



A WORLD BANK COUNTRY STUDY

# China's Management of Enterprise Assets: The State as Shareholder



# China's Management of Enterprise Assets: The State as Shareholder

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*The World Bank  
Washington, D.C.*

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and Development/THE WORLD BANK  
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First printing August 1997

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ISSN: 0253-2123

## **Library of Congress Cataloging-in-Publication Data**

China's management of enterprise assets : the state as shareholder.  
p. cm. — (A World Bank country study)  
Includes bibliographical references.  
ISBN 0-8213-4011-5

1. Government business enterprises—China.
2. Corporations, Government—China.
3. Government ownership—China.
4. Privatization—China.
5. Industrial policy—China.— I. World

Bank. II. Series.  
HD4319.C53 1997  
352.2'66'0951—dc21

97-29483  
CIP

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## Acknowledgments

This report is based on the findings of missions that visited China during 1994/96. The main mission took place in June /July 1996 and was comprised of Harry Broadman—Task Manager (China and Mongolia Department), Stijn Claessens (Office of the East Asia and Pacific Regional Vice President), Dirk Elsen (East Asia and Pacific Division of the Legal Department), Joseph Saba (Private Sector Development Department), Geng Xiao (Consultant—University of Hong Kong) and Xiaoning Gao (Resident Mission in China).

The principal Government interlocutor for the report was the State Commission on Restructuring the Economic System (SCRES); other agencies on the counterpart team included the State Economic and Trade Commission (SETC), the National Administrative Bureau for State-Owned Property (NABSOP), the Ministry of Finance (MOF), the State Administration for Industry and Commerce (SAIC), the State Accounting and Audit Bureau (SAAB), the People's Bank of China (PBC), and the Industrial and Commercial Bank of China (ICBC).

The Bank team members want to express their gratitude for the warm hospitality, earnest cooperation and thoughtful information they received from all Chinese enterprise, bank and government officials. A special appreciation is extended to SCRES: Guo Shuqing, Secretary General; Deng Xianhong, Deputy Director, Comprehensive Department; and Zhang Changyuan, Division Chief, Comprehensive Department.

Comments by Peter Harrold, John Nellis, Professor Gary Jefferson, and by Tamar Manuelyan Atinc, Bonita Brindley, Bert Hofman, Xiaofeng Hua, Kathie Krumm, Anjali Kumar, Natalie Lichtenstein, Morris Mould, Vikram Nehru, Richard Newfarmer, Roy Pepper, Richard Roulier and Mike Walton are gratefully acknowledged.

Meredith Dearborn, assisted by Elizabeth Perez, Kathleen Hall and Joan Grigsby, did the desktop publication of the report.

The principal author is Harry Broadman.

The Division Chief is Klaus Rohland and the Department Director is Nicholas C. Hope.

## Abbreviations and Acronyms Used

AAC	Audit Administration of China
ASC	Accounting Society of China
CPA	Certified Public Accountant
CRS	Contract Responsibility System
DAAA	Department of Administration of Accounting Affairs
FASB	Financial Accounting Standards Bureau
FDS	First Department Store (Group) Company
GDP	Gross Domestic Product
GVIO	Gross Value of Industrial Output
ICBC	Industrial and Commercial Bank of China

LDC	Local Development Company
LLC	Limited Liability Company
LLSC	Limited Liability Shareholding Company
MOF	Ministry of Finance
NABSOP	National Administrative Bureau for State–Owned Property
SAIC	State Asset Investment Company
SAMB	State Asset Management Bureau
SAMC	State Asset Management Committee
SAMO	State Asset Management Office
SAOC	State Asset Operating Company
SOE	State–Owned Enterprise
SSB	State Statistical Bureau
TVE	Township and Village Enterprise

### **Currency Equivalents (as of May 15, 1997)**

Currency	=	Renminbi
Currency Unit	=	Yuan (Y)
\$1.00	=	Y 8.3
Y 1.00	=	\$ 0.12

### **Fiscal Year**

January 1 December 31

### **Abstract**

China has not yet separated government from state–owned enterprises (SOEs); and SOE reforms to date have produced new problems that threaten their objectives. An emerging corporate governance vacuum, tax evasion, decapitalization through wage increases, and the private taking of assets and socialization of liabilities impair performance and threaten the validity of the system. More than marginal adjustments to current policies are necessary. This report argues to extensively diversify ownership, allowing for passive state minority shares; simplify organizational structures and integrate cross–regional and cross–sectoral shareholding; further develop property right/asset exchanges; eliminate policy–induced barriers to entry and exit in inherently competitive sectors; intensify incentives to meet debt–service obligations; create a market for managerial talent; and require independent audits of financial accounts and make them publicly available.

## Executive Summary

China has not yet separated government from state-owned enterprises (SOEs); and SOE reforms to date have produced new problems that threaten their objectives. An emerging corporate governance vacuum, tax evasion, decapitalization through wage increases, and the private taking of assets and socialization of liabilities impair performance and threaten the validity of the system. More than marginal adjustments to current policies are necessary. This report argues to extensively diversify ownership, allowing for passive state minority shares; simplify organizational structures and integrate cross-regional and cross-sectoral shareholding; further develop property right/asset exchanges; eliminate policy-induced barriers to entry and exit in inherently competitive sectors; intensify incentives to meet debt-service obligations; create a market for managerial talent; and require independent audits of financial accounts and make them publicly available.

China's reform of industrial state-owned enterprises (SOEs) seeks to maintain state ownership of the key enterprises and improve their performance by establishing market-oriented incentives. Most other countries in transition have turned to systemic, widespread privatization of SOEs. In China, the State, or its agents, carry out "shareholder" functions performed by private owners in market economic systems.

There have been payoffs to China's strategy. Reforms have boosted SOE total factor productivity growth rates. SOEs remain key drivers of the nation's industrial sector, accounting for one-third of production, over one-half of total assets, two-thirds of urban employment and almost three-quarters of investment. But industrial SOEs profits have declined from 6 percent to below 1 percent of the gross domestic product (GDP) in recent years. Many of them continue to be technologically inefficient, remain obligated to provide "cradle-to-grave" social services to workers and their families, and carry a rising proportion of redundant employees and retirees on their payrolls. The result is that an increasing proportion are losing money: in 1996 about 50 percent of industrial SOEs incurred net losses (up from one-third just two years ago)—amounting to 1.3 percent of GDP. Factory capacity utilization rates for major industrial products have also fallen below 60 percent. Yet SOEs continue to absorb more than three-fourths of domestic credit, and their borrowing comprises about 60 percent of the total nonfinancial public sector deficit. This crowds out investment by nonstate firms, which have been the engines of growth. It also undermines a weak state-dominated banking system: 20 percent of bank portfolios contain nonperforming loans to SOEs, resulting in state banks with negative net worth.

Despite past progress, SOE reforms have not met the policy aspirations of the Government. *Many experiments carried out have been genuinely creative, but few have fundamentally tackled the core of public enterprise reform. Some of China's SOE reforms have provided temporary relief, but few are enduring successes. Worse still, some reforms have created new problems, such as asset-stripping, tax evasion, decapitalization and wage manipulation. By spilling over to the fiscal and financial sectors, they jeopardize other critical elements of the Government's economic reform program and undermine resource allocation and macroeconomic stability.* These problems are the product of and are compounded by the complex transition process China's economy is undergoing. In their call for establishing a "modern enterprise system" early in the next century, China's authorities have focused attention on the need for clearer property rights within a sound economic legal framework; organizational reform; strengthened corporate governance; and international-based financial accounting systems. These are all critical components for reform of China's management of state assets in the enterprise sector, and the focus of this study.

Today, the SOE reform program is modeled on the modern corporation. Within the context of a "socialist market economy," the Chinese corporate form (as set out in the 1994 Company Law) has become the vehicle for "separating" governmental and business functions and "state asset preservation and increase." These are the two

policy goals that lie at the heart of China's state asset management reforms.

The universal problem of a corporation's owners is how to structure the enterprise *internally* to provide sufficient incentives for managers to attain owners' goals. At the same time, various *external* incentives discipline the conduct of managers and ultimately affect firm performance. Internal incentives involve election of the board of directors; mergers/acquisitions; increases and decreases in capital; disposal of assets; and determination and deployment of retained earnings and dividends. External incentives include the extent of interfirm competition, such as entry by new rivals; an absence of fiscal subsidies; scrupulously fulfilling debt–service obligations and allowing for bankruptcy when they are not filled; the competitiveness of the labor market; and compliance with legal obligations, such as monitoring of financial accounts through independent audits.

### **The Economic Legal Framework and SOE Property Rights**

From a legal perspective, the main thrust of China's SOE reforms is to clarify the roles of the State and SOEs along four dimensions: (a) introducing business autonomy; (b) corporatizing SOEs; (c) clarifying the role of the State as SOE owner; and (d) defining the role of the State as regulator.

Some degree of business autonomy has been introduced. But the implementation of the 14 Autonomous Management Rights is uneven, with few industrial SOEs enjoying all such rights. Corporatization of industrial SOEs is proceeding gradually. This is because it is often difficult to *identify an SOE's "investor."* The competing claimants—the government agencies—often cannot agree on who is (or shall be) the investor. This problem is compounded when an SOE has large liabilities. *Everybody wants the valuable assets, but nobody wants the liabilities* . SOEs resist regulatory organs as they fear erosion of their rights. This gives rise to disputes between stakeholders. There are no formal, transparent mechanisms to settle these disputes and build a body of case law to interpret the legal framework.

Government agencies serve as shareholders and administrators at the same time, and *multiple agencies* are acting as shareholders. *No single entity is responsible for an SOE's "bottom line."*

#### **Policy Recommendations .**

The economic legal framework provides an adequate *basis* to help define, separate and allocate the ownership, management and regulatory roles of government and SOEs. But, *in practice* , there is effectively little separation between the affairs of business and those of administration. Substantial progress is thus needed on mechanisms for the *implementation* of the economic legal framework and clear assignment of property rights.

*Clarify Regulations* . There are several gaps in the law which must be filled. In particular, (a) regulations governing the conversion of SOEs into limited liability companies (LLCs); (b) regulations regarding the transfer of state property; and (c) regulations further clarifying managers' autonomous rights.

*Foster Market Transactions* . While there are some contractual provisions in the General Principles of the Civil Code, the basic building blocks of property, tort, contracts and succession have yet to be legislated. A new unified Contract Law is in the advanced stage of drafting and its completion should be accelerated. Clarity and enforcement of generic property rights through a cohesive framework also should receive high priority. This can be accomplished through a comprehensive property law that defines and enforces property rights in all sectors of the economy and without regard to ownership or nationality.

*Accelerate Corporatization* . Where SOEs have been incorporated, the process has helped make profits and losses more transparent, established book values of assets and clarified property rights. Accordingly, accelerating the process of corporatization under the Company Law, regardless of an enterprise's financial performance, would be

highly beneficial.

*Enhance Creditor Rights to Force Exit of Value—Subtracting SOEs* . Available tools for exercising creditor rights are inadequate. This stifles SOE restructuring and rechanneling of SOE assets and liabilities to higher values in use. The new Insolvency Law under consideration should be promulgated as soon as possible.

*Build Commitment to Reform By Changing Expectations* . International experience shows that governments must *alter expectations* by declaring a *credible commitment* to fundamental reforms coming within an announced time frame. In this regard, the Government should, within one year's time, classify the 1,000 priority SOEs into competitive and noncompetitive sectors. Then, within five to seven years, it should carry out a plan for broad ownership diversification, including reducing state ownership to a passive minority share, and ending fiscal and financial subsidies to the competitive sectors. Resources for technical renovation of those of the 1,000 that are in the noncompetitive sector could be earmarked in a special trust fund under MOF's control.

At the same time, more fundamental reform should be applied to all other SOEs *not* part of the 1,000 priority group. The Government should *completely withdraw from* inherently competitively structured industries where small and medium sized firms predominate. This would formalize a process that is already under way, and signal that the Government is serious about *embracing* nonstate competition to foster stronger business performance.

*Reallocate Land—Use Rights* . The reallocation of land—use rights of money—losing but potentially commercially viable SOEs located in prime downtown areas offers an important opportunity for enterprise transformation. Land—use rights should be allocated in line with market principles of economic efficiency if the value of the State's land assets are to be preserved and enhanced. The emerging practice, which should be encouraged, is to allow industrial SOEs to sell the leasehold land rights to new commercial occupants, split the proceeds with the municipality and use their own share to fund their modernization needs.

### **Reform of Organizational Structures**

Early steps have been taken to establish the modern corporate form. Still, the basic elements of the modern corporation are an *innovation* for the State and an *imposition* for most SOEs. Some of the key external incentives to instill effective discipline on SOEs remain nascent. There is weak product market competition across geographic markets, especially at the wholesale level; a robust market for managers does not exist; commercial transactions lack security; executive fiduciary duties are absent; and the obligation to service debt is not enforced.

New multitiered state asset management organizational structures and holding companies lack clear internal lines of authority. *The boards of directors and the senior executives are often the same people* . In addition, board members are nominated not by a commercially oriented owner's representative, but by governmental or Party bodies. Introducing individual shareholders through public listing has not effectively redefined the main organizational characteristics of ownership/management interests. But ownership diversification by institutional investors has been an effective mechanism in some cases to discipline new corporate structures.

With a few exceptions, line bureaus, existing group enterprises and existing large enterprises are transforming into State Asset Operating Companies (SAOCs) without introducing a modern corporate form or developing modern matrix management structures. In virtually all cases, SAOCs retain

governmental as well as ownership functions. *In fact, many of the underlying SOEs see no difference between the old line bureaus and the new SAOCs, other than a name change* .

The multitiered network is burdened with conflicts of interest that prevent the separation of business from government. *The greatest success in meeting this objective has been at the enterprise level, where the Chinese*

*corporate form is based on an effective international model. But at the intermediate and upper tiers, the Chinese approach has not taken advantage of international experience to reconcile contradictions between a State's governmental functions and enterprise ownership interests .*

*Even in the more effective international models of state asset management—the French and New Zealand systems—these contradictions are present. But, unlike China, these systems employ market-based incentive structures to mitigate these contradictions. Chinese policymakers should consider these alternatives in restructuring state asset management organizations. However, both French and New Zealand authorities have realized that these inherent contradictions stand in the way of better SOE performance that match the results of nonstate firms. As a result, they are privatizing SOEs to lock in hard-won reforms and ensure superior business performance, especially in the competitive sectors .*

### **Policy Recommendations .**

Within this context, China could strengthen the State's ownership interest through several organizational reforms:

*Simplify the Organizational Network .* China's present structures and their component bodies should be *simplified* and organizational layers *eliminated* wherever feasible. Experiments in a dozen cities involving the 1,000 priority SOEs should be piloted to assess the benefits and costs of delayed organizational structures, where intermediary agencies are replaced by direct representatives of the State on enterprise boards of directors.

*Reorient Organizations Toward Financial, Rather than Administrative, Management of Assets .* State asset preservation and enhancement will ultimately require that state asset management institutions shift from their traditional role of administrative control of state-owned property to financial management. This will necessitate not only changes in governance incentives and reform of accounting and financial system controls, but also restructuring of organizational structures. This will be critical for improving the efficient management of state assets in noncompetitive sectors, e.g., local public utilities, where the rationale for government intervention can be strong. It is proposed that within municipalities, the State would continue to have a direct shareholding in such utilities, but majority ownership could be sold or transferred to a consortium of local development companies (LDCs) established to promote the development of a municipality. These LDCs would be commercially oriented entities independent of government budgets; their funds would be raised from the public institutional investors and, potentially, social security funds.

*Introduce Independent Professional Managers .* Developing a class of professional managers requires improved university and on-the-job training. Independent persons with potentially strong managerial skills should be identified through rigorous and impartial evaluations. Foreign experts could coach managers through "twinning" arrangements; study or training abroad could be beneficial. Compensation and job security of managers must be closely linked to enterprise performance. A robust "market for managers" within a firm, across firms, across sectors, and across regions must also be developed.

*Increase "Outsider" Participation .* Nonstate participation should be increased through: (a) appointing nonstate representatives to SOE boards; (b) diversifying SOE ownership through selling shares on national and international stock exchanges to bring on nonstate shareholders where the result is passive minority state ownership; and (c) contracting out the provision of services (e.g., transport, accounting, social services) to the nonstate sector.

*Innovate the Use of Shareholders, Directors and Managers .* Board members should be from different regions and have diverse backgrounds. *Cross-sectoral and cross-regional diversification* of management and of the shares held by SAOCs and the other state asset management organizations is also key.

*Delink Social and Commercial Functions* . Many of the SOE social service burdens—housing, hospitals, and schools—must be passed to municipal or regional governments or to nongovernmental entities. Housing divestiture will yield proceeds to help SOEs meet other social debts. Cross-firm municipal pooling of pension obligations and payroll taxes earmarked for pension, unemployment and health benefits should accelerate.

### Corporate Governance

Enterprise managers increasingly control state assets and cash flows. Insider-dominated SOEs may deliver efficient performance, but only if the firm does not receive any subsidies, faces robust competition, and scrupulously repays its debts. Unchecked insider control results in asset-stripping, poor investment decisions, and decapitalization through excessive wage increases. Combined with poor monitoring by other stakeholders, this corporate governance vacuum leads to the misallocation of nonperforming debts to state-owned banks and fiscal authorities, especially when the credit system is weak. *All of society will repay depositors through budgetary subsidies, creating a larger fiscal deficit and inflationary pressure. Society bears the costs of resource misallocation and of macroeconomic instability when assets are privatized and liabilities are socialized* . Unchecked insider control is occurring in large and medium Chinese SOEs. Avoidance or diversion of SOE payroll tax contributions to unemployment insurance and pension pools is also widely reported.

*Effective bank governance of SOEs is still nascent. Only in exceptional circumstances do banks discipline an enterprise in arrears. Banks rarely withhold loans or recover assets from SOEs. Many banks explicitly state they will not force SOEs into bankruptcy* . The practice of banks clearing SOE debt restructuring decisions with (many) government agencies is incompatible with the objective of transforming them into modern, independent commercial banks.

### Policy Recommendations .

Several policy recommendations are suggested:

*Increase Fiscal and Financial Discipline* . Fiscal or financial subsidies to SOEs should be made transparent and over time eliminated. Fiscal subsidies for "operational losses" should continue to be decreased and then eliminated. Equally important, the new set of corporate income tax credits and deductions introduced under the various government-sponsored restructuring programs actually *enlarge* rather than limit fiscal subsidies. A time frame for their phaseout should be devised. The remaining financial system subsidies—directed loans and rolled over unpaid debts—should be made more transparent by "budgetizing" them, i.e., transfer them out of the banking system *into* a special MOF budget fund and then phased out. Efforts should also accelerate to halt the flow of "bad" bank debt to value-subtracting enterprises and to restructure the stock of "bad" debt. *The Government could establish a national or provincial institution to restructure the "stock" of bad enterprise debt after halting the "flow" of bad debt. It could provide financing for uncreditworthy enterprises while isolating them from the banking system, to ensure that transition financing does not accumulate as bad debt for the banks* . Banks must be able to obtain more frequent and better financial information from SOEs and request independent audits. Banks could be prohibited from lending to enterprises that are in arrears for more than 180 days and allowed to provision automatically at greater rates for past-due loans.

*Encourage Competition* . Rigidities remain to be tackled in the industrial sector. (a) Eliminate policy barriers that prevent nonstate firms from entering markets. This can come about by facilitating

business licensing and registration procedures, further reducing import quotas and tariffs, and rationalizing the foreign direct investment policy regime. (b) Promote competition across regions by opening up wholesale distribution channels to new entrants and breaking the system of interlocked supplier-customer relationships; also eliminate the VAT and income tax disincentives to cross-provincial product trade. (c) Allow equal access to

factor markets by eliminating discrimination against firms of different ownership forms as regards access to bank credit, fuel and material input prices, and (d) Adhere to the regime for tax neutrality across all firm ownership forms, as embodied in the recent tax reforms.

*Grant Managerial Autonomy Within a Market-Based Context* . The granting of the 14 Autonomous Management Rights should proceed. Insider control can be held in check if subsidies are halted, competition is strengthened, and debt-service obligations are met.

*Diversify SOE Ownership* . Implementing and managing SOE ownership diversification should be done with well-defined institutional responsibilities and through transparent and competitive procedures. There are three keys to success: (a) diversify ownership—both on a cross-regional and cross-sectoral basis; (b) ensure transferability of ownership shares; and (c) ensure investments on behalf of the State are owned, supervised or managed by independent professionals whose remuneration is incentive-linked to investment performance.

Like other transition economies, *China's Government faces a tradeoff between maintaining control of SOEs and enhancing their asset values. Fundamentally reorienting SOEs' incentives toward the market may well require reducing the State's involvement to passive minority ownership of SOEs* . Improving the performance of the 1,000 priority SOEs will be complex, and government's skills and budget are limited. *China could consider experience of other transition economies: a phased sequence of increasingly broader ownership diversification. In Phase I, the 1,000 priority SOEs undergo corporatization under the Company Law within a specified time—one to two years. In Phase II, over three years, on a cross-sectoral and cross-regional basis, a large but not a majority ownership stake of each corporatized SOE is managed by an SAOC, reformed into an independent, professional investment management corporation. Of the remaining shares of the SOE, some are assigned to other SAOCs and some are traded on the secondary market. In Phase III, after five years, all funds trade among one another* .

*Foster Mergers and the "Market for Corporate Control."* Mergers and acquisitions should not be administratively arranged. A "market for corporate control" could be established to provide for transactions through freely functioning competitive forces, provided that a public social safety net is established for redundant workers. *The emerging network of property rights transactions centers should be enlarged and strengthened. Such transactions should be open, and transparent. Closed transactions would likely undermine public support for reform and could cause lower market valuations of the assets* .

### **Financial Accounting Systems and Controls**

Accounting reforms are prerequisites to provide SOE owners, boards of directors and managers with reliable information to monitor enterprise performance. *Without accurate, transparent and commercially meaningful financial information on enterprise performance, all other aspects of SOE reform could be for naught* . China's 1993 Accounting Standards and international standards differ on the policy basis of the accounting framework, the intended audience and the definition and application of terms. Most other national accounting standards identify "investors and creditors" as the primary users of accounting information. China's standards do not. China's Standards give priority to administrative control, which conflicts with the goal of separating government and enterprises. *Drafts of soon-to-be-issued standards are more precise and comprehensive than the general principles embodied in the 1993*

*Standards. If they are implemented, accounts prepared under Chinese and international standards will become more similar* .

*Application of financial accounts to assess an SOE's assets and net worth—consistent with international standards—is still problematic. Many enterprises lack the capacity to prepare the accounts; tertiary businesses' assets, costs and implicit liabilities, especially social obligations, are unclear; inconsistencies exist within a single*

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enterprise group; and costs are often determined arbitrarily. Lack of *independently* audited financial information is one of the main barriers to improving the efficiency of SOEs.

### **Policy Recommendations .**

Most of the accounts and the financial control mechanisms in China's industrial SOEs are still aimed at *counting* rather than *financial management* , which does not create strong incentives for efficiency. Sound accounting standards and independent audits will strengthen the system of checks and balances.

*Introduce Cash Flow Forecasts .* These should be issued on a semiannual or quarterly basis. Large group enterprises will find rolling cash flow forecasts more helpful.

*Systematize Working Capital Analysis .* In most SOEs, different independent profit center workshops or production units still rely on an "internal banking system." Each unit writes checks and makes demands on the central finance department with little coordination. All units and the "internal bank" must be given information to plan or to deal with working capital shortages.

*Improve Financial Controls for Interenterprise ("Triangular") Debt .* Many SOEs are heavily indebted to other SOEs. Control systems to manage such debts must be strengthened.

*Strengthen Capacity for Assessing Returns on Long-Term Investments .* Investment performance analysts who can take debt service into account and use financial modeling skills are scarce, and training is limited. This capacity should be enlarged.

*Enhance the Role of Independent Accountants .* A nongovernmental Financial Accounting Standards Bureau-type organization (such as in the United States) could be established to set professional standards for accounting and auditing practices, phasing in a self-regulatory role. After China's accession to the World Trade Organization, foreign accounting services could be expanded.

