

## Reforms of the State Owned Enterprises in the People's Republic of China

Poonam Gupta and Amitendu Palit

### 1. INTRODUCTION<sup>1</sup>

The success of the Chinese reforms process over the last three decades, which has transformed a predominantly state owned economy with a per capita income of \$183 (at 2002 prices) in 1979 to \$1268 in 2004 has truly been phenomenal. Recent problems, that have started to emerge as potential roadblocks in its growth process (e.g. related to the financial sector, environment, social inequality, external imbalances) notwithstanding, there is a consensus among observers and practitioners that the, mainly “home grown”, Chinese reform process can impart useful lessons for other developing countries.

An important component of the reforms in the PRC has been the reform of its state owned enterprises (SOEs). While the reforms in other sectors in the PRC started in 1978, concerted reforms in SOEs were started in mid 1980s and were carried out in two main phases. In the first phase, lasting for about a decade from mid 1980s to mid 1990s, reforms were limited to changing the management incentives within the state ownership. The second phase of the reforms, started in mid 1990s, focused on shifting the ownership of enterprises from the state to the domestic private sector as well as to foreign investors. These efforts have yielded benefits far greater than the reforms in the first phase when focus was on greater autonomy and incentives to the management. The economic gains from the SOE reforms have been impressive and have extended to improvements in efficiency and productivity; higher investment and R &D expenditure; higher growth and spectacular export performance of the industrial enterprises.

While the SOE reforms have been going on for almost three decades in the PRC, the largest action seems to have occurred only in the years from 1995 to early 2000s. In this sense the ownership transfer of SOEs has been quite rapid. There has expectedly been some adverse impact of these reforms on employment, but because of the policies adopted by the government to cushion the effect on labor, these effects have been limited.

This study analyzes the various aspects of the SOE reforms in the PRC.<sup>2</sup> In particular it looks at the extent, pace, and sequencing of reforms; the factors that determined the various aspects of the reform program; the institutional handling of the reforms and the modalities adopted for privatization and giving up government monopoly control; roles played by different stakeholders including by the various levels of the government, employees, and managers; handling of the massive restructuring of labor through social safety nets, unemployment benefits and re-employment training provided to the laid off workers; gains from the SOE reforms; and the challenges that have been faced during this process.

The salient features of the SOE reform process in the PRC can be summarized as follows:

- (i) **SOE reforms were a part of the more comprehensive product market reforms.** An interesting and useful sequencing seems to have been calibrated in the overall reforms process in the PRC, where larger product market reforms including the SEZs, FDI and trade reforms were carried out first and the ownership reforms in the SOEs were carried out subsequently. Thus SOE

reforms were a part of the more comprehensive product market reforms; and that probably weakened any potential resistance to SOE reforms and made the outcome much more favorable.

- (ii) **The modalities and pace of reforms were tailored to meet the desired objectives and to suit the conditions prevailing.** Within the SOE reforms several different modes of reforms were used ranging from greater autonomy to the managers, to ownership sale to the employees and managers, to outright privatization to domestic and foreign investors. While the autonomy and incentives to the managers yielded limited gains, these gains were short lived and eventually as the SOEs faced increased competition from the wider product market liberalization, it necessitated the need for ownership transformation. These reforms were carried out in a decentralized manner in which the local and provincial governments and the local bureaucratic machinery played a major role.

As with other reforms, the reforms in SOEs were introduced in a gradualist and incremental way. They were often first experimented with in certain regions and then replicated at a larger scale. The ownership transformation was carried out in the early 1990s, a decade and a half after the reforms started. The pace of reforms with respect to SOE reforms seems to be gradual until early 1990s, when the ownership reforms were first started, but the subsequent ownership transformation was achieved quite rapidly.

- (iii) **Local sensitivities were kept in mind and local government and bureaucracy were entrusted with the major aspects of reforms.** In order to transfer the ownership of SOEs, several sensitivities were kept in mind. For example rather than using the term privatization, the term *Gaizhi*, (which means restructuring) was used. Before the major restructuring was carried out, the ownerships of the SOEs were transferred to the provincial and local governments. This was apparently done with the following three objectives. First, the resistance to ownership reforms would be spread out across these levels of the government rather than being directed at the central government; second, by making the budget constraint more direct and binding for the provincial and local governments the consensus would be easier to arrive. Finally, since the local officials were closer to the ground it was perhaps easier for them to carry out the process by tailoring it suitably for the local conditions.
- (iv) **Various forms of reforms were used during the restructuring, with open sales and leasing becoming more popular overtime over employee shareholdings and management buyouts:** In the initial years of reforms employee shareholding was the preferred mode of restructuring which later led to more management buyouts. Several enterprises were also allowed to spin off or to restructure through bankruptcy; but these arrangements were supposedly abused. Hence in more recent years open sales and leasing have been the more preferred modes of restructuring. There were also regional variations in the modalities of reforms. In terms of the sequencing of privatization, within firms the smaller ones were allowed to be privatized first and subsequently it was extended to the medium and larger firms.
- (v) **Labor market implications were carefully examined and addressed, which succeeded in cushioning the effect on labor.** Several crucial reforms related

to labor were started much before the privatization and large scale layoffs took place. In the first phase of reforms the enterprises were gradually granted increasing flexibility in hiring labor; subsequently the use of contractual labor was allowed. The SOEs identified surplus labor and the reforms in social security were started, these included pension reforms, health benefits and unemployment insurance reforms etc.

Perhaps the most important and politically sensitive part of the reforms was the laying off of labor in the second phase of reforms based on ownership transformation. The extent of the layoffs was unprecedented—more than 40 million workers were laid off from the SOEs from mid 1990s to early 2000s. It seems that while there was little communication with the labor or public at large during this process, the government did try to treat this issue with utmost sensitivity and addressed several aspects to ease the cost of layoffs on labor. Just like the use of the term ‘gaizhi’, the term *xiagang* (the literal meaning of which is losing the position, and which referred to workers laid-off from SOEs who remain registered with reemployment centers and maintained some ties with the SOEs), was used instead of unemployed for the labor that was laid off. The restructuring had to be approved by the employees conference. Several measures were used to ease up the transition for the workers, e.g. workers maintained their relations with the old enterprises where they also went for retraining; generous layoff packages were provided (including a premium for losing their status as state employees), an attempt was made that at least one member of the family retained his/her job, workers were allowed to keep the medical and social security benefits, a preference was often given to the employees to hold shares of the transformed enterprises, apart from providing credit if they did not have money to finance the share purchase; the receipts from land holdings use was often used to pay up the arrears to the employees, settling of employees arrears was usually given priority over other settlements; negotiations were conducted and incentives provided to the new owners of the enterprises to keep as many people as possible.

Despite being an overwhelming success, there have been a few challenges in the reform process and some unfinished reforms. These relate to the social security reforms; corporate governance in the remaining SOEs and the development of the modern corporate governance practices and the institutions that support it; the dividend payments by the SOEs etc.

The rest of this study is organized as follows: we discuss the timing and pace of the SOE reform process since 1978 in the next section. In section 3 we discuss the modalities of the SOE reforms. In Section 4 we discuss the issues related to the handling of labor. In section 5 we discuss the benefits of the reforms on the economy. Section 6 discusses the challenges that the PRC faces in taking the reform process further, the lessons that can be drawn for other economies in transition including India, and the last section summarizes the main findings.

## **2. TIMING AND SEQUENCING OF SOE REFORMS**

Theoretically speaking, the key to improve the performance of the SOEs is to align the interests and incentives of the management with that of the owners. There can be two

different ways to achieve this: first providing incentives to the managers in such a way that the agency costs are minimized; second to assign well defined property rights and move the ownership to the non state sector. In addition to these two schools of thoughts it is also believed and argued that product market competition can exert important pressures to reform SOEs. The PRC experimented with both the systems: management incentives; and privatization; and along with these increasingly subjected the product markets to competition.

While the overall reforms in the PRC started in 1978, concerted reforms in SOEs were started in mid 1980s and were carried out in two main phases. In the first phase, from mid 1980s-mid 1990s, focus was on enhancing the performance of the SOEs through greater autonomy to the enterprises and by linking the salaries and bonuses of the management to various performance indicators, which were enforced through performance contracts. In some cases the enterprises were leased as well, often on the basis of the managers paying a fixed proportion of the profit to the state. In the second phase the ownership reforms were carried out.

It seems to us that there was no blue print of the policies to improve the efficiency of the state sector on the eve of the reforms. The issue was subject to continuous deliberations and discussions, based on which policies evolved continuously. There are various reasons for why a country might decide to restructure or privatize the SOEs. These include improving efficiency by reducing the agency costs or by better defining the property rights; to create fiscal space if the state owned enterprises are making losses and to reduce the burden on state owned banks; and to foster competition and improve productivity by letting the market play a larger role in economic decision making. Similar factors influenced the decisions in the PRC at various stages of its reform process, though different factors weighed in at different points in time. The ultimate objectives to reform the sector were to increase efficiency and to reduce the fiscal burden on account of the loss making enterprises.

Thus the impetus to SOE reforms, including the thrust on privatization in mid 1990s, usually came when the SOEs were making losses. Sensitivities of the stakeholders particularly those of labor were always kept under consideration. Efforts were made to gauge the public response to proposed reforms through surveys, e.g. in early 1980s a group of young reformers conducted a survey to assess the public reactions to an economy which was more market determined. The survey also included questions such as how would you feel if employment in enterprises was not permanent (but was rather contractual).

### **2.1. SOE Sector on Eve of the Reforms**

On the eve of the reforms in 1978, 80 percent of the industrial output was being produced in the state sector and the rest by collective enterprises<sup>3</sup>. According to an estimate there were 30,000 large and medium sized firms and 150,000 small firms in 1978. These enterprises received output and input targets (the planning and allocation of which was done at the provincial and local levels), and some financial targets on sales or profits. The government set the prices, and at these set prices the enterprises were generally profitable. Thus the markets for products and inputs were virtually non-existent. Since there was no competition from the private sector the enterprises earned monopoly rents. The state banks and the central banks provided finances, and the enterprises were required to keep the surplus cash with the central bank. The firms in turn had to surrender their profits and did not have the flexibility to take their investment decisions, or to plough back the profits in to the enterprise.

Thus the SOEs faced a soft budget constraint, but since the SOEs were on average profitable, it did not matter.

The immediate need under these circumstances was not really to temper with the ownership structure of the SOE but rather to increase the availability of food and other consumables for people, to incentivize the people and to enhance efficiency by encouraging foreign capital and encouraging foreign trade. Thus, this is where the reforms concentrated in the early years—on agriculture, on SEZs, and on opening up the foreign trade.

## **2.2. SOE Reforms during 1979-1989**

During 1979-1984. Though greater emphasis was put on enterprise profits and the enterprises were allowed to retain the profits above a certain target. The target of profits and the share of profits to be retained had to be negotiated. This was later combined or substituted by a formal tax on profits, which also had to be negotiated.

