59]

Registration. In October 2005, the National People's Congress approved important amendments to China's Company Law that will facilitate new business registration. Among other changes, minimum capital requirements for limited liability companies (LLCs) have been reduced – e.g., to RMB 30,000 for manufacturing LLCs, from the previous RMB 500,000 – and single-person LLCs are now allowed.

Farmers and rural producers, however, need access to more flexible forms of business organization (e.g., cooperatives). Examination of key rural products for the Northeast (e.g., rice, dairy, ginseng, pine mushrooms) indicates that local producers face profitability constraints (Box III-1). This reflects the inability of small and scattered rural producers to organize joint investments in key supply chain assets (e.g., quality control and certification, cold chain facilities, joint warehouses, IT systems, market research, brand development, joint sales forces). Such supply chain assets are needed to enable rural producers to compete on speed, agility, reliability, and quality (instead of only price) and thereby to retain more profits and to reduce working capital requirements.

Box III-1. Supply Chain Issues for Rural Northeast

<u>Rice</u>: While some rice farmers' associations have been formed (e.g., for Heilongjiang province in October 2004 and for Wu Chang county in 1997) – to promote brand development, regulate competition, advise the government, and exchange market information – Heilongjiang's rice sector still suffers from many problems that hurt the sector overall. Large numbers of small rice processors and distributors may, for instance, maintain lax control over sanitation procedures and engage in uncontrolled mixing of different grades of rice. Infringement of trademarks and appellations of origin (e.g., from Wu Chang) is common. Producers typically lack capacity for more value-added rice processing (e.g., for rice biscuits or wine). Small producers are unable to get good rates or service from transport providers. Advertising and distribution costs to break into new markets, like Shanghai, are high. Service from the agricultural extension system is poor, and farmers lack up-to-date market information.

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[58] C. Bai, Y. Du, Z. Tao, S. Tong, "Local Protectionism and Regional Specialization: Evidence From China's Industries," *Journal of International Economics*, 2003, pp. 3-6, 19.

[59] In Heilongjiang, for instance, we were told that 66 enterprises designated by the provincial economic and trade commission receive more favorable treatment (in terms of fewer and lower fees, and better access) from the local railway bureau.

Ginseng. Jilin produces about 120,000 tons of fresh ginseng (i.e., 80% of national and 70% of world output). After corn and soybeans, ginseng ranks third in Jilin in terms of output value. Low international prices (e.g., $12/kg for Jilin ginseng vs. $170/kg for South Korean ginseng in Hong Kong) reflect many factors: a lack of attention to international quality standards, sanitation, and quality control; large numbers of small and independent ginseng producers; primitive workshop-style processing; reliance on numerous intermediaries rather than long-term contractual relationships with retailers or overseas wholesalers; an inability to derive practical benefit from publicly-funded ginseng research; highly dubious official inspections and certifications; and no common-use storage or other facilities, all of which have contributed to lack of an international brand image for Jilin ginseng. A producer-run association would facilitate adoption of GAP/GMP/GSP standards; dissemination of market information; coordinated supply chain management to preserve quality and minimize physical losses; investments in product development; influence with major transport service providers, wholesalers, and hyper-retailers; and cost-sharing for advertising, joint sales forces, and related steps to support brand development.

Wild mushrooms. The main market for matsutake ("pine") mushrooms is Japan, which annually imports about 1100 tons from China, 600 tons from North Korea, and 350 tons from South Korea. Due to over-harvesting, Jilin's annual harvest has dropped from 300+ tons in the 1980s to less than 100 tons now. While South Korean pine mushrooms sold for $150/kg (in 2001), the retail price for Jilin's has declined steadily to $36-48/kg in 2004 – apparently even below the price paid for North Korean mushrooms. A lack of investment in joint-use cold chain facilities diminishes the shelf-life, quality, and – hence – price of this highly-perishable product from Jilin. Un-scrupulous intermediaries have further tarnished the reputation of Jilin's mushrooms. The profit margin for these middlemen, however, is high – up to 50%. An ability by local gatherers to work together in a business association to limit harvesting to sustainable levels, grade and guarantee quality, make joint investments in cold-storage and protective packaging, negotiate prompt and cost-effective delivery to major markets in Japan could reverse Jilin's decline in wild mushroom production.

Source: Yuan, 2005; Hu, 2005.

China's rural producers need to be able to form farmer cooperatives that can respond to members' business needs, levy user fees, and support joint investments in common-use supply chain assets. Cooperative farmers' associations have been very successful in many parts of the world (Box III-2). China has some quasi-cooperative farmers' associations, but these are still rare – in part because China does not yet have a law to enable the legal establishment and operation of such cooperatives.[60] Near-term passage of a law on farmers' cooperatives is needed to support development of supply chain linkages with coastal and export markets. Key issues are likely to include cooperative membership and governance, ownership of cooperative property, financing of investment and working capital needs, and avoidance of double-taxation.

Box III-2. International Experience with Farmers' Associations

Farmers' associations, including cooperatives, are particularly strong in North America and in northern and central Europe, where such organizations have existed for more than 150 years. These countries, the U.S. in particular, have some of the largest farmer cooperatives in the world. In the U.S., for example, Land O'Lakes has more than $6 billion in annual sales, while the Sunkist organization has more than 6500 citrus farmers as members. Successful farmers' associations can be found in most developing countries, including in East Asia (e.g., Taiwan POC, Vietnam, Philippines). In the Philippines, for example, the Free Farmers' Cooperative Movement has more than 20,000 members.

[60] Before 1949, China had a law on cooperatives. During 1956-1978, Soviet-style collectives were common. Since then, some specialized cooperatives have been organized, for instance, in Zhejiang and Sichuan. Since end-2004, Zhejiang has had a law on farmer cooperatives.

Licensing. ***Additional requirements for licenses and permits to start a business are relatively complex.*** This may mainly reflect nationwide requirements imposed by the central government. In theory, two procedures should suffice for starting a business: (1) notification of existence, and (2) tax and social security registration.[61] All countries, however, pose additional requirements. Both the Liaoning survey and the World Bank's *Doing Business* survey indicate that 12 additional procedures are standard for registering a business in China. For half of these, only a minority of countries in the world require similar procedures (Table III-2). In addition, many special-purpose approvals may also be required (Box III-3).

Table III-2. Frequency of Additional Registration-Related Procedures

Procedure	Percent of countries
Tax registration	93
Labor registration	87
Administrative registration	76
Bank deposit	68
Notarization	63
Health benefits	62
Notice in newspaper	38
Company seal	36
Court registration	32
Chamber of commerce	27
Statistical office	17
Environmental protection	12

Source: *Doing Business 2004*, table 2.1

Box III-3. Licensing in Northeast China

City A: Before registration, approvals may be required from the Party Discipline Committee; Foreign Trade Committee; Public Security; Fire Control; Sanitation; Quality Examination; Environmental Protection; Cultural; Commerce; Property; Capital Examination. After registration, approvals may be required from Public Security, Quality Examination; the company's bank; Administration of Foreign Exchange; and Customs in order to complete such procedures as making seals, code registration, opening of bank accounts, and registration. In addition, the company must register with the State Tax Bureau, local tax bureau, and local finance bureau.
City B: For all kinds of enterprises, a list prepared by the local business center includes up to 112 different items for which approvals may be required.

Source: FIAS, 2005a.

[61] Canada has one of the most streamlined systems, whereby an "entrepreneur submits the federal registration form through the online Electronic Filling Center and receives a business number within the hour. With this number, the entrepreneur applies with the Canadian Customs and Revenue Agency for tax numbers, payroll deductions, and import and export licenses. World Bank, *Doing Business in 2004: Understanding Regulation*, p.17.

The establishment of "one-stop halls" is a common response to the complexities of business entry. Potential investors may handle all registration and licensing requirements at a single location, a "one-stop hall" (OSH). Liaoning province, for example, established its first OSHs in June 2001. Since then, many OSHs have been set up according to administrative levels, e.g., municipal, county, district or development zone.[62] Consistent with the potentially large number of registration and licensing requirements, these OSHs tend to have a very large number of departments.[63]

The worldwide experience indicates that OSHs may serve some useful purposes, but should not be seen as a panacea. Frequently, "one-stop shops" simply turn into "one more stop" (Box III-4)

Box: III-4. Do "One-Stop Shops" Work?

During the 1980s, one-stop shops came into fashion as a vehicle to deal with administrative barriers and provide a more streamlined and investor-friendly environment. In almost all cases, the establishment of an all-powerful one-stop shop that could itself grant all necessary permits has proved unrealistic. Hence, governments have instead tended to set up one-stop shops that seek to consolidate all necessary permit-seeking in one place. Worldwide, even this has not been an easy task. In many cases, agencies delegate only junior staff who lack sufficient authority to grant approvals. Hence, efficiency gains fail to materialize and investors may complain that the one-stop shop turns into "one more stop."

The most outstanding and well-known examples of success are the Economic Development Board (EDB) of Singapore; the Malaysian Industrial Development Authority (MIDA); and the Industrial Development Authority (IDA) of Ireland. These agencies' power and effectiveness has resulted not from a particularly strong and comprehensive legal mandate, but through political clout and seniority. In all three cases, the agency received full support from the most senior levels of government, which made the attraction of new business investment a central pillar of their economic development strategy.

Source: F. Seder, FIAS, World Bank Group.

Northeast OSHs apparently work well as initial points of contact and information providers, but not at solving complex inter-agency issues. By bringing representatives of disparate agencies together in OSHs, Liaoning has overcome a common problem. But the authority of OSH representatives varies by municipality and by OSH. In many OSHs, there is little internal flow of documents between OSH "windows." Reports of progress in combining approvals are more an expression of hope than a reality. "There is still little oversight of broader procedures, little coordination among the windows involved in a single process, and many enterprises are still required to visit the home departments."[64]

[62] Among major Liaoning cities, for example, Anshan has 8 OSHs, Shenyang 9, Dalian 12, and Jinzhou 3. Foreign Investor Advisory Service (FIAS), 2005a, p. 19.