### **S UMMARY OF POLICY RECOMMENDATIONS**

*(priority policies are italicized )*

Objectives	Short term	Medium term	Long term
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#### **Economic Legal Framework and SOE Property Rights**

Implement clarifying regulations under the Company Law	Issue regulations governing conversion of SOEs into LLCs/LLSCs <i>Issue regulations regarding property transfers from wholly owned SOEs</i> Issue regulations clarifying 14 Autonomous Rights		
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## China's Management of Enterprise Assets

Strengthen legal framework	Promulgate new unified Contract Law <i>Promulgate new Insolvency Law</i>	Promulgate comprehensive Property Law Promulgate new State Asset Management Law	
Accelerate corporatization	<i>Incorporate under Company Law the priority 1,000 SOEs</i>	Incorporate under Company Law the remaining 14,000 ± large and medium industrial SOEs	Complete incorporation of all remaining SOEs
Enhance creditor rights	<i>Prohibit banks from lending to SOEs in arrears for more than 180 days</i> <i>Allow banks to automatically provision at higher rates for past-due loans</i> Empower banks to obtain more frequent and better information from SOEs (e.g., to request independent audits)		
Build credible commitment for more fundamental reforms through changed expectations: divestiture/ liquidation	<i>Classify 1,000 priority SOEs into competitive vs. noncompetitive sectors</i> <i>Devise plan to liquidate assets of effectively bankrupt firms among the 1,000 priority SOEs</i>  <i>Initiate plan for complete withdrawal of state involvement in all nonpriority SOEs in competitive</i>	Liquidate assets of effectively bankrupt firms among the 1,000 priority SOEs In noncompetitive-sector 1,000 priority SOEs, for those not brought to bankruptcy or liquidation, earmark special trust fund under MOF for technical renovation Begin process to cover all remaining 14,000 ± large and medium industrial SOEs  Finish plan for complete withdrawal of state involvement in all nonpriority SOEs in competitive sector	Complete process to cover all remaining 14,000± large and medium industrial SOEs

## China's Management of Enterprise Assets

*sectors*

Facilitate market-oriented reallocation of land-use rights	<i>Issue regulations encouraging SOEs located in prime downtown areas to sell the leasehold land rights to new commercial occupants, splitting the proceeds with municipal governments</i>
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### Organizational Reforms

Simplify multilayered network of state asset management institutions	<i>Implement in one dozen cities involving the 1,000 priority SOEs program for collapsed state asset management network structures</i>	Assess program's effectiveness and broaden to 56 cities and all large and medium industrial SOEs	Broaden program to all cities
Reorient state asset management organizations to focus on financial rather than administrative management of assets	<i>Create in 8 pilot "comprehensive" cities local development companies (LDCs), funded independently of government, which would manage local utility SOEs</i>	Broaden to 56 "comprehensive" cities	Broaden to all 110 "comprehensive" cities

*(table continued on next page)*

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Objectives	Short term	Medium term	Long term
Introduce independent, professional managerial skills	Identify through impartial means existing and potential competent managers for training for 1000 priority SOEs  Initiate management training programs in 1000 priority SOEs through universities,	Identify through impartial means existing and potential competent managers for training for all other large and medium SOEs  Initiate management training programs in all other large and medium SOEs through	Broaden program to all remaining SOEs

## China's Management of Enterprise Assets

	study abroad, and foreign twinning arrangements	universities, study abroad, and foreign twinning arrangements	
	Introduce modern management information systems in priority 1000 SOEs	Introduce modern management information systems in SOEs all other large and medium	
	<i>Introduce new managerial compensation incentives in 1000 priority SOEs, where pay is directly linked to enterprise performance</i>	Introduce new managerial compensation incentives in all other large and medium SOEs, where pay is directly linked to enterprise performance	
Increase outsider participation	<i>Appoint nonstate representatives on SOE boards of directors for 1,000 priority SOEs</i>	Appoint nonstate representatives on SOE boards of directors for all large and medium industrial SOEs	Broaden program to all remaining SOEs
	<i>Diversify ownership for 1,000 priority SOEs through share sales to nonstate individuals and entities; allow for passive minority state ownership</i>	Diversify ownership for all large and medium industrial SOEs through share sales to nonstate individuals and entities; allow for minority state ownership	Broaden program to all remaining SOEs
	Contract out tertiary services to nonstate entities for 1,000 priority SOEs	Contract out tertiary services to nonstate entities for all other large and medium SOEs	Broaden program to all remaining SOEs
Innovate usage of shareholders, directors and managers	<i>Diversify regional origin and sectoral expertise of board members of 1,000 priority SOEs</i>	Diversify regional origin and sectoral expertise of board members of all large and medium industrial SOEs	Broaden program to all remaining SOEs
	Diversify regional origin and sectoral expertise of management of 1,000	Diversify regional origin and sectoral expertise of management of all	

## China's Management of Enterprise Assets

	priority SOEs Encourage staggered elections of boards of directors	large and medium industrial SOEs	
Delink social from commercial functions	<i>Establish 8 pilot city experiment (from 56 "comprehensive" cities) to transfer all pension, health and education responsibility from SOEs to government, with compensatory fiscal transfers (if needed); housing stock to be commercialized</i>	Broaden experiment to cover all 56 "comprehensive" cities	Broaden experiment to cover all 110 "comprehensive" cities

### Corporate Governance

Increase fiscal and financial system discipline	<i>Accelerate phaseout of all fiscal subsidies to competitive-sector SOEs for "operational losses"</i>	Terminate all fiscal subsidies to competitive-sector SOEs for "operational losses"	
	Phase out tax credits and deductions under current restructuring initiatives in 56 "comprehensive" cities	Phase out tax credits and deductions under current restructuring initiatives in 110 "comprehensive" cities	
	<i>Budgetize financial system subsidies to under special MOF account</i>	Terminate all such subsidies to competitive-sector SOEs	
	<i>Establish/select agency to coordinate phase out "flow" of bank credit to phase out of "flow" of bank credit to uncreditworthy SOEs</i>	Authorize agency to restructure the "stock" of bad bank debt	
	<i>Reduce coverage of directed bank credits</i>	End directed credits except for policy banks	

*(table continued on next page)*

*(table continued from previous page)*

## China's Management of Enterprise Assets

Objectives	Short term	Medium term	Long term
Encourage competition	<p><i>Eliminate policy barriers to entry in competitively structured markets by easing licensing and registration procedures and reducing quotas and tariffs</i></p> <p>Open up wholesale channels to nonstate firms and eliminate VAT and income tax jurisdictional disincentives</p> <p>Issue decree to ensure broad policy neutrality (e.g., taxes) and equal market access (e.g., fuel/material inputs) across different ownership forms</p>		
Grant managerial autonomy within a market-based context	<p><i>Accelerate implementation of 14 Autonomous Rights to all large and medium industrial SOEs</i></p>	Complete implementation for all SOEs	
Diversify SOE ownership	<p><i>Reform SAOCs into independent, professional investment companies</i></p> <p><i>Issue procedures for cross-sectoral and cross-regional SAOC diversification of ownership shares of the 1,000 priority SOEs</i></p> <p><i>Assign large but not majority ownership stake of each of the 1,000 priority SOEs across reformed SAOCs (cross-sectorally/cross-regionally); allow for passive minority state ownership; trade remaining shares to other reformed SAOCs</i></p>	<p>Begin similar process for all other large and medium industrial SOEs</p> <p>Allow full share tradability across all (reformed) SAOCs</p>	Complete process
Foster market-oriented mergers and acquisitions	<p><i>Create "market for corporate control" by issuing regulations at the national level that formally empower municipal property rights transaction centers</i></p> <p>Require property rights transaction centers to corporatize under the Company Law as LLSCs</p>	Expand the number of property rights transaction centers and link them regionally	

### **Financial Accounting**

**Systems and Controls**

Implement second-generation accounting standards	<i>Issue new accounting standards</i>		
<i>Require implementation of new Standards within a prespecified time frame for 1,000 priority SOEs</i>	Require implementation of new Standards in all SOEs		
Improve financial management	Establish requirements for cash flow forecasts on a semiannual or quarterly basis for all small and medium SOEs; rolling forecasts for large SOEs Introduce management information and compliance reporting systems; also financial controls for interenterprise debt		
Strengthen enterprise capacity for assessing long-term investments	Institute training, such as strategic analysis, and modern software capability within 1,000 priority SOEs	Institute training, such as strategic analysis, and modern software capability within all large and medium industrial SOEs	Institute training, such as strategic analysis, and modern software capability within all remaining SOEs
Enhance role of independent accounting capacity	<i>Require independently audited financial accounts of all large and medium industrial SOEs, with public disclosure in annual reports</i> <i>Authorize creation of independent, FASB-type, professional standard-setting organization</i> Liberalize barriers to foreign accounting services under WTO	Require independently audited financial accounts of all remaining industrial SOEs, with public disclosure in annual reports	

**1—  
The Next Phase for Modernization of Chinese SOEs**

## Introduction

China's approach to reform of industrial state-owned enterprises (SOEs) is to maintain state ownership of the key enterprises but improve their performance by establishing market-oriented incentives.<sup>1</sup> This strategy is unlike most other countries in transition to market economic systems, which have turned to systemic, widespread privatization of SOEs. By contrast, of the 118,000 Chinese industrial SOEs, relatively few (between 2 and 5 percent) have been divested to the nonstate sector, and these virtually all have been "small" firms.<sup>2</sup> Thus, in China, the State, or its agents, carry out "shareholder" functions otherwise performed by private owners in market economic systems.

There have been payoffs to China's strategy. Reforms have boosted SOE total factor productivity growth rates, for example.<sup>3</sup> Despite an increase in the size of the nonstate sector—propelled by reforms that have liberalized market entry, removed price controls, eased investment restrictions, increased tax neutrality across enterprise forms, and exposed the domestic market to international competition—SOEs remain key drivers of the nation's industrial sector, accounting for one-third of production, over one-half of total assets, two-thirds of urban employment and almost three-quarters of investment. SOEs provide essential raw materials and dominate such capital-intensive sectors as power, steel, chemicals and machinery.<sup>4</sup>

But, although as a group industrial SOEs report operating profits, such profits have declined to an average of 1 percent of the gross domestic product (GDP) in recent years (compared to at least 6 percent in the late 1980s), and the trend continues to be downward: by the third quarter of 1996 industrial SOE profits were only one-fourth of their level the previous year, reaching a historical low of less than 1 percent of GDP. Many industrial SOEs continue to be technologically inefficient, remain obligated to provide "cradle-to-grave" social services to workers and their families and are carrying a rising proportion of redundant employees and retirees on their payrolls.<sup>5</sup> The result is that an increasing proportion of the firms are losing money: in 1996 it is estimated that about 50 percent of industrial SOEs incurred net losses (up from one-third just two years ago)—amounting to 1.3 percent of GDP.<sup>6</sup> In addition, a significant portion of SOE production capacity is lying idle: the recent industrial census reveals that for almost half of the 900 major industrial products surveyed, factory capacity utilization rates average below 60 percent.<sup>7</sup> The financial performance of SOEs is also generally lower than that of the nonstate sector: in 1995 the average rate of return on assets for industrial SOEs was 6 percent; in contrast, for collectives it was 8.4 percent, and for foreign-funded firms it was 9.9 percent.<sup>8</sup> Yet SOEs continue to absorb more than three-fourths of domestic credit and their borrowing comprises about 60 percent of the total nonfinancial public sector deficit. Taken together, this crowds out investment by nonstate firms, which have been the engines of China's growth. It also produces a situation that undermines an already weak state-dominated banking system, where capital-asset ratios are low and declining; indeed, if, as the government estimates, the banks' nonperforming assets are equivalent to 20 percent of portfolios, the net worth of these banks is already negative.<sup>9</sup>

The financial burden that loss-making SOEs are placing on the banking system and public budgets, along with the need to maintain social stability in the face of increased worker redundancies, pose serious challenges to China's government. This is evidenced in the fifty-point "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure" of the Third Plenum of the

Fourteenth Party Congress in November 1993, the "10,000-1,000-100-10" SOE reform experiment initiated in January 1994,<sup>10</sup> and the Ninth Five-Year Plan (1996-2000) presented at the Eighth National People's Congress in March 1996. In their call for establishing a "modern enterprise system" early in the next century, the authorities have focused attention on the need for clearer property rights within a sound economic legal framework; organizational reform; strengthened corporate governance; and implementation of financial accounting procedures in line with international standards. These are all critical components of the regime for management of state assets in the enterprise sector.<sup>11</sup>

State asset management reform thus constitutes a core element of the next phase of SOE reform in China. It is the focus of this study. There are of course other critical components of China's "SOE problem", such as nonperforming bank debt, pension and social service reform, worker redundancies and public finance and investment. These issues are the focus of other studies and therefore are indirectly dealt with here.<sup>12</sup>

### Progress of Reforms to Date

China's experiments in state asset management reform have been wide-ranging. They have included use of incentive contracting, giving SOE managers greater autonomy, SOE ownership diversification, corporatization of SOEs and transforming SOEs into shareholding companies. A centerpiece of these experiments has been decentralization of governmental authority, with all but about 23,000 industrial SOEs placed under the supervision of *local* governments rather than under the *central* authorities in Beijing. Most recently, a multitiered organizational network of state asset management bureaus, state asset operating companies and state asset supervisory committees has begun to emerge. At the same time, large-scale national enterprise groups, entrusted to manage directly state assets, are being established. These various entities are to be the "independent" representatives of the State as owner of SOEs, as sector line bureaus and ministries, which have been the traditional hallmarks of the planned economy, are either phased out or limited to carry out "trade association" or nonownership, governmental regulatory functions.

Within this context, experiments in state asset management reform are part of the broader set of SOE reforms that have been under way since 1978. These reforms are comprised of (a) changes in the enabling policy environment, in part influenced by government actions (such as "hardening budget constraints" through stronger fiscal and financial system discipline) but increasingly driven by market forces (such as competition) and (b) proactive enterprise restructuring directly managed by government (such as delinking social obligations from enterprises and dealing with redundant workers).

### The Enabling Policy Environment

#### Hard Budget Constraints.

Chinese authorities recognize that a key way to foster and indeed lock in SOE efficiency gains is to reduce fiscal and financial system subsidies for loss-making SOEs. Fiscal subsidies have decreased steadily in recent years. In 1993 SOEs in all sectors received direct fiscal subsidies of Y 44.5 billion (equivalent to almost 2 percent of GDP), but in 1995 such subsidies fell to Y 36.6 billion (equivalent to 1 percent of GDP). A similar picture emerges locally. Sichuan Province and Shanghai, for example, report that direct fiscal subsidies to industrial SOEs are provided only for "policy losses" (e.g., in the coal sector where prices are controlled below costs) or for "operational losses" when there are extenuating circumstances and only on a temporary basis (e.g., when a money-losing enterprise cannot meet its employee medical expenses). Importantly, however, as described below, a new set of

corporate income tax credits and deductions that have been introduced under the various government-sponsored restructuring programs *enlarge* rather than limit fiscal subsidies.

Dealing with subsidies provided through the financial system has been more problematic. They are less transparent than subsidies provided under the budget and therefore are less easy to monitor and reduce. While some reduction has taken place, it has principally come through the tightening of credit under the inflation control program: in 1996 the coverage of the credit plan was further reduced; short term money market rates were freed; and administered interest rates were cut (and the margin between deposit and loan rates increased) to yield lending rates that are positive and deposit rates that are close to zero in real terms. However, the four main state-owned banks still often roll-over unpaid credits (principal and interest) automatically to SOEs. Interest rates

also have not been liberalized enough under the credit plan for the banks to differentiate terms among enterprises according to credit risks, giving rise to cross-subsidies.

Where fiscal and financial system budget constraints have become hard, Chinese SOEs—like SOEs in other countries undergoing transition—have been able to avoid adjustments by resorting to interenterprise arrears. Alternatively, they arrange for soft financing on nonmarket terms from public utilities or other enterprises. The State Statistical Bureau (SSB) estimates that as of year-end 1996, interenterprise debts are roughly equivalent to Y 1 trillion (about one-fifth of GDP), an increase from Y 600 billion at year-end 1994.<sup>13</sup>

### **Interfirm Competition.**

Another potent component of the enabling environment that the authorities are using to engender and sustain SOE restructuring has been to increase the degree of product and factor market competition. In the aggregate, the national market share of industrial output of SOEs has been eroded by collectives and other nonstate firms over the past two decades from about three-fourths to one-third. Still, as a result of the legacy of a planned economy and substantial decentralization, in some market niches (notably heavy industry), SOEs profit from regional autarky and face few nonstate competitors (township and village enterprises—TVEs—and private firms). The 1994 World Bank survey of 156 industrial SOEs in five cities, for example, reveals that the average provincial market share for each firm's principal product is 53 percent. The survey also suggests that on both the input and output sides of interfirm product sales and purchases, SOEs are interlocked with one another: the average share of inputs purchased from each SOE's largest supplier is 60 percent, and 78 percent of the surveyed SOEs said their largest supplier is another SOE. By the same token, the average share of sales made to each of the surveyed SOE's largest customer is 41 percent, and 60 percent of the surveyed SOEs indicated their largest customer is another SOE.<sup>14</sup>

With respect to entry conditions, implicit and explicit policy barriers to new competition—especially among would-be rivals based in different regions of China—are being reduced. But they are still substantial. Business licensing procedures, for example, deter new entrants from "foreign" provinces. The result is that in key industrial sectors, such as electronics, petrochemicals and machinery, interprovincial market share patterns have not altered appreciably in the past several years, particularly at the wholesale level.<sup>15</sup> Tax incentives discourage cross-provincial competition, such as VAT and income tax derivation rules that allocate receipts to the home tax jurisdiction. In "downstream" industrial and commercial sectors, however, cross-market penetration is becoming more pronounced. For example, the First Department Store (Group) Company of Shanghai, one of the firms examined for this study, is expanding rapidly in more than five provinces. Its entry strategy relies on fashioning joint ventures with local firms to help neutralize its "foreignness." Overall, however, policy barriers to interprovincial entry limit the utilization of economies of scale and scope and thus retard unification of China's national market.

### **Proactive Enterprise Restructuring**

#### **100-Firm Corporatization Experiment.**

One of the current efforts on proactive restructuring of SOEs is the national-level 100-firm corporatization experiment announced in early 1994. Under this program the central government is to provide support for transformation of the pilot firms into companies under the Company Law through reform of property rights and corporate governance systems; it is also to provide support for technical renovation and restructuring of the firms. The selection of the 100 large and medium industrial SOEs to participate in the program was finalized by the State Council in mid-1995 (see Annex 1).

As of late 1996, 90 of the 100 firms have had their corporatization plans approved by the State Council. Seventy

of the 100 SOEs are locally controlled, with the remaining 30 firms under central control. About 80 percent of the reform plans submitted by the participating firms call for them to be transferred into limited liability companies (LLCs) under the Company Law (see Chapter 2). But their corporatization is not affecting their ownership structure as expected: they will all be registered as *wholly state owned* group companies. The underlying operational enterprises will become either LLCs or limited liability shareholding companies (LLSCs).

**56–City Comprehensive Capital Optimization Experiment.**

The 56–city (soon to be 110–city) program embodies a set of fiscal incentives for lowering SOE debts and raising asset–liability ratios. Each of the selected cities (see Box 1.1) has chosen the firms to participate in its respective program. In all the cities there is a mixture of locally and centrally controlled SOEs participating, although the vast majority of them are under local control (similar to the general population of SOEs in China).

<p><b>BOX 1.1: 56 CITIES UNDER THE COMPREHENSIVE CAPITAL OPTIMIZATION EXPERIMENT</b></p> <p>Under the "10,000, 1,000, 100 and 10 SOE Reform Program," unveiled in January 1994, at first 10 cities were provisionally selected to carry out "comprehensive capital optimization" SOE reforms. However, before the program started the number of cities rose to 18. The original 18 cities were Changchun, Harbin, Qiqihar and Shenjiang in the Northeast; Baoji, Qingdao, Taiyuan, Tangshan, Tianjin, and Zibo in the North; Bengbu, Changzhou, and Shanghai in the East; Wuhan in the Center; Chengdu and Chongqing in the Southwest; and Liuzhou and Zhuzhou in the South. In late 1995 the program expanded further with an additional 32 cities: Guangzhou, Xining, Huhehaote, Hefei, Boatao, Shijiazhuang, Nibo, Wulumuqi, Changsha, Jilin Anshan, Fushun, Benxi, Luoyang, Jinan, Dalian, Nanjing, Xian, Kunming, Zhengzhou, Haikuo, Nanchang, Nanning, Fuzhou, Xiamen, Lanzhou, Guiyang, Shenzhen, Datong, Hangzhou, Beijing, and Yinchun. Another 6 cities were added in 1996, including Huangshi, Wuhu, Jiujiang, Foshan, Zigong, and Mianyang. The authorities announced in late 1996 that in 1997 they would enlarge the number of cities from the current 56 to 110.</p> <p><i>Source:</i> World Bank mission.</p>
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The program contains several elements. One component is a profit tax reduction (off the 33 percent nominal rate) provided under Ministry of Finance (MOF) authority. SOEs within the 56 cities receive an 18 percent income tax credit, making their effective tax rate 15 percent (previously the program provided for a 15 percent income tax deduction, creating an effective tax rate of about 23 percent). A second fiscal incentive is provided directly by local finance bureaus within the 56 cities. Chengdu's Finance Bureau, for example, provides for SOEs to pay only 40 to 60 percent of the 15 percent income tax liability, and "borrow" the rest at an interest rate about 2 percent below the nominal lending rate for working capital loans (10.98 percent in the third quarter of 1996). A third component is an accelerated annual depreciation rate increase from 3 to 5 percent. *Taken together, these initiatives weaken the fiscal discipline needed to encourage enterprise restructuring and are thus counterproductive .*

**1,000–Firm Reinvigoration Program.**

As part of the Ninth Five–Year Plan (1996–2000), a program was recently announced to "grab and reinvigorate" 1,000 large SOEs selected by the central authorities. These firms are to form the "core" of the country's "modern enterprise system." The "reinvigoration" process is to include technical renovation, interest payment exemptions, debt forgiveness, and redundancy payments for idled workers. "Main bank" relationships are also to be forged,

beginning with a pilot program of 300 of the selected firms (see Chapter 4). At the same time, the Government announced it would "let go" the remaining SOEs, providing a special fund to them to encourage "reorganization, bankruptcy, debt write-offs, merger into partnerships, leasing, contractual operation or sales, as their specific circumstances permit."

As of late 1996 the selection process was not finalized, but it appears that approximately 880 of the 1,000 SOEs to be selected are in the industrial sector. It is reported that the potentially participating firms account for about two-thirds of the assets held by all industrial SOEs and more than 70 percent of sales revenue, profits and tax receipts of the 305,000 SOEs in all sectors throughout the economy. By implication, the number of industrial SOEs to be "let go" would include the remaining 15,600 "large and medium" and 102,300 "small" SOEs in that sector. Although the identities of the 1,000 firms are not yet known with precision (and thus difficult to determine the exact mix between locally and centrally controlled SOEs in the program), it appears that the program may constitute some degree of recentralization of Beijing's authority over SOEs otherwise under the control of municipal and provincial governments.

### **Social Liabilities and Assets: Housing, Hospitals, and Schools.**

In restructuring SOEs to enhance their asset values and improve performance, Chinese authorities increasingly recognize that they should pass many of the "cradle-to-grave" social service burdens SOEs carry—employee housing, hospitals, schools, administration of pension insurance, restaurants, among other facilities—to municipal or regional governments or, to a lesser extent, new or existing nongovernmental entities. Indeed, the extent of enterprise-based "small societies" is striking; see Annex 2 for a case study of one SOE's social services. Separating these social functions from SOEs' productive functions is critical because their continuance, especially enterprise-provided housing, which is the largest component of an SOE's social costs, hinders the mobility of workers and managers. As long as housing remains linked to jobs, agile labor markets, which are key to the establishment of a modern corporate system, cannot develop.

Various reforms for delinking social services from SOEs are underway. While much work remains to be done in this area, significant progress has been made. SOE housing subsidies are being reduced, for example, over a several-year period through either raising rental rates or by converting them into wages. Sales of apartments are also being conducted. Cross-firm municipal pooling of pension obligations and payroll taxes earmarked for pension and health benefits are gaining prominence.<sup>16</sup> By the same token, schools and hospitals are being slowly divested to local governments. Beyond housing, health facilities and schools, other existing social assets of SOEs are beginning to be used imaginatively to facilitate the restructuring of overindebted SOEs, while protecting social needs (Box 1.2).