A byproduct of the flexibility to determine prices and procure inputs was the revival of the collectively owned units in the form of Town and Village Enterprises (TVEs) between the mid 1980s and end 1980s (see Box 1). Consequently, the share of industrial output accounted for by the collective units increased from 20 percent in end 1970s to about one-third in end 1980s.

It is also important to note that in pre-reforms the PRC distorted incentive structures in the labour market had produced different outcomes in urban and rural areas. The 'iron rice bowl' phenomenon had led to serious overcrowding of SOEs in urban areas, while its marginal application, along with controls on migration imposed through the household registration system (*hukou*), rendered large segments of the rural labour force surplus and non-participative in industrialization (Debroy, 2008). Reforms loosening hukou and enabling rural workers to take up jobs in towns and cities helped in growth of TVEs<sup>4</sup>. These reforms must be seen as an important precursor to SOE reforms as they succeeded in making labour supply more elastic and responsive to market-based incentives.

It was in 1984 that far greater autonomy was given to the state enterprises in choosing their production levels; in setting the prices; and in hiring and investment decisions. These reforms were carried out with the slogan "Zhengqi Fenkai" meaning separating the party and the management. The enterprises were allowed the flexibility to sell the production above the quota level themselves. For goods above the quota, for production goods, enterprises were allowed to charge 20 percent more than the prices set by the state, thus a dual price system was allowed. Furthermore, the enterprises were allowed to use the money in their depreciation fund; and sell idle assets to finance investment; greater flexibility was granted in deciding the wages, which could be linked with profits. Flexibility was also given to the enterprises to choose their middle level managers. A very important measure used at this time was to allow hiring of workers on a contractual basis. Brooks and Tao (2003) and Gang et al (1998) confirm that by 1990 SOEs were hiring most of their new workers on a contractual basis.<sup>5</sup> Greater flexibility in terms of the input and output mix; and pricing and employment laid the grounds for a market economy.

During this time, as earlier, the enterprises continued to remain profitable, and hence as such there were no pressing needs for the reforms which took place in the SOEs in mid 1980s (see Yusuf et. al. (2006)). The reforms of this period were guided more by the practical administrative problems of monitoring and deciding on the inputs, outputs and price

targets for the thousands of enterprises and products; and the overall objective of improving the efficiency of the system.

Around 1986-87 the increased autonomy to enterprises was followed by a contract responsibility system in which the management signed a performance contract with the government laying down the targets that the managers would achieve. The contract had to be negotiated between the government and the management and included the revenue sharing agreements etc. By the end of 1980s, almost all SOEs had adopted the performance contracts that continued through 1993.<sup>6</sup>

The empirical evidence on the effect of reforms in this period on the performance of the state enterprises is somewhat mixed. Li (1997) assesses the impact of the reforms in the 1980s on the productivity of state enterprises by using a sample of 272 state enterprises. He finds that the state enterprises experienced significant improvement in productivity and a large part of the improvement can be attributed to improved incentives, intensified product market competition and improvements in factor allocation. Others, however, dispute such findings.

In another empirical study Li and Wu (2002) use a sample of 680 SOEs and compare the relative effectiveness of management based vs. ownership based reforms. They find strong evidence that the ownership reforms improve the economic performance but do not find evidence that management based reforms have a similar impact on economic performance.

Thus the key features of this decade were the rise of TVE, laying the foundation for more market based reforms, and reforms based on greater incentives to managers to reduce the agency problems. Overall observers regard the reforms in the 1980s, based on greater autonomy and incentives, to have limited success. There can be several reasons for the lackluster performance outcome of these measures: performance contracts alone are not enough to improve the performance of the SOEs, they need to be coupled with an increase in product market competition; the performance criteria were inadequate; without ownership transfers and clear property rights, greater autonomy and performance criteria cannot deliver; if anything, it is likely that they may make the agency problems even more serious.<sup>7</sup>

**BOX 1: THE RISE AND FALL OF THE TOWN AND VILLAGE ENTERPRISES (TVEs)**

TVEs refer to mostly small and medium industrial enterprises in rural PRC. These existed under the name Commune and Brigade Enterprises as far back as in 1960s, but were revived following the agricultural reforms in late 1970s. The objectives behind the revival of TVEs was to absorb surplus labor from agriculture and to alleviate poverty. There were two kinds of TVEs: private TVEs, run by individuals or as partnerships and joint ventures; and collective TVEs run by local governments or administrative units with or without households.

These TVEs flourished in the early years of reforms due to the availability of surplus labor (rendered surplus by the rise in agricultural productivity) and capital that was available due to a rise in income levels. Another factor that aided in their growth was the flexibility to buy inputs and machines—which was liberalized in 1984. Local governments also provided them active support, in particular by securing them credit from the state owned banks; and just like other SOEs they could earn monopoly rents with limited competition from the private sector.

Their rise was quite impressive and timely with the annual growth rate averaging about 25 percent a year between mid 1980s to mid 1990s according to an estimate. By 1995 TVEs accounted for almost a quarter of PRC's GDP, 2/3 of the total rural output and more than 1/3 of PRC's export earnings. The success of TVEs demonstrated the benefits that (even semi) privately owned enterprises could impart to the society, through increased output employment and efficiency; and were also instrumental in helping people migrate from agriculture into rural industries, rather than to urban areas.

The success of the TVEs was widely recognized and contributed importantly to the successful transition of the economy from agriculture to industry; but soon the limits of these enterprises for enhancing the economic prosperity were evident. There were several problems which started affecting their economic performance including vaguely defined property rights, soft budget constraints; and high non performing loans. In the absence of strict regulations to limit their effects on environment many TVEs are also believed to have impacted the environment adversely.

As the government policy changed toward the management and ownership of enterprises, it affected the working of the TVEs too. Initially, starting in late 1980s the TVEs were leased out; and then in late 1990 as the government started privatizations, it first started in the rural areas and with the TVEs, which were often sold to their managers.

Source: Biggeri (2001) and Field et al (2006)

**2.3. SOE Reforms during 1989-1997**

Reforms suffered a setback in 1989-1992; and were limited to further freeing up of prices. The period was also marked by high bank credit and investment, high inflation and probably some overheating of the economy, as well as political turmoil following the Tiananmen Square. Hence the reforms were put on hold briefly in 1989-1991 and were revived only in 1992. Subsequent reforms during 1992-1997 continued on the same line as those in the earlier years. Prices of industrial inputs and outputs continued to be liberalized; domestic price structure increasingly reflected the international prices; a new uniform accounting system was introduced, and a uniform VAT system was adopted in 1994.

From late 1980s to early 1990s the performance contracting system was scrutinized further and largely abandoned after 1994. One main reason was the flawed performance contracts which made the attainment of the performance criteria laid out in the contract without improvement in efficiency.

One big reform, which was introduced earlier, but was practiced more around this time, was the greater flexibility in hiring labor. The number of contract workers (hired for a limited period on contract and without the full range of benefits) increased from 10 million in 1988 to about 16 million in 1991 and to 55.5 million in 1996. Another change was the increasingly large number of enterprises selling shares and listing them in Shanghai and Shenzhen stock exchanges. However it is believed that the listing in the stock exchanges perhaps did not improve the corporate governance practices or brought in the modern corporate governance culture in the enterprises, as the management still continued to be selected by the government rather than by a board of directors.

Other developments taking place at this time, which set the stage for the big privatization move in the years ahead, was the expansion of FDI, from USD 11 billion a year in 1992 to 27 billion in 1993 and 40 billion a year in 1996. Faced with competition the performance of several SOEs deteriorated but they continued to borrow heavily from the state owned banks, with little regard to the credit worthiness of their projects or to the rate of return they would generate; inflation escalated yet one more time; even though the interest rates were raised, the real rates remained negative. Against the backdrop of these developments the central bank resorted to credit control from the banks in the form of credit quotas, however this measure made the problem even worse by making the SOEs default on their payments to other SOEs.

Perhaps in view of these challenges, at the end of 1993 the Chinese communist party adopted the following reform priorities in the third plenary session of the 14<sup>th</sup> Congress: SOEs would be transformed in to modern enterprises and ownership would be diversified; a competitive market would be created for state and non state enterprises; and the social security system would be reformed. It was also clarified that corporatization would be the favored method of enterprise reform; state ownership would be maintained in key industry and infrastructure sectors; various different forms of ownership would be encouraged; and the bigger enterprises would be held on to and the smaller ones would be allowed to go. These objectives were reaffirmed in the 15<sup>th</sup> Congress in 1997.<sup>9</sup> In 1995 the central government formalized the privatization through the policy of Zhuada Fangxiao (keep the large and let the small go). The term Gaizi also came to be used at this time. In 1999, NPC (National People Congress) changed the constitution to endorse these decisions.

In subsequent years the ownership transformation was clearly based on these priorities. The privatization phase of the SOE reforms can be said to have started in early-mid 1990s. In this phase, the reforms were extended to allow for privatization of the small and medium enterprises. The privatization first started at the local level and with the privatization of the TVEs and in the rural areas.

**Table 1: Evolution of the State Owned Enterprises**

	1978	1990	1998	2004
Number of enterprises	30,000 large and medium enterprises	150,000 small enterprises	114,000 in 1996	34,000 in 2003
Output produced (% of GDP)			41 percent	33 percent in 2003
Output produced (% of industrial output)	80 percent in SOEs and 20 percent in collective enterprises	55 percent in SOEs, 20 percent in collectively owned; and 5 percent each in privately owned and foreign invested		30 percent in foreign funded enterprises in 2001

Source: Garnaut et al (2005), Yusuf et al (2006) and other sources.

Initially gaizhi was tried as a “bottom up” approach in which localities were encouraged to reform the SOEs while no official announcements were made in support of the SOE reforms. The ownership transfers were initially carried out through the transfer of ownership to the employees. However, limitations of this approach became evident soon. Subsequent reforms in this phase allowed for enterprises to operate under several different ownership modes, including joint ventures, or enterprises fully owned by individuals or collectives; and foreign owned enterprises. Simultaneously, the larger enterprises were encouraged to form business groups in order to gain from the economies of scale and to improve performance. Since the early 2000s the ownership change has been extended to medium and large enterprises and a range of restructuring mechanisms are being used including bankruptcies, liquidations, listings, debt for equity swaps, sales to private owners, auctioning of state firms and so on.

Besides the fiscal drain imposed by the SOEs, several external developments—the East Asian crisis, commitment to join the WTO, greater integration with the rest of the world through trade and FDI, - were the triggers for the privatization move in the PRC. The East Asian crisis of 1997-98, though the PRC was not directly affected by it, gave a wake up call to the government to fix the weaker sectors of the economy, namely the SOE sector and the state banks. Despite having transferred the ownership of the SOEs to the provincial and local governments, they continued to face soft budget constraints as the banks were still making loans available to them. Many of these loans were turning in to non-performing loans and eventually resulting in a fiscal bail out, with the magnitudes of these bail outs becoming larger. For example, in 1998 the government reportedly issued 270 billion Yuan worth of special bonds to recapitalize the four largest banks; in 1999 four AMC's were created which purchased 1.4 trillion Yuan in bad loans; in 2003, the official figures for NPLs were 13 percent of the total assets of the 16 major banks.