[63] For example, a Jinzhou OSH houses 40 departments covering 303 examination items. Departments represented in Dalian include the following: municipal planning; economic and trade commission; construction commission; public security; civil affairs; land planning; development office; housing; transportation and port bureau; foreign economic and trade; public health; environmental protection; statistics; quality inspection; price controls; industrial and commercial bureau; local tax administration; State tax administration; water; labor; personnel; commercial bureau; culture; city planning; comprehensive law enforcement; agriculture; forestry; seas and fishery; port management; security; meteorology; population control; and customs.

[64] FIAS, 2005a, pp. 18-24.

It makes sense to focus more on simplifying business entry requirements (including fees). As noted earlier, half of the most-common procedures in China for starting a business (i.e., newspaper notice, company seal, and registrations with the court, chamber of commerce, statistical office, and environmental bureau) are not standard around the world. Other pre-operation approvals (e.g., security, fire, sanitation, quality and technical supervision, foreign economic trade, tax) are uncommon for high-income countries. Unusual fee practices – such as basing fees on the value of a company's registered capital or charging a fee for tax registration – could usefully be abolished. International best practices in regulatory simplification include Sweden's "guillotine" system and Mexico's "regulatory impact assessments (Box III-5). *Existing OSHs in the Northeast could serve a useful role in identifying bottlenecks to business start-up.*

Box III-5. Other Approaches to Regulatory Simplification

Sweden: In 1984, the Swedish government realized that it was unable to compile a list of the laws and regulation in place and decided to start a regulatory reform based on the "guillotine" system. The Government instructed all government agencies to establish registries of their ordinances by July 1, 1986. While preparing their lists, governmental agencies screened their regulations having to justify the relevance of regulations to be registered. The system was extremely effective in reversing the burden of proof for keeping regulations in place: ministry officials commented on rules deemed unnecessary or outdated and had to provide justifications to maintain other regulations deemed adequate. When the "guillotine" went into effect, hundreds of regulations not registered were automatically cancelled without further legal action. All new regulations and changes to existing ones were henceforth to be entered in the registry within one day of adoption.

Mexico: Different countries have adopted different institutional solutions to successfully implement RIA system. For instance, the USA delegated RIA functions to a presidential officewhile in Great Britain a ministerial panel oversees RIA implementation. Mexico is often referred to as best practice for the establishment of a commission at federal level: the Comisión Federal de Mejora Regulatoria (COMEFER). By law, COMEFER plays the crucial role of overseeing the regulatory process developing cost-effective regulations, mainly by carrying out the following functions: (i) eliminating or simplify reporting requirements of citizens and firms; (ii) reviewing legislative drafts and carrying out RIAs; (iii) assessing existing regulation and proposing amendments; and (iv) developing and running programs for regulatory improvements at the state and municipal levels. Hence, COMEFER represents the key oversight body to ensure regulatory quality and legal consistency in Mexico. In addition, COMEFER plays a vital role of developing analytical expertise, providing guidance and training across the public administration. COMEFER ensures that transparency is widely applied to the legislative process: upon submission of draft laws from other agencies, COMEFER publishes both the proposal and comments.

World Development Report 2005.

Premises. Key considerations include cost, land use procedures, and building permits.

The Northeast appears to be reasonably competitive in terms of real estate costs. The main exception seems to be in industrial park rents (Table III-3), which may be heavily subsidized by some municipalities elsewhere in China. While not surprising, given the intense competition among cities in China to attract investment, such subsidization may distort markets and investment activity.

Table III-3. Real Estate Costs for Major Alternative Sites
(U.S. dollars)

	Dalian	Shenyang	Beijing	Shanghai	Chongqing	Shenzhen	Bangkok	Seoul
Factories	20-30	29	53-73	25	27	24	56	n.a.
Industrial parks	0.20	3.75	3-6	0.2-0.5	1.5	2.9-8.5	4.5	0.02
Office space	30	16	30-60	37.5	12	3-14	11	40
Apartments	2,300	3,000	2,500-4,900	2,200-3,800	2,500	362	1,630	1,776

Source: J. Kurihara estimates, based on JETRO, "China: An Overview," 2004, p.22
Note: Except for apartments, which are shown at average total monthly cost, costs are per square meter per month.

Most best-practice principles for a real estate market oriented toward long-term leases are generally followed in Liaoning province,[65] and presumably elsewhere in the Northeast. These principles include:

- Clear and sufficient duration of leases;
- Transferability of a lease to a third party, such as a mortgage lender; and
- The lessee's rights to property built on the leased land during the lease term and to fair compensation for the property at the end of the lease term.

Local governments should respond to concerns about the legality, and hence security, of land use rights granted to businesses. China's system of land use rights generally provides sufficient security of tenure for businesses, as indicated by ongoing real estate and industrial development. Massive urban development, however, has aroused fears about accelerated loss of agricultural land. This has led to tighter enforcement of central policies on land use. Municipal officials may be uneasy about the potential conflict between achieving faster industrial/economic development and preserving agricultural land, while entrepreneurs may worry about the risks (e.g., confiscation) of illegally granted land.[66] Hence, *municipal governments should ensure that businesses are protected from entering "development zones" or receiving usage rights for land whose transfer to construction land has not been duly approved. A useful first step would be for municipal governments to verify whether current land use practices conform with central government policies and whether the rights of legitimate land users are sufficiently protected.*

Public dissemination of information on the status of the annual land quota for development and how land quota considerations affect decisions on specific land-use applications should also be improved. In this regard, Dalian Development Zone stands

[65] This discussion of land use is based on FIAS, 2005a, pp. 67-85.
[66] For instance, press reports indicate that nationwide, between March and June 2004, 3,763 development zones were abolished and about 1100 square kilometers of land were returned to farmers.

out in providing the clearest guidelines on the way in which land development quotas are applied to decisions on specific investment projects.

More generally, land approval remains one of the least transparent processes that businesses must engage in to implement an investment project. The project approval process in China is not just a technical review to ensure compliance with building and zoning laws, but also a process of allocating a public asset. The latter aspect may seemingly justify local interference in business decisions that would be left solely to private investors elsewhere. Reports suggest that land use and project approvals in the Northeast still involve factors other than the merits of the proposed project and that these approval processes lack sufficient clarity, transparency, and predictability.

Moreover, after approval of an investment project and land use application, any significant change by the investor would require re-approval. When a land plot or structure is granted to an investor, the practice has been for local authorities to specify permitted land use in great detail in the decisions and granting documents. Issues arise when the land user must adjust the project design to suit changing circumstances, which often occur as an industrial project is designed and implemented over a period of time.

In other transition economies, some of the more progressive jurisdictions are dropping use of detailed land-use descriptions and restrictions in favor of broad categories of permitted use (e.g., "commercial" or "industrial"). In Russia, for example, St. Petersburg uses a list of a dozen broad land-use categories. These broad categories of permitted land use are indicated on the location approval documents, so the investor is not required to produce unnecessarily detailed information at the very initial phases of project development. This also limits official discretion in deciding whether an application meets the intended use of a particular parcel of land. In such jurisdictions, it is rarely a problem to change land or building-use designations from one type of commercial or industrial use to another.

Preliminary review and approval of investment projects should be limited to in focus and scope. The focus should be on broad requested land use categories, such as "commercial" or "industrial," instead of the much more detailed business approvals that are required now. The scope of involved agencies should be limited to those specifically concerned with land use – and, in clearly defined cases, protection of the environment, roads and traffic, and perhaps fire protection access. *This simplified approach should result in a more automatic, transparent, and predictable land allocation process for investors.*

At least in Liaoning province, the issuance of building permits is not considered to be overly burdensome. On average, around 3 months are required to obtain a construction permit. However, simplification of fees and approvals for small projects would be useful.

Inspections. Inspections are not seen as a major problem, at least in Liaoning province, although the potential for harassment and abuse is high. In one city, 129 separate authorities are authorized to conduct inspections of businesses. The general view among firms is that too-frequent inspections and a lack of guidelines on authority of inspections distracts from actual management of the business.[67]

Recommendations for improving the inspection regime include the following:

- *Complying with the new Administrative License Law and good practice in requiring at least two functionaries to participate in any inspection, to reduce opportunities for arbitrary or non-transparent actions;*[68]
- *Maintaining inspection records at the inspecting institution and allowing access by the representatives of inspected firms;*
- *Requiring inspectors to leave an identical copy of the inspection report with the inspected firm; and*
- *Using some sort of "risk assessment" methodology to eliminate needless inspections.*

Surveyed firms in Liaoning province indicate that State and local tax administrations consistently follow national work standard guidelines. This work standard provides, among other things, that no firm should be subject to more than two tax inspections per year and that no fees (except those indicated by law or regulation) should be charged by tax inspectors.

B. Taxes, tax administration, and administrative fees

Key issues are tax rates and administrative fees; tax administration and inspections; and use of tax concessions.

Tax rates and fees. While it appears that actual tax rates do not vary much by region,[69] the picture changes substantially when administrative fees are included. Survey data show that taxes and fees relative to sales tend to be higher in the Northeast (averaging 7.1 percent) than in the Southeast (5.7 percent) or Central China (6.7 percent) (Table III-4).

Thus, administrative fees appear to be more of a burden than taxes. There is also a negative relation between total taxes/fees and firm satisfaction with the efficiency of local government for services. For instance, while reporting that taxes/fees average 7.5 percent of sales, only 27 percent of surveyed firms in Changchun consider government services to be efficient. In Shenzhen, by contrast, where taxes/fees reportedly average 3.9 percent of sales, 41 percent of surveyed firms rate government services as efficient (Table III-4).

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[67] This discussion of inspections is based on FIAS, 2005a, pp. 107-13.

[68] More generally, the Administrative License Law, which became effective in July 2004, enshrines many principles (e.g., access to information, stakeholder consultations, minimal costs) and procedures (e.g., opportunities for applications by e-mail) that should serve to lower administrative barriers to doing business. FIAS, 2005a, pp. 15-7.

[69] For example, the main taxes paid by firms (i.e., business, VAT, and income) account for 2.4-3.2% of industrial, wholesale, and retail sales in the three Northeast provinces, versus 2.6% in Zhejiang and 3.0% in Guangdong. *China Finance Yearbook, 2004* and *China Statistical Yearbook, 2004*.