The separation of social assets from productive assets has become integral to getting listed on the stock exchanges; it is also the procedure followed when SOEs form joint ventures with foreign investors. Once an SOE has permission from the authorities to be listed, including a portion of the provincially allocated share quota (see below), it typically reorganizes into two parts: a new legal entity, i.e., the listed firm, which will receive the productive assets, and the original SOE, which will maintain the nonproductive assets, redundant workers and retirees. Following the initial public offering of shares, the original SOE becomes either the majority holder of the listed firm or it establishes a service contract with the listed entity

through which it provides the social functions; the latter route is the one taken by the Shanghai Petrochemical Company, one of the firms examined for this study.

**BOX 1.2: INNOVATIONS IN ENTERPRISE RESTRUCTURING IN SHANGHAI**

**Shanghai No. 4 Plastic Products Factory (S4PPF)**, which mainly produces plastic shoes, has been losing money since the early 1990s. Very slow to respond to changes in consumer tastes, its sales plummeted and in 1994 it declared bankruptcy. Its aggregate debt reach Y 40 million, while the value of its fixed assets, excluding the now valuable Pudong land on which its facilities sit, stood at Y 30 million. Its employees number 500 workers, and there are 800 retirees. As part of the bankruptcy plan, S4PPF has sold off most of its equipment, the proceeds of which have gone to the workers and retirees for subsistence. In 1996 S4PPF received permission from Shanghai authorities to auction off its factory's land-use rights, which gives to the successful bidder 70 years' use of the land. The auction proceeds will be used for reassignment of the workers and for retirees' benefits.

**Shanghai No. 3 Radio Factory (S3RF)**, one of the 100 enterprises selected for the national corporatization program, mainly assembles radios, TVs, and other low-end electronics equipment, using components purchased from over 100 suppliers, and its sales are made through distribution companies and local retail stores. S3RF's cumulative losses between 1989 and 1994 total Y 60 million, and the firm owes Y 190 million in debts to its bank and other enterprises. At present, S3RF has 1,780 retirees, which exceeds the present workforce of 1,300. A recent asset valuation of S3RF by the Shanghai State Asset Management Bureau (SAMB) estimated the firm's net assets at Y 160 million (excluding land and buildings). S3RF's restructuring plans include the development of extensive commercial relationships with TVEs and others through various joint venture, leasing, licensing and trademark agreements as well as dealing with its bloated workforce. S3RF has formed separate accounting units, with productive assets placed in various legal entities and "nonproductive" social assets in others. It has created a joint venture with one of the productive units and a Singapore firm; this joint venture recently registered a profit of Y 30 million. Of the 200 workers that are explicitly redundant, about 80 will be laid off and the remainder will retire or take extended sick leave. Perhaps the most innovative component of S3RF's restructuring program entails the subleasing of portions of its land, which is valuable Shanghai riverfront property, to outside (domestic and foreign) investors for development of services industries, and relocating some existing facilities to suburban areas.

*Source:* World Bank mission.

**State Land Resources.**

The land owned by the State accounts for approximately one-third of the total national land. In cities, where SOEs are generally located, meeting the land-use needs of a rapidly changing economy is a major challenge. Large areas of older cities are dedicated to obsolete uses, such as highly polluting heavy industry. In the typical Chinese municipality, industrial facilities occupy up to 30 percent of the land in the city center. International experience suggests that this proportion will decline by about half as an economy's development matures. The result is that many of China's large, older cities, such as Shanghai, face a massive redevelopment challenge. Although farmland is usually owned collectively by rural villages, under present Chinese land law, when nonstate-owned land is to be transformed into nonfarm use, it must first be turned into state-owned land, after which the land-use right can be transferred to commercial users. Consequently, at present, government exercises significant market power in the primary market for the transfer of land-use rights.

There has not been a systematic evaluation of the market value of total state-owned land, but most estimates indicate a value of around 15 trillion yuan.<sup>17</sup> The market price for the land occupied by SOEs in city-districts is estimated to be 6 trillion yuan. A study of the 18 pilot cities chosen for comprehensive reform reveals that the average scale of land in city-districts is 210 m<sup>2</sup>, and land values are estimated to be about 40,000,500,000 yuan per

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SOE worker.<sup>18</sup> Transfers of land–use rights to mobilize resources to facilitate the reform and restructuring of industrial SOEs is increasingly being practiced, and cities have embraced the income possibilities in urban land markets as a way to solve the problems of social insurance. Indeed, there are many cases of SOEs that are either insolvent or have too few net assets to participate in social insurance schemes but possess huge areas of land allocated to them free of charge, some of which is in prime downtown urban areas. Some of these firms have made use of

their present land assets by relocating their facilities from prime real estate areas to suburban locales. See Box 1.3.

### **BOX 1.3: UTILIZATION OF STATE –OWNED LAND ASSETS FOR ENTERPRISE REFORM**

The Beijing No. 1 Light Industrial Corporation was one of the first SOEs to use its land–use rights in order to marshal resources for its renovation needs. Beginning in 1993 the firm began to move a number of its facilities from the city center to outside the Fourth Ring Road, where factories are being rebuilt using new or updated technologies. The vacated downtown land is now being used to develop tertiary industries. Another case in the capital city is the Beijing Match Factory, which was making a loss in the first half of 1993. It moved to suburban Tongxian County and cut its staff from 868 to 300. The new factory started operation in February 1995, and has realized a profit rate of 10 percent in 1996. At the same time, 275 million yuan have been invested at the old factory site to build an apartment building block, which is estimated to bring a sale value of 344 million yuan.

In Tianjin, the No. 1 Light Industrial Department also has been experimenting in relocating small and medium SOEs from their prime downtown areas as a key form of enterprise reform. For example, the No. 7 Paper Making Plant leased out its plant area with the approval of the City Planning Bureau, and obtained a land compensation payment of 54 million yuan. It used 11 million yuan for lump–sum compensation to 365 people who were laid off, and 25 million yuan on over 700 people who were relocated to other plants in the paper–making sector.

Although there is not uniformity nationwide as to the allocation of the proceeds of land–use rights between the enterprises and government agencies, in practice the bulk of the proceeds goes to the enterprises. Beijing stipulates that 60 percent of the proceeds from the transfer of land–use rights should be kept by the enterprises, with remainder turned over to the city government treasury on behalf of the State. Tianjin stipulates that enterprises are to hand over 7 to 15 percent of the proceeds to the State, with the firms keeping the balance.

*Source* : World Bank mission.

### **Labor Market Flexibility.**

The authorities also recognize that infusing the labor market with greater flexibility is an essential ingredient in reforming SOEs. As in delinking social burdens, appreciable progress is also being made in this area (with even greater progress still needed). Whereas contracted (as opposed to permanent) workers and staff accounted for only 5 percent of the industrial SOE laborforce in 1985, at year–end 1995 the proportion was 60 percent.<sup>19</sup> Unemployment insurance schemes are also gaining prominence through municipality–based earmarked payroll taxes (collected from firms of all ownership forms). In 1996 about 2 million surplus workers were laid off in the 18 pilot cities; total unemployment in all urban areas stood at 20 million persons.

The current policy regarding the disposition of surplus workers emphasizes maintaining social stability. In implementing reform measures, therefore, local governments carefully monitor the socially affordable level of

unemployment in light of the strength of the local economy. Government policymakers recognize that this is inefficient, but the social security system is not yet adequately developed to handle significantly larger open unemployment rates. Still, recent labor and wage reforms are providing more incentives to improve efficiency and increase labor mobility; see Hu (1996).

One area in which reforms are being actively implemented is in worker retraining. As a case in point, in Beijing the Jingqing Labor Employment Service Company was recently established to implement a pilot training and reemployment program of workers made redundant by the restructuring of the Beijing Match Factory. Based on an assessment of the capital city's labor market demand, the service company opened such training disciplines as financial accounting, computer software and programming, business management, retail sales service, culinary art, cosmetology, hairdressing, gardening, driving, automobile maintenance, and tailoring. Five hundred fifty-eight workers of the match factory who had been made redundant and were not able to find a new job readily have entered into the training program; during the training process they are still being paid a basic salary. Following

an initial success of the pilot program, the Jingqing Company is now planning to take over the task of reemploying all the workers made redundant during the restructuring of the match factory.

### **Mergers and Joint Ventures.**

The restructuring of large and medium industrial SOEs through mergers and acquisitions, domestic and foreign joint ventures, and other forms of integration and consolidation is in full swing (Box 1.4). These initiatives are important, in part, because they help solve the problem of duplication of facilities and suboptimal plant scale that exists as a result of the earlier decentralization drive, which engendered regional autarky. Sino-foreign joint ventures are additionally important because they often foster the transfer of international advances in technology. Mergers and acquisitions of debt-ridden SOEs are being encouraged by the granting of five-year suspensions on loan payments of interest to the acquiring firm (for the debts of the acquired entity). Promoting conversion of interenterprise debts (payables and receivables) into equity shares is also resulting in increased mergers and consolidations of money-losing SOEs. These mergers are for the most part administratively arranged by government, which, as the State's owner-representative, plays the key role in identifying the parties and arranging for the transaction. (An exception to these government-arranged deals are those mergers consummated through new property rights transaction centers, see below.)

#### **BOX 1.4: SOE MERGERS : RECENT EXPERIENCES IN THREE MAJOR CITIES**

**Beijing :** Over the last five years, 173 economically strong Beijing SOEs have been merged with 242 loss-making ones, with a total of 147,000 employees, 12 million square meters of land and Y 3.1 billion (\$369 million) in fixed assets. The first SOE merger in the capital occurred in 1987 when one gear-manufacturing enterprise took over another. Some mergers have come about as a result of enterprises placing advertisements in newspapers seeking partners with which to merge. One, a Beijing factory whose X-ray machines have a dominant role in the domestic market, was in urgent need of additional workshops and funds to allow it to expand production. The factory merged with two debt-stricken enterprises and developed itself into a comprehensive medical-equipment production enterprise. The merged firm has become one of the top 100 enterprises in Beijing in terms of sales revenue.

**Shanghai :** In Shanghai, SOE mergers have focused on dealing with 638 loss-making enterprises between 1991 and 1996. These involved fixed assets of Y 5.9 billion (\$702 million). Shanghai's best-known SOE merger involved the Sanqiang Knitting Mill. It took over seven loss-making enterprises and raised its sales volume from Y 90 million (\$11

million) to Y 1.2 billion (\$142 million), with an eightfold increase in production. In the process, Sanqiang reassigned the 50,000 employees of the merged enterprises and inherited the enterprises' debts.

**Tianjin** : The Tianjin municipal government has taken the lead in trying to solve the city's SOE problems by issuing regulations that provide a one-year readjustment period for merged enterprises with surplus employees; during this period the municipal labor bureau will pay unemployment benefits to the surplus employees. Moreover, if an enterprise finds itself unable to pay off the debts of enterprises taken over, the Tianjin municipal government will mediate between the enterprise and banks to seek a solution. The city is currently in the process of sponsoring the formation of several large conglomerate groups with sales volumes exceeding Y 10 billion (\$1.2 billion).

*Source:* World Bank mission.

### **Exit, Bankruptcy and Liquidation.**

Restructuring of money-losing industrial SOEs via exit, bankruptcy and liquidation is much less pronounced. In all locations examined for this study, there was virtually unanimous agreement among governmental authorities, enterprise managers, bankers and workers *against* pursuit of bankruptcy or other forms of exit; instead, mergers and acquisitions are the preferred routes for dealing with money-losing SOEs. Within the 18 (now 56) experimental cities there have been 472 industrial SOEs identified for bankruptcy, but procedures have begun for 161 of them, and only 58 firms have been declared bankrupt. The general picture that emerges is that exit of money-losing firms is not being widely practiced except in cases of *small* SOEs. Most locales report 15 to 25 SOE bankruptcy cases in the past five years, all confined to small-size SOEs.

### **Divestiture, Ownership Diversification and Shareholding.**

SOE divestitures to the nonstate sector are occurring, though generally only involving *small* industrial SOEs. These divestitures occur in several forms, including acquisition by private enterprises or individuals, employee stock ownership schemes, and conversion into collectives. Chengdu, for example, reports that about 15 industrial SOEs (out of a total of 2,000) have "changed hands," all involving small firms at the county level or below with assets of less than Y 50,000.

Partial divestiture to nonstate interests through minority shareholding is more common, mainly by Sino-foreign joint ventures and through ownership diversification on stock exchanges in China and elsewhere; see Box 1.5.[20](#) In the World Bank's 1994 survey of 156 SOEs, for example, among the 44 SOEs that had become companies under the Company Law, the average ownership share of the State was 53 percent, the average ownership share for nonstate interests (nonstate firms, employees, managers or other individuals) was 34 percent, and the average foreign investor share was 13 percent. The survey also revealed that 8 percent of the respondent SOEs indicated they had sold or leased machinery and equipment to nonstate interests in the first half of 1994, up 3 percent for all of 1990; similarly, 3 percent indicated they had leased state-owned buildings and land to the nonstate sector in the first half of 1994, up from less than 1 percent for all of 1990.[21](#)

### **BOX 1.5: OWNERSHIP DIVERSIFICATION OF CHINESE SOES ON STOCK EXCHANGES**

The State Planning Commission determines an annual quota for listings on the two domestic stock exchanges—at Shanghai and Shenzhen. For 1995 the national quota was Y 5 billion, which was divided among firms within 30 provinces and 14 cities. There are two types of

shares listed on the domestic exchanges: "A" shares are for domestic investors only and paid for in Renminbi; "B" shares are restricted to foreigners and paid for in hard currency. There are four subcategories of "A" shares: state shares (held by government agencies or wholly state-owned SOEs); legal-person shares (held by various types of institutions, mostly majority state-owned or controlled); employee shares; and individual shares. Only the last form of shares is generally tradable. All "B" shares are tradable. Some firms are also listed on foreign stock exchanges. "H" shares are issued for the Hong Kong Stock Exchange. "N" shares are issued for listings on the New York Stock Exchange, either through Initial Public Offerings (IPOs) or Administrative Depository Receipts (ADRs). Both "H" and "N" shares are tradable. The total number of SOEs listed in 1995 was 323, an increase from 1993 when the number of listings was 183. In 1995, on the Shanghai exchange the average combined state and legal-person ownership share totaled about 62 percent, while on the Shenzhen exchange it totaled about 58 percent.

*Source:* Xu and Wang (1996).

Following the announcement of the Industrial Policy program in 1994,<sup>22</sup> there have been discussions about developing policy guidelines for the minimum amount of state ownership required for state control in various sectors. Thus, there is a proposal—not yet approved—that for certain sectors, "relative control" by the State, with a minimum of 30 percent state ownership, is required; for some sectors, "majority control", i.e., at least 51 percent state ownership is required; and for other sectors, "absolute control", i.e., 100 percent state ownership is required. Determinations of which sectors fall into each of these three categories are still being made.<sup>23</sup>

### Property Rights Transaction Centers.

Although auctioning is sometimes used for the transaction of SOE property rights—in Harbin two small SOEs were recently publicly auctioned—negotiated transactions are most common and, to a lesser extent, transactions are brokered. In Wuhan, for example, the recent divestiture of five small SOEs was a closed negotiated transaction, with the Mayor making the final decision as to the sales price. Public auctions and independently brokered transactions are being conducted by an emerging network of property rights transaction centers.

There are as many as 150 property rights transaction centers in China, but the principal ones are in Shanghai, Beijing, Shenzhen, Tianjin, Guangzhou and Chengdu, which are organized as LLCs under the Company Law; Box 1.6 describes in detail the operations of the Chengdu Property Rights Transaction Center. Although the charters and operating procedures for the centers are approved by the respective municipalities, there does not yet exist a provincial or national legal basis for the operations of such entities. There are no regulatory measures that mandate the channeling of SOE property rights transactions through the centers, and a growing business for them involves nonstate enterprises. In the main, these centers bring together prospective merger partners; to a lesser extent, they function as nascent venture-capital operations. They operate on a fee-based system.

#### **BOX 1.6: THE CHENGDU PROPERTY RIGHTS TRANSACTION CENTER**

The Chengdu Property Rights Transaction Center was established in 1988 as a nonprofit institution under the sponsorship of the Chengdu municipal System Reform Commission. It was the first such center in China. Between 1988 and 1993 the Center intermediated 275 mergers and acquisitions, of which 80 percent involved SOEs, valued at Y 1.5 billion. During that period, no fees were charged. In 1993/94 the Center became organized as an LLC under the Company Law with registered capital of Y 4 million. The shareholders of the Center are 30 legal persons based throughout Sichuan Province, the largest of which is Chengdu High

## China's Management of Enterprise Assets

Tech Investment Fund (Y 1 million investment). There are 28 members on the Center's board of directors, 22 of which are sponsoring enterprises, 4 are from the municipal government, and 2 are outsiders. The Center's President is on the board; a consulting firm he heads is one of the Center's sponsors, with an investment of Y 350,000. The Center has 23 salaried staff and 150 brokers who work on commission. The fee the Center charges to clients is regulated by the municipal State Administration for Industry and Commerce and is uniform at 5 percent of the transaction value for all clients. In 1996, the value of the Center's transactions exceeded Y 200 billion. Most of the recent transactions have involved a mixture of SOEs and nonstate enterprises, including the sale of SOEs' bank debt to other firms to establish equity positions. Few transactions have involved the sale of land or other forms of property.

A recent case study illustrates the Center's operations. An SOE in the color printing business in Chengdu faced excess demand for its products but it could not arrange for sufficient capital from the banks or other investors to expand. After securing permission from the State Asset Management Bureau (SAMB), the SOE's effective owner, the enterprise approached the Center to find new investors. The Center (a) assisted the SOE to transform into an LLC under the Company Law; (b) it also arranged for an accountant to audit the SOE's financial accounts. At the same time, (c) the Center located a Hong Kong investor willing to become a joint-venture partner, taking a 20 percent stake in the newly transformed firm and SAMB retaining an 80 percent share. The new board of directors was comprised of three SAMB officials and two representatives of the Hong Kong partner. To raise additional capital, the board decided to sell a further portion of the state's share in the joint venture. With the Center's help, it arranged for four private individuals to join as equity partners to hold a 30 percent ownership stake in the venture (with the state's share decreasing to 50 percent). Finally, (d) a new board was constituted: three officials from SAMB, the four private individuals and the two Hong Kong representatives.

*Source:* World Bank mission.

### **Programmatic Resource Costs.**

As the above analysis shows, government support for SOE restructuring programs is wide-ranging. In 1996, support for debt relief was estimated at Y 20 billion to raise the "bad" debt provisions of the four state-owned "specialized" banks to facilitate mergers and bankruptcy, plus Y 24.4 billion for conversion of SOE debt into state equity. Overall, SSB has estimated that the total budgetary cost of the sponsored SOE restructuring programs over the full Ninth Five-Year Plan period will be approximately Y 500 billion (\$60 billion) or Y 100 billion (\$12 billion) on an annual basis; this is equivalent to about 1.5 percent of GDP annually. SSB's cost estimate includes Y 280 billion for technical renovation of the 1,000 "core" SOEs, Y 160 billion for worker redundancy payments, and Y 35 billion for bad debts in bankrupt firms.

### **Remaining Challenges**

#### **Transforming Chinese SOEs into Modern Corporations**

*Despite the progress of past reforms, they have not met the policy aspirations of Chinese authorities. To be sure, there have been many experiments carried out. While many have been genuinely creative, few have directly tackled the fundamental enterprise reform issues with which most other transition economies are wrestling. In turn, while some of China's reforms have provided temporary relief, there are few enduring successes. Worse still, the effects of some, such as asset-stripping, tax evasion, decapitalization and wage manipulation, by spilling over to the fiscal and financial sectors, jeopardize critical other elements of the Government's economic reform,*

*let alone undermine resource allocation and macroeconomic stability* . These problems are the product of and are compounded by the complex transition process the Chinese economy is undergoing.

Today, the SOE reform program is centered on the creation of a "modern enterprise system" based on the model of the modern corporation. Within the context of a "socialist market economy," the Chinese corporate form (as set out in the Company Law; see Chapter 2) has become the vehicle for "separating" governmental and business functions and "state asset preservation and increase."<sup>24</sup> These are the two policy goals that lie at the heart of China's state asset management reform program.

There are four pillars of the modern corporate form; see Box 1.7. They enable the enterprise to mobilize and deploy financial and human capital and transform inputs into outputs on a large scale efficiently and with clarity and singleness of purpose. The weakness or absence of one or more of the attributes significantly impairs the corporation's efficiency. For example, with weak transferability of ownership interests, the flexibility of owners to reallocate assets to higher–use values is blunted. This would distort the market value of the business, which indicates how well management is performing. Thus, weak transferability would undercut a powerful mechanism that disciplines corporate management to satisfy owners' goals of asset value maintenance and increase.

<b>BOX 1.7: THE FOUR STRUCTURAL ATTRIBUTES OF THE MODERN CORPORATE FORM</b>
1. <b>Separate identity</b> . The corporation is a legal entity distinct from its owners ("shareholders"), with a clear definition of and accounting for its own assets and liabilities;
2. <b>Limited liability for owners</b> . Owners' risk of financial loss is limited to their contribution to the corporation's capital;
3. <b>Centralized role for corporate management and a board of directors</b> . The day–to–day affairs of the corporation are conducted by one or more persons ("managers"), who are hired by the owners. A board of directors, elected by the owners, represents the owners' interests by giving direction to management and carrying out oversight of managers' performance; and
4. <b>Transferability of ownership shares</b> . The shareholders' ownership interests are transferable, and a transfer by an owner does not, in itself, change the rights and obligations of the corporation with respect to its own assets and liabilities.
<i>Source:</i> World Bank staff.

### Market–Oriented Corporate Governance Mechanisms: External and Internal Incentives

Operating a large modern corporation inevitably involves the separation of the firm's ownership from its management. The owners select managers to run the firm, and in the process the owners relinquish some of their control as they delegate (some) decision–making to managers. "Corporate

governance" refers to the set of relationships that link the ownership and control of an enterprise, the mechanisms through which these relationships are mediated (e.g., monitoring and evaluation controls), and the nature of incentives, risks and constraints that affect how the actions of a firm's owners, managers and workers as well as others (e.g., banks, suppliers and customers) influence the firm's conduct and performance. The classic problem of the owners is how to structure *internally* the corporate organization and regulate its operations in a manner that provides incentives to managers for the attainment of the owners' goals.<sup>25</sup> At the same time, various *external* incentives discipline the conduct of managers and ultimately affect firm performance (see Box 1.8). International experience suggests that improved business performance depends not only on how well an SOE implements the

four key attributes that comprise the modern corporate form, but also on the dynamic interplay of these internal and external incentives.<sup>26</sup>

<b>BOX 1.8: INTERNAL AND EXTERNAL INCENTIVES DETERMINING CORPORATE PERFORMANCE</b>
There are two categories of variables whose dynamic interplay determine the performance of the large modern corporation: the "internal" incentive arrangements that directly link owners and managers, and the "external" factors that discipline and monitor the behavior of managers and ultimately the firm's performance. While internal incentives are <i>necessary</i> to achieve corporate efficiency, they are <i>not sufficient</i> ; external incentives must also be manifest.
(a) <b>Internal Incentives</b> . These include the structures and mechanisms by which the owners cause the managers to act for the goals set by the former, i.e., the internal "corporate governance" arrangements. This involves defining how the owners, the board of directors and managers interact with one another to fulfill the owners' objectives. The arrangements stipulate how various decisions will be made and who will be accountable for them. The principal decisions include owners' election of the board of directors, the naming of corporate officers, approval/disapproval of changes to the corporate charter, mergers/ acquisitions, increases and decreases in capital, major debt borrowings, disposal of assets, determination and deployment of retained earnings and dividends, and the setting of managerial pay.
(b) <b>External Incentives</b> : These are variables that are not usually under the direct control of owners (although they can have some indirect influence on them). They include the extent of product market competition (including the ability for the firm to affect market prices and for new competitors to enter and exit the market); the functioning of equity and debt markets (including the effectiveness of the "market for corporate control" and of (credible) threats of bankruptcy or liquidation for value–subtracting firms); the competitiveness of the labor market (including the market for managerial and entrepreneurial talent); and the corporation's legal obligations (including monitoring of financial accounts through independent audits).
<i>Source:</i> World Bank staff.