Having steadily laid down the institutions of a fully market determined economy for almost one and a half decades authorities probably felt more confident about carrying it through and about being able to manage the public opinion on this issue. Perhaps foreseeing the inevitable, extensive ground work was laid down to ease up the cost of transition on labor since the early years of reforms. These were matched by further social security policies, e.g. an unemployment insurance fund was started for laid off workers in 1992. Subsequently it

was superseded by two provisions: one providing unemployment insurance to laid off workers for two years and second an allowance for the xiagang workers. Enterprises set up unemployment centers with the help of the public funds; and a national health insurance system was started (more on these programs in Section 4).

**Table 2: Time Line of SOE Reforms and Related Events**

Year	Policy Change/Outcome
1978	Prices decontrolled; more autonomy to enterprises for choosing their inputs and output mix.
Mid-end 1980s	Incorporation of SOEs allowed-shares allowed to be exchanged among SOEs and then private shareholding allowed.
1984	Directive to reform the state enterprises through incentive contracts. State council passed regulations for greater autonomy to the state owned industrial enterprises.
Mid 1980s	SOEs could hire new workers on a contractual basis.
1988	State owned enterprise law was brought in which sought to reform the state enterprises through incentive contracts, and later allowed for leasing arrangements.
1984-1989	Rapid rise of the Town and Village Enterprises (TVEs)
Late 1980s	Leasing of small SOEs, privatization of TVEs
1990-91	Shenzhen and Shangahi stock exchanges opened, and now shares could be issued to the public.
1992	Privatization started at the local level because of the debt build up of the SOEs.
1993	The Chinese communist party adopted the following reform priorities in the third plenary session of the 14 <sup>th</sup> Congress: SOEs would be transformed in to modern enterprises and ownership would be diversified; a competitive market would be created for state and non state enterprises; and the social security system would be reformed.
1995	The central government formalized the privatization policy through the policy of Zhuada Fangxiao--keep the large and let the small go. The term Gaizhi came to be used at this time. The state decided to keep 500-1000 large enterprises (the top 500 enterprises with central government held 37 percent of the state industrial assets and earned 63 percent of the profits of the state sector).
1997	Objectives of the 14 <sup>th</sup> NPC meetings were reaffirmed in the 15 <sup>th</sup> Congress in 1997.
1998	Gaizhi term brought in the cities. The gaizhi was done in two ways: first, the employee shareholding was promoted, and thereafter concentrated ownership through management buyout was given prominence.
1999	NPC (National People Congress) changed the constitution to endorse the decisions taken in the 14 <sup>th</sup> and 15 <sup>th</sup> Congress.
1996-2001	50,000 small and medium size SOEs were restructured through a variety of means: public offering, employee buyouts, open sales, leasing, joint ventures, bankruptcy etc.
2002	Employee buyouts however resulted in disappointing outcomes: unprofessional management, bureaucrats were still able to milk the enterprises, poor governance by the board of directors who were still selected by the government representatives. Hence these continued to perform poorly and were unable to service their bank loans.
2003	SASAC (State owned assets supervision and administration commission) established to regulate and manage state assets and further restructuring and privatization of these assets.

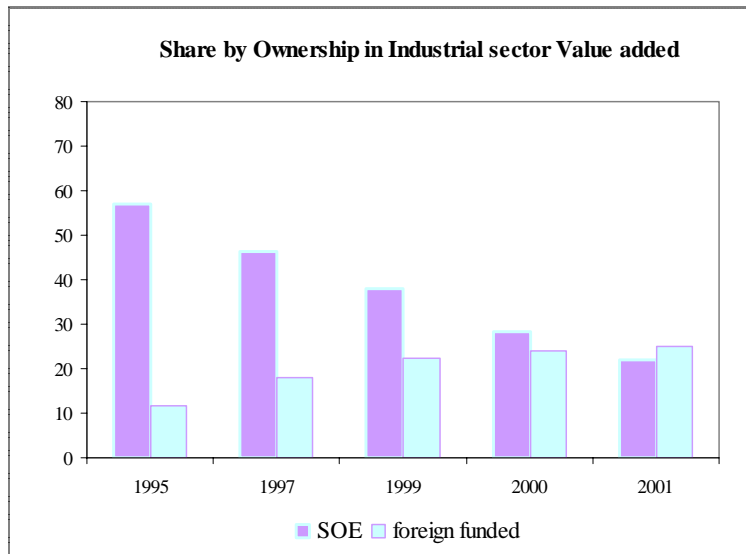
Source: Garnaut et al (2005), Yusuf et al (2006), various other sources.

Thus to summarize, while explicit reforms slowed down in this decade, even as the performance of the TVEs and SOEs deteriorated, but important ground work was laid down to set the stage for a more market based economy in the years ahead. The major efforts included freeing up the prices, initiating necessary labor reforms, setting up and reforming the social security system, building the necessary political consensus by reaffirming these reform priorities as well as by bringing in the required constitutional amendments.

#### 2.4. Ownership Reforms since mid 1990s

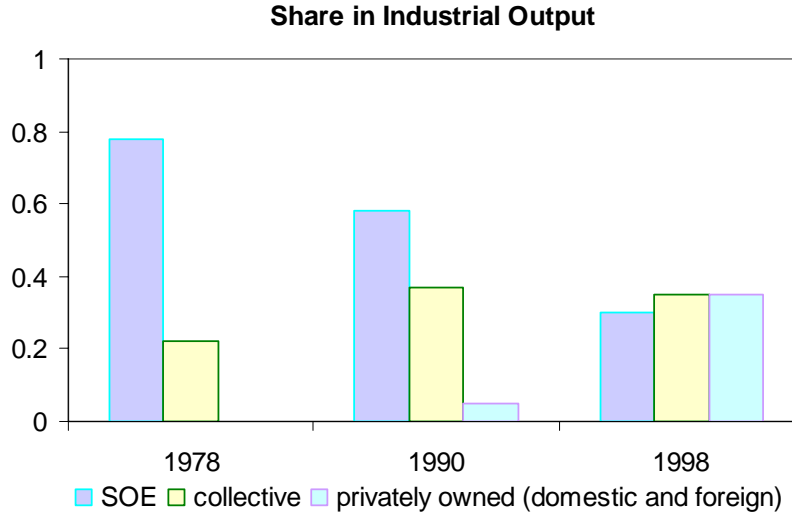
In the phase of accelerated restructuring since mid 1990s the share of SOEs in industrial activity declined from about 60 percent in 1995 to about 22 percent in 2001, see Figure 1. As Figure 1 shows the rise of the foreign funded enterprises has been equally impressive during this period, and in 2001 these overtook the SOEs in terms of contribution to industrial activity.

**Figure 1: Share by Ownership in Industrial Sector Value Added**



Source: Brooks and Tao, 2003.

Figure 2 shows the share of SOEs, collective enterprises and private sector enterprises (both domestic and foreign) in industrial output. From being owned completely by the SOEs and collectives in 1978, the sector has seen an increase in the share of collectives (on account of the increase in TVEs in 1980s); by a decline in the share of SOEs, which is also partly picked up by the private sector. By 1998, the share of private sector had increased to almost one-third. Commensurate with this was the decline in the number of employees working in the SOEs. In 2001 SOEs accounted for only 1/3<sup>rd</sup> of the workers in the industrial sector, compared to 2/3<sup>rd</sup> in 1995, Figure 3. The number of employees in the SOEs, almost halved from 110 million in 1995 to about 62 million in 2001, and remained at that level through 2005 (more on the restructuring of labor in section 4).

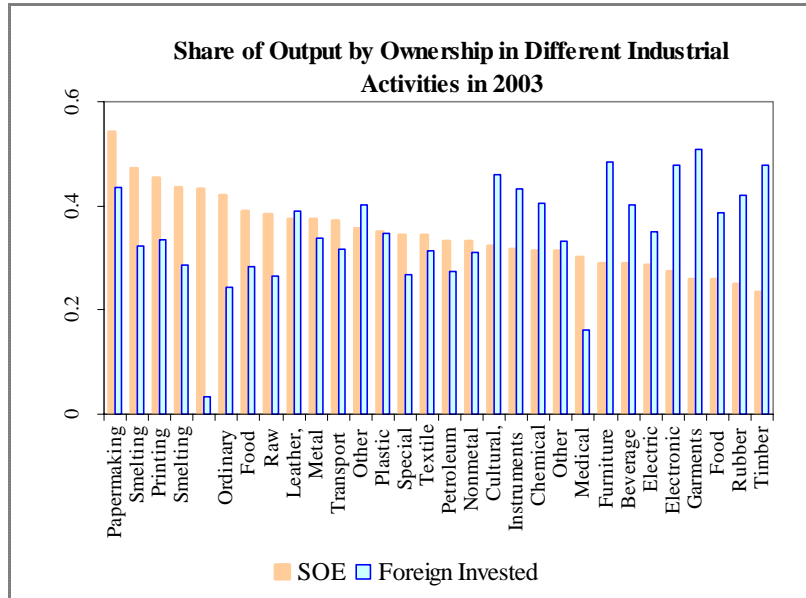
**Figure 2: Share of Various Types of Enterprises in Industrial Output****Figure 3: Share by Ownership in Industrial Employment**

Source: Brooks and Tao, 2003.

The trend in ownership change has continued in the 2000s and the more recent data shows that the ownership of SOEs has been diffused further through sales of smaller enterprises and encouraging these to be replaced by joint ventures and wholly privately owned enterprises. The current ownership structure is quite diverse in the PRC and comprises of enterprises under many different forms of ownerships: state owned, joint ventures, partnerships, wholly owned, and foreign enterprises.<sup>10</sup> The SOE reforms have mostly focused on the secondary sector, but within the secondary sector, at least at a two digit classification level, reforms seem to have extended uniformly to various activities. As Figure 4 shows the share of SOEs in various industrial activities had come down to about 25-50 percent by 2003. Unsurprisingly, the decline in the SOEs share seems to have been picked

up by the foreign enterprises which contribute more to the output of several industrial activities than the state owned enterprises.

**Figure 4: Share by Output by Ownership in Different Industrial Activities in 2003**



Source: Girma, Gong and Görg (2006)

In terms of the sectoral or geographical sequencing of reforms, the reforms at the enterprise level were determined by the size of the enterprises and their economic performance.. So the smaller enterprises and the enterprises which were not economically viable were restructured first. The pace differed across provinces, e.g. progress was faster in some provinces such as Shangdong

### 3. MODALITIES OF REFORMS

In this section we discuss the various modalities of SOE reforms, including the forms of Gaizhi, valuation and transfer of assets; and the roles played by the various stakeholders in the process.

#### 3.1. Forms of Gaizhi

There can be several different modes of restructuring and privatization, including public offering, internal restructuring (through incorporation and spinning off), ownership diversification, employee shareholding, open sale, leasing etc. Within privatization alone, the extent of privatization or the way it is conducted (valuation of the enterprise, who all are allowed to participate, and who retains the controlling share) can have important implications for the performance of the enterprise, the social equity issues and for building consensus and the political economy of reforms.