Table III-4. Taxes and Fees Relative to Sales, For Selected Cities and Regions, 2003-2004

Region	City	Taxes and fees as % of sales	% of firms rating government services as efficient
Northeast	*Average*	*7.1*	
	Fushun*	4.9	NA
	Anshan*	6.5	NA
	Shenyang*	7.1	NA
	Dalian*	7.1	36
	Changchun	7.5	27
	Benxi*	7.7	21
	Ha'erbin	8.6	44
Southeast	*Average*	*5.7*	
	Shenzhen	3.9	41
	Jiangmen	5.6	38
	Hangzhou	5.8	51
	Wenzhou	7.5	21
Central	*Average*	*6.7*	
	Zhengzhou	6.0	43
	Wuhan	6.7	35
	Changsha	6.9	27
	Nanchang	7.1	24
West	*Average*	*8.9*	
	Chongqing	6.7	55
	Kunming	7.9	37
	Xi'an	8.3	31
	Nanning	9.7	24
	Lanzhou	10.2	22
	Guiyang	10.6	22

Source: World Bank, 2004a and 2004b
* Data collected in 2004.

Tax administration. ***Domestic enterprises and foreign-invested enterprises (FIEs) both rate tax administration as the biggest administrative obstacle to doing business***, at least in one province. This appears to reflect variations in tax administration practices, including various local tax concessions, and local administrative fees.[70]

In general, local tax systems are very complicated and characterized by different applications, rates, and systems. Fiscal incentives to attract investment are common. Foreign companies typically enjoy more tax breaks than do domestic companies. Although some tax policies are national, local governments play a role in complicating the tax system by offering different local incentives and applying different tax procedures

[70] This section draws on FIAS, 2005a, pp. 95-105.

depending on the investment. The combination of complex procedures, variable and unclear incentives, and official discretion creates potential for abuse.

Key recommendations for improving local tax administration include the following:

- *Increasing the public's accessibility to information on tax laws, regulations, and procedures;*[71]
- *Providing "advance rulings," whereby the tax administration would express a self-binding opinion in response submission by an enterprise of a tax question specifying the facts of a particular situation;*
- *Uniformly improving VAT refunds to the international benchmark of 15-20 days;*[72]
- *Encouraging greater use of "e-filing"; and*
- *Developing a credible tax appeals* process, which separates appeals review from the initial complaint.

It is impressive that some e-filing already occurs, at least in some Liaoning cities (Table III-5). Since e-filing reduces tax administration burdens and increases data accuracy, Dalian's progress and experience in implementing e-filing may provide a model.

Table III-5. Electronic Filing of Tax Submission,
For Selected Cities in Liaoning
(% of submissions)

Type of tax		Shenyang	Dalian	Anshan	Fushun	Jinzhou
Business	(local government)	0	5	0	0	0
Income	(local)	0	5	0	2	0
VAT	(central government)	0	0	0	0	0
Foreign enterprises	(central)	0	0	0	0	0

Source: FIAS, pp. 97-8

Tax preferences. Since 1979, China has introduced various tax preferences to encourage investment. As of 2002, 110 regions or zones had extended tax preferences, most frequently involving lower corporate income tax for foreign-invested enterprises (FIEs) (Table III-6). The current number of tax preferences zones is almost certainly higher.[73]

Table III-6. China-Wide Tax Preferences for Investment, 2002

Program	Established	Number	Main Benefits
Special economic zones	1979	6	15% tax rate for FIEs
Coastal cities	1984	14	15-24% tax rate for FIEs
River deltas/Coastal zones	1985	3	15-24% tax rate for FIEs

[71] Interestingly, in Dalian municipality, the tax authorities schedule a "publicity month" for explaining key tax rules to interested members of the public.
[72] Some businesses in Northeast indicate that VAT refund can now take 3-4 months.
[73] There may now be as many as 425 special preference zones in China. FIAS, 2005b, p. 46.

High/New technology zones	1991	53	15% tax rate for FIEs
Central and western China	1999	19	15% tax rate, until 2010, for selected industries
Export processing zones	2000	15	Accelerated VAT redemptions
		110	

Source: PricewaterhouseCoopers, 2002.

Not surprisingly, local governments in the Northeast show great interest in creating additional tax preferences to attract business investment, especially foreign investment. Tax preferences raise many issues, including whether they actually make a difference to foreign investors frequently covered by *double-taxation treaties* or whether governments are simply giving money away (Box III-6).

Box III-6. Tax Preferences: A Race to the Bottom?

Concern is often expressed about whether competition for investment between countries is leading to a "race to the bottom" in corporate tax rates. Competition might pressure governments to cut corporate taxes to attract or retain investment. The concern is greatest for firms that are the most "footloose," such as multinationals producing tradable goods.

Tax rates seem to affect where firms invest. But the impact will likely vary between firms, industries, and locations. A meta-analysis of 25 studies, mostly on FDI into the U.S. or FDI by U.S. firms, concluded that a 1 percentage point increase in tax rates reduces FDI by about 3.3 percent. Other surveys and evidence support a similar conclusion.

International tax competition can have both positive and negative effects on welfare and efficiency. It is not immediately clear that it makes countries worse off. Allowing countries or regions to set taxes based on local preferences for and costs of providing local public goods is generally more efficient than mandating uniform taxes and expenditures across regions. Many also argue that competition between governments on taxes usefully serves to discipline governments and prevent them from wasting public resources or becoming intrusive.

If there is a "race to the bottom," corporate taxes should have fallen in the 1990s as global integration increased. Although marginal tax rates have fallen, corporate tax rates are broadly similar in East Asia, Latin America, and Europe (about 30-35%) and tax bases have often been broadened. As a result of the latter, corporate tax revenues have increased or remained steady on average.

Tax rates are not the only factor influencing investment decisions. Infrastructure, law and order, and education of the workforce can be even more influential; and it is difficult for governments to sustain these services with a shrinking tax base. Location decisions are also influenced by agglomeration economies. Together, these factors mean that investments are not as responsive to tax rate changes as some might think. A better strategy is to improve the overall investment climate, thus reducing the pressure to compete on taxes. Addressing issues of particular importance to foreign investors (e.g., customs administration, property rights security)will likely make a location more attractive and benefit local firms as well.

Source: World Development Report 2005, p. 107-8, 168-70.

Central and local governments should review current tax preferences. Key considerations include actual benefits to foreign investors, given treaties to avoid double-taxation; promotion of a "level playing ground" for foreign and domestic business; and possibilities that local governments could find a better use for foregone tax revenues. Better alternative uses could include, for example, additional investment in infrastructure to enhance their city's overall quality of life or subsidies for international-standard health and education facilities that may be a key concern for foreign companies and their dependents.[74] Current shortfalls in such infrastructure and services leave the Northeast at a disadvantage vis-à-vis more developed investor destinations, such as Beijing, Shanghai, Suzhou, and Guangzhou.

Fees are a bigger problem than taxes. Businesses remain unclear about types of fees that can be imposed. There is potential for abuse. The problem of fees in China is well-known.[75] At least some cities, such as Dalian, are in the process of reviewing their administrative fee structures. Some cities may continue to maintain complex fees. One Northeast city, for example, provided a list of 94 different types of fees, plus local and national taxes.[76] The Northeast provides both good and bad examples of fee structures (Table III-7). In the "good" examples, the fee structure is simple and the fee base is objectively measurable. There is no ambiguity and virtually no room for abuse from either side. Among the "bad" examples, the fee structure is more complex and the fee base is changeable and typically dependent on another value (e.g., land value, business revenue, project investment) that may not be easy to define. The latter type of situation poses great potential for abuse of both payers and collectors.

Table III-7. Selected Good and Bad Fee Structures in Northeast

Good Examples	Bad Examples
• Construction permit cost based on square meters of construction, e.g., RMB 1.38 per square meter for a "brick and concrete structure outside the city planning area" • Fixed cost for a certificate, such as "Land registration and certificate at RMB 20 per certificate	• For enterprise registration: 0.8% of the total registered capital; for registered capital over RMB 10 million, 0.4% for the excess over RMB 10 million; no charge for excess over RMB 100 million. Minimum charge of RMB 50. • Quality supervision fee for water conservancy project: 1.0-2.5% of project investment • Road transportation management fee: 0.8% of business revenue • Per cubic meter of surface water: RMB 0.1 for residents; RMB 0.25 for industry and administrative institutions; RMB 0.4 for catering businesses; RMB 3.0 for special industries • One-time takeover of farmland: based on land "value"

Source; FIAS, 2005a, p. 36.

[74] FIAS has found, for instance, that local living services in the Northeast are "not yet totally acceptable. While the Japanese and Korean community seemed generally satisfied with the quality and availability of housing, there were some concerns about…availability of suitable international schools and adequate healthcare services." FIAS, 2005b, p. 30.
[75] See, for example, "Would You Like that with Fees?" in World Bank, *China: National Development and Sub-National Finance: A Review of Provincial Expenditures*, CHA-22951, 9 April 2002, p. 12.
[76] FIAS, 2005a, pp. 31-6.

Key recommendations for improving fee structures include the following:

- *Clearly list all fees at the time of business start-up, for instance, by having the Bureau of Industry and Commerce provide newly-registered companies with a definitive list of the fees that can later be charged;* [77]
- *Fees should be reasonable (usually commensurate with administrative costs incurred by the administrative authority);*
- *Fees should be clearly stated in publicly available legal documents;*
- *Standard fee criteria should apply to each applicant; and*
- *Applicants should have a realistic opportunity to file an appeal.*

C. Customs

Foreign companies rank customs as the second most severe obstacle, after tax administration.[78] Businesses indicate that customs registration and export clearance procedures have recently been simplified and clarified. But import clearances and the State Administration for Entry-Exit Inspection and Quarantine (CIQ) clearance process are said to need more simplification, clarity, and transparency.[79]

Dalian accounted for 99 percent of almost 875,000 import/export applications in Liaoning province in 2003 (Table III-8). Staff workloads vary considerably.

According to customs officials, processing times for both import and export clearance ranged from 5 minutes to 3 days. This compares favorably with survey data for Guangzhou and Shanghai.[80] Moreover, 3 days' maximum processing time on customs clearances is considered internationally competitive.