Providing for sound corporate governance is a challenge that all large modern corporations the world over must meet. It is difficult to ensure that the actions of a firm's managers (the "agents") are consistent with the interests of the firm's owners (the "principals"). When managers do not act in the interest of owners, "principal–agent problems" arise. The extent of this conflict depends on a number of factors, most importantly the degree of information about the activities of the managers. Owners have dealt with the principal–agent problem through a variety of means including: improved information flows; more intense monitoring by owners and others (including banks) of managers' conduct and performance; and implementing mechanisms to better align the interests of managers and owners/shareholders (for example performance contracts, stock options and ownership). Of course, different types of corporate governance systems have been used to solve the principal–agent problem. For example, the United States and the United Kingdom rely heavily on shareholders' actions in stock markets, Japan utilizes a bank–based system and Germany's framework is centered on institutional investors (other companies and banks); see Annex 3.

*There is no obvious ranking as to which of these three, or any other, corporate governance system is best for promoting efficient corporations. But there is a clear consensus worldwide that all of the most successful corporate governance systems are centered on the judicious use of market–based incentives.<sup>27</sup> As China continues to embark on its own version of corporate governance, this lesson is critical .*

The free play of interfirm competition is a critical external incentive. International experience shows that policies that stifle the operation of inherently competitive sectors, as well as prevent the progression of traditional "natural" monopolies into more competitive regimes, impose costs on society in the form of high consumer prices, poor production efficiency and retarded innovation. Distinguishing between competitive versus noncompetitive sectors is thus an important policy issue in designing further SOE reform initiatives (See Box 1.9). In this regard, governments worldwide typically categorize public enterprises into three groups, and this taxonomy provides a useful guide for Chinese policymakers: (a) in "strategic" industries—the national military defense sector, the currency mint, and the mining of rare metals that have national defense applications—there is, with few exceptions, a compelling rationale for state involvement; (b) in "monopoly or quasi-monopoly" industries—usually local utilities in the energy, transportation and communication sectors—the rationale for government involvement, either through direct ownership or regulatory oversight of nonstate-owned service providers, has historically been strong inasmuch as market forces alone often produce suboptimal results; however, as pointed out in Box 1.9, sectors can evolve to a point where the competitive provision of such services is most efficient, and this outcome has often entailed the divestiture of utility firms to nonstate owners; and (c) in "commercial" industries—most of the manufacturing and services sectors—there is generally little justification for state involvement, as competitive market forces often engender the greatest efficiencies.

### Objectives, Structure and Scope of the Study

The principal objective of this study is to describe and assess the progress achieved in China's reform of its state asset management regime. The study also suggests policy recommendations for modifying that regime so that Chinese authorities can meet their SOE reform objectives more effectively. The overarching policy question guiding the study is: how can China's state-owned assets be managed to increase the efficiency of industrial SOEs within the context of the authorities' goal of keeping public enterprises as the mainstay of the industrial sector and without causing major disruptions in social stability?

Chinese policymakers recognize that to deal with these concerns poses a formidable challenge. The solution largely turns on four issues. Each of them is a focus of subsequent chapters:

- (a) clarifying and assigning SOE property rights within a sound economic legal framework so that an enterprise's identity, functions and responsibilities are delineated legally and operationally from those of government (Chapter 2);
- (b) reforming organizational structures so as to provide for efficient representation of ownership interests and monitoring of enterprise performance (Chapter 3);

#### BOX 1.9: COMPETITIVE VERSUS NONCOMPETITIVE SECTORS

The overwhelming majority of industrial sectors in countries around the world today possess underlying organizational structures that are *inherently* competitive. Thus within the typical industrial sector, maximum social efficiency is realized when numerous firms are producing the product (or service); the output share of each firm is not large enough to control the prevailing price in the market; any attempt by a firm to charge an above-market price will produce a loss of consumers or entry by rival firms eroding any temporary excess profits; and prolonged losses of poorly performing firms will bring on a change of management, a buy-out by new owners, exit or liquidation of the firm. In such "naturally" competitive sectors, artificially restricting the number of firms or output through government intervention, such as by establishing policy barriers to entry or exit, burdensome registration or licensing requirements, or international tariffs and quotas, raises consumer prices, reduces productive

efficiency of the firms, and stifles innovation. Society is thus made worse off.

There are a limited number of other sectors where society benefits from fewer firms. These "natural" monopoly (or oligopoly) sectors have a special characteristic unique to the product (or service) they are producing, often due to industry-specific technologies: as production expands, the average cost of producing each additional unit declines. In such special situations, it is most efficient to let one or a few firms produce as much as the market demands; indeed too many firms all trying to take advantage of the sector's inherent economies of scale will result uneconomic duplication of facilities and chronic losses. But doesn't allowing only one or a few firms to operate in a market simply invite them to take advantage of the opportunity to set prices too high? There are two answers to this dilemma. In some cases, the best solution is to give the firms exclusive market franchises *in return* for subjecting their price-setting or profits to regulation. In other cases, the cost of entry and exit by rival firms is relatively low. As a result, the credible threat posed by *potential* competitors exerts a sufficiently strong discipline on the incumbent firm (or firms) to keep prices at competitive levels; these are sometimes referred to as "contestable" markets.

Competitive sectors generally encompass all of manufacturing and many natural resource and services industries; this includes, for example, chemicals; steel; machinery; automobile production; textiles; electronics; oil, gas and coal; and construction. Some utility service industries possess organizational structures that are naturally monopolistic (or oligopolistic). Underground pipeline distribution of natural gas at the city level to residential consumers is a good example; universally, such firms are given market franchises and subject to regulation. But economic history teaches that many industries thought to be natural monopolies actually go through life cycles; as they mature, technology advances and markets grow, they evolve into competitive sectors. Whereas long distance telecommunications or postal services previously were considered natural monopolies, today they are inherently competitively structured. The airline industry has evolved into a contestable sector. Clearly, putting in place policies that prevent such an evolution will inflict costs on society.

*Source:* World Bank staff.

(c) devising corporate governance mechanisms that find the right balance between managerial autonomy and owner accountability (Chapter 4); and

(d) utilizing commercially based, transparent financial accounting procedures for assessing enterprise profitability, assets and liabilities (Chapter 5).

Policy recommendations are outlined at the end of each chapter and summarized at the end of the Executive Summary. In developing these recommendations, the study draws not only on China's experiences, but also on lessons learned from state asset management reform in other economies.[28](#)

The scope of the study is both China's national-level state asset management policy framework and the reform experiences of China's governments, enterprises, banks and other institutions at the municipal and provincial levels. Annex 4 lists the entities with whom the main mission for the study met in the field. The study also analyzes data on 156 industrial SOEs in five cities surveyed for the recent World Bank report *China: Reform of State-Owned Enterprises* (1996) and enlarges upon the recent high-level workshop (cosponsored by the Bank and the Government) on *Policy Options for Chinese State-Owned Enterprise Reform*, which generated insights on reform of China's state asset management system.[29](#) Finally, the study makes use of data gathered in operational work on enterprise reform and restructuring carried out by the Bank and the International Finance Corporation.

### Main Conclusions of the Study

China's initiatives for improving state asset management reflect a serious commitment to reform. But many of them have not been fully implemented. Managers do not possess adequate freedom to make business decisions efficiently. For example, on average barely a majority of the 14 Autonomous Management Rights have been ceded to SOE managers.<sup>30</sup> Moreover, about 5 percent of SOEs have been corporatized. The relevant portions of the economic legal framework have been enacted, but implementation and enforcement of various laws and regulations remain weak; SOE property rights are not clearly delineated. While material improvements in SOE productivity have been engendered by reform, they simply are not enough for most SOEs to survive in a competitive environment. SOE financial accounting controls have been strengthened, but still fall far short of the announced goal of bringing them to international standards. It is also questionable whether, as a result of the organizational reforms under way, the general lines and division of authority between governmental administrators and enterprise managers are becoming clearer than under the traditional sector line bureau system. By the same token, it remains the case that government and Party officials exert control over many key SOE managerial appointments and dismissals, and the vast majority of SOEs remain obligated to provide an array of social services to employees. As a result, there has been little progress in providing for separation of the affairs of business and those of government.

*The various incentives underlying China's state asset management system are in need of better alignment with market principles and more rapid, systematic implementation. Without this, enhancements in SOE performance already realized cannot be sustained, and the increasingly evident weaknesses among SOEs will get worse .* Improvements in SOEs' productivity and profitability engendered by such reforms will increase the share of SOE investment financed from the firms' retained earnings, thus reducing public sector borrowing and adding to the country's macroeconomic stability. At the same time, such reforms are vital to completing the transformation of SOEs into modern corporations—the ultimate goal of the Chinese leadership. This is one of two main conclusions of this study.

The other main conclusion is that China's state asset management experiments are producing *new, unanticipated problems within the overall SOE reform regime and exacerbating existing problems in other areas of economic policy* . For example, local decentralization has eroded the old system of center-directed government oversight of SOEs. This corporate governance vacuum is giving rise to problems such as "insider control" and asset stripping. It is also leading to opportunistic collusion between local governments and SOE managers regarding tax revenues and other resources.

Asset stripping is indeed widely reported, with insiders (managers and workers) taking SOEs' good assets and leaving debt-ridden shells. The result is, in effect, "privatization of assets and socialization of losses and liabilities." SOEs' explicit and implicit liabilities are left with the state banking system and government. The authorities recognize the growing importance of the asset-stripping problem, and in early 1997 the State Council formed the Leading Group to Stop the Drain of State Assets, headed by Vice Premier Zhu Rongji. SOE payroll tax avoidance or diversion is also widely reported (though less well-documented), especially as regards contributions to unemployment insurance or pension pools. These programs are essential elements to establishing a social safety net. Undermining their fiscal support could jeopardize progress of China's overall reform effort.

Rectifying insider control problems and the like necessitates strengthening internal governance incentives, such as introducing mechanisms that provide for more effective representation of the owner's interests. But it also requires stronger external "checks and balances," such as eliminating subsidies from the fiscal and financial systems, increasing product and factor market competition, and ensuring that debt-service obligations with banks (or others) are scrupulously fulfilled.

The study's policy recommendations are unified by the theme that only by fundamentally reorienting internal and external enterprise incentives toward market principles will China solve the core of its SOE problem. In part, this means that the Government's policy program should focus on systematically developing broad markets for SOE property rights transactions. The goal should be to establish a competitive and transparent enterprise restructuring *process*, not mandating a *specific outcome*. International experience is replete with examples of countries that have pursued particular enterprise reform configurations only to find they turn out to be "dead-ends."

*But fundamentally reorienting enterprise incentives toward the market also means reducing the state's involvement in SOEs.* The Government will have its hands full trying to improve the performance and competitiveness of its chosen 1,000 priority SOEs. The job is complex, and government's resources in skills and budget are limited. Chinese authorities have rightly chosen to focus their energies on this relatively small number of large firms that account for the bulk of state assets. *The Government needs to recognize, however, that there is a tradeoff between maintaining control of these SOEs and enhancing their asset values. Higher asset values could come with passive minority state ownership either through joint ventures or public shareholding with the nonstate sector, where assets are managed by independent professional money managers.*

What of the remaining 304,000 SOEs? The authorities have already stated their intention to loosen controls on them. But the Government could go further and faster. *It could go further by orchestrating a complete withdrawal of state involvement in inherently competitively structured industries where small and medium sized firms predominate.* While the details of such a divestiture program will need to be worked out, promulgating such a decision would simply make formal a process that is already underway. It would signal a credible commitment by government for deeper SOE reform in a portion of the economy where state ownership brings few benefits and many costs; in fact, the divestiture process could yield significant state revenues. More important it would change expectations on the part of remaining SOE managers that the Government is more serious about *embracing* nonstate competition as a way of fostering stronger business performance.

The reform program could also proceed more rapidly. The longer the delay in divesting these SOEs to the nonstate sector, the larger the losses through insider control and asset-stripping, the bigger the fiscal costs in terms of lost capital revenues or higher current subsidies, and the greater the contamination of bank portfolios with bad debts. These costs today are serious but still manageable. But if they are left unresolved they will accumulate and corrode the very foundations and credibility of China's entire economic reform regime.

### Endnotes

1. The number of industrial firms in China (as of year-end 1995) is 7.34 million. The industrial sector is comprised of 118,000 SOEs, 1.48 million urban collectives and suburban and rural TVEs, 5.7 million "individually owned" firms (with no more than seven employees), and 60,300 "other" firms (includes private firms with more than seven employees, joint ventures and fully foreign-funded businesses). In 1995, SOEs accounted for 34 percent of the gross value of industrial output (GVIO); the GVIO share for collectives and TVEs was 37 percent, for individually owned it was 13 percent, and for "others" it was 17 percent. In Chinese terminology, "nonstate" enterprises includes all ownership forms other than SOEs. Most collectives and TVEs are public enterprises; however, there are significant differences between these firms and SOEs in terms of property rights and other features; see Broadman (1995).

2. Of the 118,000 industrial SOEs, 87,905 are classified by Chinese authorities as "independent accounting systems." These are the industrial SOEs on which Chinese statistical authorities systematically gather data, and they account for about 70 percent of China's industrial fixed assets. It is within this subset of industrial SOEs that Chinese statistical authorities define (on the basis of assets and employees) size categories: there are 15,668 "large

and medium" industrial SOEs and 72,237 "small" industrial SOEs. The "large and medium" industrial SOEs account for about 80 percent of SOE industrial output.

3. While reforms appeared to have increased total factor productivity growth of SOEs above what it otherwise would have been, such growth is still a third to half of that of nonstate firms. There is a rich literature on these points. See, e.g., Groves, T., Y. Hong, J. McMillan, and B. Naughton (1994); Jefferson, G. and T. Rawski (1996); Perkins, F. (1996); and Woo, W.T., W. Hai, Y. Jin, and G. Fan (1994).

4. These data came from the recently completed Third National Industrial Census, which contains data through end-1995. See State Statistical Bureau of China (1997).

5. According to the Third National Industrial Census, in 1995 SOE payments for welfare and pension funds totaled approximately 15 percent of "total sales profits;" see State Statistical Bureau of China (1997).

6. The State Statistical Bureau estimates that losses in SOEs swelled in the first three quarters of 1996 to Y 65 billion, up to 20 percent from the previous year. Whereas the "large" SOEs are, on average, profitable, earning a 10 percent rate of return on assets in 1995, "medium" and "small" SOEs suffered negative rates of return on assets of -1 percent and -2 percent, respectively (calculated from *1996 Statistical Yearbook of China* ).

7. See State Statistical Bureau of China (1997).

8. Calculated from *1996 Statistical Yearbook of China* .

9. According to People's Bank of China Governor Dai, 8 percent of outstanding loans at state banks are more than 3 years overdue, and another 12 percent are overdue (but less than 3 years). *New York Times* , July 16, 1996, page C 1.

10. The "10,000-1,000-100-10" enterprise reform experiment consists of: (a) 10,000 large and medium SOEs are to have their assets evaluated using new valuation techniques; (b) the assets of 1,000 large SOEs are to be placed under the supervision of new asset management committees; (c) 100 large and medium-size SOEs are to be transformed into shareholding companies under the new Company Law; (d) 10 municipalities will undergo "comprehensive capital optimization" reform, including debt restructuring, technology upgrading, mergers and consolidations, bankruptcy and divestiture of social services. In fact, 56 rather than 10 cities have been chosen for comprehensive reform (see below).

11. China's state assets fall into three categories: (a) "operational," (b) "administrative and institutional," and (c) "natural resources." The vast majority of these assets (approximately 80 percent) are operational, of which 70 percent are embodied in industrial SOEs. This study's principal focus is on operational assets within these industrial enterprises, although we also touch on, where necessary, administrative and natural resource assets. The Government is in the process of analyzing a comprehensive evaluation appraisal of the country's operational assets that was carried out as of March 31, 1995. As preparation for that appraisal, an experimental survey of 124,000 SOEs was conducted. Based on that preliminary survey, the value of China's total state owned assets is

## China's Management of Enterprise Assets

estimated to be about Y 5,192 billion, of which Y 4,132 billion are operational assets.

12. See for example, World Bank, 1996. "China: Restructuring SOE Bank Debts"; World Bank, 1997. *China Pension System Reform*; World Bank, 1995. *China: Labor Market Development*; and World Bank, 1995. *China: Public Investment and Finance* .

13. Mission interview with SSB officials and *SSB News Bulletin* of January 25, 1995.

14. World Bank (1996), *China: Reform of State–Owned Enterprises* .

15. Domestic trade in consumer and producer goods is still heavily controlled by state–owned distribution entities. Prior to 1993, the allocation of producer goods was handled by the municipal Material Supply Bureaus of the former Ministry of Materials and Equipment, and consumer goods were allocated through the Ministry of Commerce, via large state–owned

(domestic) trading enterprises in municipalities, and through the network of All–China Supply and Marketing Cooperatives in rural areas. In 1993, these two distribution systems merged, forming the Ministry of Internal Trade, which has a network of 12 sector bureaus in each locality. There has been growth in nonstate distribution entities, especially in retail distribution, but the bulk of distribution entities overall are still state–owned. See, e.g., World Bank, "China: Internal Market Development and Regulation," Report No. 12291–CHA, March 17, 1994.

16. World Bank (1997), *China: Pension System Reform* .

17. See Guo Shuqing (1995) for a good discussion of use of state–owned land assets.

18. Guo Shuqing (1995).

19. State Statistical Bureau of China (1997).

20. In addition to the two domestic stock exchanges in Shanghai and Shenzhen, there are about two dozen informal share trading centers located throughout the country. These centers are supervised by the China Security Regulatory Commission.

21. World Bank (1996), *China: Reform of State–Owned Enterprises* .

22. The State Council's "Framework for National Industrial Policy in the 1990s," issued in June 1994, focuses on four key areas: (a) "to solidify the status of agriculture as the country's fundamental industry and increase farmers' incomes; (b) to strengthen the development of and foreign investment in infrastructure; (c) to improve financing for five 'pillar' industries (electronics, machinery, petrochemicals, automobiles and construction); and (d) to adjust

foreign trade systems to boost China's competitiveness in the international market."

23. See *South China Morning Post*, November 18, 1994.

24. See Jiang (1996).

25. See Berle and Means (1967).

26. See Iskander (1996).

27. See Shleifer and Vishny (1996) for survey.

28. See, for example, Aoki, M. and H-K Kim, eds. (1995); and *Bureaucrats in Business* (1995).

29. The proceedings of the workshop are contained in Broadman (1996).

30. See Chapter 3 of World Bank (1996), *China: Reform of State-Owned Enterprises*.

## 2—

## The Economic Legal Framework and SOE Property Rights

### Introduction

Under China's previous central planning system, the exercise of state ownership of SOEs meant that the Government would use, control and dispose of operational state assets through its administrative hierarchies. Enterprise managers were seen as merely the bottom level of government appointees taking orders from their superiors. In a very real sense, Chinese government officials, enterprise managers and workers, and bankers were all part of one big family.

Like other economies making the transition to the market, a major task of Chinese enterprise reform since the 1980s has been to attempt to separate SOEs from government. This reform effort—manifested by defining the various roles of SOE managers and government and other officials, and by introducing the notion of the enterprise as a separate legal entity—has become known as "the separation of capital and government." This objective has been supported by efforts to establish a sound economic legal framework to provide the elements necessary for economic agents to carry out activities in a market-oriented environment. These elements include: defining different forms of property and the assignment of property rights;<sup>1</sup> enabling the entry and exit of firms; setting the "rules of the game" for transactions (including those pertaining to arranging for finance, especially debt-service and leverage obligations); and ensuring the efficient settlement of disputes in accordance with the law. Implementing such a framework would facilitate entrepreneurial incentives, increase business efficiency and provide a "level playing field" that allows for competition to thrive and mitigates the importance of informal networks and political connections. These issues are paramount for reform of China's state asset management

system.

In the course of the past two decades, China has made substantial progress in developing this framework (Box 2.1).<sup>2</sup> The Fourteenth Party Congress' Fifty-Point Plan in 1993 provided a major impetus. As a corollary to its call for the establishment by the end of the century of a "modern enterprise system which meets the requirements of the market economy," it sets a similar target for "a legal system adapted to the socialist market economy." The challenge before Chinese authorities has been to not only *enact* a sound economic legal framework but to *implement* these legislative achievements into meaningful change in the day-to-day life of economic actors. This requires both popular acceptance of laws and regulations as well as an effective institutional infrastructure that educates people about the law, enforces the laws, settles disputes in accordance with the law and disposes of adequate human and material resources to properly perform these roles.

### BOX 2.1: CHINA'S RECENT LEGISLATIVE ACHIEVEMENTS

The legislative agenda of the Standing Committee of the Eighth National People's Congress (for 1993-98) comprises over 150 pieces of legislation, many of which support the establishment of the socialist market economy. Critical pieces of legislation enacted recently are the Company Law (1993), Central and Commercial Banking Laws (1995), and the Security Law (1995). Other key pieces of the legislative puzzle, including a new State Asset Management Law and revised Contract and Insolvency legislation, are on the drawing board. Earlier important enactments include the Economic Contract Law (1981 and revised in 1993), the Foreign Economic Contract Law (1985), the Trademark Law (1982) and the Patent Law (1984).

*Source:* World Bank mission.

### The Challenge of Separating Business from Government

There is a multiplicity of legal relationships that a Chinese SOE maintains and enters into with the State. First and foremost, there is the relationship with the State in its capacity as the legal owner of SOEs, their property and assets. Consistent with the constitutionally mandated primacy of public ownership, the *State-Owned Enterprise Law* (1988) (hereafter *SOE Law*) provides that "[p]roperty in [SOEs] shall be owned by the whole people."<sup>3</sup> This basic principle is confirmed in the *SOE Property Regulations* (1994), where it stipulates that the State Council shall exercise the property rights over SOE assets on behalf of the Chinese people. At the same time, the State functions as the regulator of the business environment in which the SOE (and other firms) operate. The SOE also has certain legal obligations and rights over the assets "entrusted" to it and bears *de jure* responsibility for managing and operating these assets, as well as liabilities, including social liabilities. Finally, as the SOE transacts its business, it creates legal relationships with other SOEs (and other economic actors) in product, factor and financial markets. In the course of these transactions, rights or claims to SOE assets are created.

As a result of these complex relationships, the task of separation is not an easy one. The main thrust of China's state asset management reforms has not involved shifting property ownership nor property rights from the State to the nonstate sector as other transition economies have pursued, although some ownership diversification of SOEs has taken place (Box 2.2). Rather, the principal focus is to clarify the roles of the State and SOEs along four dimensions:

- (a) introducing business autonomy;
- (b) corporatizing SOEs, i.e., establishing SOEs as separate legal entities;

- (c) clarifying the role of the State as SOE owner; and
- (d) clarifying the role of the State as regulator.

### **BOX 2.2: DIVERSIFICATION OF CHINESE SOE OWNERSHIP**

Public ownership is the mainstay of Chinese enterprises. Within that context, there are experiments where ownership of SOEs is being diversified to include nonstate participation. The First Department Store (Group) Corporation in Shanghai is piloting with limited employee ownership at the subsidiary level. Limitations include that employee equity stakes are transferable only to other employees and are bought back by the subsidiary at retirement. The authorities in Huangshi have transferred ownership or control of more than 1,000 (small-scale) municipally controlled SOEs through various transactions including mergers, joint ventures, leasing and direct sale between 1989 and the end of 1995. Another example is the Guangdong Provincial Freeway Company (GPFC), which was established in 1985 by the provincial government for the construction and operation of expressways in Guangdong Province. Faced with budgetary constraints, the provincial authorities decided to pioneer nonstate financing of toll highways by attracting capital from domestic and foreign private investors. The Guangdong Provincial Expressway Development Company (GPED) was established as a subsidiary of GPFC and existing operating assets (bridges and expressways) were injected into GPED. Five percent of GPED's shares were placed with a Malaysian company and almost 31 percent of its shares were sold as "B" shares to foreign investors through the Shenzhen stock exchange in May 1996. The share offering was more than two times oversubscribed. GFC's stake in GPED is currently about 45 percent.

*Source:* World Bank mission reports.