Theoretically speaking, unless the controlling rights are transferred to the private sector the full efficiency gains cannot be realized. Also it seems from the cross country and the PRC specific literature that for social equity it is important that the sale of shares is extended to employees and not just to the managers or the public at large. The empirical evidence also

shows that the largest gains from privatization have been obtained when the valuation and sale has been conducted in a transparent manner; has allowed the general public to participate; and the controlling rights have been transferred to the private sector; who in turn operate in a competitive environment (which often means that the sector is opened up for private entry at the same time that the erstwhile state owned units are privatized).<sup>11</sup>

On the whole it seems that the policy makers in the PRC were fully aware of these considerations and the policies were formulated at different points in time based on these considerations. At the same time since Gaizhi was a decentralized process, there was significant regional variation in the form and outcome of Gaizhi. The exact mode of Gaizhi was based on the local conditions, including the health of the enterprises and the fiscal positions of the local governments. An empirical exercise conducted by the World Bank shows that the regional, governmental factors mattered more for the form of Gaizhi than the firm level characteristics. The stronger the fiscal position of the local government the more likely it was for firms to go through the forms of Gaizhi other than internal restructuring (see Garnaut et al, 2005). Results from a survey conducted by the World Bank show that while in the faster growing regions of South and South West, privatization was the preferred mode; in the lagging North and North West Gaizhi was more about internal restructuring. Restructuring was not a one-off event but involved several rounds of Gaizhi.

The most common form of Gaizhi, especially in initial years (and probably because it encountered less resistance), was **employee shareholding**. Several different modes of employee shareholding were allowed (as a limited liability company, as an employee shareholding cooperative, or as a block share holding company). Employees often used compensations given by the local governments (to compensate them for their removal from the state employee status) to buy the shares of the SOEs. They were also granted flexibility in paying for the shares if they did not have the required funds. However, in subsequent rounds of restructuring the management consolidated their share holdings and there were several cases of management buyouts, many of which were controversial. Hence in more recent years the regulator State-owned Assets Supervision and Administration Commission (SASAC) has discouraged management buyouts.

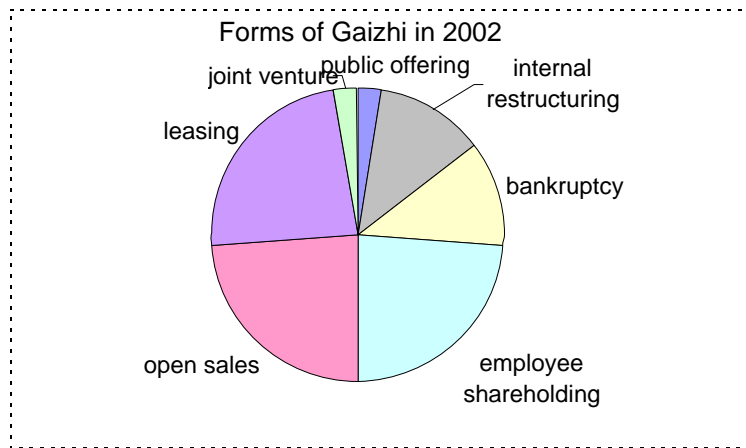
Other popular modes of restructuring were open sales and leasing. Minority stakes were offloaded through IPOs or private offering of equity, though the state remained the majority holder. In more recent years **open sales** have been conducted as well, in some cases joint ventures were formed with domestic private or foreign firms. Often the enterprises were **leased** out to the outsiders or former employees, especially when lessees did not have enough money to buy the firm.

Several enterprises also went through internal restructuring. There were two main forms of **internal restructuring**: incorporation (which became popular after company law came into effect in 1994) and spinning off (which involved splitting the firm in to smaller firms with the old firm being the controlling firm). In many instances, spin offs were used as a measure to separate the assets in to a separate firm, while the liabilities remained with the old firm and these were often defaulted upon.

Finally, after the Bankruptcy law was introduced in 1988, bankruptcy and reorganization was used as a means to restructure SOEs especially in the mid 1990s. It led to an expected abuse of this provision—SOEs would file for bankruptcy to avoid paying their debts and the rules had to be tightened. Debt equity swaps were also introduced in 1999 and four AMC's by the four major state banks were established to settle the NPLs.

There has been a shift in the most popular form of Gaizhi overtime. While earlier bankruptcies and employee shareholding were more important, these have given way to open sales and leasing in early 2000s. Bankruptcies were common in the mid 1990s with the passing of the Bankruptcy law and the provision of central government funds to write off the bank debts of bankrupt SOEs. In late 1990s employee shareholding was more important (1/3 of the Gaizhis in 1999 involved employee shareholding). Since early 2000s open sales, and leasing have become more common forms of Gaizhi. As Figure 5 shows, in 2002 about a quarter each of Gaizhis involved employee shareholding, open sales and leasing; and 10 percent each went through bankruptcy and internal restructuring.

**Figure 5: Forms of Gaizhi in 2002**



Source: Garnaut et al. (2005)

The process of privatization through issues of shares picked up momentum in the 1990s after capital market reforms allowed enterprises the opportunity to get listed on stock exchanges. This actually set in motion the process of Share Issue Privatization (SIP) – a privatization process that is pretty unique to the PRC. In contrast to most other countries, where SIP involves trading of government shares in secondary market with the buying/selling resulting in a change in nature of shareholders, in the PRC government shares in SOEs were not put up for sale. Rather, productive assets and employees of SOEs were pooled into a new shareholding company, which in turn, sold new shares to private investors and retained the proceeds obtained from such sale. As a result, instead of a change in portfolios of shareholders, the equity-base of the company itself enlarged (Jiang et al 2006).

### 3.2. Valuation and Transfer of State Assets

There were several elements of the Gaizhi process which were common across different forms of Gaizhis. These were the valuation and transfer of assets; determination of the net worth of the enterprises; settling the existing debts to the banks or dues to the employees; and granting the land use rights; see Box II for the typical steps in the Gaizhi process. The Gaizhi process entailed several steps: non productive assets were separated and handed over to the local governments along with the employees to manage and turn around. Assets were valued by an asset valuation agency and verified by the local asset management agency and the proposal submitted to the local office of the SOE reform.

The governments set up three funds to help fund the Gaizhi process, in particular of the firms with little or negative net worth: state asset exit funds, SOE bankruptcy provisional funds; funds to assist prepare for enterprise reform. The funding for these funds came from transferring ownership rights, selling and leasing of state assets. These funds provided loans to help meet the cost of deploying labor, or meet the cost of restructuring, especially when the net worth was negative. Richer provinces found it easier to set up these funds, while the poorer regions demanded greater help by the central government.

**Asset Valuation:** The asset valuation industry is nascent in the PRC, having come up into being in the late 1980s. The industry is regulated by the 1991 State Councils Regulation on the Management of State Asset Valuation. There are several methods for valuing business assets: historical cost and realized profits, replacement cost and business income, current cash equivalents and realizable income and discounted cash flows. However, sharp fluctuations in asset prices, underdeveloped capital markets, and insufficient information, often made it difficult to arrive at fair valuations of assets. The approach that is best understood and widely applied is the cost approach. Finally, since the fees of the valuers depend on the valuation and they fear penalty if they undervalue state assets, valuation companies are often believed to be overvaluing the state assets. The foreign investors often complained about the SOEs being overvalued. There is also a concern that vested interests make the valuers undervalue the assets.

#### **BOX 2: A TYPICAL GAIZHI PROPOSAL**

A *gaizhi* proposal usually has the following elements:

1. *A summary of the enterprise*  
Name, sector, affiliation, main product, number of employees (including laid-off workers), occupied land area, asset structures.
2. *Performance*  
Key indicators of performance during the past three years.
3. *Enterprise assets: Current status and proposal for disposal*  
Total assets, debts and net assets (both book value and market or current valuation), proposal for dealing with the net assets and the land.
4. *Redeployment of workers*  
Proposal for redeploying workers, contract for redeploying workers, pension, and medical coverage for retired workers, etc.
5. *Form of gaizhi*  
Form, scope, and content of gaizhi (e.g., governance structure).
6. *Post-gaizhi business operation*
7. *Post-gaizhi development planning and forecast of economic efficiency*  
Investment plan, governance structure, efficiency and risk analysis.

Source: Garnaut et al (2006)

After the valuations the governments are often willing to settle the deals at less than the valuation prices—when e.g. it receives the entire or substantial fraction of the payments upfront; or when the employment is secured post Gaizhi. Moreover smaller firms as well as the firms in which employee shareholding is the mode of Gaizhi often get a discount on the valuation price.

**Debt Obligations:** A typical SOE is highly leveraged and may have obligations in the form of bank debts, unpaid taxes, overdue wages, pensions and social insurance payments. Though the non performing loans to the state banks always existed, they became apparent after the financial system reform of 1992. Banks in general had little leverage in recovering their debts. Some of them tried to freeze deposits of the SOEs who had non performing loans but it resulted in further defaults and the SOEs resorted to cash transactions. While the government cancelled the debts of many larger SOEs the smaller SOEs wanted a similar treatment. As mentioned earlier, enterprises often resorted to spinning off/bankruptcies to avoid paying off their debts.

**Land use rights:** land was earlier owned by the state and SOEs used them free of costs. A Land Law was enacted in 1998 and according to which the land should be used to earn revenues. There can be four ways to allot land use rights—appropriation, leasing, buying or converting land use rights into equity.

### **3.3. Various Stakeholders and the Roles Played by them during Gaizhi**

Obviously there were various stakeholders in the reforms of the SOEs and these often had conflicting objectives. The stakeholders included the central government and its various arms including the state owned banks, who had extended credits to the SOEs and experienced bad debts, were interested in the restructuring and in recovering their dues. The major four banks belonging to the central government were the largest creditors to the SOE sector. The other stakeholders included the Ministry of Finance, who also wanted to minimize the fiscal stress arising from the mounting losses of the SOEs; and the Ministry of Labor who was overseeing the interests of the labor and would have liked to minimize the costs of restructuring on the labor. Then there were the local governments who owned the SOEs and wanted the SOEs to turn around but also wanted to protect the labor.<sup>12</sup> Finally, the employees, managers, creditors, public, outside creditors and investors also had a stake in the process.

While the interests of the local government, banks and the Ministry of Finance aligned on one hand, those of the local government and the Ministry of Labor aligned on the other. Local governments weighted the pros and cons of transforming the SOEs by assessing the burden imposed by the loss making SOEs and comparing them against the privatization receipts adjusted for the cost of restructuring. The public played a passive role in the process partly because they were not informed adequately or ahead of time about this process. The public entered the debate in late 1990s when the sales of a large number of TVEs were made to the management and many of these sales allegedly took place at prices which seemed lower than the valuation of assets.