Some CIQ controls and inspections (e.g., mechanical and electronics product inspection) do not have direct equivalents in OECD countries. CIQ processing times in Liaoning province range from 1-18 days for import clearances and 1-30 days for export clearances. According to official data, 26 percent of all imports and 41 percent of all exports have had CIQ clearances. This suggests that a significant share of Northeast imports and exports have much longer clearance times, which may place the region at a disadvantage relative to the Southeast.[81]

Frequent physical inspections and disincentives to use inland customs appear as issues. The share of physical inspections (25-30%) is still high. In addition, apparently because customs workloads are lower, the probability of detailed inspection (regardless of past performance and risk) is much higher for inland cities than for Dalian. While Dalian will continue to offer scale-based efficiencies, experience in other countries

[77] It appears that Dalian is following a similar approach.
[78] World Bank 2004a. While this survey data is for one Northeast province, there is no reason to expect that the other two provinces' performance would be better.
[79] This discussion of customs is based on FIAS, 2005a, pp. 115-29.
[80] Survey data showed averages of 4 days for export clearance in these two cities. World Bank, 2003.
[81] For Shanghai and Guangzhou, the longest delay to clear import customs averaged, respectively, about 9 days and 12 days for firms surveyed in 2003. Ibid.

indicates that inland customs clearance can become an attractive and competitive alternative. Further research on the needs and problems experienced by inland-clearing manufacturers, to identify the service mix needed to facilitate their operations, would be useful.

Table III-8. Customs Applications in Liaoning Province, 2003

	Dalian	Shenyang	Jinzhou	Anshan	Fushun
Customs:					
Total import & export applications	859,791	10,220	1,108	226	264
Number of staff	470	15	14	6	2
Applications per staff	1,829	681	79	38	132
Import refusals	0.10%	0.00%	0.00%	0.00%	0.00%
Export refusals	0.10%	0.00%	0.00%	0.00%	0.00%
CIQ:					
Total import & export applications	262,430	26,876	3,040	4,565	na
Number of staff	616	94	70	36	18
Applications per staff	426	286	43	127	na
Import refusals	0.33%	0.00%	2.27%	0.00%	na
Export refusals	0.13%	0.00%	1.28%	0.00%	na

Source: FIAS, 2005a, p. 123, based on data from local authorities.

Customs procedures need to be further standardized, formalized, and simplified so that official discretion is minimized. Import clearance processes (especially documentation requirements and treatment of incomplete documentation), guarantee requirements and applications, and inspection and quarantine clearance are cited as examples where greater clarity, transparency, and simplicity in law and procedures is desired. Some customs and CIQ offices issue oral notifications in case of incomplete documentation and final refusal. Finally, although some customs administrations are beginning to use the internet to disseminate information,[82] some foreign businesses and SMEs still cite difficulties in accessing relevant laws, regulations, and guidelines.

Manual declaration processing with data entry at the customs house is still the norm. Manual and remote electronic declarations are used in parallel only in Dalian, where about 30 percent of import declarations and 16 percent of export declarations are sent electronically. A higher proportion of CIQ clearance requests are sent electronically. Opportunities for enterprises to directly input customs declarations and information, which would increase accuracy and reduce administrative burdens, are under-developed.

Key recommendations for improving customs administration include the following:

- *Additionally updating customs law, regulations, and procedures to provide further clarity, transparency, and simplification, especially for import clearance documentation, guarantees, and inspection/quarantine clearance;*

[82] For example, see www.lnciq.gov.cn for Liaoning Province Customs and www.dlcustoms.gov.cn for Dalian customs.

- *Further improvements in accessibility to customs laws, regulations, procedures, and guidelines;*[83]
- *A specialized WTO consultation office to provide quick advise and regular training to advise Liaoning officials on WTO requirements and implementation;*
- *Official written notifications and refusals for all issues that cannot be immediately resolved;*
- *Greater use of computerized and remote clearances;*
- *Methodical tracking of elapsed time between goods arrival and release, to enable customs authorities to identify and correct clearance problems;*
- *Facilitating inland clearance by training inland customs officials in the methods used in Dalian port;*
- *Developing and widely implementing a modern electronic customs declaration system; and*
- *Introducing a more formal and automated risk management system to guide and control decisions on physical inspection.*

D. Corruption

While the Northeast's reputation for corruption probably discourages inward investment,[84] actual corruption is most likely to hurt domestic SMEs. For obvious reasons, reliable data on corruption is scarce. In nationwide investment surveys of China and some Asian competitors and peers, corruption is deemed to be less of a business problem than in most of the other countries. Nonetheless, 55 percent of surveyed Chinese firms reported paying bribes averaging 2.6 percent of sales (Table III-9.) Corruption burdens are likely to weigh more heavily on firms with less influence and financial resources. Hence, the SMEs that are needed to provide local bases of component supply and services are more likely than FIEs or large SOEs to suffer.

Table III-9. Business Exposure to Corruption, Selected Countries in Asia
(percentages)

	China	India	Indonesia	Malaysia	Philippines
Firms reporting corruption as a major constraint	27	37	42	15	35
Firms paying bribes	55	n.a.	51	n.a.	51
Bribes relative to total sales	2.6	n.a.	4.6	n.a.	4.0

Source: WDR2005

[83] Some EU and transition countries integrate the presentation of all information for each customs clearance procedure in a comprehensive on-line manual. Such guidelines are translated into English and posted on the internet to help foreign businesses understand and comply. Best-practice is to provide a comprehensive website where all relevant laws, regulations, process manuals, guidelines, and forms can be downloaded. For one of the best examples, see Sweden Customs' website at www.tullverket.se.
[84] Yusuf, 2005, p. 27

The impact of corruption on business varies among Northeast cities. According to the World Bank survey of 3900 firms in 23 cities, Dalian is among the best-ranked in terms of informal business payments relative to total sales. Changchun and Benxi are rated about average. Ha'erbin is worse than average in terms of informal payments relative to sales. Heilongjiang's particular problems with corruption are long-standing.[85]

Incomplete SOE reform, distribution of public land, and tax administration provide opportunities for corruption. Prescriptions for reducing corruption seem often to focus on addressing symptoms – e.g., through better law enforcement and good governance education – rather than its sources.[86] A more direct response would include three previously-discussed reforms:

- *Reducing the State's share in Northeast industry through transparent sales processes*;
- *Greatly simplifying land-use approvals and making the approval process more transparent*; and
- *Simplifying licensing, taxes, and fees while basing fees on objective measures*.

E. Court-Based Resolution of Commercial Disputes

In general, businesses in China seem relatively confident that the legal system will uphold their property rights.[87] The issues have more to do with cost, timeliness, and potential discrimination against non-local parties to a commercial dispute.

Some courts appear to be reasonably speedy, but resolution of commercial disputes in court is too expensive. In China's coastal cities, a plaintiff can expect it will take 180 days to resolve a simple commercial dispute (e.g., debt collection) in court (Table III-10). A few East Asian court systems are faster – e.g., Singapore at 50 days and South Korea at 75 days. But China compares favorably with other East Asia countries and with OECD high-income countries in terms of speed. The main issue for China is that court costs for the resolution of a commercial dispute – estimated at 32 percent of per capita GDP – are too high. High court costs may discourage companies from turning to the courts to protect their commercial rights.

Table III-10. Efficiency of Courts
In Resolution of Commercial Disputes, Selected Countries

	# of required procedures	*Expected days required*	*Cost relative to per capita GDP*
China (Shanghai)	20	180	32%
OECD High Income	18	213	7%
Germany	26	154	6%

[85] For an account of manipulation of coal production and distribution in Heilongjiang in the 1970s, see J.D. Spence, *The Search for Modern China*, (Norton, 1991), pp. 674-5. For recent reports on Heilongjiang, see *Caijing*, May 2005; *China Daily*, 16 December 2005; and *China Daily*, 28 December 2005.

[86] CSIS Hills Program on Governance, "Governance in China," May 2003.

[87] In China, only 17.5% of survey respondents indicate lack of confidence that the courts will uphold their property rights, compared with 19% lack of confidence in Malaysia, 29% in India, 34% in Philippines, and 41% in Indonesia. WDR2005, p. 246.

Hong Kong, China	17	180	7%
South Korea	23	75	5%
Malaysia	22	270	19%
Singapore	23	50	14%
Taiwan, China	15	210	1%
Thailand	19	210	30%
United Kingdom	12	101	1%
United States	17	365	<1%

Source: World Bank, 2004b.

But while courts are relatively fast in coastal cities, resolution of commercial disputes can take too long in inland cities, including in the Northeast. A 2003 survey of firms found that average court times to resolve commercial disputes ranged from 176 days in Dalian, which had the fastest courts among twenty-three cities in China, to 411 days in Ha'erbin (Table III-11). Whether these long times reflect insufficient qualified staff, inadequate procedures, and/or other factors is not known.[88]

Table III-11. Average Time to Resolve a Commercial Dispute in Court, 2003
(in days)

Dalian	176
Shenzhen	176
Jiangmen	189
Nanchang	201
Chonqing	204
Benxi	210
Changchun	219
Zhengzhou	252
Changsha	256
Xi'an	256
Kunming	259
Wenzhou	262
Nanning	265
Lanzhou	268
Hangzhou	286
Wuhan	335
Guiyang	365
Ha'erbin	411

Source: World Bank, 2004a

Concerns about fair treatment in commercial disputes outside one's home locality may also discourage cross-provincial trade and investment. Issues likely to arise in doing business include collection of receivables, government contract awards, and protection of

[88] Recognizing the importance of speedier adjudication of commercial disputes, high-ranking authorities in Ha'erbin indicated in mid-2004 that serious efforts were underway to accelerate court proceedings.

intellectual property. While we have not specifically examined this issue in the Northeast, a nationwide survey in 2003 by the Development Research Center of 3500 firms highlighted the following concerns as relatively common:

- Reluctance of local courts to respond to commercial lawsuits brought by firms from outside the province;
- Tendency of courts to favor local firms in judicial proceedings;
- Passivity of local courts in enforcing judgments against local firms in favor of firms from outside the province;
- Preferential treatment toward local construction firms in government contract awards;
- Unwillingness of local authorities to protect the intellectual property (e.g., brands, trademarks) of firms from outside the province.[89]

Thus, in addition to remaining administrative barriers to inter-provincial trade and licensing requirements (Section III.A), concerns about fair treatment by the legal system in a commercial or investment dispute may serve as a further disincentive to invest or do business in another city. Some empirical analysis of this issue would be useful.[90]

F. Access to Finance

The 2003 World Bank survey of 3900 firms in twenty-three cities showed wide variations in access to finance (Figure III-1). Firms reported above-average access both to bank loans and to trade credits in a few cities: Hangzhou, Shanghai, Jiangmen, Chongqing, and Beijing.