### **Business Autonomy**

The attempt to define a sphere of autonomy for SOEs goes back to the *Factory Director Regulations* (1986). These regulations designated the factory manager as the legal representative of the SOE. They stipulated that the manager shall have the power to make all decisions concerning the

enterprise's operation. In addition, the manager was authorized to resist attempts from any organizations or individuals outside the SOE to interfere in its affairs. Managers were appointed by "competent authorities in charge of the enterprise" or the "administrative organ in charge of cadres" (taken to mean the Party). However, in reality, under these regulations the manager was given only nominal authority to make final decisions. Indeed, the degree of autonomy that the manager actually enjoyed was unclear: important matters required the approval of the "competent authorities" and "administrative organs," and he/she was required to carry out the decisions made by such authorities. In effect, the regulations sketched out a system replete with hierarchy. Indeed, it consisted of many structures similar to the Chinese government hierarchy.

The *SOE Law* (1988) supersedes the *Factory Director Regulations* and introduces SOEs as legal persons. One of its stated objectives is to define the rights and obligations of SOEs and safeguard their legitimate rights. SOEs enjoy autonomy in accordance with the law with respect to their business operations and are granted the right to possess, use and dispose of the property given to them by the State to operate and manage. The law also introduced a set of 14 rights (precursors to the *Autonomous Management Rights Regulations* —see below) to the enterprise legal person (represented by the manager) to define the SOE's sphere of autonomy. These rights concern an SOE manager's right to decide on:

- 1) production;
- 2) prices of products and services;
- 3) independent sale of products;
- 4) selection of suppliers;
- 5) foreign trade;
- 6) investment;
- 7) use of reserve funds;
- 8) disposing of assets;
- 9) operating jointly or merging with other units;
- 10) hiring and firing workers;
- 11) personnel management decisions;
- 12) distribution of wages and bonuses;
- 13) organization of international divisions; and
- 14) the refusal of prorations.<sup>4</sup>

The description of these rights in the SOE Law is very general. Moreover, virtually every right is subject to State Council "regulations" or "stipulations."

The SOE Law's emphasis on the enterprise legal person allows the possibility of separating the rights and responsibilities of owners of the enterprise assets from the rights and obligations of the enterprise organization. Under the SOE Law, the enterprise legal person possesses the capacity to enter into contractual relations with the owners and other stakeholders of the enterprise. This is a significant step away from the hierarchical factory system, where the owners (the State and its agencies) and the enterprise organization were not clearly separated legally. However, the legal separation provided for under the SOE Law does not effectively reduce administrative interventions by government. Under the Law it is specified that the director of the enterprise, who represents the enterprise legal person, should be either appointed by the government supervisory departments or elected by the congress of employees with approval by the government supervisory departments.

To reduce further administrative interventions, the State Council issued the *Autonomous Management Rights Regulations* (1992). These provide more detailed and meaningful descriptions of the earlier 14 autonomous rights, even though many of the rights continue to be subject to restrictions, such as the requirement to seek "approval of the responsible government departments." Importantly, these regulations require the enterprise to be responsible for its own profits and losses, specify the conditions for property rights transactions, and state more clearly the legal responsibilities of enterprises and government supervisory departments. To further protect SOE autonomy, government departments

that violate SOE autonomy are subject to disciplinary actions, and anyone who obstructs a factory director or management personnel in the execution of their duties shall be penalized by the public security authorities and may be subject to criminal prosecution.

### Corporatization

The attempts to give SOEs a legally defined sphere of autonomy goes hand in hand with "corporatization." SOEs that exist as separate legal entities with their own "commercial" objectives, as well as (autonomous) rights and obligations under the law, are likely to be more focused on achieving such objectives and are more susceptible to being held accountable for their performance than SOEs that exist as an integrated part of government departments. The enactment of the *Company Law* in 1993 (but which became effective in July 1994) is the most important legal development for the drive to establish SOEs as separate legal entities.

The Company Law provides a national legislative basis for LLCs and LLSCs, i.e., companies limited by shares. It enshrines well-known corporate legal concepts including: (a) *limited liability*, (b) *share capital*, and (c) separation of ownership from management as reflected in a governance structure comprising (in addition to management) *shareholders' meeting* and *boards of directors*.<sup>5</sup>

In fact much can be gleaned from the Company Law's use of these concepts to appreciate the evolution of China's reforms for the management of state assets embodied in SOEs. For example, it contains a separate section on "wholly state-owned companies." Unlike other LLCs, these companies do not hold shareholders' meetings and most powers otherwise represented by a meeting of shareholders are exercised by the board of directors. However, the merger, division, dissolution, change in capital and the issue of bonds must be decided by "the organization authorized by the State to make investments or the department authorized by the State." In addition, transfer of property of a wholly state-owned LLC is subject to approval procedures handled by the "authorized organization" in accordance with laws and regulations. An exception is made for "large" wholly state-owned LLCs with sound operation and management systems that may be authorized by the State Council to exercise the rights of asset owners. These notions are increasingly reflected in the various organizational structures being established throughout China as part of the country's emerging state asset management network (Chapter 3).

### The State as SOE Owner

Defining a sphere of autonomy and establishing SOEs as separate legal entities needs to be counterbalanced by protection of the legitimate interest of the State as owner. Here the trend is clearly toward a supervisory role as opposed to involvement in the day-to-day affairs of the SOE. To safeguard the owner's interests and give incentives for good performance, the Factory Director *Regulations* introduced the "tenure target responsibility system," under which the decision to renew the term of factory directors was based on an evaluation of the director's performance against specific predetermined targets. This system was superseded by the "contract responsibility system" under the SOE Law to improve performance and increase accountability. The contracts include specific targets, and under the Autonomous Management Rights Regulations, SOEs that fail to meet the targets make up for that failure from other sources like retained earnings and wage reserve funds. Moreover, in case operational losses result from poor management, bonuses and wages of management and staff are supposed to be reduced according to their responsibility.

Another important legal development is the adoption of the *Supervision Regulations* (1994).<sup>6</sup> The Regulations reconfirm that SOEs have to establish "asset operations responsibility systems." They also provide the legal basis for the emerging network of state-owned bodies designated to supervise SOE property (see Chapter 3). The Regulations provide that state-owned assets are managed centrally or, with the authorization of the State Council, at the level of the province, autonomous region and municipalities under the administrative guidance of the National Administrative Bureau for State-Owned Property (NABSOP).

The Regulations create a "Board of Supervisors" for each SOE, which consists of representatives from the enterprise's official supervisory departments, NABSOP, MOF, the State Economic and Trade Commission, other government departments and state banks, and experts, managers, workers invited by the enterprise's supervisory departments. This Board is responsible for monitoring the maintenance and appreciation of the value of state assets in the enterprises, including the prevention of asset stripping.<sup>7</sup> The Board is to report frequently to its supervisory organ and to make recommendations on the appointment and dismissal of SOE managers. As specified by the Regulations, the Board should not intervene with the enterprise's managerial autonomy. The enterprise legal person is still to exercise property rights over the enterprise assets on behalf of the owner, the State. To prevent supervision from being overzealous, the Regulations specifically prohibit these Boards and other supervisory organs from interfering in SOE operations. Corrective measures and disciplinary action are taken against those Boards and other supervisory organs that overstep their authority.

### **The State as Regulator**

The SOE Law pointedly refers to this as the objective of "the State regulating the market, while the market leads the enterprise." The Autonomous Rights Regulations give some explanation of the regulatory role of the State. But they do so not as comprehensively as the November 1993 fifty-point plan issued at the Third Plenum of the Fourteenth Party Congress. The plan elaborates in detail the State's economic management role to create a favorable environment for economic development.

Dispute settlement is another function the State plays as regulator. Although the number of court cases involving economic matters, in general, has been increasing,<sup>8</sup> most SOE property rights disputes are settled by interested government parties through out-of-court mechanisms. A State Asset Dispute Arbitration Body has been established within NABSOP and analogous bodies in subcentral state asset management agencies. These bodies have been given the authority to adjudicate disputes arising from unclear SOE property rights that are manifest when SOEs merge with or acquire one another. Little information exists, however, as to how widely they are used.

### **Implementation of the Economic Legal Framework**

Some degree of *business autonomy* has been introduced. One measure, the extent of implementation of the 14 Autonomous Management Rights, suggests uneven progress, with few industrial SOEs nationwide enjoying all such rights. Most SOEs do not have full "investment authority," full rights to "hire and fire employees," full rights to "set wages" and full "export and import rights." A recent State Council survey on the implementation of the 14 Rights concluded that most of the rights remained in the hands of line bureaus. The 1994 World Bank 156-SOE survey in five cities corroborates this finding: more than 90 percent of the SOEs surveyed indicated that they were fully autonomous in production, sales and selection of suppliers. However, more than 60 percent of the SOEs surveyed indicated

constraints were significant with respect to the rights to trade, dispose of assets, and engage in mergers.<sup>9</sup> The Party still exerts strong control over many key SOE managerial appointments and dismissals.

In the firms examined for this study, SOE managers exercise discretion over the use and disposal of enterprise assets. They also benefit from significant job-related perquisites, such as expense allowances for entertainment, transportation and housing, as well as other economic rents. Rules for allocation of control rights and enterprise cash flow also appear to be unclear. Overall, although SOE managers have no legal recognition of property rights, they have de-facto rights to use and dispose of state assets and to enjoy incomes so generated.

*Corporatization* of industrial SOEs appears to be proceeding gradually. As of 1996, approximately 5,800 industrial SOEs have become corporations, i.e., a corporatization rate of less than 5 percent. Yet accurate data on

even this aspect are difficult to come by, in part because the corporate registration process is highly decentralized with no systematic reporting and collection by national authorities. The World Bank survey indicates that 44 of the 156 firms became companies under the Company Law; but this higher observed corporatization rate may simply reflect the fact that the survey was designed to track SOEs chosen for reform and, thus, there is a selection bias toward corporatized firms.<sup>10</sup> Even under the high-level 100-firm corporatization pilot program the transition from the factory system to modern corporation based on the Company Law is slow. One indication of the difficulties and slowness in transition is the fact that a majority of the 100 firms have chosen the wholly state-owned company as their legal organizational form.

*The business license registration process under the Company Law illustrates why, absent policy changes, transforming SOEs into companies is likely to proceed slowly. Identification of an SOE's "investor," which must be specified in the articles of association under the Company Law, is often a difficult task. This is not simply a problem of tracing funds; it is a political economy problem of assigning property rights. The competing claimants—the government departments and agencies, including line bureaus and ministries—often cannot reach consensus as to who is (or shall be) the "investor." This property rights assignment problem is compounded in most cases when an SOE has large (explicit and implicit) liabilities. Everybody wants the valuable assets, but nobody wants the liabilities. With the unclear assignment of property rights, this leads to an asymmetry in the allocation of rights and obligations for good and bad assets. Because assignment of the liabilities is difficult to implement, they are "socialized" (further discussed in Chapter 4).*

With respect to the *State as owner*, it is widely understood that the State Council is the unambiguous representative of the State as the "ultimate owner" of the state assets embodied in SOEs, with the State Council's overall policy framework for management of state assets administered through guidelines and regulations issued by NABSOP. Still, efforts are being made to clarify who concretely represents the "acting owner" of such assets. Reformers are struggling to define explicitly who is the "shareholder" (or "investor") in a Chinese SOE, and what are the rights and obligations of the shareholder vis-à-vis managers.

In fact, for all intents and purposes the State is regarded as a "fictional owner." It is widely recognized that it does not have as strong an incentive and as much information as individual owners or legal-person institutional investors in monitoring and protecting property rights. The Supervision Regulations provide some direction for separating Government's broad role in managing economic development from its narrow function in overseeing the value of the State's assets. They are also helpful

in laying out a legal framework for ostensibly controlling asset-stripping in SOEs. However, there is still a lack of clarity as to who really is in control of an SOE's assets as an "acting" owner on behalf of the State. The real "acting" owners of the state assets under the current institutional setting in China are still to be found somewhere in the government hierarchy. As a result, decision-making by these acting owners is constrained by bureaucracy. If the "acting" owners are within the government hierarchy, the managers appointed by them are also, in effect, part of the government hierarchy. Other stakeholders in SOEs, such as workers, suppliers, banks and customers, also perceive SOEs and their managers as part of, or close to, the government hierarchy. They take advantage of the weakness of the bureaucracy to exercise and monitor property rights in SOEs.

With respect to the State's *regulatory role*, SOEs resist supervisory organs as they fear erosion of their autonomous rights. This gives rise to disputes between the various stakeholders, including SOE management, supervisory organs and government departments. There are no formal, transparent dispute settlement mechanisms to settle these disputes and build a body of case law that will facilitate the interpretation of the legal framework for state asset management and give guidance to the various parties involved.

### Clarification and Assignment of SOE Property Rights

Fostering market transactions requires a legal framework that provides for clarity and enforcement of property rights, and the exercise of those rights through enforceable contracts. China's *General Principles of the Civil Code* provides for some contractual provisions, but the basic building blocks of property, contracts, and tort have yet to be legislated. A new unified Contract Law is being drafted. Generic property rights lack a cohesive legal framework, and as a result, property rights over some specific assets fall under sectoral laws. For example, intellectual property has its own regime. Ownership of financial instruments falls under the securities and capital markets legal regime. Rights over land use are covered by yet another legal regime; as discussed in Chapter 1, reform of land-use rights is integral to creating favorable conditions for the reform of industrial SOEs, especially those located in prime downtown areas.

If on the one hand, government departments and agencies are still exercising *both* the role of shareholder and administrator, there also are *multiple* government departments exercising the role of investor, often overlapping with one another. The result is that across agencies—both horizontally and vertically—there is fragmentation and partial exercise of the investor function, with no single entity responsible for an SOE's "bottom line."

Senior government officials and enterprise managers in China have a good conceptual understanding about the rights and obligations of typical shareholders in a private corporation. However, considerable confusion appears whenever the concepts of ownership and property rights are applied to SOEs. This is because of the fragmentation of both shareholders and their rights and obligations. This fragmentation of property rights is different from the situation of individual or legal-person institutional shareholders in a modern corporation. In China, only a subset of the shareholders' rights and obligations is usually retained by the ultimate owner, e.g., the right to sell the enterprise. Another subset of rights is kept by the enterprise legal person; for example, the use of after-tax profits or dividends is largely decided by a subsidiary instead of their parent holding or group company (see Chapter 5). Still another subset of shareholders' rights is found in government or Party agencies; for example, the right to select managers.

From this perspective, China's state asset management reforms can be seen as an attempt to *rebundle* property rights and make them less fragmented but without generally transforming state shareholders into individual or legal-person institutional shareholders. However, the rebundling process must be designed carefully; otherwise it could lead to unwanted consequences. If the consolidated and integrated property rights are given mostly to the "acting owners" through extreme decentralization of authority, the "ultimate owner" may no longer be able to compel effectively its "agents" to act on its behalf. On the other hand, if the consolidated and integrated property rights are retained mostly by the "ultimate owner," and the "acting owners" are controlled tightly, the system would not be very different from the earlier central planning regime.

*SOE managers are de-facto enjoying more autonomy than otherwise formally indicated, and are doing so in great part because of poorly defined property rights*. To the extent that subsidies (from either the budget or hidden in the financial system) still make their way to SOEs, that the firms are protected from competition in product and factor markets by policy barriers to entry or similar institutional constraints, or that debt-service obligations can continue to go unmet (because the state-owned banks themselves do not yet operate according to commercial principles), the resulting corporate governance vacuum propels such managers to engage in opportunistic behavior. *The resulting unchecked insider control leads to, in effect, the privatization of SOE assets and the socialization of their liabilities, with the State as owner assuming the unlimited liabilities of loss-making SOEs* (see Chapter 4). The socialization of the liabilities, in turn, ultimately translates into inflationary pressure and greater national debt via further subsidies from the budget and the state banking system. Society as a whole thus bears not only the direct liabilities of the loss-making SOEs but also the extra costs of macroeconomic instability.

The delineation and enforcement of liabilities—including bank credit and social obligations—are important parts of clarifying property rights. In economies where there are well-defined and enforced private property rights, any particular shareholder's or stakeholder's attempt to escape their liabilities, arising from the negative present value of a corporation's net assets, would violate other shareholders' or stakeholders' property rights. The result is that all shareholders have incentives to monitor each others' fulfillment of their liabilities and obligations. Experience in other transition economies shows that the mechanisms of self-enforcing contractual relations and internalization of liabilities are weakened or absent when the State is the dominant owner of enterprise (and bank) assets and is an ultimate enforcer of contracts and property rights. The possibility of negative net asset values may not be a serious social problem in mature market economies if property rights over assets in the corporation include claims only on any positive residual profits. When the present value of residual profit streams becomes negative or zero, the owners of the corporation's net assets would lose all of their investment but would not incur any more liabilities than their original investment in the corporation (the limited liability feature of the modern corporation). Any negative present value would have to be shared by other stakeholders, including banks, bondholders, suppliers, customers, and employees. This would likely trigger a process of bankruptcy where legal procedures would define how liabilities would be shared. International experience shows that creditor monitoring plays an important role in enterprise performance; see Box 2.3.

### SOE Bankruptcy: A Window on Unclear Property Rights

The emphasis of reform on improved SOE performance will only work if enterprises that fail to meet the market test engage in a process of rechanneling their assets and liabilities to higher use values. This can come about through bankruptcy, exiting the market, liquidation, or through other means for

transferring property rights. SOE bankruptcy thus provides one prism through which to assess the impact of clarified property rights and other legal reforms, and the extent to which China's SOEs are exposed to the pressures of the emerging market economy. The Autonomous Rights Regulations are specific with regard to exit. They stipulate that SOEs are responsible for their own profits and losses, are required to reorganize and restructure to live up to this challenge and should be declared bankrupt if they are unable to repay fully their debts. The legal framework for bankruptcy is provided for in the *Enterprise Bankruptcy Law* (enacted in 1986, effective in 1988) and gives creditors a legal basis to exercise their rights.

#### BOX 2.3: INTERNATIONAL EXPERIENCE IN CREDITOR MONITORING : THE CASE OF HUNGARY

International experience shows that debt plays an important role in ensuring effective corporate governance, albeit a different and largely complementary role to that played by equity. Creditor monitoring and control is generally considered to be more appropriate when tight controls on spending or investment are needed, particularly in times of financial distress. As with equity holders, creditors can monitor either actively or passively. The active mode involves hands-on evaluation of a firm's operations, investment decisions and capacity and willingness to repay. The passive mode depends on collateral for security, and to the extent there is analysis behind a lending decision, it is primarily of the value of the security interest rather than the operations of the firm. There are three crucial underpinnings to effective creditor monitoring, as illustrated in the case of Hungary: (a) adequate information, (b) market-oriented creditor incentives, especially those of banks, and (c) a robust legal framework for debt collection; see Gray and Holle (1996).

In Hungary, as in most transition and developing economies, information asymmetries have been frequently severe. Inadequate financial accounting often masks the true value of assets,

## China's Management of Enterprise Assets

and dramatic changes in prices and demand reduce the value of any prior information. Even if reliable information on firms is available, bank employees have not been not trained in techniques of market analysis and loan appraisal, and thus have had difficulty using the data from potential borrowers. When these information distortions have been large, they have made it highly costly, if not impossible, for new investors to fund the growth of firms. There has been greater reliance on risky (and thus expensive) informal credit markets or on retained earnings. As a result, the most profitable firms have grown the most rapidly.

Hungary's experience with bank reform until mid-1994 showed relatively little attention to the dangers of potentially negative incentives arising from recapitalization. Hungarian banks were effectively recapitalized four times—in 1991, 1992, 1993, and 1994. Over four years, about \$3.4 billion—equivalent to about 9 percent of 1993 GDP—was injected into Hungarian state banks (and this number is likely to increase still further in the near future). Yet little else was done to create strong and appropriate incentives for bank restructuring. No independent, in-depth portfolio or operations reviews were completed prior to the recapitalizations. Performance-based contracts were not implemented, nor were bank managers given strong and clear incentives to undertake actions that would increase the value of the banks they managed.

Hungary is still in the early stages of developing a market-oriented legal framework for enterprise debt-collection mechanisms, although it has made some initial progress and is arguably farther down this path than other reforming socialist economies. Procedures for workouts and formal reorganizations are being developed (but more must be done to develop a viable liquidation processes). The country is relatively advanced in developing a judicial workout system. The Hungarian Parliament adopted a tough new bankruptcy/liquidation law that took effect on January 1, 1992. It required managers of firms with arrears of 90 days or more to file for reorganization or liquidation. Managers of bankrupt firms retain their jobs after filing, and have the first opportunity to present a reorganization plan. Creditors then vote on the plan, and have an opportunity to present alternative plans. If an agreement cannot be reached, the procedure reverts to liquidation. Resolution of bankruptcy cases has typically been quite speedy, with more than 90 percent completed. In addition to the judicial bankruptcy process, the Hungarians adopted a nonjudicial workout procedure (the "loan consolidation" process), concurrent with the year-end 1993 recapitalization in an attempt to force banks to resolve problem loans expeditiously. The process is akin to a general workout under contract law, in that any agreement binds only those parties that negotiate it—primarily the major banks, with government creditors agreeing to go along on a pro-rata basis. The procedure does not appear to have strengthened the capacity of debt overall to serve as an effective control instrument. To the extent it undermined the developing bankruptcy process, it may even have been a setback.

*Source* : Gray and Holle (1996).

As noted in Chapter 1, data regarding SOE bankruptcies reveal a relatively consistent pattern: although SOE bankruptcy cases are occurring with increasing frequency, the overwhelming number of them deal with small, *not* large and medium money-losing industrial SOEs. The procedures of the Bankruptcy Law are not wholly followed. Creditors seldom exercise their property rights over assets of bankrupt SOEs, while municipalities and their SOEs view bankruptcy as a way to achieve debt forgiveness. Courts are rarely used, and decisions (including those on asset disposal values) are often made by political authorities—through a closed negotiated process rather than public, transparent transactions. As a major and mostly secured creditor of SOEs, the Industrial and Commercial Bank of China (ICBC) has a strong interest in the implementation of proper procedures to protect its

property rights over assets in which it has taken a secured interest. ICBC's experience in Mudanjiang municipality is indicative of difficulties faced in this regard, as illustrated in Box 2.4; another example of ICBC's experience in attempting to exercise its secured creditor rights—in Wuhan—is described in Chapter 4 (see Box 4.3).

### BOX 2.4: UNCLEAR PROPERTY RIGHTS AND RECOGNITION OF SECURED INTERESTS IN SOE BANKRUPTCIES

ICBC reports that by the end of 1995, 145 SOEs went bankrupt in the Hailin, Ning'an, Dongnin and Muling counties/cities under the jurisdiction of Mudanjiang municipality. Of the 70 bankrupt SOEs that had mortgage loans outstanding with ICBC, the mortgages were declared invalid in 69 cases by certain government departments that, as ICBC reports, considered only their local and departmental interests without abiding by the law. ICBC management, convinced that SOE reform should be carried out in accordance with laws and regulations, intervened with the Mudanjiang municipal government in October 1995 and imposed "credit sanctions." This resulted in an emergency meeting of the municipal government chaired by the Mayor. An agreement was entered into to safeguard ICBC's creditors' rights in these bankruptcy procedures. In all 69 cases the mortgages were "redeclared valid."

Source: ICBC 1996 Bulletin No. 2.

## Conclusions

Within the context of China's state asset management reform program, much progress has been made over the past 15 years in the economic legal framework. It largely provides for an adequate legal and regulatory *foundation* to help define, separate and allocate the ownership, management and regulatory roles of government and SOEs and for the development of market-oriented business practices among the stakeholders (broadly defined) of SOEs.

Thus the Chinese authorities have put in place at the national level a mosaic of legal instruments that in principle (and on paper) provides for a workable legal basis for (a) SOEs to assert autonomy; (b) SOE corporatization; (c) the definition and role of the state as shareholder; and (d) the definition and role of the state as regulator. This national legal framework is complemented by legal instruments at the local level.

Despite these advances, *in practice* from the perspective of institutional reform, the government–enterprise relationship has not materially changed much, with effectively little separation between the affairs of business and those of administration. Substantial progress is thus needed on mechanisms for the *implementation* of the economic legal framework and clear assignment of property rights.

## Clarifying Regulations

Several gaps in the law would benefit from additional clarifying regulations. In particular, (a) regulations governing the conversion of SOEs into LLCs; (b) regulations regarding the transfer of state property; and (c) regulations further clarifying managers' autonomous rights.

## Strengthen the Legal Framework for Market Transactions

As noted, the basic legal building blocks of property, tort, contracts and succession have yet to be legislated. Drafting of the new unified Contract Law should be accelerated. Clarity and enforcement of generic property rights through a cohesive framework also should receive high priority. This can be accomplished through a

comprehensive property law that defines and enforces property rights in all sectors of the economy and without regard to ownership or nationality.