## **4. LABOR REFORMS AND RESTRUCTURING DURING THE REFORMS**

The labor market in pre SOE reform period was characterized by over staffing in SOEs in the urban areas. There was surplus labor in the rural areas as well in the form of low land-labor ratios. The labor market was characterized by a significant rural-urban segmentation, prohibiting movement of people across rural and urban areas and also effectively within

urban and rural areas. In pre-reform period urban workers in SOEs received greater social and livelihood security. In general employment in SOEs was fully secure and firms had no rights to fire their employees, which in turn resulted in little motivation on part of workers and reflected in low productivity.<sup>13</sup> According to one estimate, about 20-30 percent of the employees in SOEs were redundant prior to the reforms (Yao, 2007).

Labor reforms were an integral part of the enterprise reform throughout. Below we discuss the four aspects of the labor reform process. First softer reforms were initiated in the earlier years of the reforms which tried to increase the absorption of labor in to TVEs as the labor was rendered surplus by productivity enhancement in agriculture.

In the earlier year of the reforms as the TVEs expanded, they absorbed labor from agriculture. The surplus labor was identified (from Fan gang et al). The surplus labor were supposed to leave their jobs and become left-post workers. These workers maintained their relationships with the enterprises but were not employed in the main production lines. They were enrolled in retraining programs; engaged in side-line production; or were on extended unpaid leave. Against this backdrop some of the earlier reforms introduced were, in 1979 bonuses, piece wages introduced in enterprises to improve labor productivity; and simultaneously the government encouraged self employment (see Debroy (2008)). In 1983 a scheme “job holding without pay” was instituted which allowed employees to find and try jobs outside while being on leave with the SOEs for a few years. Several thousand personnel exchanges were set up to facilitate such transfers.

The second aspect of the reforms was the increased flexibility provided to the enterprises to hire labor on more flexible terms and mostly to hire workers as contractuels. This was one of the most important reforms and which impacted urban workers probably more than the rural workers and was really a prerequisite to the deeper reforms in the SOE sector that followed (see Debroy, 2008).

The third aspect of the reform was the far reaching and deep reforms in the social security system. These included the pension benefits, unemployment benefits and health benefits. We discuss these in detail below. Finally, to ease up the transition on laid off workers extensive measures for retraining, reemployment and compensation were used, which we discuss later in this section.

**Social Security System:** Success of the SOE reforms depended on the parallel implementation of reforms in social security system. The three main components of the current social security network are unemployment insurance, medical insurance and pension insurance (Yao and Lai, 2007). Prior to enterprise reforms, the benefits were linked with individual enterprises and the respective enterprises bore the main burden of providing benefits to their employees. Thus if an enterprise closed not only would it put the existing employees out of work but would deprive them and existing retired employees of pensions. Reforms of the social security were aimed at delinking the benefits from state enterprises, and introducing cost sharing between employers, employees and government, and pooling of resources across enterprises within a jurisdiction. As a result, the government decided to revamp the insurance system by passing a series of far-reaching regulations (Yao, 2007).<sup>14</sup> The government went in for a three-tier social security system. The first was to entitle the laid-off workers to receive a living allowance from reemployment service centers for three years. This was to be followed by unemployment insurance for another two years, assuming that the workers remained unemployed at the end of the first three years. Finally, if they still remained unemployed they were allowed to apply for the urban minimum living allowance.

Over time, there have been efforts to consolidate these systems with the new laid-offs now directly obtaining unemployment insurance (Zeng, 2005). However, the social security network is struggling to cope with the problems of limited funding and coverage, as well as irregularities like payment arrears and improper implementation (Zeng, 2005).

The system is mostly confined to urban areas and a significant number of self-employed, private and joint venture companies are not covered. The new regime extends to non-SOE employees also, and aims to include the laid-off and ex-SOE workers as well. There are ongoing attempts to draw the informal sector within the coverage of the system. This has important implications for ex-SOE employees as many of them are currently engaged in community services coming under the purview of informal sector activities.

**Pension reforms:** Pension reforms started as early as in 1978, were aimed at extending the coverage of the pension system to the non state sector. In 1986 pension was pooled across enterprises at the municipal level; and were separated for contractual workers and regular workers. Unlike in the past when SOEs had the entire responsibility of providing social security to employees, the current unemployment insurance for urban employees is financed, apart from enterprises, by the employees themselves, insurance interest and government subsidies. In 1991 state council introduced universal pooling of pension insurance. In 1995 there was a transition from Pay as You Earn to partial accumulation of funds and the concept of individual contributions for pensions was introduced.

The growth of the current system was facilitated by a State Council circular passed in 1998 that provided for pooling of pensions at provincial levels (Garnaut et al 2005). The present pensions combine defined benefits and contributions, with individuals also assuming responsibility of determining pensions through their contributed premiums.

**Health and unemployment:** The medical insurance system has also undergone fundamental changes and has shifted to a combination of social pooling and individual contributions. The principle of social pooling with individual accounts has also been extended to medical insurance. Individuals contribute a part of their medical expenses. A Bylaw passed by the State Council in 1999 entitled urban employees (in SOEs, collectives, foreign funded enterprises and other enterprises) paying unemployment levies for at least a year to be eligible for unemployment insurance. The unemployment insurance funds are vested with a unified management at the municipal level in large cities. The fund not only pays unemployment benefits, but also medical costs of unemployed workers for a maximum of 24 months.

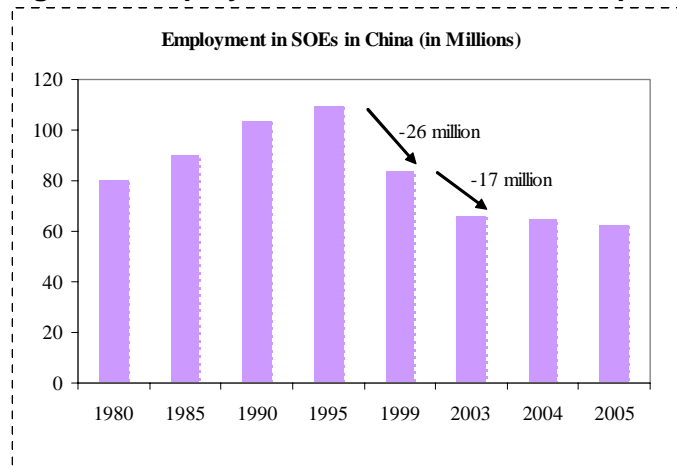
Similar to the bylaw on unemployment insurance, another bylaw passed by the State Council in 1999 entitles urban residents to a minimum living standard that varies according to local costs. Residents with family incomes lower than the minimum standard are entitled to be compensated by the Government. This has come into force in 30 out of 31 Chinese provinces (Garnaut et al 2005). This measure, in addition to unemployment insurance, has helped the laid-off workers, particularly those who have found it difficult to get jobs following restructuring. There was significant increase in the central government expenditure on social security in recent years from 1 percent in 1997 to 6.3 percent in 2002.

Finally, while the social security reforms did cushion the labor from the effects of retrenchment and set the stage for wider reforms, some proactive measures were used when the retrenchment of labor occurred. As Chart 7 shows, the reforms resulted in employment in SOEs declining by 27 million workers between 1995 and 1999 and by another 17 million workers between 1999 and 2003.

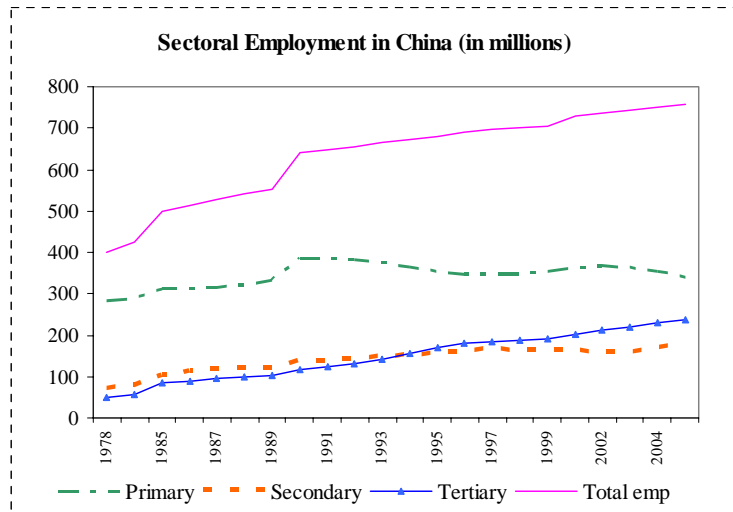
The impact on labor was handled quite impressively. While understandably, with the change in ownership, there are fewer people working in the SOEs, there does not seem to be a large overall impact on employment.<sup>15</sup> We do not observe a decline in overall employment or a decline in the industrial sector employment during this period. To a large extent it seems that the workers were re-employed in the restructured entities or elsewhere and therefore the total employment or the employment in the secondary sector was not impacted, see Figures 7 and 8 below. It also seems that some re-employment has probably been to the tertiary sector, since the share of employment in secondary sector has been stagnant, while that in the tertiary sector has increased.

Given the significant socio-political repercussions which job losses were likely to generate, the government undertook several measures to ensure that the transitions occurred as smoothly as possible. To safeguard the interests of the employees the central government required that every gaizhi plan be approved by a conference of the employees. Restructuring plans had to be approved by employees before they could be accepted. The governments stipulated that the departments in charge of SOEs, departments for labor administration and the trade unions have obligations to help SOEs redeploy their excess workers. In 2003 SASAC issued the guidelines that a restructuring plan concerning the resettlement of employees be approved by the employee representatives, A security fund was set up in 1993 to help employees who lost their state jobs. The fund was later replaced by two allowances: unemployment insurances (to benefit the unemployed state and non state employees) and to provide allowances to xiangang. While there was some regional variation on these policies but on the whole these were similar.

**Figure 7: Employment in State Owned Enterprises in the PRC**



Source: Constructed by Authors' using several different editions of Chinese Statistical year Books

**Figure 8: Total and Sectoral Employment in the PRC**

Source: Constructed by Authors' using several different editions of Chinese Statistical year Books

The Supreme Court also required the settlement of labor claims to be the first priority during gaizhi/bankruptcy. Workers were often also given a compensation for losing the status of state employees, usually in the form of the shares of the gaizhied enterprise, even if they retained their jobs. Furthermore, displacement of labor was accompanied by simultaneous programs of retraining to ensure that the laid-off employees get the opportunities of developing better capacities. These programs began from 1994 and were expanded in scope from the late 1990s.

According to one estimate, while 30 million workers were laid off since 1998, about 8.7 million could not find a job. There was some labor dispute and social unrest but these costs/labor unrests have been muted because the workers were mentally prepared; the social security system cushioned the effects on them; and the private sector absorbed many of the workers.

One of the consequences of employee conferences playing active roles in the reform agenda was to push those restructuring plans where employee interests were more secure post-restructuring, e.g. the restructuring plans with employee shareholding. Employee's involvement was crucial in minimizing discontent and resistance to privatization. The prospect of becoming shareholders not only indicated a larger say in the running of the companies post-restructuring, but also the possibility of earning profits over and above wages.