According to survey data, firms in some cities are above-average in access to trade credits, but below-average in bank credits. Included are the coastal cities of Guangzhou, Dalian, Shenzhen, and Tianjin as well as the Northeast inland city of Changchun. Better access to trade credits may indicate better integration into global supply chains in which dominant supply chain partners provide material inputs on credit.

Firms in two of the four Northeast cities surveyed – Ha'erbin and Benxi – indicated below-average access both to trade credits and bank credits.

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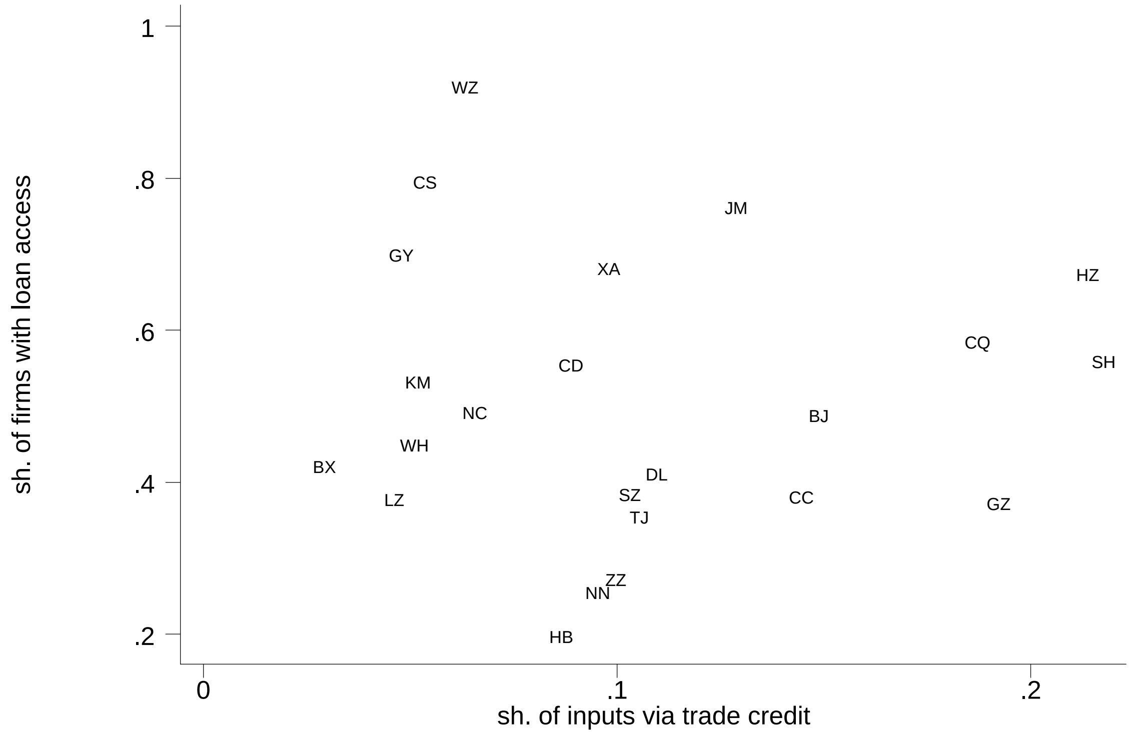
[89] Li Shantong, "Research on Measures, Objects, and Degrees of Local Protection in Chinese Market," DRC, 2003. See also World Bank, 2005a, *China: Fragmentation of National Product and Factor Markets – Economic Costs and Policy Recommendations*, report 31973-CHA.

[90] This could involve, for example, an analysis as to whether local vs. non-local origin has a significant effect on outcomes of commercial disputes in court.

Figure III 1. Access to Finance by Firms in 23 Cities



Note. BX=Benxi, BJ=Beijing, CC=Changchun, CD=Chengdu, CQ=Chongqing, CS=Changsha, DL=Dalian, GY=Guiyang, GZ=Guangzhou, HB=Ha'erbin, HZ=Hanzhou, JM=Jiangmen, KM=Kunming, LZ=Lanzhou, NC=Nanchang, NN=Nanning, TJ=Tianjin, SH=Shanghai, SZ=Shenzhen, WH=Wuhan, WZ=Wenzhou, XA=Xi'an, ZZ=Zhengzhou.

Access to credit is a particular problem for small enterprises, which may discourage growth of supplier networks and clusters needed for the revitalization of Northeast industry. Large SOEs and government infrastructure projects likely enjoy preferential access to bank credits, while non-state enterprises (especially small companies) are likely "crowded out" (as also discussed in Section II.A). The nearly-complete liberalization of interest rates for lending, which occurred in October 2004, should help. But a number of factors discourage lending to small and medium enterprises (SMEs), especially the smaller ones. These include the following:

- Banks perceive that risks are lower for large SOEs or public infrastructure projects than for often-private SMEs. The government may well feel obliged to "bail out" a distressed SOE or provide some other solution for an SOE that cannot service its debt.
- Relative to loan size, loan processing and administration costs are lower for large SOEs and infrastructure projects than for SMEs.
- The legal framework for protecting creditor rights is still weak and uncertain. Some SMEs borrowers simply disappear. Enforcement of court orders is unreliable.
- SME financial statements are unreliable. SMEs may have 2-3 sets of books – i.e., for the owner, the tax authorities, and the bank.

- Audits of SME financial statements are unreliable. Audit report findings often reflect negotiations between enterprises and outside auditors. Auditors face sharp competition and are eager to retain clients and obtain fees.
- The profitability of formerly state-owned SOEs may be constrained by hold-over contractual obligations from their ownership transformation, for example, to maintain redundant workers or excessive pre-transformation debt.
- While banks prefer real estate as collateral for secured loans, SME assets tend to be mostly inventory, receivables, and intellectual property.
- Banks lack access to reliable credit information on enterprises that are not already clients.
- The credit assessment skills of bank loan officers remains underdeveloped and linked to assessments of collateral value rather than company cash flow.
- Lack of familiarity with good SME lending practices makes SME lending seem more risky.

SME access to finance depends significantly on size of firm and loan amount. The size of SMEs varies widely.[91] A medium-sized industrial firm with RMB 400 million in assets is likely to enjoy much better access to finance than would a small firm with less than RMB30 million in assets. Indeed, access to finance may not to be much of a constraint for many of the medium-sized firms that are the main focus of this assessment. Availability of collateral and loan size – relative to cost and risk – are key issues for banks.

Governments have attempted to facilitate greater credit access for SMEs, for example, through credit guarantee facilities (CGFs). SME policy over the past several years has emphasized the use of CGFs to facilitate SME access to finance. Through guarantee fees to absorb risk premiums, CGFs have often been used as a way to circumvent interest rate controls.

International experience with CGFs is generally negative. According to one survey of worldwide experience, many credit guarantee schemes have failed. "Moral hazard" arises when incentives to undertake adequate credit analysis or repay are weakened. Poorly designed schemes soon face problems and have limited impact. Distortions induced by subsidized credit are likely to damage financial markets and capital allocations. If it remains the policy to encourage CGFs, however, CGF operations should at least reflect lessons learned from international experience (Box III-7).[92]

[91] For example, among industrial enterprises, those with 300-2000 workers, RMB 30-300 million in revenues, and RMB 40-400 million in assets are classified as medium-sized.
[92] According to a more recent survey by Enterplan (2005) of four countries, key factors for successful CGFs include "an open competitive banking environment" and "a high degree of transparency with respect to participating bank performance," i.e., atypical conditions in China.

Box III-7. International Experience with Credit Guarantee Facilities

Expectations of the positive contribution that guarantee schemes can make can easily be exaggerated. It is quite wrong to expect a guarantee scheme by itself to be a panacea for solving the whole problem of harnessing mainstream financial institutions to provide finance to SMEs. This problem is usually a large and complex one, requiring segmented solutions to match segmented market niches and issues. Even when the guarantee program is targeted at the appropriate SME segment, if the guaranteed loans are used as a substitute for inadequate equity from the owner-manager, for example, the high cost of the loans is likely to contribute to increasing, not lowering, the failure rate of small firms. More generally, imposing a guarantee scheme on a faulty financial system, unsound and inefficient financial institutions, and a general culture that condones non-repayment of debts, may make matters worse rather than better.

If – nonetheless – credit guarantee schemes are pursued, they should at least reflect lessons learned from international experience and incorporate the following design principles:

- There should be a realistic assessment of potential demand for credit guarantees.
- The CGF should be constituted as a local, independent legal corporation. Its ownership and governance should reflect the interests of SMEs or their representatives, lending institutions, and financial supervisors.
- The CGF should follow market forces. As many competent lenders as possible should be accredited by the CGF. Interest rates should not be constrained. Competition should be encouraged.
- The CGF should have adequate capital and staff. Resources should allow guarantee requests to be reviewed, and claims processed and paid, quickly (e.g., within 1-3 weeks).
- The CGF should have a public mission statement and publish timely reports of its activity.
- The CGF should have strong marketing and communications functions, both to lenders as distributors of guarantee services and to SMEs.
- Market penetration of the CGF should depend on its acquisition of expertise in SME lending and finance and on its attainment of economies of scale in handling risk assessment, claims, and debt recoveries.
- CGF success depends on commonality of interests between the CGF and lending banks.
- Initial operations are crucial in establishing a CGF's reputation with lenders and borrowers. Initial development plans and targets for the CGF should not be too ambitious.

Source: Graham Bannock and Partners, Ltd., 1997.

To improve SME access to finance, the authorities should instead (i) encourage new entry into the Northeast's financial sector, (ii) create a supportive legal and regulatory environment, (iii) disseminate best practices in lending, and (iv) promote non-bank sources of SME finance.