### **Accelerate Corporatization**

Where Chinese SOEs have been incorporated, enterprise governance has been enhanced. Moreover, the process has helped make SOE profits and losses more transparent, established book values of SOE assets and clarified SOE property rights. Accordingly, accelerating the process of corporatization under the Company Law, regardless of an enterprise's financial performance, would be highly beneficial. This could entail a prespecified time frame when all 15,600 large and medium industrial SOEs would be incorporated; subsequently, attention could focus on corporatization of the smaller industrial firms.

### **Enhance Creditor Rights to Force Exit of Value-Subtracting SOEs**

The inadequacy of available tools for exercising creditor rights, including the credible threat of bankruptcy or liquidation, raises concerns about the weakness of external disciplining measures to improve corporate performance and foster needed SOE restructuring and rechanneling of assets and liabilities to higher values in use. Indeed, liability management by SOEs at all levels in China is not well devised. Rechanneling of SOE assets and liabilities to higher values in use through exit, bankruptcy and liquidation cannot be considered a serious disciplining mechanism when in a universe of over 118,000 industrial SOEs, only a handful have experienced such a process, and even then with little regard to commercial factors.

The absence of such mechanisms for large and medium SOEs is only in small part due to problems in the existing Bankruptcy Law. For example, the law does not give effective recognition to a creditor's claims on a defaulter's assets. Consequently, most creditors, especially banks, prefer to keep nonperforming debts "sleeping" (or worse, roll them over with new debt) rather than recover only part of them through a court or out-of-court settlement. The new Insolvency Law currently under consideration by the National People's Congress is likely to make some progress in addressing this problem. But even first class bankruptcy laws and procedures will not fully solve the immediate problems China faces to facilitate the exit of money-losing large and medium SOEs: (a) separating good SOEs from bad, (b) carrying out financial reorganization of sound (or potentially sound) SOEs, and (c) liquidating value-subtracting SOEs. Indeed, bankruptcy measures are most helpful in mature economies with private property rights where a firm has a going concern value (i.e., the firm should not be liquidated) *and* there are multiple-asset claimants all of the same priority rank, thus giving rise to a "free rider" problem (each claimant has an incentive to block a negotiated agreement that otherwise would be in the collective interest unless he or she

got a disproportionate share of the benefits). In China (as in other transition countries) where SOE property rights are publicly held and ill-defined, bankruptcy measures will not help settle conflicting claims of different arms of the State or its agents (e.g., the specialized banks). Rather, the decision to exit should turn on the owner's (i.e., the State's) appraisal that in a commercial environment—one with hard budget constraints and product and factor market competition—the firm will not be a viable concern.

The process of asset and liability reorganization embodied in SOE restructuring need not result in liquidation or even significant worker layoffs, a point often overlooked by authorities in transition economies. Indeed, with the State as owner, the process should be viewed from a public policy perspective: it is a mechanism that facilitates an economy to redeploy assets to higher-valued uses, which over time can *augment* job creation, an outcome far superior to maintaining the status quo.

### **Build Credible Commitment to Property Rights Reform through Changing Expectations**

In the end, the difficulty in readjusting the relationship between the State and enterprises in part is due to the fact that the new property rights approaches and concepts are complex and lag behind actual developments in the marketplace. It is very difficult to change in a relatively short period of time the assignment of property rights formed under the prolonged existence of a planned economic system. China, of course, is not alone in this regard, as the experiences of other economies undergoing transition amply demonstrate. But far more important is that such reform will involve fundamental readjustments in the relationships among various interest groups. This political economy perspective is important to understand fully the barriers to, and devise solutions for, advancing SOE reform: it is proving very difficult for competing claimants to give up their vested interests and powers, or to accept the risks and liabilities.

Thus, a central challenge for the Government is both to articulate more effectively how the social gains from further reform outweigh the costs, and to create sufficient incentives so that the actors implement more fundamental reforms. Based on other countries' experiences,<sup>11</sup> the key to success is for the Government to take early actions that *alter the expectations* of SOE shareholders, managers, workers and the public that there is a credible commitment for more fundamental reforms coming within an announced time frame. In this regard, for example, the Government could, within one year's time, classify which of the 1,000 priority SOEs fall into the competitive sectors and which fall into the noncompetitive sector. This would prepare the way for carrying out within five to seven years a plan for broad ownership diversification. This would include passive minority state ownership (see Chapter 4), and ending fiscal and financial subsidies for the priority 1,000 SOEs that fall into the competitive sectors, while focusing resources earmarked in a special trust fund under MOF for technical renovation of those that are in the noncompetitive sector.

Within the same phased time frame, greater credibility for commitment to more fundamental reform could be introduced and expectations readjusted with regard to the plans for all other SOEs not part of the 1,000 priority group. The preferred option is for the Government to orchestrate a *complete withdrawal* of state involvement in inherently competitively structured industries where small and medium sized firms predominate. While the details of such a divestiture program will need to be worked out, promulgating such a decision would simply make formal a process that is already underway. It would signal a credible commitment by government for deeper SOE reform in a portion of the economy where state ownership brings few benefits and many costs; in fact, the divestiture process could yield significant state revenues. More important it would change expectations on the part of remaining SOE managers that

the Government is more serious about *embracing* nonstate competition as a way of fostering stronger business performance.

A second best policy would be: within one year, regulations could be issued that clarify the precise extent of flexibility nonpriority SOEs have as regards mergers, leases, joint ventures, collectivization or whole or partial divestiture to the nonstate sector, etc., the procedures that must be followed in notifying the State of an enterprise's specific intentions through compacts, and the phaseout of all fiscal and financial subsidies. A decree could then be issued specifying that within five to seven years, these compacts must be implemented.

### **Reallocate Land–Use Rights**

The reallocation of land–use rights of money–losing but potentially commercially viable SOEs located in prime downtown real estate markets offers an important opportunity for enterprise transformation. But such actions should be strategically conceived. If all the returns from the transfer of land–use rights are arbitrarily handed over to the State, an enterprise will likely face diminished resources for restructuring and reorganization. Because such schemes could undermine the integrity of the market valuation process for land, they could also serve to reduce

the overall value of land assets for the economy as a whole. Land–use rights should be allocated in line with market principles of economic efficiency if the value of the State's land assets are to be preserved and enhanced. The emerging practice, which should be encouraged, is to allow industrial SOEs to sell the leasehold land rights to new commercial occupants, split the proceeds with the municipality and use their own share to fund their modernization needs.

### Endnotes

1. We define a property right as a socially enforced right to select uses (including disposal and sale) of an economic good, where an economic good covers not only real property but also other economic resources such as financial assets, human capital and intangible assets.
2. For an overview, see Lichtenstein (1993). The World Bank is assisting China to strengthen its economic legal framework through the Economic Legal Reform Project, which began in 1994.
3. The full name of the SOE Law is: "People's Republic of China, Industrial Enterprises Owned by the Whole People Law" (1988).
4. The rights to "invest" (6) and "merge" (9) as well as the rights to "personnel management" (11) and "organization of international divisions" (13) are combined in the SOE Law as the right to "form associations and invest" (Article 34) and the right to "decide on the establishment of its organizational structure and staffing" (Article 32), respectively. These rights are presented as fully separate rights only in the Autonomous Rights Regulations.
5. For a detailed description of these corporate forms under the Company Law, see Lichtenstein (1993).
6. The full name of the Supervision Regulations is: "Regulations Governing the Supervision and Management of State Owned Enterprises' Property" (1994).
7. It should be noted that this Board of Supervisors is different from the Board of Directors. The Board of Directors is selected by the shareholders and represents the owner of equity and can exercise a full range of owners' rights. The Board of Supervisors has only the power to monitor the enterprise management ex–post and to report misconduct by the management to the owners.
8. "Court Workload Surges," *China Daily* , July 8, 1996.
9. World Bank (1996), *China: Reform of State–Owned Enterprises* .
10. World Bank (1996), *China: Reform of State–Owned Enterprises* , Chapter 3.

11. See Chapter 4 on the Polish experience.

### 3— Reform of Organizational Structures

#### Introduction

Organizational changes have been the most visible aspects of China's state asset management reform process. The key structural manifestation of these changes is the emerging multitier State Asset Management System, which comprises a network of dedicated institutions at the central and subcentral levels. At each level of government—national, provincial, municipal and district—there are typically three tiers: (a) an "upper-tier organization," which represents the State as owner, usually through an executive body; (b) an "intermediate organization," which is entrusted by the upper-tier institution to manage state-owned assets; and (c) the "operational enterprises," i.e., SOEs.

Two other types of organizational changes under way are also critical aspects of state asset management reform; indeed, they are best seen as integral components of the emerging multitiered system: the transformation of large and medium SOEs into LLCs and LLCs under the Company Law; and the establishment of 57 enterprise groups under central-level authority, an effort that began in 1991 and accelerated after the promulgation of the Industrial Policy program in 1994.

#### Organization of the State Asset Management System

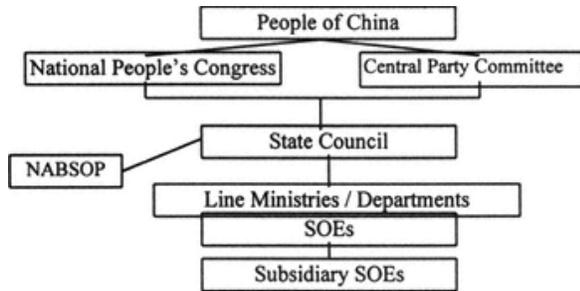
At the national level, the upper-tier institution is the State Council, acting as the "ultimate owner" on behalf of the people of China. The administrative arm of the State Council to carry out its state ownership functions, as described by the Supervision Regulations, is NABSOP. Established by the State Council in 1988, NABSOP's principal functions are: "the drafting of regulations, statistical compilation, property rights definition and asset evaluation, supervision of asset preservation and appreciation, formulation of performance targets and appraisal of performance, and resolution of property rights disputes over state-owned assets."<sup>1</sup>

Figure 3.1 illustrates how China's state asset management system has evolved since the creation of NABSOP in 1988, the current phasing out of line bureaus and ministries, and the prospective objective of bringing in new stakeholders. It is this organizational transition that is the focus of this chapter.

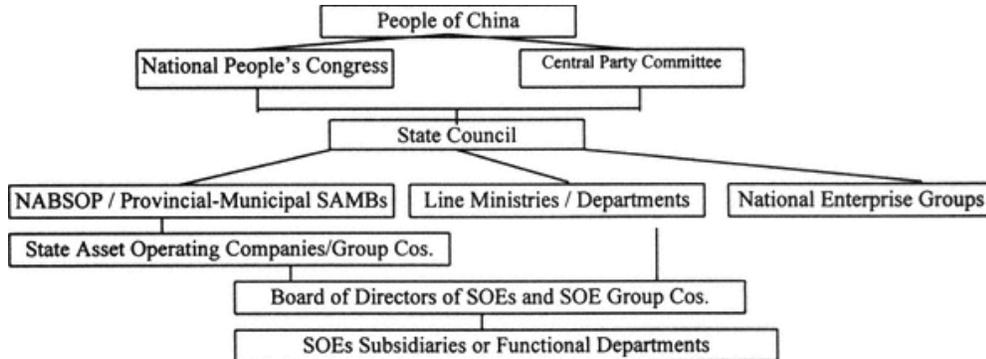
Analogous to NABSOP, upper-tier executive bodies are also being established nationwide at subcentral levels of government, such as municipal-level state asset management bureaus (SAMBs). These receive "guidance" from the national-level NABSOP but are not under its direct control. Another variant of these upper-tier organizations includes centrally controlled, large group enterprises governing various industrial sectors throughout the country, such as SINOPEC (China National Petrochemical Company). These enterprise groups are "entrusted" to manage state assets directly, reporting directly to the State Council without reporting to NABSOP. There are presently 57 such enterprise groups (Annex 5).

The intermediate-tier functions are carried out in a myriad of ways. In some cases, there are provincial-level group enterprises with regional monopolies in one sector, such as the Dongfang Electric Group. These large entities (often referred to as "Group Companies") are entrusted to invest in and manage directly the state assets in operational enterprises. Each Group is to be converted to a wholly state-owned corporation (LLCs) under the Company Law. In many cases, one or more of its subsidiaries will be organized as LLCs, revalued, separated from social assets and its shares offered on domestic and international markets (e.g., Wuhan Boiler Group intends for its subsidiary, Wuhan Boiler Company, to offer B shares).

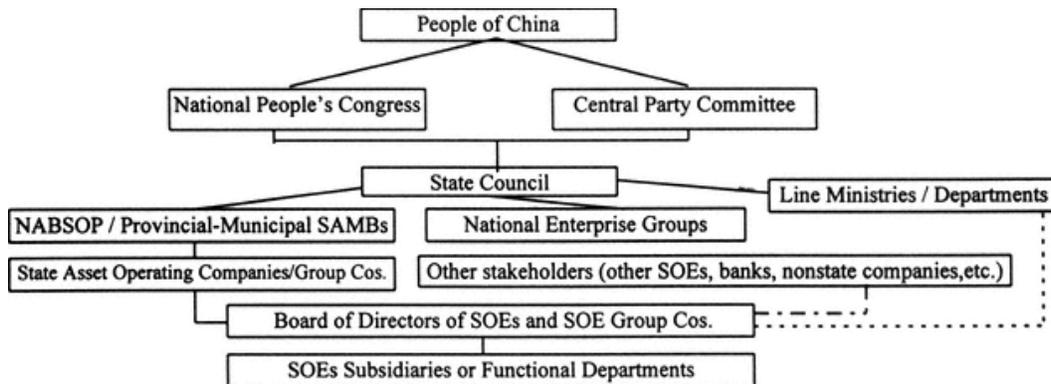
## China's Management of Enterprise Assets



(a) In the past, line ministries/departments managed state assets in SOEs.



(b) At present, new state asset management organizations and enterprise groups are being introduced



(c) In the future, line ministries/departments will be phased out; the new state asset management organizations, enterprise groups and other stakeholders will participate in SOE governance.

Figure 3.1:  
Organizational Structures of China's State Asset Management System  
Source: World Bank mission.

For the most part, the intermediate tier is comprised of provincial—and municipal—level holding enterprises—State Asset Operating Companies (SAOCs)—which may or may not have their own operations. In many cases, these holding companies are being constituted by corporatizing all or most of the traditional line bureaus or ministries as wholly state-owned LLCs. For example, in Wuhan the Chemical Bureau has been converted, in part, to the Wuhan Chemical State Asset Operating Company (the other portion of the bureau was converted to the Wuhan Chemical Industry Management Office, which is responsible for planning, strategy and policy for the whole chemical sector in Wuhan.) Wuhan Chemical State Asset Operating Company is registered as an LLC under the

Company Law. It manages 13 SOEs within Wuhan's chemical sector. Box 3.1 contains the approval by Chongqing municipality for creation of the Hua Mao State Asset Operating Company. The approval reflects the creation of a commercial entity from a line bureau and the consolidation under it of nine related enterprises. A variant of the Group Company and SAOC is the "sponsored" holding companies, formed by combinations of previously existing enterprises and governmental agencies; the vast majority of these sponsored holding companies are, or will be, organized as LLCs (most wholly state-owned) and entrusted to act as SAOCs.

At the third, or operational tier, are the numerous SOEs of various size and organizational forms, usually including ownership-diversified enterprises such as LLCs, LLSCs listed domestically and internationally and joint ventures.

### State Asset Management at the Subcentral Level

Below the national level, there are several models of the three-tier state asset management system; while the models differ somewhat in their organizational form at the upper and intermediate tiers, their functions and substantive roles are identical in practice. Shanghai's system is the basis for most other cities. In Shanghai, a State Asset Management Committee (SAMC), organized as a governmental department, exercises the state's ownership interests in the state's municipal assets. The SAMC is comprised of the heads of the major departments of the municipality (more than 30 persons) and chaired by the mayor. The SAMC has established an executive body—the State Asset Management Office (SAMO)—to perform the administrative functions prescribed by the Supervision Regulations, including the determination of performance indicators and the development of the performance contracts to be executed between the SAMC and its holding companies at the intermediate layer. The SAMO is a bureau-level organization with its own budget and a staff of about 50 drawn from governmental agencies. At the intermediate tier, Shanghai has converted almost all sector line bureaus into holding companies or sector "trade associations." Figure 3.2 illustrates the Shanghai model.

Shenzhen's system is a variant of Shanghai's. It employs a State Asset Investment Company (SAIC) as the upper-tier institution, where the SAIC is a corporatized legal entity. The SAIC's board members are drawn from the main municipal bureaus, and the board is chaired by the mayor. The Shenzhen SAIC's staff and their functions are substantively identical to the Shanghai SAMO.

Another prominent model is the one established by Chongqing. Chongqing's state asset management system has a Leading Group—an interagency council chaired by the mayor—acting as the top tier that determines major policy and personnel appointment matters. The Leading Group has a small, internal executive staff, not a large, separate state asset management bureau. Figure 3.3 illustrates the Chongqing model, showing the relationship among all three tiers: the Leading Group, an SAOC (Hua Jin Asset Operating Company), and one of its operating entities, the San Ling Industry Company.

<b>BOX 3.1: CHONGQING APPROVAL FOR ESTABLISHMENT OF HUA MAO STATE ASSET OPERATING COMPANY</b>
The proposal for establishing Chongqing Hua Mao State Asset Operating Company (Asset Company) is hereby accepted by the Chongqing Municipal Government (CMG).
The Asset Company is to utilize operational state assets entrusted to it in a market-oriented fashion, with autonomous operation and assuming sole responsibility for profits or losses. The Asset Company is to be an enterprise legal person under the Company Law, enjoying independent civil rights and bearing civil responsibility as well as a city level commercial state asset management. It is to be supervised by the CMG SAMB. The Asset Company and the relating enterprises are equal civil bodies linked by property rights and property right

## China's Management of Enterprise Assets

<p>representatives who will be sent to those enterprises by the Asset Company. The company will enjoy a portion of any state asset gains as well as bear limited responsibility for enterprise debts based on the amount of investment it has made.</p>
<p>The main functions of the Asset Company are:</p>
<p>1. To enhance the value of state assets within entrusted scope according to the authorizing management contract signed with SAMB.</p>
<p>2. To work out a program of the company's operation within the state asset management system.</p>
<p>3. To be involved in the decision-making of asset management form of the investing enterprises and distribution method of state asset gains.</p>
<p>4. To examine value-appreciation indicators of enterprise state assets.</p>
<p>5. To be in charge of collecting state asset gains.</p>
<p>6. To be engaged in purchasing, selling and renting of state asset rights according to relevant laws.</p>
<p>7. To develop activities of capital raising and necessary funds circulating according to relevant regulations.</p>
<p>8. To appoint property right representatives according to regulations concerned.</p>
<p>9. To carry out autonomous operation and other investment developing activities.</p>
<p>The business scope of the Asset Company includes management of state assets of SOEs, joint-stock companies and Sino-foreign joint ventures, state assets as shares invested into other enterprises, and the capital raised from issuing negotiable securities by banks so entrusted. The management forms of the Asset Company include stock controlling, shareholding, jointly operating, assets management responsibility system, leasing, property right transferring and investment development.</p>
<p>The registered capital of the Asset Company is 300 million yuan, composed of state assets of nine city-level experimental enterprises and the gains of state assets before the end of 1994 (mainly the state shares dividend from Chongqing Department Store Co. Ltd., and Chongqing Friendship Store Co. Ltd.)</p>
<p>Profits of the Asset Company will include:</p>
<p>dividend from state shares of joint-stock enterprises.</p>
<p>property right gains from state-owned wholly funded enterprises.</p>
<p>rent collected from leasing whole enterprise state assets.</p>
<p>net income collected from the transfer of state property right.</p>
<p>other incomes from autonomous operation.</p>
<p>A board of directors of the Asset Company will be set up with seven to nine persons who will be selected and appointed by the Municipal Finance and Economic Bureaus and SAMB. The chairman of the board of directors will be nominated by the Finance and Economic Bureaus, approved by SAMB. The general manager of the Asset Company will be appointed (and can be dismissed) by the board of directors. A board of supervisors should be set up according to</p>

relevant regulations. The size of the staff will be determined through negotiations with departments concerned; some staff members in the departments such as the Finance and Economic Bureaus, the First Commercial Bureau, the Second Commercial Bureau might be transferred to the newly established Asset Company.

The Asset Company should finish the required formalities and be put into operation as quickly as possible. The CMG departments concerned should try their best to assist the Asset Company and solve problems which might emerge at the establishing period so that it can ensure the proper performance of the Asset Company in accordance with new enterprise mechanism, realize value appreciation of state assets and provide useful experience of overall transferring of management mechanism and establishing modern enterprise system to commercial enterprises in Chongqing.

Source : Chongqing State Asset Management Bureau.

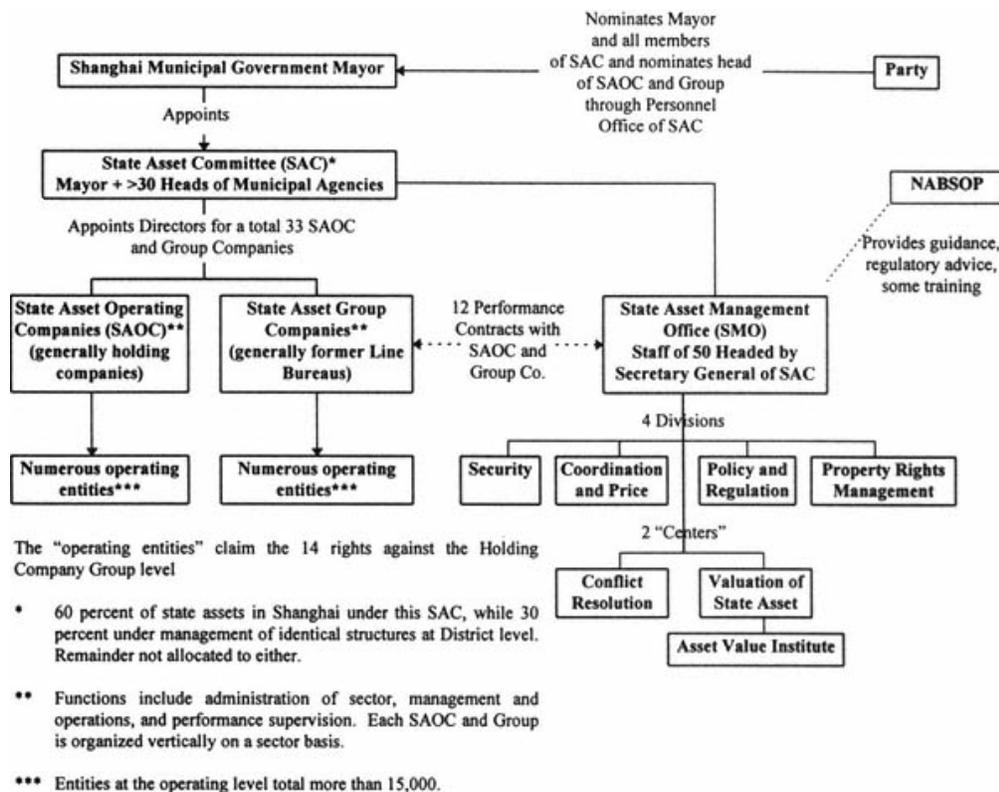


Figure 3.2:  
Shanghai State Asset Management System  
Source: World Bank mission.

### Separation and Monitoring

The composition, operations and dynamics of the upper and intermediate tiers of the new structures do not provide for significantly greater organizational separation of governmental affairs from the ownership functions. Organizational reforms have not resulted in such separations since they have not produced specific, clearly identified and accountable entities whose duties and powers are focused solely on and capable of achieving the objectives of the owner.

The new structures have also not put in place processes for effective monitoring of SOEs. This is particularly so at the upper tier, which has not developed an organization to advocate effectively the State's shareholder interests. The State Council and NABSOP are fundamentally governmental bodies. At lower levels, SAMCs (and the Shenzhen SAIC's board of directors) are drawn from different governmental agencies. Monitoring of the intermediate and operations tiers' performance is also fragmented, with companies reporting to different governmental agencies for different purposes.