**Retraining and Reemployment Centers:** As mentioned earlier, the restructuring of SOEs and the concomitant displacement of workers was accompanied by extensive re-training arrangements. As SOE reforms gained pace from the mid-1990s, the laid off workers were provided a safety net under a re-employment program (*xiagang*). Each SOE had to set up a reemployment center to take unemployed and *xiagang* workers. Under this program the employees could register with the Reemployment Centers where they could stay until they found a job for up to three years without being paid formal salaries. The centers provided retraining, job search assistance and unemployment benefits. The latter was a monthly

remuneration lower than the wages, which the employees used to earn earlier. Each SOE was required to consult with the employee representative committee at least 15 days before employees were made redundant. Xiagang workers had to sign a contract with the center to receive a living allowance for the next 2-3 years or until reemployed. They became officially unemployed after that and received unemployment insurance for two years and after that minimum living allowance.

### **Box III: Labour Restructuring**

1979: Bonuses, piece wages introduced in enterprises to improve labor productivity

1980: A formal government regulation was announced which encouraged self employment

1983: A scheme "job holding without pay" was instituted which allowed employees to find and try jobs outside while being on leave with the SOEs for a few years. Several thousand personnel exchanges set up to facilitate such transfers.

1985: SOEs in principle were allowed to hire and fire

1985: Contract labor allowed.

1993: Security fund set up for covering employees displaced from the SOEs. Fund also covered employees whose employment contracts were terminated, or were dismissed.

1993: Government stipulates that departments in charge of SOEs, labor administrations and trade unions must be proactive in redeploying excess workers of SOEs.

1994: First pilot 're-employment' project for helping displaced SOE workers launched by the Ministry of Labour and Social Security (MOLSS) in 30 municipalities. The project was later expanded to 200 cities (Zeng, 2005).

Mid-1990s: SOEs gained the right to lay off permanent workers. Employees could no longer have lifetime tenures with SOEs.

1995: Labor Law which made contract labor mandatory in all industrial enterprises including TVEs.

1998- 2002: Around 25 million SOE and Collective Employees laid-off as part of the *xiagang*. Laid-off workers could move into re-employment centers and be there for 3 years till they found an alternative occupation. After three years, however, the enterprise could sever links with the employee if the latter hadn't been able to find a job. (Brooks and Tao, 2003).<sup>16</sup>

1998 : A new reemployment project – 'Ten Million in Three Years' – launched by the MOLSS for re-employment training and job counseling for 10 million laid-off workers during 1998-2000.

2001: A second round of 'Ten Million in Three Years' launched for taking care of laid-off workers during the period 2001-2003

Source: Garnaut et al (2005) and Yusuf et al (2006) and various other sources.

Between 1998 and 2001 about 13 million *xiagang* and unemployed workers found jobs through the centers. The benefits from these programs were mixed. While a large proportion of displaced workers are reported to have found new jobs; some results, based on a survey reported in Appleton et al 2002, show that middle-aged workers often with lower skill and education levels, and women, were less likely to find a job. The success of retraining programs varied widely between provinces.<sup>17</sup> Generally, the longer-duration programs were found to have yielded better results, along with the ones where the training costs were partly borne by the trainees (Zeng, 2005).

From a level of about 9.5 million at end-1999, the number of workers at reemployment centers dropped to about 6.4 million by end-2002. While some of this reduction was certainly on account of workers getting new jobs, the rest might have become registered unemployed or simply withdrawn from the workforce (Brooks and Tao, 2003).

The reemployment centers were financially supported by both Central and provincial governments. The financial requirements of the centers were estimated through a carefully crafted 'bottom-up' approach. Provincial labor bureaus made the initial financial assessments depending upon the volume of lay-offs and training requirements in their territories. These requests were forwarded to the Ministry of Finance at the Centre, which, after satisfying itself regarding the justification for funds, included the outlay in its budget and transferred the same to the local finance departments. The latter forwarded the funds to the provincial labor bureaus, which, in turn, passed it on to different SOEs.<sup>18</sup>

On their part the SOEs were required to report at the end of every financial year the number of workers trained, the nature of training provided and the number of workers who got reemployed. During the period 1998 – 2003, the Central government's total expenditure on training was estimated at around 40 billion Yuan.<sup>19</sup> The authorities also took the help of UN organizations like the ILO in developing training modules.<sup>20</sup> The ILO collaborated with the Ministry of Labor and Social Security (MOLSS) for designing the retraining and job creation schemes, including those for the *xiagang* workers (Brooks and Tao, 2003). These centers were closed down in 2005, and the *xiagang* workers have been moved to regular unemployment rolls.

To summarize: the labor reforms started around the same time as the other reforms. Reforms were more subtle first, and mostly confined to identifying surplus labor, and encouraging self employment. Then contractual labor was allowed and greater flexibility in hiring and firing labor was given to the enterprises. Large scale layoffs occurred from mid 1990s onwards. Efforts were made to minimize the impact on labor through extensive reforms in the social security system; retraining and reemployment efforts; through negotiations with the new owners; by compensating the workers and by paying their arrears. Thus, while overall labor was impacted the effects were largely contained. However, despite these efforts to make the adjustment process rather smooth, there was some evidence of discontent among workers. The increase in unemployment rate during 1995-2002 precipitated some labor unrest and reflected in the increase in the number of labor disputes.<sup>21</sup>

**Fiscal costs and the effects on financial sector:** Our reading of the literature indicates that the SOE reforms were fiscally neutral. In most cases and on average the privatization receipts, leasing receipts and the proceeds from the sale of land use rights were sufficient to fund the transformation, especially the repayment to labor. The implications for the financial sector are probably not as neutral. Since the state owned banks were the main source of credit to the SOEs, their portfolios would be affected closely by the health of the SOEs. In general the SOEs faced soft budgets as they could borrow from the state owned banks. This

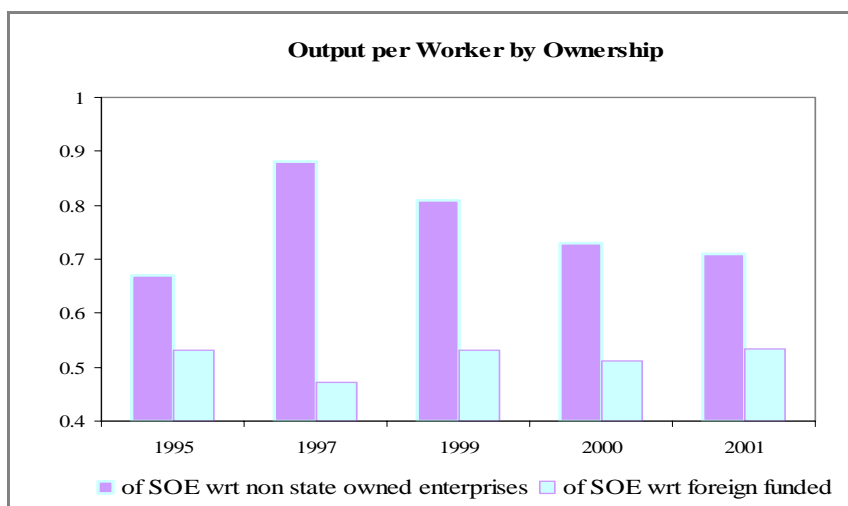
was true even during the early years of reforms and when the SOEs were semi privatized. Thus when the profitability of the SOEs decreased, it affected the banks which were more true during the reform process. The SOEs would treat the amount owed to the banks as the amounts owed to the government and these would be given the least priority for repayments; with the claims of the employees, outside creditors getting priority for repayment. In addition, enterprises often filed for bankruptcies or spun off assets to avoid paying their dues to banks and other creditors. Hence the NPLs of banks increased during the restructuring, even as the four major banks created asset management companies to recover some of their bad debts.

## 5. ECONOMIC GAINS FROM THE SOE REFORMS

Given the multitude of reforms that have been implemented in the PRC since 1978, it is perhaps not easy to isolate the effects that can be attributed to the reforms and privatization of the SOEs. However invoking the existing literature on this issue we can look at the effects of Gaizhi at two levels. First, at the macro level, one can compare the performance of the SOEs with that of the privately owned enterprises. Second, one can compare the performance of the same enterprise pre and post Gaizi. In the latter, one can also relate the improvement in performance to the specific kind of ownership structure. Both kinds of evidence suggest that the effects of economic reforms on Chinese economy have been extensive and wide ranging.

In terms of output per worker foreign owned enterprises in the PRC are the most productive, followed by the private owned enterprises; the state owned enterprises being the least productive. Figure 9 shows the output per worker in SOEs as a ratio of the output per worker in non state owned enterprises (including both domestic private and foreign funded enterprises) as well as a ratio of output per worker in foreign funded enterprises. As is clear from the chart output per worker in SOEs is significantly below that in privately owned enterprises; and is even lower and of the order of 50 percent the output per worker in foreign owned enterprises. Thus an ownership transfer to the private domestic and foreign investors has resulted in an increase in the overall productivity of the economy.

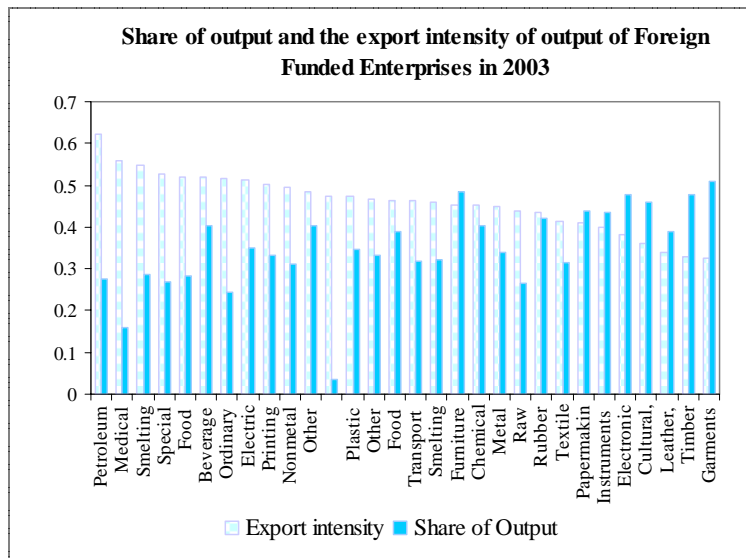
**Figure 9: Output per Worker by Ownership**



Source: Brooks and Tao, 2003.

Exports have played an important role in the economic prosperity of the Chinese economy; and the ownership transformation has been instrumental in the export performance of the enterprises. It is the privately owned firms who have been most efficient domestically and hence competitive abroad and have engaged in exports. In Chart 10 we look at the export intensity of foreign funded firms across different industrial sectors. The data used in this chart has been drawn from Girma, Gong and Görg (2006). The chart shows that the foreign enterprises in general export a large percentage of their output.