The Northeast's financial sector is dominated by the four main state-owned commercial banks, with some participation by China's shareholding banks and city commercial banks. Local banking would likely benefit from investments by foreign investors in the Northeast's city commercial banks. In other places (e.g., Beijing, Xi'an), the city commercial bank has attracted foreign investment – typically involving shareholdings of about 15 percent for the strategic partner and 5 percent for the International Finance Corporation (IFC). Before these foreign parties would consider an investment and begin due diligence, however, it was necessary for the city commercial bank's financial statements to be presented according to international accounting standards (IAS) and to be audited. *Thus, if cities like Ha'erbin wish to attract foreign investment in the local city commercial bank, the bank's financial statements must first be presented according to IAS and audited by an international auditing firm.*

In its review of cities in Liaoning province, FIAS also concluded that foreign firms (e.g., from Japan or South Korea) would be more likely to invest in the Northeast if these firms enjoyed ready access to higher-quality banking services. Thus, FIAS recommends that *the authorities should reduce or remove restrictions on Japanese and Korean bank branch activity in key cities*, such as Shenyang and Dalian.[93]

Three enhancements of the legal/regulatory environment would facilitate SME access to finance. First, in order to reduce risks and provide greater predictability for banks, *the National People's Congress should approve a new law on enterprise bankruptcy that reflects international best practices, including priority for secured creditors.* Second, *banks should promote more widespread development and use of credit-reporting systems*. Third, the authorities should pursue commercial law changes that would facilitate use of additional assets as collateral. SMEs tend to be poor in terms of real estate assets; their main assets may be inventory, receivables, and intellectual property. While changes to China's commercial law would be needed to facilitate the use of such other assets as collateral, other transition economies with German-style commercial law (e.g., Slovakia) have successfully implemented such reforms, as FIAS has stressed in its work on this topic with People's Bank of China and the National People's Congress.

Successful SME lending commonly involves the use of specialized policies and practices that enable banks to penetrate the small business market on a commercially sustainable basis.[94] Loans typically are based not on SME assets, but on judgments regarding an enterprise's cash flow, debt service capacity, and character of its owners and management. Since confidence regarding these judgments naturally increases as borrowers repay loans, default risk is often controlled in part by policies that "graduate" SME borrowers to larger, longer-term, and sometimes less-expensive loans as their repayment performance is established. Policies requiring frequent (e.g., monthly) repayments serve to monitor cash flow and repayment performance and to minimize default risk.

Lastly, while banks will likely continue to provide the biggest share of financing for SMEs, *greater efforts should be made to expand SME access to non-bank sources of finance*. This would involve legal, regulatory, and institutional developments to support more use of factoring and leasing (which a new leasing law would help), venture capital, private equity, and small public share offerings.

G. Labor Flexibility

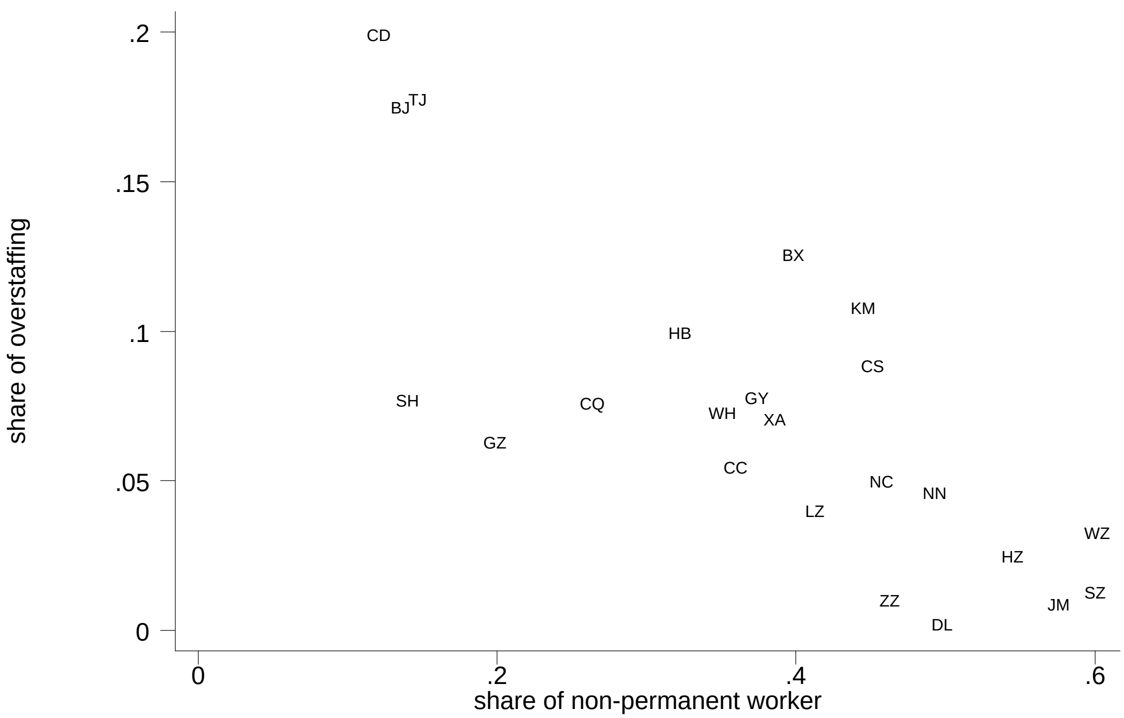
Laws and regulations on employment should achieve an appropriate balance between protecting the legitimate rights of workers and giving company managers sufficient flexibility to run their businesses in an efficient manner.

[93] FIAS, 2005b, p. 31.

[94] The World Bank is working with China Development Bank on an on-lending project that would also train local participating financial institutions in such international best practices in SME lending.

Labor conditions in the Northeast are somewhat ambiguous. In the World Bank's survey of 14 Liaoning cities in 2004, both domestic and foreign businesses rated labor regulations as one of the biggest investment climate issues. The 2003 World Bank survey of 23 cities tried to measure labor flexibility objectively, in terms of percentage of over-staffing and percentage of non-contract staff. Dalian (as well as the coastal cities of Wenzhou, Hangzhou, Jiangmen, and Shenzhen) appeared most flexible, with low over-staffing and higher percentages of contract staff. The labor situation seemed somewhat mixed for other Northeast cities. While 40 percent of their workers were non-permanent, Benxi firms also reported 13 percent over-staffing on average. In Ha'erbin, over-staffing was somewhat lower (about 10 percent) while the share of non-permanent workers was also lower (about 35 percent). Among the inland Northeast cities, Changchun appeared the most flexible in terms of over-staffing (about 5 percent) and about 37 percent of non-permanent workers (Figure III-2).

Figure III-2. Measures of Labor Flexibility for Selected Cities



Source: World Bank, 2003. BX=Benxi, BJ=Beijing, CC=Changchun, CD=Chengdu, CQ=Chongqing, CS=Changsha, DL=Dalian, GY=Guiyang, GZ=Guangzhou, HB=Ha'erbin, HZ=Hanzhou, JM=Jiangmen, KM=Kunming, LZ=Lanzhou, NC=Nanchang, NN=Nanning, TJ=Tianjin, SH=Shanghai, SZ=Shenzhen, WH=Wuhan, WZ=Wenzhou, XA=Xi'an, ZZ=Zhengzhou.

It appears that labor laws and regulations are stringent, but not consistently enforced.[95] Long-term contracts of more than 10 years exist in old SOEs. New private enterprises or enterprises operating with diversified state-private ownership tend to have fixed contracts of less than 3 years. In about half the firms surveyed, some salaries were below the minimum wage. Only at about one-third of surveyed enterprises were trade unions involved in setting minimum wage. In one city, actual working time exceeded legal maximum overtime at almost one-third of the enterprises surveyed. While firms are supposed to pay premiums for overtime (e.g., 150 percent on a normal working day, 200 percent on a weekend), this small survey indicates that firms tend just to pay the normal wage without any overtime premium. On the matter of employee dismissals, law and local regulations may require compensation (e.g., 1 month for each year, up to 12 months' salary) in cases where employees are dismissed for incompetence or a large-scale layoff for business reasons. In case of large layoffs, national labor law and local regulation require the company to explain the situation to the trade union and local government 30 days ahead of time. In two Liaoning cities, 40-60 percent of firms indicated a requirement to notify the trade union and/or government prior to an employee's dismissal, while 20-40 percent of the firms surveyed (including foreign proprietorships as well as domestic private businesses, as well as SOEs) indicated that they would also need obtain trade union and/or government approval. *In practice, local firms enjoy considerable autonomy in dismissing employees as well as in setting wages and arranging overtime.*

Inconsistent enforcement of labor laws is undesirable for several reasons. First, the legitimate interests of workers may not receive sufficient protection. Second, those firms that rigorously adhere to labor laws and regulations will be placed at a competitive disadvantage. Multinational companies – who often must also answer to shareholders, international media, and non-governmental organizations – may feel compelled to honor labor laws/regulations and disadvantaged by competing firms who do not. Third, in a situation characterized by rampant non-compliance of labor rules, non-complying firms will always be vulnerable to selective harassment and rent-seeking. *Hence, it makes sense to bring labor law/regulations and their implementation into alignment by tightening implementation where necessary to improve worker protections and by loosening labor rules where possible to address legitimate business needs for labor flexibility*.

H. Infrastructure and Urban Quality of Life

The Northeast presents a mixed picture in terms of adequacy of infrastructure. *Power and transport infrastructure appears adequate*. Survey data indicate that losses to businesses from power outages and transport problems tend to be lower in Northeast cities – especially Dalian, where reported losses averaged just 1.2 percent in 2003. Losses were reportedly higher in other cities, including in the Southeast, perhaps

[95] This preliminary conclusion is based on a small survey of firms in two cities in Liaoning Pronvice. Liaoning Province Development Research Center, 2005, "Report on Flexibility of Labor Resources in Liaoning Province," background paper.

indicating that economic growth had outpaced development of the power sector and supply chain infrastructure (Table III-12).