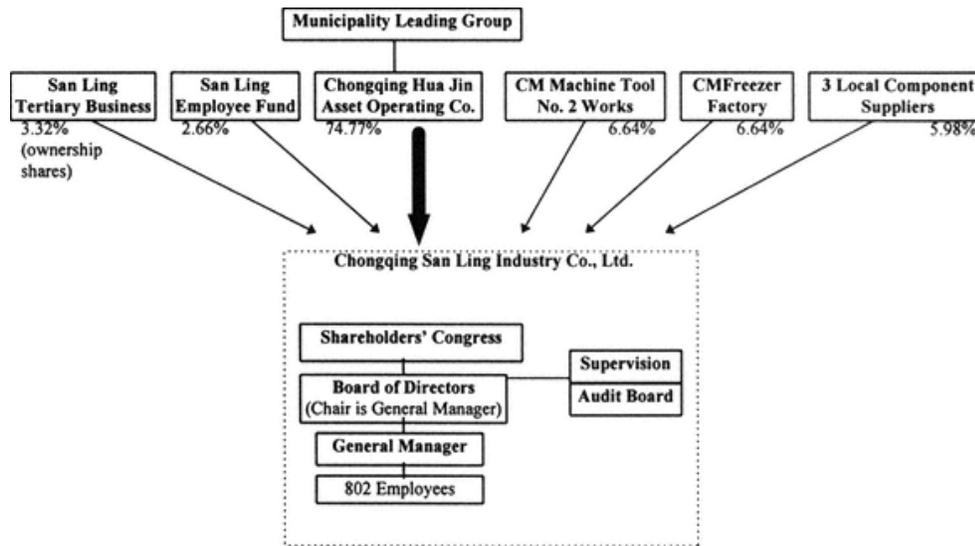


Figure 3.3:  
Chongqing's State Asset Management System  
Source: World Bank mission.

These organizations are building capacity for more efficient SOE performance monitoring (e.g., the Shanghai SAMO is acquiring modern technical skills for interpretation of SOE accounts and the ordering of independent audits), but they remain largely administrative bodies. Few have the budget, skills or freedom from governmental influence to propel the bulk of state enterprises into modern corporations. None receive timely financial performance information, with many receiving only annual reports. Their staff remain civil servants, and their heads often have duties in *other* agencies (e.g., the Sichuan SAMO head is also the deputy head of the Finance Bureau). Their staff are often without the necessary economic incentives to act decisively or authoritatively in the interests of the owner. Rather, they act primarily as a conduit—documenting or expressing administrative approval as to the adequacy of the documentation of transactions. *Overall, in the absence of more substantive "separation," these structures face inherent internal contradictions between governmental and shareholder—ownership incentives. In such circumstances, the scope of reform they can accomplish is very narrow.*

### The Enterprise Level

#### Implementation of the Corporate Form

In their dash to efficiency under a nascent market-oriented legal and regulatory environment with unclear or poorly defined property rights, Chinese SOEs face a formidable hurdle to introduce (or in some cases, strengthen) the four basic elements of the modern corporation (recall Box 1.7). *The reality is that in China the corporate form is an innovation for the State and an imposition for most enterprises, not a natural evolution. The result is that the fundamental attributes of the modern corporate form are not yet well-established, though early steps have been*

*made in the right direction .*

With respect to establishment of a *separate legal identity* , there has been only a minor degree of corporatization (Chapter 2). But the corporatization process has not resulted in a clear definition of property rights. Responsibility for residual risk, particularly allocation of liabilities, is also not well defined.

In the case of *limited liability* , there is a perception at all levels that the State's liability for SOEs is greater than its formal or legal shareholding. Moreover, an organizational blurring has occurred and this has given rise to widespread problems with the definition and allocation of responsibility for liabilities. This includes not only bank–SOE debt, but also social liabilities such as schooling, medical care, unemployment benefits and pensions. In many cases, these are shared by enterprises with local governments, but with imprecisely defined accountability. Accounts receivable/payable, rights of lenders in property financed and property relationships between companies controlled by the same group enterprise often are unclear (see Chapter 5).

*Centralized management* , another element of the modern corporation, is relatively well established—except that usually the corporate form envisions shareholders to come first and then the most competent management is chosen. In China, centralized management existed *before* the company did; in fact, before there were shareholders. With the sequence reversed, there are different dynamics. In China, shareholders, as such, seem to have little, if any, influence on management. This will remain the case so long as the majority shareholder remains the same state agency and the same persons that in the old system appointed and gave orders to management.

At the same time, management is often lacking the authority to deploy and dispose of the corporation's property. As a result they cannot effectively face competition. Chinese SOE managers are like generals who in battle cannot redeploy their troops or equipment to fight the more agile opposition.

*Transferability of shares* is available for only the small portion of companies whose shares are listed on the two stock exchanges (although there are about two dozen informal share–trading centers). Moreover, transferability is, in general, segmented: those individuals who own "A" shares can only seek to transfer among Chinese citizens; and "B" shareholders may seek transferability only among nonnationals. All other shareholders must seek approval for share transfers from state asset management institutions.<sup>2</sup>

Overall, many of the basic corporate elements are weak or absent in China's corporatized SOEs. This weak structure limits their ability to operate in a commercial manner and to preserve and increase state asset values.

### **Implementation of the Incentive Structure**

The key organizational issue for ensuring the effective use of *internal incentives* (recall Box 1.8) is the extent to which China's SOEs possess the structural setup for the owners to maximize profitability and accountability, while permitting the managers the necessary degree of autonomy to operate the corporation efficiently (the internal governance mechanisms through which such incentives actually operate are assessed in Chapter 4). From this perspective, China's new corporate structures, in the main, lack clear lines of authority between owners and management. *In every case examined for this study, the majority of members of the boards of directors and the senior executives are one and the same. There is no real distinction. In addition, board members are nominated not by a commercially oriented owner's representative, but by governmental or Party bodies .*

The introduction of individual shareholders through the public listing of operational enterprises' shares has not effectively redefined the main organizational characteristics of the ownership/management interests in these companies. This is true even for the most advanced cases of SOEs that have been corporatized, such as the

Shanghai Petrochemical Company Ltd., whose shares are listed on the Shanghai, Hong Kong and New York Stock Exchanges (Box 3.2). Institutional shareholders of SOEs,

<b>BOX 3.2: SHANGHAI PETROCHEMICAL COMPANY LTD .</b>	
<pre> graph TD     SC[State Council] --&gt; SINOPEC[National Co. SINOPEC]     SINOPEC -- "Appoints all Directors 62% A shares majority shares" --&gt; SPCL[Shanghai Petrochemical]     SPCL --&gt; Board["Board—17 members of which: 6 are from Ji, 8 are from divisions within the company; and 3 are outsiders"]     Board -- "Appoints Executive" --&gt; Exec["President and Vice Presidents (all but 1 Vice President are Board members)"]     Exec -- "Manage divisions" --&gt; Divs[6 boxes representing divisions]     SINOPEC -- "Contracts" --&gt; JT["SINOPEC Shanghai Tinshan Co. ('JI') Noncore business Community services Founded 1993"]     JT -- "Payment" --&gt; SINOPEC     </pre>	<p>Organization Chart of SPCL</p> <p>Related transactions:</p> <p>Raw materials: Crude oil for feedstock—subsidize prices</p> <p>Sales: 33% to State Plan</p> <p>83.6% to East China customers</p>
<p>The board and the management of the Shanghai Petrochemical Company Ltd. (SPCL) are appointed by the majority owner—SINOPEC, the national petrochemical monopoly. Of SPCL's 18 directors and executives, only 3 are not from the company's staff. In addition, all three of the members of the company's Supervisory Committee are from the company's staff. The appointment and compensation of the Directors, executives and Supervisory Committee are determined by SINOPEC. All SPCL directors are elected simultaneously for a term of three years. All but three have been with SPCL (or its forerunner) most or all of their careers. Only three have had any experience outside the company complex and only two have had extensive experience outside Shanghai. Thus the owners' representatives and the management are essentially a closed community of long standing, reflecting a sectoral and regional isolation imposed by outmoded self-reliance and regional protectionist policies.</p>	
<p>Neither the Company Law nor the SPCL's Articles of Association provide for mandatory representation of minority holdings. Since shareholder(s) of greater than 50 percent elect the entire board at one time, so long as SINOPEC retains the majority, it has effective control. Without minority rights to elect a representative to the board and since SINOPEC has made it clear that it will retain a majority shareholding, the other owners of SPCL—in the Shanghai, Hong Kong and New York stock markets—lack the ability to effectively discipline or monitor SPCL management performance.</p>	

On the other hand, SPCL management reports that it has been influenced by the disclosure requirements for public listing, combined with a desire to maintain a strong price for shares in order to raise capital in the future. So long as the company has shares to sell and the majority stake of SINOPEC is maintained, the owners' best check and discipline on the company board and management is the public share price. However that price is already low compared to other international firms within the petrochemical industry: SPCL's price/earnings ratio is less than 50 percent of similar companies. This ratio might go lower if SPCL management no longer has an incentive to maintain the public share price (i.e., if SINOPEC's shareholding is reduced to just over 50 percent).

*Source* : Mission interviews with senior SPCL management; Annual reports; US SEC Form 10-K and Form 20-F.

whether in the form of traditional line ministries and bureaus, other enterprises, or the new state asset management institutions, although providing more sophisticated oversight than individual shareholders, are generally not organized in such a way to marshal sufficient information, experience and skill to assess effectively an enterprise's performance. Still, in some cases, ownership diversification by institutional investors has been an effective mechanism for disciplining the new corporate structures. For the Wuhan Organic Chemical Company (WOCC), for example, a number of nonstate entities that had

minority interests and influence, but unclear property rights in the enterprise, were able to transform their interests into specific property rights, in the form of shareholding. Then, these entities further negotiated their representation on the WOCC's board and caused the General Manager to be appointed by minority board members and consequently to consider market share and profitability more closely. Thus, WOCC's board diversification provided a vehicle for debate about strategic issues: the company's marketing, dividend and investment policies.

Despite the significant progress since the opening of the Chinese economy in 1978, some of the *external incentives* key to instilling effective discipline on SOE conduct and performance remain nascent. There is weak product market competition *across* geographic markets, especially at the wholesale level (Chapter 1). While a competitive labor market is beginning to develop, for all practical purposes there isn't a robust market for managers.<sup>3</sup> The lack of security for commercial transactions, the absence of concepts of executive fiduciary duties, and the weak systems in place for competitive financial intermediation also mean corporatized Chinese SOEs are not subject to one of the most powerful external incentives that impinge on most modern corporations—the obligation to service debt. While banks and SOEs report that collateral is, in fact, given for loans, the taking of security does not affect the interest rates or terms of the loans (these are determined by policy guidelines within the financial sector). *Importantly, enforcement of SOE collateral is not widely practiced*. The banking system continues to lend to SOEs largely on the basis of the credit plan, and bankers are unaccustomed to managing differentiated interest rates, risks, liquidity or asset liability. Asset-backed lending to SOEs is also essentially nonexistent.

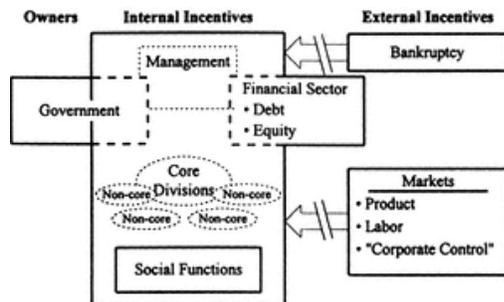
Nor are the emerging capital markets yet a significant external factor for SOE discipline and performance monitoring. Rather, present policies and practice limit capital markets to a means for resource mobilization, determined not by competition among all enterprises and won by the most efficient users, but rather determined by administrative planning. In cases of SOE restructuring, potentially viable enterprises are chosen administratively and restructured—with liabilities removed to a sister company—and then presented to the public as attractive vehicles for investment. Since the enterprises' dividend, investment and management policies and personnel are all determined by the majority owner (the State), there is no effective "market for corporate control."

Overall, the transformation process of organizational structures at the enterprise level holds the most promise among the three tiers, largely because it is rooted in a model that has proven successful worldwide. But to date, China's implementation of the modern corporate form is still evolving (Figure 3.4). The authorities recognize that further changes are called for in improving internal management structures, especially delinking social service obligations, and in strengthening external discipline, especially interfirm competition and debt-service obligations.

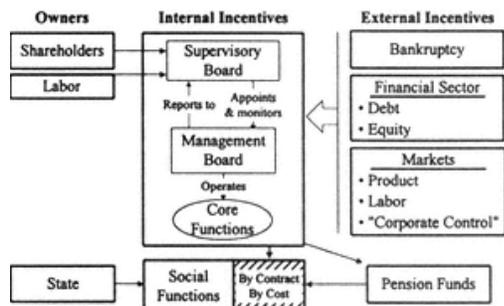
### The Upper Tier

To monitor management performance, the more efficient upper-tier organizations set performance indicators and monitor their compliance through a combination of receipt of financial statements, performance contracts with enterprise management, and audits by a supervisory committee; frequency, quality and comprehensiveness of information varies. However, unlike an owner that can take a number of enforcement actions for noncompliance (most significantly, replacement of management, cutoff of capital and debt or ultimately exit by sale), these organizations have "no teeth." They do not have the authority, resources or incentives, as representatives of the owner, to take specific measures to discipline a lower-level

entity's board or management in the event of noncompliance (e.g., change existing dividend and investment policies, control bank and interenterprise debt, reallocate profits, and set personnel appointment and compensation policies). There are no clear incentives for NABSOP or the SAMOs to act as market-based, efficient monitors for the owner, since they have little to risk or gain as a result of enterprise financial performance. Staff pay and promotions are determined by administrative criteria, not the success or failure of commercial ventures. Some of the national enterprise groups, such as SINOPEC, have no board of directors. The managers report through the enterprise president directly to the State Council.



In Chinese SOEs, internal and external incentives are blunted; social functions are integral to the firm...



...whereas the modern corporation is disciplined by internal and external incentives; it has shared responsibilities

Figure 3.4:  
Implementation of the Modern Corporation  
Source: World Bank mission.

None of the upper-tier organizations have the independent power to appoint the board of directors of the intermediate-level enterprises. They do not independently develop or approve corporatization plans for the intermediates. In some cases (e.g., the relationship between NABSOP and large group enterprises such as SINOPEC), they have little or no authority at all over the intermediary. In addition, these organizations have no ability to exert financial discipline on the underlying enterprises' liabilities. They do not act for the owner in approving or disapproving loan guarantees. They come to learn of these undertakings usually after the fact. Generally, they have no contact with the intermediate enterprise's "main bank." Thus, they have neither the information nor the enforcement power to ensure an enterprise's continued financial viability.

The large majority of the entities the upper tier manages—SAOCs—are being organized as wholly state-owned LLCs. Under the Company Law, there is a strong incentive for the owner to place its own, nonconflicted representatives on the board of such LLCs. The powers of the directors of this form of corporation are greater than those of other corporate forms, since there is no shareholders meeting and certain powers normally reserved to the shareholders are given to the directors (Article 66 of the Company Law). Although the directors may also serve as managers (Article 69 of the Company Law), directors who have day-to-day interests in management cannot also be expected to exercise assessment of management. Their dual role creates significant burdens for their supervision by the owner's representative.

### The Intermediate Tier

The transformation of line bureaus, existing group enterprises and existing large enterprises into SAOCs has not effectively introduced a modern corporate form. Only in a few cases (e.g., Shanghai First Department Store (Group) Co. and Hwa Jin Assets Co., Ltd.), are SAOCs developing modern matrix management structures. However, these reforms have been limited. In virtually all cases, SAOCs retain governmental duties as well as ownership functions. For example, they are responsible for dealing with redundant labor in the underlying SOEs. The result is that the organizational structures at the intermediate level continue to be more administratively, rather than commercially, oriented. *In fact, many of the underlying SOEs see no difference between the old line bureaus and the new SAOCs, other than a name change .*

*Most intermediate-level holding or group companies do not have powers and rights that normally attach to a modern corporate parent .* For example, the Vice Chairman of the Dongfang Electric Group indicated that his board does not have: (a) the authority to appoint and dismiss a subsidiary's management or its boards of directors (the chairmen and general managers are usually nominated by governmental or Party authorities, not the management of the parent company); (b) the right to initiate the bankruptcy or liquidation of loss-making, nonviable enterprises within the group; (c) the right to receive, retain or reallocate subsidiaries' profits and determine their dividend and investment policies; and (d) the right to limit the debt of the subsidiaries. Critically, while lacking the right to financially control and limit the liabilities of the subsidiaries, the parent groups are nevertheless responsible for liability management, bearing the residual risk of loss for the State as owner.

*Few SAOCs are being organized on a cross-sectoral or cross-regional basis .* This exacerbates China's rigid pattern of industrial organization, where excessive sectoral specialization and regional self-sufficiency have slowed the development of a flexible and unified market. One innovative cross-sectoral SAOC examined is the Hua Jin Asset Operations Company in Chongqing, which is under formation. This SAOC has begun to diversify its portfolio of investments across several sectors, and seeks to supervise but not directly manage its shares in its invested companies. In fact, it has had mixed success in asserting its rights under the Company Law to appoint individuals to the boards of its subsidiaries who are neither managers of the operating company nor appointees of

the local government.

Overall, most of the intermediate structures amount to superfluous layering. They are generally counterproductive to advancing Chinese SOEs into modern corporations. Only if these structures themselves are restructured into commercial corporations and staffed by professionals whose compensation is tied to corporate performance can they play a useful *transition role* in diversifying state assets. But in the long run, most of them should be eliminated.

### Conclusions

China's state asset management organization is burdened with contradictions and conflicts of interest; taken together, they prevent attainment of the separation objectives called for in the Supervision Regulations. The greatest success in meeting these objectives has been at the enterprise level, where the Chinese corporate form is based on the modern corporation, which has proven to be effective in many countries. But at the intermediate and upper tiers, the Chinese approach ignores many of the lessons of international experience. Part of the difficulty is the owner–manager conflict inherent in any large multilayered business organization. Thus, an operational enterprise may have been granted the 14

Autonomous Rights, but its managers find these rights compromised or reduced by the enterprise's SAOC. For this reason, operational managers insist on being the chairmen of their boards and having the boards drawn mostly from their staff and local officials.

But this conflict is also the product of fundamental contradictions between a State's governmental functions and enterprise ownership interests. Indeed, even in the more effective multitiered organizational models of state asset management around the world—for example, the French and New Zealand systems—these contradictions are present (Box 3.3). But, unlike China, these systems employ market–based incentive structures that go a long way to mitigate these contradictions. In that regard, they constitute alternative modes for Chinese policymakers to consider in restructuring the country's state asset management organizations. Still, in the end, both the French and New Zealand authorities have concluded that because of the fundamental contradictions, their state asset management systems are not producing—and *cannot produce*—the strengthened economic performance promised, let alone match the performance of nonstate firms in their economies. Like other countries, Austria, for example, they have begun to dismantle these state asset management organizations—especially in the competitive sectors—and have embarked on privatization of SOEs as a way of locking in hard–won SOE reforms and ensuring superior business performance.

Within this context, China could strengthen the State's ownership interest and better achieve the aims of the Supervision Regulations through several organizational reforms:

#### **Simplify the Organizational Network**

China's SOEs that are less encumbered by the new multitiered organizational structures—insofar as the State's interests as owner are represented at the enterprise–board level—appear to be the more resilient to shifts in market forces, more innovative in devising business strategies and better performers. Most of the SOEs examined for this study perceived no effective change from the new state asset management network of SAMBs, SAOCs, etc., relative to the old line bureau system; some even suggested they were more hampered or confused by the new, layered arrangements. International experience suggests that organizational efficiencies have been most pronounced where reforms have not utilized large holding company structures. With these findings in mind, China's present structures should be modified based on the principles of greater simplicity and clarity in the role and function of the component bodies and, wherever feasible, *eliminating layers*. Experiments in a dozen cities involving firms in the 1,000 priority SOEs should be piloted to assess the benefits and costs of collapsed

organizational structures; i.e., where intermediary agencies are replaced by direct representatives of the State on enterprise boards of directors. A determination for broadening such a reform could then be made.

The experience of other countries in economizing on state representation are instructive. In Brazil, reforms in organizational structures resulted in a small number of highly skilled senior staff, about 60 professionals to oversee 250 enterprises. Korea reduced its representation on public enterprise boards of directors to two professionals out of nine directors, even though the government held majority ownership, and New Zealand relinquished ministerial representation on boards of public enterprises altogether. France has created a state–shareholder council, which reports directly to the finance ministry. It is charged with evaluating the most efficient ways the state should intervene in the running of public sector companies. The council is comprised of 10 individuals drawn from the private and public sectors, and is chaired by a person drawn from the private sector. At the same time, there are stringent rules that

separate the duties of finance ministry staff between regulatory authorities and fulfilling state–shareholder responsibilities.

### **BOX 3.3: ALTERNATIVE STATE ASSET MANAGEMENT ORGANIZATIONAL MODES : FRANCE AND NEW ZEALAND**

**France's** state asset management system is not based on a conceptual model, but has evolved over time case by case. As a result, the system is comprised of several types of organizational designs, largely differentiated between competitive and noncompetitive sectors. The French SOE system was established following World War I, grew rapidly in the mid–1940s, and following nationalizations, expanded further in the early 1980s. In the late 1980s, a privatization program was begun in the competitive sector, covering 21 major SOEs, including 14 industrial groups (e.g., Renault, Air France and Aerospatiale), four banks, insurance companies, among others. In the future, following full implementation of the program, SOEs will be concentrated in the noncompetitive sector (e.g., electricity, coal, natural gas, railways and subways, postal services, and (for a time) telecommunications. French SOEs have two main legal forms, "public establishments" (PEs) and "public commercial companies" (PCCs). PEs generally engage in noncompetitive utility services and under the law must provide equal access to all customers (common carriage). PEs are not corporatized. State ownership of PEs is 100 percent, but subsidiaries with minority nonstate ownership can be created. The PCCs are usually in the competitive sector and are corporatized (joint–stock companies). State ownership of PCCs can be either complete or partial; a 1991 decree provides for nonstate capital investors in PCCs. For the typical PCC, the State acts akin to a private shareholder. Through its representative (see below) it appoints members of the board, approves the company's strategic plan, its financial accounts and distribution of earnings. It determines the amount of debt the firm can issue, any increase in share capital and merger and acquisition decisions. For PEs, the State generally exercises direct control, typically through line ministries or bureaus. Through its various departments, the Ministry of Economy and Finance acts as the State's custodian of SOEs. The Treasury department carries out ownership functions, the Budget department handles any budgetary assistance paid by the State and the Price department (in conjunction with line ministries) makes decisions regarding price–setting in the state sector. The Economics and Social Fund is a special account within the state budget to coordinate the Government's investment policy toward SOEs. The Fund's board is comprised of heads of line ministries, representatives of financial institutions and high level civil servants. It is chaired by the Minister of Economy and Finance. The Government must provide the Parliament with an annual list of SOEs, and

their audited balance sheets and profit and loss statements.

In **New Zealand**, the Government transferred enterprises in the competitive sector from line ministries to 19 corporatized SOEs as part of a wide-ranging state asset management reform program that began in 1984. Under the State Owned Enterprise Act of 1986, all the SOEs became limited liability corporations and new organizational structures for control and monitoring by the State were established. The commercial functions of the enterprises were separated from their previous social service obligations. The shares of each SOE are held by two ministries, which act as the SOE owners on behalf of the Crown—the Ministry of Finance (MOF) and the Ministry of State Owned Enterprises (MOSOE) (created in 1986). As specified under the SOE Act, each year all the SOEs must prepare a public statement of corporate intent (SCI), which is to be approved by MOF and MOSOE. The SCI sets out the performance targets for the next three years, the level of dividends to be paid, and any compensation that the SOE expects to receive from the Government for pursuing noncommercial objectives. A State-Owned Enterprises Steering Committee and Crown Company Monitoring Unit also monitor the performance of the SOEs. The Committee is comprised of individuals from the nonstate sector who advise the heads of MOF and MOSOE on strategic issues. The Unit, also comprised of nonstate individuals, reviews the SCI for MOF and MOSOE. Audited financial accounts are delivered to MOF and MOSOE and to the House of Representatives annually. The most innovative feature of the New Zealand state asset management model is the use of nonstate representatives on the SOEs' boards of directors. The case of CoalCorp illustrates the point. CoalCorp is monitored by a board comprised of five to seven directors from the nonstate sector. Board members are appointed and removed by MOF and MOSOE. Ministers or other government officials do not usually sit on the board. Nor are managers of the company appointed to the board. Membership on the board is part-time employment and is remunerated as such. In addition, of the 30 people in CoalCorp's head office, only two were associated with the previous State Coal Mines (the forerunner of CoalCorp); and only a handful of CoalCorp's employees are ex-ministry of Energy or civil servant staff. In 1994, the New Zealand government announced its intent to privatize CoalCorp through share sales to the public.