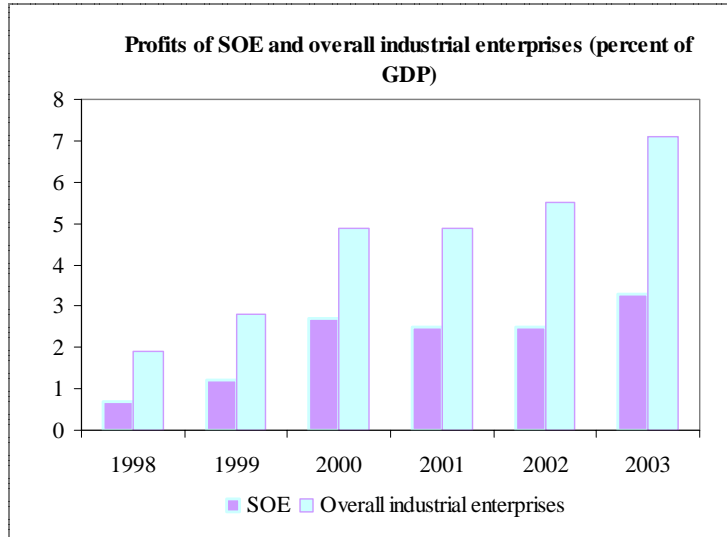
**Figure 10: Share of Output and the Export Intensity of Foreign Enterprises in 2003**



Source: Girma, Gong and Görg (2006)

With the SOEs going through Gaizhi the profitability of the remaining SOEs has improved significantly in recent years, e.g. profits of industrial SOEs has increased from 0.7 percent of GDP in 1998 to 3.3 percent of GDP in 2003, though it remains substantially below the profits earned by non state owned enterprises. Overall the SOEs have become profitable over time and are now in a position to distribute profits. Existing evidence shows that the non-state owned enterprises are more efficient, innovate more and spend more on the Research and Development than the firms owned by the state.<sup>22</sup>

The performance of enterprises is also seen to depend on the different forms of Gaizhi. Evidence from a survey of about 700 gaizhi firms conducted by the World Bank finds that there are interesting differences among different gaizhi firms based on the mode of restructuring. The results show that the firms which were restructured through public offering or employee shareholding performed better than the firms which were internally restructured. In fact in this survey the post gaizhi performance, different mechanisms to restructure rank as follow (from worse to best): internal restructuring; management buyout; employee buyout; public offering; and foreign ownership.

**Figure 11: Profits of the Industrial Sector and SOEs (as percent of GDP)**

Interestingly, Gaizhi resulted in a reduction in the number of managers and the reorganization of the board of directors. In a World Bank's survey data almost 1/3 of the managers were laid off, equivalent to the proportion of labor that was laid off. Gaizhi firms invested more than the non Gaizhi firms in new equipment and new technology. The results are much less clearer on other performance indicators of the gaizhi and non gaizhi firms and different kinds of gaizhi firms, such as tax overdue, social security overdue and bad loans overdue.

There have been debates over the impact of share issue privatization (SIP) on profitability. The evidence in this regard is mixed. Sun and Tong (2003) and Wang et al (2004) argue that such privatization did not improve profitability and led to sharper declines in return on sales (ROS) for enterprises having undergone SIP. Jiang et al (2006), however, after adopting a match sample approach for SOEs having undergone SIPs and for those that have not, find that SIP has positively impacted profitability. Given that SOE reforms in the PRC are now trying to cope with the emerging challenges of corporate governance, more research is required on the broader impacts of the SIP process.

## **6. ONGOING REFORMS, REMAINING CHALLENGES AND LESSONS FOR OTHER COUNTRIES IN TRANSITION**

While there is near unanimity in the view that gaizhi has been an overwhelming success in transforming a huge and scattered state owned enterprise sector in the PRC, however there have been some features of the process, and some cases of ownership transfers, in which irregularities have been reported. In hindsight it would be useful to draw lessons from those aspects of gaizhi as well which have been deemed successful and the aspects in which things could have been done differently. Going forward the challenges seem to be in improving the corporate governance and building the institutions necessary to support a modern system of corporate governance in the PRC.

## 6.1. Expost Problems and Challenges in Gaizhi

**Valuation of SOEs:** The main areas of concerns in the gaizhi process have been on the valuation of the SOEs: whether the valuations were fair and aimed at maximizing the returns to the government, or were the assets stripped at less than the market value; was there sufficient transparency in the process of ownership transfer; these concerns have been particularly serious in the cases where the firms were bought by the managements as the potential conflict of interest is likely to be much more serious in the management buyouts. In addition concerns have also been raised on the corporate governance practices in the remaining SOEs and the restructured SOEs with the majority stake of the government; and on the contribution that the private sector is making to the society, i.e. rather than just engaging in profit maximizing activities which probably results in increasing inequalities and other social and environmental costs to the society.

To look in to these concerns and to guide and regulate the further restructuring, a state owned assets supervision and administration commission (SASAC) was established in 2003. It brought together the various functions performed by other ministries relating to the SOEs. SASAC acts as a regulator and supervisor of the state assets and oversees the various aspects of transformation or privatization of the remaining SOEs.

To address the concerns that the valuation has not been fair in the case of some of the ownership transfers; it has been decided that the cases where the transfer has taken place at a value less than 90 percent of the appraisal value would be scrutinized. To avoid the potential conflicts of interest MBO will be discouraged and the MBOs would not be allowed for the larger state enterprises. In the existing SOEs and the restructured SOEs with the majority share controlled by the government, appointment of managers continues to be a political process. However not only is this against the modern corporate governance practices, but also affects the overall efficiency and working of the enterprises. At the minimum the government should recommend the managers to the Board of governors, and not appoint them.

It has been felt that the ownership structure should be diverse and mixed, and where possible the outside investors should be encouraged. A diverse mix of owners promotes natural checks and balances in the enterprises and brings diverse expertise on board. Another way of enhancing the checks and balances can be through better defined creditor's rights. So that the main creditors can monitor the decisions of the enterprises and ensure that these are commercially sound so that the value of their credit is intact. Also more disclosure and availability of information, so that monitoring of the process takes place by the public at large. In that context at the local government level considerable advances have been made.

**Corporate Governance:** The main elements of a modern corporate system include: private ownership and a competitive market environment; a mix of large firms and SMEs (small and medium firms) with churning taking place in the latter through entry and exit; corporate governance institutions that encourage managerial initiatives and reduce agency problems; competition policy and a system that encourages innovation.

In particular the various aspects of corporate governance are: (i) Rights of the minority shareholders. (ii) Appointment of managers and board of directors based on merit. (iii) Separation of management and board of directors. (iv) An independent and efficient judiciary. (v) Bankruptcy laws; the take-over rules, disclosure requirements. These will go a

long way in helping the PRC achieve a mixed enterprise structure which has diverse ownership, is of the scale comparable to the more developed economies and is geared towards maximizing the shareholders value and impart gains to the society at large. According to Clarke (2003) a fundamental dilemma in Chinese Corporate Governance laws stems from the state policy of maintaining controlling ownership in enterprises in several sectors. On one hand the state wants these enterprises to run efficiently, and on the other hand it maintains objectives other than maximizing the wealth of the shareholders, such as maintaining employment levels, direct control over sensitive industries etc.

During the reforms of the SOEs the government retained ownership of some of the larger SOEs. It listed about 1200 SOEs on the two stock exchanges as Limited Liability Companies or the Limited Liability Share Companies (LLC and LLSC respectively). The corporate governance problems in the PRC pertain to these SOEs as well as to private shareholding companies.

The idea behind listing the larger SOEs was to separate the management and operations from the government and to increase efficiency. In practice, however, in the listed SOEs the government retains the controlling share, thus the market induced discipline does not exist and corporate governance is not taking hold. Even though ownership has been partially privatized the management has either not been replaced or even if replaced has continued to be political appointed. Minority shareholders have not been granted any control rights, their only right being limited to receiving dividends when distributed. The minority shareholders cannot file suits and cannot expect to win; they have no effective rights to elect the board of directors. According to one discussant of this report, since SOES continue to serve political purposes, further reforms will be limited in the SOEs.

Bankruptcy, mergers and acquisitions and minority shareholders rights are some of the areas of corporate governance where institutions and regulators are needed for the functioning of the market economy. In the PRC these functions are performed by the Executive branch of the government and thus are usually discretionary. Though there is in principle a bankruptcy law and in the second half of the 1990s several thousand of state enterprises were declared bankrupt, but these were decided by the government ministries often first trying that a healthy enterprise absorbs a poor performing company.

**SOE Dividends:** Another issue which is being debated in the PRC is that of dividend payments by the SOES. Apparently SOEs have not paid any significant dividend to the government despite having earned substantial profits in the last few years. According to one estimate (World Bank 2005) the profits made by SOES amounted to 6.5 percent of GDP in 2003, equivalent to 35 percent of fiscal revenue. There are several issues related to dividend sharing between the SOEs and the government: (i) Who should receive the dividend: the ministry of finance, or the SASAC or some other government agency? Currently no government agency receives dividends on a regular basis. (ii) How much dividend should be paid: the division of the dividends earned between retained earnings and the dividends paid out. While the former finances the investment of the company, the latter help finance general government expenditure and help encourage consumption.

Currently there is no uniform policy on dividend payouts. Often since the better performing, profit earning firms are spin offs from the existing SOES, they pay dividends to parent companies who retain and use it for intra group activities.

There is near unanimity among the observers and academics that since the government bore the restructuring costs and is ultimately the owner of the SOEs it should share the

profits too. The issue of dividend payouts is also related to corporate governance issues. While the retained earnings may make into investments, they are not subject to the scrutiny of the markets to the same extent as the investments raised through the markets would be. Hence a larger dividend payout to the government or the public would result in greater consumption and would also reduce the discretionary spending by the managers and increase shareholders wealth.

One of the key challenges facing SOE reforms in the PRC pertain to reforms of state-owned banks. Four major banks accounting for almost three-fifths of the total assets of the banking system - the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the Agricultural Bank of China (ABC) and the China Construction Bank (CCB) – have been identified for reforms. Apart from recapitalization, the ongoing reforms also focus on changing the legal structure and improving corporate governance standards by bringing in strategic investors. The early progress has been reasonably encouraging though more needs to be done for increasing operational efficiency and commercial orientation (Podpiera 2006).

## **6.2. Comparison with the East European countries**

What makes the Chinese experience different from that of the Soviet economy and East Europe? In terms of the outcome the Chinese transformation of the economy from a predominantly state owned to privately owned was much smoother and yielded greater benefits. The Chinese system for one was much more gradual and rather than relying on a big bang privatization, first experimented with the management based transformation and also with the transformation of smaller enterprises. Also the reform program's sequencing was probably different. Rather than starting with the ownership transformation they first freed up FDI and set up the SEZs.

Transition economies in East Europe used a variety of schemes for privatization, which have been put together in two categories by Yusuf et al (2006): non equivalent privatization which involved a quick ownership sale to citizens or employees. It was broadly deemed iniquitous as only the few people with resources could participate in it; and equivalent privatization, which involved getting the enterprises valued first and then sold partially to employees, public and the balance left with the government,. Theoretically this method was preferred over the non equivalent method as it allowed broader sections of the society to participate and was deemed to be a fair process.