Table III-12. Indicators of Adequacy of Infrastructure

	Power and transport losses relative to sales	Kilometers of sewer line per 10,000	Access to tap water	Square meters paved road per capita
Northeast:				
Ha'erbin	2.8%	1.4	81%	4.1
Changchun	2.0%	1.7	76%	5.5
Benxi	2.2%	n.a.	n.a.	n.a.
Dalian	1.2%	n.a.	n.a.	n.a.
Liaoning province	n.a.	2.1	87%	3.5
Other cities:				
Beijing	3.5%	4.3	100%	7.0
Tianjin	2.9%	8.8	100%	5.4
Shanghai	2.0%	2.5	100%	11.6
Hangzhou	2.1%	2.6	97%	6.1
Guangzhou	3.5%	2.3	92%	10.6

Source; World Bank survey (2004) and provincial statistical yearbooks, 2003.

Northeast cities seem to lag somewhat behind many major cities, however, in other infrastructure and urban quality of life. In some basic indicators of urban infrastructure (e.g., tap water, waste water treatment, roads), Northeast cities appear to be somewhat behind coastal cities in terms of public access. *Continued investment in urban infrastructure is likely needed to enhance the appeal of Northeast cities to investors,* especially foreign investors. More generally, investment in urban infrastructure may counteract the emergence of urban poverty. Investment in urban transport and infrastructure has been shown to support growth, while state-of-the-art information technology infrastructure is now viewed as a practical necessity for cities seeking to cultivate high-tech industry. In addition, greater reliance on private providers of public services can help to increase competition, counteract urban poverty, and enhance the quality of life in Northeast cities.[96]

Northeast cities are also lacking in education and health care facilities for foreign dependents. In a situation where a foreign company is choosing between two otherwise comparable locations, such quality of life considerations could be a deciding factor. In Beijing, Shanghai, Suzhou, and Guangzhou, foreign employees and their families have access to medical facilities and schools oriented toward the needs and expectations of expatriate staff. By contrast, the Northeast lacks comparable facilities. A small market and higher costs may discourage for-profit schools or health care providers oriented toward serving expatriate families from setting up operations in the Northeast.

[96] Demurger, 2001; and Coyle, Alexander, and Ashcroft, 2005; cited in Yusuf, 2005.

It was suggested earlier that tax concessions for foreign investors are probably a waste of money. A preferable alternative would be *to end such tax concessions and use the increased tax revenues to finance additional investment in urban infrastructure and perhaps some subsidies for schools and health care facilities oriented toward international company staff and their dependents.*

I. Skills and Technology

The Northeast appears to have some advantage in endowments of trained and technical human resources. For instance, Liaoning province has 70 colleges and universities, plus 38 national-level scientific research institutes. The ratio of scientists and engineers to total population is 3.4 to 1,000 in Liaoning province. Its universities graduated 221,000 students (with a preponderance of engineers) in 2003, versus 106,000 for universities in Guangdong.[97]

These statistics are partly supported by survey data. In the World Bank's 2003 survey of twenty-three cities, firms in Changchun reported above-average percentages of both trained staff and technical staff, presumably a result of the city's focus on auto manufacturing. Firms in Ha'erbin reported above-average percentages of technical personnel. The coastal cities of Guangzhou, Hangzhou, and Shanghai, along with Chongqing, however, came out on top in terms of highest percentages of both trained staff and technical staff (Figure III-3). It appears that trained and technical staff are being drawn away from the Northeast, because cities elsewhere (e.g., in the Southeast) offer both greater business opportunities and higher quality of life.[98]

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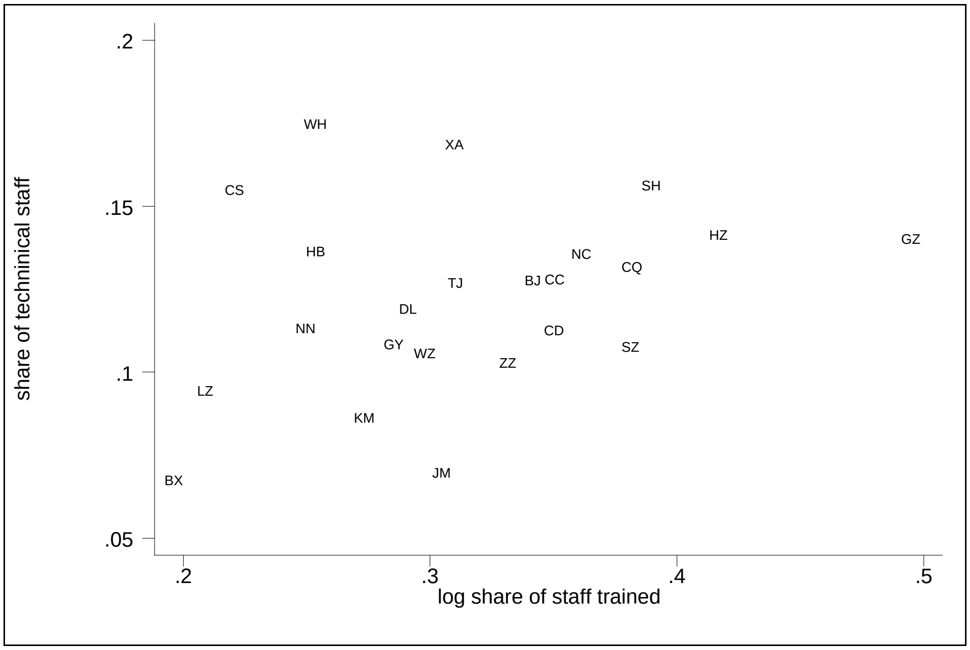
[97] Yusuf, p. 28.

[98] Shenzhen illustrates the mobility of human resource endowments and the need to create or maintain both business opportunities and quality of life in order to retain human talent. Shenzhen has grown from a small fishing village of 20,000 in the late 1970s to a megalopolis with a total population (migrants included) that may now exceed 10 million.

Figure III-3. Staff Quality for Selected Cities



Note. BX=Benxi, BJ=Beijing, CC=Changchun, CD=Chengdu, CQ=Chongqing, CS=Changsha, DL=Dalian, GY=Guiyang, GZ=Guangzhou, HB=Ha'erbin, HZ=Hanzhou, JM=Jiangmen, KM=Kunming, LZ=Lanzhou, NC=Nanchang, NN=Nanning, TJ=Tianjin, SH=Shanghai, SZ=Shenzhen, WH=Wuhan, WZ=Wenzhou, XA=Xi'an, ZZ=Zhengzhou.

Successful efforts outside China to revitalize "rustbelt" areas have included support for research-oriented universities and institutes that are a source of new technologies, training in needed skills, industrial extension, and consulting services. Research universities and institutes can become the hubs for new industrial clusters under some quite specific circumstances, including location in a city that offers high quality of life and local political support for efforts by the research community to build linkages with business.[99]

Research universities and institutes should have incentives to commercialize their findings and build tangible connections with industry. Germany's experience suggests to some that "the most effective means to encourage industry R&D directly seems to be partial funding of specialized research institutes connected to industry clusters, partial subsidization of research contracts between firms and research institutions, particularly for small firms, and generous support for universities."

While they should not attempt to create industrial clusters, governments can play a useful role in reinforcing industrial clusters that exist or develop. Clusters often emerge and begin to grow naturally, as happened in Silicon Valley. Once a cluster begins to form, "government at all levels can play a role in reinforcing it. Perhaps the most beneficial way is through investments to create specialized factors, such as

[99] Yusuf, p. 29.

university technical institutes, training centers, data banks, and specialized infrastructure….New clusters are most effective if they are built around a concentration of specialized expertise….*Government policy will be far more likely to succeed in reinforcing an existing or nascent industry cluster than in trying to promote an entirely new one."*[100]

More generally, given the difficulty in "picking" winners (either cities or "pillar" industries), ***it makes sense to adopt nationwide policies and programs for moving all of China toward becoming a "knowledge economy."*** Priority actions to promote life-long learning and move all of China toward becoming a knowledge economy include the following:

- Pursing reform of the economic incentive and institutional regime through the rule of law and its enforcement, property rights, clearer regulation, stronger economic competition, and insulation of business management from political influence;
- Taking steps toward reform of the educational system, including new regulations to facilitate integration of the private sector into the formal education system and exploit opportunities for learning based on information and communication technologies;
- Improving the regulatory framework, including freer access to the Internet;
- Diffusing new technologies throughout China by strengthening technical standards, encouraging new businesses and other agents of technology dissemination, and multiplying local support structures of information and technical assistance;
- Reforming government R&D programs to bring in the business sector, increase funding to selected networks of public and private universities, and use technology "foresights" to make informed technology choices;
- Attracting foreign investors in strategic areas, especially service businesses; facilitating global technological alliances for Chinese enterprises; and intensifying incentives for Chinese experts overseas to return to China; and
- Promoting massive training of public officials to adapt the management of the economy and society to more knowledge-based development.[101]

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[100] Michael E. Porter, 1990, *The Competitive Advantage of Nations*, Free Press, p. 635

[101] Carl J. Dahlman and Jean-Eric Aubert, *China and the Knowledge Economy: Seizing the 21st Century*, World Bank, 2001, p. xxv.

IV. Facilitating Investment and Innovation: Public and Private Institutions

As noted in *World Development Report 2005*, "investment climate improvements are a process, not an event."[102] The contrast between Southeast and Northeast development, hindrances from SOEs, and impediments to new investment compel re-consideration of the government's role in Northeast economic development. Worldwide historical experience indicates that the government's role should shift from direction of Northeast economies to facilitation of private sector investment and innovation. In making this shift, the government should consult closely with private sector businesses. As the Northeast's investment climate improves, efforts at investment promotion are likely to show greater results.

A. The Government's Role

A classic in-depth study of the competitiveness of ten leading trading nations (Denmark, Germany, Italy, Japan, South Korea, Singapore, Sweden, Switzerland, United Kingdom, and United States) arrived at several conclusions highly relevant to development of Northeast China:

- Governments are at a disadvantage in managing enterprises and responding to market forces and rapid changes typical of international competition. "Even when staffed with the most elite civil servants, governments make erratic decisions about the industries to develop, the technologies to invest in, and the competitive advantages that will be the most appropriate and achievable….Government simply cannot be as in tune with market forces as industry participants."
- Governments do not control a region's underlying competitive advantage. Governments can only facilitate effective exploitation of competitive advantage, by creating appropriate institutions, a supportive investment climate, and necessary or desirable inputs ("factors") for use by enterprises.
- One of the most important and traditional roles of government is creating and upgrading factors – e.g., skilled human resources, basic scientific knowledge, economic information, and infrastructure.[103]

The experiences of South Korea, Japan, Germany, and Italy highlight the importance of comparative advantage, intense competition, and public investment in education and infrastructure; effective support for research and development (R&D); avoidance of direct interventions (e.g., targeting "pillar" industries); government standard-setting and "signaling" of priorities; and local government initiative.