The pace of privatization differed across countries. What should be the pace of privatization? On this the views of the academics differ. One view favors a fast pace as it does not give enough time for the resistance forces to be mobilized. While the slow pace often makes the process difficult as the vested interests get time to become stronger and they may either succeed in blocking it or try to do it in a way which favors them. The other view suggests that the pace of reforms should be commensurate with the private sector's ability to absorb the laid off workers; with the capacity to expand the social safety net; and with the availability of managers. According to this view a rapid privatization in the earlier stages of transition may imply that only a few private individuals would have the necessary resources to bid for these; and thus result in inequalities (this is what happened in some of the eastern European countries) while the slow pace provides information on the SOEs to the prospective buyers and so on.

Judged by these parameters the pace of Chinese reforms speed seems to be right—neither too fast, as in some of the Eastern European countries, nor too slow (though some observers think that it could have been and needs to be faster).

Another view is that rather than the pace it is the sequencing which matters for the success of the program and explains why the PRC succeeded better than many east European countries. An important building block in the success of the SOE reforms is the creation of market friendly institutions and the developments of market mechanisms. The PRC, even though needs to make a lot of progress to take the institutions and market to the levels of the developed countries, was far ahead of the East European countries on eve of the privatization—e.g prices were determined by the markets, the economy was opened significantly to trade and FDI and thus subject to competition; and the SOEs had started facing somewhat harder budget constraints and so on. In fact to some extent the privatization and the institution building happens simultaneously. In general as the Chinese experience shows institution building is endogenous to reforms.

In terms of sequencing both East European countries and the PRC have found it easier to privatize smaller retail and manufacturing enterprises because it is politically less sensitive, buyers can be readily found and the adjustment is easier.

### **6.3. Public Ownership of Industry and Privatization in India**

The presence of public sector in Indian manufacturing is rather modest when compared with the levels at which the PRC started its restructuring. Also the present structure of the state ownership in Indian industry differs from the ownership structure in the early years of the Chinese reform. In the PRC on the eve of the reforms the industrial sector was either owned by the state or by the collective organizations; industrial activities were conducted in several hundred thousand enterprises of varying sizes; and the ownership of these enterprises was shared between the center and the provincial and local governments. On the other hand the public sector ownership in Indian industry is much more concentrated, is mostly in industries which are capital intensive (heavy industries) and is mostly under the central government.

The central ownership is about 1/3<sup>rd</sup> of the industrial enterprises in India, but this is concentrated in a few hundred enterprises. Because of its earlier industrial policy with emphasis given to heavy industry and preference given to the public sector in these sectors, the public sector's presence is larger in heavy industry. The sectors in which the public sector enterprises exist are mostly monopolies and therefore it is not surprising that many of them are profit making—they seem to be enjoying monopoly rents rather than the profits reflecting productivity. Thus one needs to look beyond just the profitability of these enterprises to decide whether certain sectors or enterprises should be restructured or privatized and what kind of benefits would this yield to the society.

Since the SOEs are owned mostly by the central government; the restructuring and privatization efforts have been carried out by the central government in India. The first efforts were started in the early 1990s through the Ad hoc Sales of Shares. The main objective seemed to be to create fiscal space, rather than the broader objectives of a diverse ownership. This involved selling shares of companies, often as a basket, to the institutional investors; later these sales were also done for shares of individual companies.

In 1992, the government appointed a Committee on Disinvestment of Shares in public service enterprises (PSEs) to formulate a proper policy in this regard. The committee

recommended limiting disinvestment to below 49 percent in industries reserved for public sector (eight industries as per the Industrial Policy in 1991). Sale of shares of SOEs slowed down in mid 1990s to end 1990s and picked up again in early 2000s. During this period “strategic” sales were carried out. The Government established a new Department for Disinvestment to oversee the program. As a matter of policy it was announced that the Government equity in all non-strategic public service units (PSUs) will be reduced to 26 percent or less and the interests of the workers would be protected. The government undertook strategic sales of 13 enterprises, 3 hotels of Hotel Corporation of India and 19 hotels of India Tourism Development Corporation by the end of 2001-02. Altogether, the receipts from disinvestment from 2000-01 to 2003-04 summed to 264 billion Rupees.

Gupta (2005) has looked at the impact of equity sales on several performance indicators including the firm profitability, labor productivity in an econometric assessment of privatization efforts in India. She finds that firms experience a significant increase in profitability, labor productivity, R&D investment and intensity, asset size, and employment after partial privatization. She finds that a 10-percentage point increase in the level of private equity would increase annual sales and profits by about 13 percent and 10 percent, respectively. Gupta’s results also suggest that partial privatization does not cause the government to abandon the political objective of maintaining employment.

Differences in the industrial structure of the public sector enterprises in the PRC and India notwithstanding, there are several interesting lessons that India can learn from the PRC, these are summarized in the next section.

## **7. SUMMARY**

SOE reforms program has been an integral part of the reform program that the PRC undertook. The program has evolved in many stages from relying mostly on enhancing the incentive structure of the managers and greater autonomy to them, to privatization. The transitory costs of the reforms seem to have been well contained, and the massive movement of labor away from state sector to non state sector seems to have been rather smooth. Hence the Chinese experience provides the countries like India a very rich reforms experience to draw from. Useful lessons can be drawn not only from the measures which succeeded but also from the strategies which did not succeed, including the earlier strategy of reforming through incentives to the management and not the ownership change.

### ***Lessons to be learnt from the Chinese experience:***

1. Change in ownership yields efficiency gains and is beneficial for the economy. Larger benefits are reaped if the ownership structure is diverse, as it may provide important checks and balances.
2. The efficiency gains from ownership transformation need not come at the expense of employment losses, especially if product market competition is undertaken at the same time. Thus the overall sequencing of reforms is important for the success of the reforms.
3. Delegating the job of restructuring and privatizing to a more local authority may make the process administratively easier and more successful. The success in pushing through SOE reforms had much to do with delegation of reform initiatives at the provincial/state levels.

4. The pace of SOE reforms in the PRC was gradual in the beginning and then quite rapid from mid 1990s. The approach followed in reforming SOEs was similar to that in other segments of the economy: calibrating the pace of reforms in a gradual and consistent manner. A gradual pace can not only yield benefits, but is also politically and socially more acceptable. Moreover, just like the Chinese started with the privatization of the smaller enterprises and with a few enterprises at first, a pilot program might be useful. In implementing a reform program that involves several sensitivities - like that of restructuring public enterprises - pilots beginning with a select few enterprises in terms of their size, nature of activity and location can produce very useful results for further reforms, as seen from the Chinese experience.

5. It is conceivable to win the support of labor, this is especially easy when the economic conditions are more benign, but also if the employees are engaged in the process. This was done through several specific measures in the PRC, including by making employee conferences key part of the ongoing restructuring negotiations. The transition for labor was made easy by several other specific measures including through retraining and reemployment facilities.

6. For political acceptance, not just the more vital issues but even the smaller ones like how to describe the process, what to call it; the modalities and the labor issues have to be clearly thought out (e.g. the Chinese called the process of privatization, *Gaizhi*; and called the people who were laid off as *xiagang*).

7. SOE restructuring in the PRC was accompanied by a radical restructuring of the social security network. The new network aims to extend to the entire work force in the long run. Since loss of social security for laid-off workers could have been a huge potential source of unrest, the new system had to expand its coverage to include the enlarging group of 'non-state' employees. In the PRC SOE restructuring, particularly displacement of labor, acted as a trigger for reforms in social security, particularly in unemployment, medical and pension insurances.

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## Endnotes:

<sup>1</sup> This study draws on various sources including, the academic research as cited, policy writings, and discussions with Chinese officials. In particular, at places, it draws heavily on Garnaut et al. (2005), and Yusuf et al. (2006).

<sup>2</sup> Since the reforms of SOEs in the PRC have been mostly concentrated in the secondary sector, the focus of our study is on the reforms of SOEs in manufacturing. However some of the lessons that we glean from here are more generic—including the institutional handling of reforms and the issues related to labor.

<sup>3</sup> Collective enterprises were owned by the urban or rural communities depending upon their activities. The community members did not play a role in controlling economic activity of these enterprises and local authorities appointed their managements.

<sup>4</sup> “Notice on Becoming Urban Residents from Rural Areas” was issued by the State Council in 1984. This made it possible for domiciled rural residents to migrate to towns and cities. See Debroy (2008).

<sup>5</sup> Also see Yusuf et. al. (2006)

<sup>6</sup> During this time another approach was tried on a limited scale in which the state enterprises were incorporated as share holding corporations and the shares were held by the employees, other enterprises and state organizations. However it did not have a large impact on the management behavior.

<sup>7</sup> With managerial autonomy agency costs may worsen due to increased discrepancy between control and ownership. Different ways to resolve the ownership costs include: stricter monitoring; appropriate managerial incentives and aligning them with those of the owners.

<sup>9</sup> In a speech around this time President Jiang Zemin said: a socialist state does not need to have the state sector as the predominant actor in the economy to maintain its socialist nature, see Gang et al (1998).

<sup>10</sup> The SOE reforms have not yet extended to the service sector activities in the PRC. There is unanimity among the researchers and policy makers on the need to extend reforms to the state enterprises who provide services, often called the PSUs in the PRC. It seems that the major reforms efforts in the future will probably focus on the state owned service providers. According to a World Bank estimate the PRC has more than one million PSUs, which mainly provide public services and employ around 30 million workers. The services are mostly provided by the state, and the involvement of the private sector in services sector is limited in the PRC.

<sup>11</sup> See Yusuf et al (2005) and Megginson and Netter (2001).

<sup>12</sup> In principle the central government owned the SOEs, but in reality these were owned and controlled by the local governments. The official transfer of ownership was done at the 16<sup>th</sup> NPC.

<sup>13</sup> See Zeng, Z.D., (2005), and Gang et al. (1998)

<sup>14</sup> The State Council promulgated the Decision on Establishment of a Unified Basic Endowment Insurance System for Employees of Enterprises (1997), Decision on Establishment of Basic Medical Insurance System for Urban Employees (1998) and Regulations on Unemployment Insurance (1999).

<sup>15</sup> According to Cai (2002) the fact that the larger enterprises were not restructured/privatized and that the laid off workers in different enterprises may have different objectives, and thus their interests may not align, explains why there was very little combined resistance by workers across enterprises.

<sup>16</sup> Also see Debroy (2008 ) for details on the support provided to *xiagang*.

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<sup>17</sup> In Hunan, 72% of the displaced workers found jobs after retraining, while in Xinjiang the proportion was only 27% (Zeng, 2005).

<sup>18</sup> The reported mechanism is what was explained to the authors by officials from the Ministry of Labor, PRC.

<sup>19</sup> As reported in the meeting of the authors with officers from the Ministry of Labor and other academic experts.

<sup>20</sup> The SIA – Start and Improve Awareness initiative – is an example.

<sup>21</sup> Estimated to have gone up from 4 percent to 7.3 percent during the period (Garnaut et al, 2005)

<sup>22</sup> A comparison of gaizhi and non gaizhi firm is clouded by the fact that there might be selection issues, i.e. selection in to gaizhi/non gaizhi status is likely to be non-random.