[102] WDR2005, p. 71.
[103] Michael Porter, *The Competitive Advantage of Nations,* (Free Press, 1990), pp. 617-26.

Box IV-1. Government Involvement (Good and Bad) in Pursuing Competitive Advantage, Selected Cases

South Korea: Some aspects of the government's role have been unqualified successes. Most significant were substantial investments in education and infrastructure; efforts to promote exports; identification of international competitiveness as a national priority; government investments in a range of industry-related R&D institutes; and encouragement of industrial clustering around technical and educational facilities. Direct government interventions in individual industries, however, had a more mixed record. Government targeting was as often wrong as right. Major focus on chemicals, plastics, and machinery industries consumed large amounts of resources with modest results. The government's selection of areas for cooperative R&D projects had a mixed record as well. Government targeting distorts private expectations and incentives, and can obscure sectors with real prospects for competitive advantage. Targeting a relatively small number of mostly end-product industries resulted in a narrow economy with shallow clusters. A great strength of government policy, however, has been its capacity to adjust and evolve. By 1990, much of the direct intervention in individual industries was being phased out.

Japan: After World War II, early industrial successes in steel, shipbuilding, and sewing machines reflected a *combination* of government interventions, demand conditions, the presence of supporting industrial clusters, and vigorous domestic competition. But in other sectors – such as chemicals and plastics, aerospace, aircraft, and software – in which Japan had no other comparative advantages, aggressive efforts by the government at sector development largely failed to produce true international competitors. A crucial aspect of Japanese protection was also that foreign rivals were often gradually let into industries, based on timetables for liberalization known in advance. This approach stimulated major efforts at upgrading within Japanese industry. For example, Caterpillar's impending joint venture with Mitsubishi is said to have been a major goad to the renaissance of Komatsu in manufacture of construction equipment. Government policies (e.g., leasing companies) have also sought to stimulate demand for new technologies (e.g., facsimile machines, robotics). Government requirements for rapid standardization in such products as cameras and sewing machines inspired intense competition in product improvement. Government policy also spurred the development of industrial clusters of supporting and related businesses. A final tool has been the use of high-visibility reports, public-private committees, and cooperative research projects for "signaling," to call attention to emerging technologies and issues (e.g., energy efficiency). As the economy developed, direct interventions decreased and the government relied more on demand creation and "signaling."

Germany: The government has had a relatively modest involvement in industrial policy. German industry has had to face foreign competition and has been strengthened in the process. The principal role of the German government, both central and provincial, has been to support education, science, and technology. Interestingly, though, direct government control is not exercised in many instances. A degree of independence is present even in government-funded technical institutes. Germany has a good record in upgrading technology because most government-funded research takes the form of joint projects with research institutes involving firms, partial funding of research contracts between firms and universities, or incentives for company research. Regulation has tended to be demanding and has generally pressured innovation. Environmental standards are also stringent, stimulating innovation in the industries affected. Despite its generally constructive role, the government has also had a persistent tendency to subsidize ailing sectors, such as steel and shipbuilding, with little effect except to postpone adjustment.

Italy: State-owned enterprises tended to be inefficient. Government resources were funneled not into factor creation (e.g., education, technology) but into rescues, subsidies, and promoting development in the South. Regional policy, based not on building clusters but attracting isolated plants to the South, was widely perceived as a failure. Local governments were more constructive, sometimes becoming involved in financing specialized university programs, infrastructure, and other factor-creating investments.

Source: M. Porter, *The Competitive Advantage of Nations*, (Free Press, 1990), chapters 7&8.

For the Northeast to move beyond a cost-driven or investment-driven economy to becoming more innovation-driven, the government should assume an indirect role. With enterprises becoming the "prime movers," the government's role "must shift from actor and decision maker to facilitator, signaler, and prodder. Intervention must decrease substantially." In an innovation-driven economy, government's most significant influences "are in creating advanced factors, upgrading demand conditions (such as through setting stringent standards and raising aspirations in areas such as health care and environmental quality), de-concentrating economic power, and signaling."[104]

While government efforts are most appropriately focused on general factors (e.g., education, urban infrastructure and quality of life), the most significant factors for competing in an innovation-driven economy are specialized and associated with industries or groups of industries. Government attempts at creating specialized factors (e.g., vocational training, applied technology) on its own are risky. Worldwide experience shows that government should involve industry in determining which factors are created (e.g., as in Germany's approach to R&D) and encourage enterprises to play a major role in factor creation.[105]

B. Public-Private Sector Coordination

Within the public sector, municipal governments are the logical focal point for many investment climate improvements: e.g., simplifying licenses and fees; making land-use approvals easier and more transparent; and improving urban quality of life. For many issues – such as development of intra-regional transportation networks and elimination of inter-provincial trade barriers – coordination among Northeast provincial and municipal governments is needed. Lastly, especially in cases where there is a need to share "costs of reform" or to support self-financing efforts by Northeast governments, coordination between central and local authorities would be essential.

In many parts of China, however, including the Northeast, public-private sector coordination is under-developed.

The Northeast suffers from an apparent lack of well-functioning business associations. Business associations can play a valuable role in improving the investment climate, by identifying members' problems, offering practical ideas for reform, and helping government monitor implementation of reform.[106] While many old-style government-supported industrial associations remain, these lack relevance, credibility, and influence in China's new market-oriented economy. Many government and business representatives suggest that old-style industrial associations still exist only to collect fees.[107]

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[104] Ibid, p. 672.
[105] Ibid, pp. 620, 627.
[106] As noted in *China Daily*, 'The main function of an industrial association is to serve as a bridge between the government and enterprises. It should provide services to enterprises, such as carrying out research and study and uniting enterprises to protect their interests." 27 July 2004.
[107] FIAS, 2004, pp. 41-2.

Old-style industrial associations should be replaced with "grassroots" business associations attuned to the market economy. New-style business associations should genuinely represent stakeholders and be internally democratic (e.g., leadership rotation and election). Several Liaoning municipalities are apparently doing something along these lines. For example, it appears that Dalian is instead attempting to promote a new type of business association: a "non-profit social organization that carries out industry services and self-disciplined management, and that is voluntarily organized by enterprises of the same industry as well as the economic organizations of other kinds." The same-industry focus may be too constraining. But it appears that Dalian has taken a critical first step toward creating a dynamic environment for business associations."[108]

Worldwide, many governments have created consultative forums to facilitate ongoing dialogues on business conditions with key stakeholders. Stakeholder involvement in such consultative forums varies widely, as do their mandates (Table IV-1). Some look at nationwide economic policy, while others focus more narrowly on private sector issues. Mandates may go beyond public-private sector dialogue and include identifying bottlenecks, building consensus, recommending policy approaches, and monitoring progress of reforms.[109] To be effective, consultative forums should encourage the free flow of information, build trust among participants, and assist in framing solutions. It is particularly important that they reflect the diversity of interests affected by investment climate reforms and not merely entrench vested interests. A high level of transparency in the operation of consultative forums, such as through regular publication of reports, can also increase public confidence in reform programs.

Table IV-1. Consultative Forums on Investment Climate, Selected Examples

	Government	Business	Trade unions	Legislators	Civil society	International organizations
Economic issues:						
Latvia	X	X	X			
South Africa	X	X	X		X	
Private sector issues:						
Vietnam	X	X		X		X
Pakistan	X	X	X			
Singapore	X	X				

Source: WDR2005, p. 72

108 Ibid.

109 In Latvia, the Steering Committee for Improvement of the Business Environment reports to the Minister of Economy. In Turkey, the Coordination Council for the Improvement of Investment Climate reports to the Undersecretary in the Prime Minister's office. Both consultative bodies include representatives from key ministries as well as associations of local firms, exporters, and foreign investors and receive support from a secretariat responsible for daily work and for monitoring reforms. Topics tend to be allocated among specialized technical committee. Turkey's Council helped design laws on recruitment of foreign personnel; FDI; company registration; and labor. It also supported reforms in customs, licensing, intellectual property rights, and land acquisition. Latvia's Committee contributes to implementing ongoing legislative and procedural reforms of business inspections, registration, taxes, customs, land acquisition, and construction.

C. Investment Promotion

Worldwide, investment promotion agencies (IPAs) play a variety of roles: information dissemination; image-building; investment facilitation; identification and targeting of potential investors; post-investment monitoring and care of investors; and advocacy of policy reforms to improve the local investment climate. Investment promotion can be expensive, however, especially during the image-building stage. IPAs appear to be more successful in places where the investment climate is already amenable to foreign investors.[110]

It appears that the Northeast is already achieving some improvements in its investment climate. Some cities, notably Dalian, appear to have made significant progress in simplification and rationalization of business licensing and fees; transparency in land use; customs clearance; electronic tax filing; resolution of commercial disputes in court; and development of market economy-oriented business associations. Real success stories should be publicly disseminated, both to inform other Northeast cities and to help attract inbound domestic and foreign investment.

As the Northeast's investment climate improves, investment promotion will have more realistic chances of being effective. In June 2005, the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) conducted a needs assessment of three Investment Promotion Agencies (IPAs) in the Northeast. MIGA concluded that these IPAs have a clear investment promotion mandate; strong government support and adequate budgets; and adequate staff with generally appropriate educational background. Local IPAs have made progress in establishing service centers to assist both foreign and domestic investors. Areas identified for improvement include the following:

- Development of a medium/long-term investment promotion strategy to guide overall direction and decision-making;
- Additional training in investment promotion;
- Improvements in foreign language skills, especially English, Japanese, Korean, and Russian;
- Additional efforts at image building and pro-active marketing, to include more systematic use of external contacts, overseas offices and networks, relations with international media, and use of existing investors for networking; and
- Improved use of information technology, including for IPA web-sites and customer relationship management (CRM).

[110] *WDR2005*, pp. 170-1. Studies show that increases in the budget of an IPA increased FDI nearly twice as much in locales with the most favorable investment climates than in locales with the least favorable.

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