*Source:* World Bank, "Corporate Governance of Public Enterprises in Transitional Economies"; World Bank, "Improving State Enterprise Performance".

### **Reorient Organizations toward Financial, Rather than Administrative, Management of Assets**

Realization of the goals of asset preservation and enhancement will ultimately require that state asset management institutions shift from their traditional role of administrative control of state-owned property to financial management. This will necessitate not only changes in governance incentives (see Chapter 4) and reform of accounting and financial system controls (see Chapter 5), but also restructuring of existing (and emerging) organizational structures. This will be critical for improving the efficient management of state assets in noncompetitive sectors, e.g., local public utilities, where the rationale for government intervention may be strong (see Box 1.9). Within municipalities, government could diversify ownership among state-owned corporations. The State would continue to have a direct shareholding in such utilities, but majority ownership could be sold or transferred to a consortium of local development companies (LDCs) established to promote the development of a municipality. These LDCs would be commercially oriented entities independent of government budgets; their funds would be raised from the public, institutional investors (enterprises, banks or other financial institutions, e.g., insurance firms) and, potentially, social security funds. For example, a power plant in or around Wuhan could be partly owned by the Wuhan SAMC and majority owned by a group of LDCs representing Wuhan, Huangshi, other nearby cities and other locales in Hubei province, including townships and villages. To ensure an

effective reorientation away from administrative control toward professional independent financial asset management, the new LDCs should not merely receive shares in the SOEs by transfer. Rather, the LDCs should be required to purchase the shares using their own funds.

### **Introduce Independent, Professional Managers**

Even if the organizational frameworks are restructured, without independent, professional managers staffing them, the progress of SOE reform will be stifled. Developing a class of professional business managers must start with improved training, both in universities and on the job. Independent persons with potentially strong business managerial skills should be identified through rigorous and impartial evaluations. Bringing in foreign experts—to serve as assessors and to work alongside managers through "twinning" arrangements—could be helpful in this regard; study/training abroad could also be beneficial. Moreover, management training should not be seen as a one-time action; it should continue throughout a manager's career. Renewal of a manager's business acumen is a dynamic process that should evolve in tandem with the development of new markets and technology. But once trained managers are in place, their efficiency will come only if they face robust, market-based incentives. Thus, managers' compensation—indeed their job security—must be closely linked to the performance of the enterprise. Managerial efficiency also will be determined by the tools made available to managers to carry out their tasks. This includes not only modern management information systems and financial controls (see Chapter 5), but also the ability to redeploy workers, equipment and other assets to their most efficient uses. At the same time, managers themselves must be exposed to incentives for mobility so as to maximize efficiency of resource allocation: this means creating a robust "market for managers" within a firm, across firms, across sectors, and across regions.

### **Increase "Outsider" Participation**

International experience demonstrates that sustaining hard-won organizational restructuring in the SOE sector is difficult without increasing the role of nonstate entities or persons in terms of SOE boards, management, financing and other supervisory roles. In Korea, restrictions were placed on the

number of civil servants serving on SOE boards, and emphasis was given to suppliers, clients, professionals and academics for board memberships. Nonstate participation is occurring in China, but it is most extensive in subsidiaries (through minority shareholding), not in the controlling SOE holding companies. Moreover, like other "outsiders," nonstate interests are largely unrepresented on SOE boards of directors. In the Chinese context—within the framework of the "socialist market system"—there are ways of increasing nonstate participation in the SOE sector through: (a) the appointment of nonstate representatives on the boards of directors of SOEs; (b) ensuring that diversification of SOE ownership through selling shares on national and international stock exchanges is used to bring on nonstate shareholders as a vehicle for introducing external forces that will motivate improved efficiency, where the result is passive minority state ownership (see Chapter 4); and (c) contracting out the provision of services (e.g., transport, accounting and even social services) to the nonstate sector.

### **Innovate the Usage of Shareholders, Directors and Managers**

Worldwide, boards of directors of modern corporations develop more strategic responses to market changes when their election by shareholders is staggered. This provides for greater institutional memory of the challenges the firm faced in the past, enabling it to prepare more effectively for the future. Diversification of board members and management is also critical if restructured enterprises are to be more accountable to their owners and more competitive. One possible reform for China is to ensure that board members are from different regions of the country and with more diverse backgrounds. In all the SOEs examined for this study, a large majority of the board in each company are engineers, went to school together, and have worked only in the enterprise they manage.

Cross–sectoral, cross–regional diversification of management would be highly beneficial. By the same token, cross–sectoral, cross–regional diversification of the *shares* held by SAOCs and the other state asset management organizations is also key (see Chapter 4).

### **Delinking Social and Commercial Functions**

The experience in other transition economies amply demonstrates the problems associated with the blurring of commercial and social objectives. In China, the authorities are acutely aware of the need to establish mechanisms for passing many of the social service burdens—such as housing, hospitals, and schools—to municipal or regional governments or to new or existing nongovernmental entities (e.g., housing) as appropriate. The divestiture of housing to nonstate entities or to individuals may well yield proceeds that can help SOEs meet other aspects of their social debts, such as pension liabilities. Nonetheless, complementary reforms in these areas should also be implemented. Thus, it is critical that cross–firm municipal pooling of pension obligations and payroll taxes earmarked for pension, unemployment and health benefits continue to gain prominence.<sup>4</sup>

### **Endnotes**

1. These functions are defined by chapter two of the *Supervision Regulations* .
2. There is a well–known case of a large–size SOE that is listed on the Shanghai stock exchange whose majority stake by the State was reduced below 50 percent when additional shares were issued and purchased by a foreign institutional investor. Discussions with the Chinese authorities and anecdotal evidence strongly suggests there are other, similar cases.
3. World Bank (1997), *China: Labor Market Development* .
4. World Bank (1997), *China: Pension System Reform* .

## **4— Corporate Governance**

### **Introduction**

Like other transition economies that have abandoned central planning,<sup>1</sup> China faces the challenge of strengthening the governance of its SOEs through implementation of market–oriented incentives. China is attempting to introduce such incentives at a time when the underlying fabric of the country's new market economic system is still being woven and against a historical backdrop of a weak tradition of market institutions. In this regard, there are several facets that make the challenge a difficult one to meet and that merit the attention of China's policymakers wrestling with SOE governance.

The State as owner—or its representative organs—has in general *poor information* about SOE managers' actions and enterprise performance. Effective governance is difficult to exercise when few state asset management institutions regularly receive timely, accurate and useful information about the financial performance of the firms they control. The *lack of clear ownership identification* of SOEs also undermines corporate governance as it leaves open the issue of who should be monitoring the managers. Moreover, the difficulty in identifying

owners—and specifying who will be responsible for SOE liabilities—is typically the constraint on corporatization. The commingling of SOE commercial and social functions and the fact that the ultimate owner of SOEs—the State—is also the regulator of SOEs, give rise to *conflicts of interest and unclear objectives*

To be sure, China's system of state asset management is relatively new, and both SAMBs and SAOCs are just defining their roles and establishing themselves as representatives of the State vis-à-vis the enterprises. As new governance practices are introduced, principal-agent problems inevitably arise (Chapter 1). Principal-agent problems are particularly visible in the inconsistencies in the new incentive contracts being drawn up between SAMBs and boards of directors of SOEs. For example, the incentive contract between the SAMB of Shanghai and its representatives on the board of the Shanghai First Department Store (Group) Company is written almost as a "management contract" (Box 4.1). But the representatives cannot be expected to directly be held accountable for most of the indicators used. Furthermore, the Company Law—as well as the Articles of Association of the First Department Store (Group) Company itself—already stipulate the rights and obligations of the representatives of the owners.

With *management skills poorly adapted to a market economy*, low (formal) remuneration and the lack of a "market for managers," efficient corporate governance in China is put at a disadvantage. The shortage of managerial skills obviously cannot be resolved quickly. In part, however, the poor labor market is caused by a policy of deliberate limited turnover and "localization" of managers. In almost all SOEs investigated for this study, none of the senior managers are from outside a company.

The fact that few, if any, *outside monitors*, especially banks, but also other enterprises, exercise discipline on SOEs means that the corporate governance function is weak. The four specialized banks are mainly other agents of the State, making the concept of limited liability of little relevance for SOEs, as the owner and creditor are one and the same. The banks are attempting to transform into commercial entities, as called for by the new Commercial Banking Law. But they have still a way to go in establishing their independence. Other enterprises, either acting as legal-person institutional investors in SOEs or as their suppliers and customers, often do not face proper governance incentives themselves.

TVEs—even though they are not completely under a hard budget constraint—do appear to exercise some competitive discipline on SOEs.<sup>2</sup> Takeovers (or threats of takeovers), which can be effective disciplining devices against poor management, are not present or only working very poorly. Most mergers and takeovers of SOEs are engineered by the State and they often do not represent market-driven events (Chapter 1).

### **BOX 4.1: INCENTIVE CONTRACT BETWEEN SHANGHAI SAMB AND THE FIRST DEPARTMENT STORE (GROUP) COMPANY**

*The Agreement of Responsibilities on the Management of the Assets of the First Department Store (Group) Company (FDS) stated goal is "to ensure the maintenance, increase the value, and improve the efficiency of the operation of state-owned assets." It stipulates that the "authorized representative of the State shall organize production and business activities and manage staff to accomplish the various target indicators." The reward system for the state representative involves a base salary plus incentive pay, based on a number of assessment indicators, to be paid by FDS. The representative cannot obtain any other income from FDS nor obtain payment from other jobs, unless otherwise approved by FDS. Of the base salary, 80 percent will be advanced, with a final settlement to be made at the end of the year. If the representative accomplishes all assessment indicators, the remaining 20 percent will be paid in full. If the representative fails to fulfill the indicators, all or a percentage shall be withheld. If the representative exceeds all indicators, an incentive equal to no more than one times the*

base salary will be granted. A special reward can be granted if an outstanding contribution is made.

The incentive pay indicators used fall into three categories: assessment indicators, evaluation indicators, and supervision and control indicators. The five assessment indicators are: the absolute amount of state equity at the beginning of the period; the absolute increase in state equity, corrected for some exogenous factors; the rate of increase in equity, again corrected for some exogenous factors; and the total profit. The five evaluation indicators are: the total return on total assets; the after-tax return on equity; the ratio of total revenues to total costs; the ratio of sales revenues to receivables; and the growth rate of pretax profits. The four supervision and control indicators are: the asset-liability ratio; the ratio of operating capital at the end of the period to that at the beginning of the period; the quick ratio; and the ratio of total profits to the sum of total profits and interest payments.

*Source:* Shanghai State Asset Management Bureau.

Some Chinese SOEs have improved some aspects of their internal governance incentives. The First Department Store (Group) Company of Shanghai, for example, has greatly strengthened its operating procedures by adopting profit centers. But in even the best cases, improvements still need to be made to fundamental incentives. This will require, among other things, outside monitors to become more active, instead of mostly passive. This is especially true for noncorporatized SOEs. But it is also necessary for corporatized enterprises, even when they have their stocks listed on (foreign) exchanges, such as Shanghai Petrochemical Company (as discussed in Chapter 3). Overall, then, in the governance system currently prevailing in China many of the channels through which managers could be disciplined and motivated are weak or missing.

### China's Emerging Corporate Governance Vacuum

#### Insider Control

Without the fundamental reorientation in internal incentives toward market principles, China's SOEs will either continue to be ruled (explicitly or implicitly) by the old procedures—which will undoubtedly retard enterprise restructuring—or find themselves in a corporate governance vacuum. As the nominal owners have only very limited control or even information about enterprise performance and asset use, control over Chinese SOE assets and cash flow rests increasingly with enterprise managers. The result of such a corporate governance vacuum is that managers (and other insiders) end up with de-

facto control over enterprises. In principle, insider-dominated firms may deliver efficient performance, as in the case of small firms with an owner-manager structure. But this is true only if certain conditions exist—in particular the firm does not receive any fiscal and financial system subsidies, it faces robust interfirm competition in product and factor markets, and it scrupulously fulfills its debt-service obligations. Experiences from other transition economies show that insider-dominated corporate control has many costs and risks: asset-stripping, poor investment decisions, decapitalization through excessive wage increases, and increases in other private benefits.<sup>3</sup> Combined with poor monitoring by other stakeholders—especially due to a weak credit system—this results in a risky situation: it leads to the allocation of bad liabilities to (state-owned) banks and fiscal authorities, which, in turn impose a tax on *all of society* to repay depositors. At the same time, managers and other insiders have strong incentives to appropriate valuable SOE assets and cash flows for their own benefit.

The evidence from other transition economies confirming these risks is telling. In many countries the problems arose prior to the formalization of a privatization process (Hungary and Russia in 1988/91), and in several they occurred where privatization was been accepted in theory but stalled in practice (Belarus, Bulgaria, Romania,

Ukraine). Assets or income flows have slipped out of State hands and into private control (if not outright ownership) through a variety of methods. In some cases, SOE privatization has been delayed less because of political philosophy or uncertainty about the optimal approach, than because continued state ownership preserved ambiguous property rights, which allowed for profit shifting, tax evasion, and asset stealing, largely for the benefit of incumbent managers. Bulgaria's experience with weak corporate governance of SOEs is a striking case in point (Box 4.2).

### **BOX 4.2: WHAT HAPPENS WITH "FUZZY " CORPORATE GOVERNANCE : THE CASE OF BULGARIA**

A coalition government liberalized extensively and early and implemented a determined stabilization program. Swift privatization was anticipated. But a change in administration in 1991 diluted the emphasis on reform and blocked the adoption of a privatization program until mid-1995. During these four years the Bulgarian State lost much of its capacity to monitor enterprise performance and management. Attempts, for example, to monitor the largest 100 loss-making enterprises and limit their actions repeatedly failed. Managers channeled enterprise assets and cash flow to themselves, leaving little to the State but liabilities. Losses of Bulgarian state enterprises averaged more than 12 percent of GDP between 1992 and 1994. The losses were covered by loans from an increasingly insolvent banking system and led to a banking crisis in 1995 when 80 percent of all bank loans had become nonperforming. Macroeconomic instability resulted in 1996 with inflation shooting up and interest rates reaching 300 percent. Bulgarian observers concluded that "[the problem of] unclear property rights is turning from a legal to a major macroeconomic problem."

*Source: World Development Report , 1996; and Claessens and Peters, 1997.*

In China, as a by-product of the decentralization process underlying enterprise reform, some control rights have ended up with SOE managers. While this has been well-known to have occurred in small SOEs, it is now beginning to occur in large and medium SOEs. This is true not only with regard to setting wages and bonuses, but also in determining large investments, where the influence of outsider directors or other representatives of owners is far more limited. Boards of enterprises are often not involved in crucial borrowing decisions. The principal banks lending to SOEs typically do not require the authorization from the board of directors of a large SOE to proceed with executing a loan—no matter what the amount. The concept of limited liability implies, however, that the equity owner has the right to approve of actions that directly affect the value of his ownership stake. Since new loans can amount to a dilution of the equity value of the firms, lending without permission from the owners violates the limited-liability principle.

### **The Creditor Incentive System**

Under central planning, banks typically monitored the production processes of enterprises closely and functioned de-facto as the budget department for an enterprise. In the move to a market economy, new monitoring skills and control procedures are needed. China's four specialized banks are developing risk-rated loan quality categories, repayment probabilities and balance ratios for use in their enterprise lending practices (as required by the new banking law). Banks also appear to have access to some information about the financial condition of their client base. At the same time, however, banks have significant deficiencies in their lending skills, their ability and incentives to monitor the financial performance of enterprises, and in their capacity to discipline loss-making enterprises. Only in exceptional circumstances can banks force a change in SOE management. In fact, several banks, for example, ICBC-Shanghai, state explicitly that they cannot change the management of an enterprise-customer in arrears to the bank. Banks also have insufficient ability to withhold loans and recover assets.

## China's Management of Enterprise Assets

There are often strong social pressures not to close but to continue bank lending to loss-making enterprises. The hope for a chance recovery is, as is typical for any bank, a further disincentive to stop lending. Many banks explicitly state they will not pursue legal remedies available to them to force SOEs into bankruptcy. Indeed, legal problems often cause further delays in pursuing bankruptcies and exacerbate China's weak credit incentive system. For example, the Bank of China had to wait until the loss-making Nanchung Dacron Factory in Sichuan became a legal entity with identifiable owners before it could proceed with filing for bankruptcy. In Wuhan, ICBC was denied its mortgage rights in eight out of nine cases. In one case, ICBC suffered large losses when a bankruptcy court decided that, because an enterprise was split into three entities and then merged again, the mortgage had become a general, not a secured, claim against the enterprise (Box 4.3). In another review, ICBC found that although 70 out of 97 debtors had mortgage agreements, only one was declared valid, representing only 1 percent of all loans involved.

### **BOX 4.3: WEAK PROTECTION OF SECURED CREDITORS**

The bankruptcy of the Wuhan Yangino Textile Printing and Dyeing Mill (the Factory hereafter) is a good example of the difficulty banks have in collecting on collateral and enforcing bankruptcy. The Factory was a SOE under the Textile Industry Bureau of Xingzhou County and, before it became bankrupt, had about 4,000 employees. The factory greatly expanded after 1989, but this was not successful and poor management led to large losses for several years. In March 1992 the Factory split into three, but the difficulties continued. In November 1992, the Wuhan branch of ICBC classified its loans to two of the three factories as substandard and secured its loan with mortgages on assets with a book value of 47 million yuan. The three factories then merged again and then entered bankruptcy and liquidation procedures in August 1994. Asset appraisal revealed that the Factory had 74 million yuan in assets but 152 million yuan in liabilities, of which 65 million yuan was to ICBC. Unrecoverable debts thus amounted to 78 million yuan.

In January 1995, the Court called the first creditors' meeting. The 47 million yuan mortgage loans of ICBC were not given priority in the liquidation over other debts for three reasons: (a) the mortgage loans were extended on the general assets of the Factory and accordingly had no priority; (b) the mortgage assets were not clear; and (c) the mortgage loan arrangements did not get the approval of the government. ICBC argued the case, but unsuccessfully. ICBC stated that it had extended the mortgage loans to the two Factories on specific assets and thus had a secured, not a general claim on the Factory. ICBC also argued that the mortgages were arranged in accordance with the regulations in Wuhan and got properly registered (and it did have the relevant certificates). Therefore, the mortgage should be clear. Lastly, ICBC argued that according to the rules issued by SAMB in Wuhan, enterprises have the right to mortgage part of their assets and do not require approval from the government. In ICBC's opinion, therefore, the mortgage loans were legal and valid, but did not get the proper legal protection in the bankruptcy procedure.

*Source: Bulletin of the Industrial and Commercial Bank of China , No. 6, April 8, 1996.*

Most often, banks end up continuing to finance loss-making enterprises or simply restructuring their obligations. Debt restructuring has mostly taken place through suspension of interest (and principal) repayments, with little requirements for operational restructuring. Consequently, debt restructuring has only had a negative impact on banks' cash flows and, at best, little improvement in the underlying asset values or creditworthiness. Banks have neither set up internal debt-workout units whose sole task is to collect on problem debts and restructure (financially and operationally) or liquidate problem borrowers. Moreover, banks still have little independence in implementing their debt restructuring policies. The current requirement of clearing debt restructuring decisions

with (many) government agencies, for example, is incompatible with the objective of transforming these banks into modern, independent commercial banks.

The World Bank survey of 156 SOEs sheds light on the creditor incentive role played by the specialized banks (see Annex 6). The data show that bank financing of circulating and fixed capital is negatively related to profit (as a ratio to sales); that is, the higher the losses, the more bank financing an enterprise receives. Profit (loss) is actually one of the few variables that is significant in explaining bank financing. The reforms over the past few years are therefore not reducing the magnitude of the bad debt problem. Rather, banks are acquiring more bad debts, with asset-stripping (see below) adding to the problem. Most bank branches report that "bad loans" account for 20 to 30 percent of their portfolios, of which 4 to 5 percent are considered "dead" (i.e., unrecoverable). One bank branch (ICBC-Chengdu) has even estimated that weak SOEs account for 80 percent of its total loan portfolio and only about 20 percent of its SOE clients were "financially strong."

### **Asset-Stripping**

The private taking of assets—asset-stripping or "draining"—is widespread in China, as is often the case in transition economies. The authorities indicate that state assets are being drained through various routes: when SOEs are transformed into joint ventures, cooperative enterprises, and joint-stock companies; when state assets are used to establish various "income-generating" businesses; through under- or overinvoicing of transactions of private entities with SOEs; and through other means. According to the experimental survey of 124,000 SOEs conducted by NABSOP in 1994, asset losses and unaccountable expenses accounted for 11.6 percent of the total assets in the sample firms.<sup>4</sup> A recent press account reported that "the annual loss of state assets has been about 50 billion yuan since the early 1980s."<sup>5</sup> Half of the new LLCs created in Sichuan and Shanghai during the past few years are in the "financial" sector, which suggests the widespread creation of "shell" companies used to drain assets. Anecdotal evidence of physical asset-stripping is plentiful; one of the banks examined for this study, for example, disclosed the "disappearance" of 1,000 tons of textiles from one of its client SOEs. The fact that the State Council recently formed a leading group headed by Vice Premier Zhu Rongji to investigate the extent of asset-stripping indicates the serious level of concern Chinese authorities have about the problem.

### **Wage Diversion and Tax Avoidance**

Analogous to asset-stripping, other types of conduct are emerging in China that are symptomatic of a corporate governance vacuum. There is evidence that insider control is associated with increased labor compensation.<sup>6</sup> SOE payroll tax avoidance or diversion is also widely reported, pertaining to required contributions to unemployment insurance and pension pools. Money-losing SOEs are typically the ones engaging in this practice. Ironically, these social insurance initiatives are precisely the

programs needed to establish a social safety net so that restructuring of money-losing firms can take place. Undermining fiscal support for these programs could thus jeopardize progress of the overall SOE reform initiative.

## **Strengthening Corporate Governance in China's SOEs**

### **Means for Reform**

Fundamental reform of China's SOE corporate governance system will mainly stem from correcting the underlying principal-agent problem. This could come through the clear assignment of legal property rights between SOE owners (or their representatives) and managers; rationalizing and improving the quality of information between owners and managers; delineated internal lines of authority that balance managerial autonomy and owner accountability according to commercial principles (rather than administrative practice);

introducing a bona fide "market for corporate control" where the assets and liabilities of poorly performing firms can be rechanneled to higher values in use through market-based transactions; among other reforms. Putting in place these fundamental reforms is difficult and will take time. During the transition, a number of measures can be used, as the experience of other economies demonstrates, including (a) incentive contracts; (b) listing and corporatization; (c) employee ownership; (d) ownership diversification; and (e) decentralized ownership. An enhanced role for banks in exercising external discipline has proven to be an especially potent governance device. While none of these reforms *alone* has provided a solution—largely because corporate performance is influenced by a large number of factors—implementing a comprehensive *package* of them has been effective.<sup>7</sup> *Experience shows that the most successful comprehensive reform programs are those that instill in SOE managers a change in expectations that Government is credibly, fully committed to reform* (Box 4.4).

<b>BOX 4.4: CHANGING EXPECTATIONS IS KEY TO SUCCESSFUL SOE REFORM</b>
<p>Polish authorities adopted far-reaching structural and institutional SOE reforms that succeeded because managers believed the Government was fully committed to change. Firms were exposed to competition with a big bang in January 1990: 90 percent of prices were freed, most trade barriers eliminated, state trading monopolies abolished, and the currency made convertible for current transactions all at once. Budget constraints were tightened: indirectly, through restrictions on bank credit; and directly, as subsidies to enterprises shrank rapidly, from more than 16.0 percent of GDP in 1986 to 3.3 percent in 1992 (tax arrears, however, as elsewhere, have proved to be the most difficult "subsidy" to eliminate, in part because of the weakness of tax administration). While the commercial banks started with large, concentrated bad loan portfolios, cleanup began in 1993 through a combination of enterprise liquidation, debt sales, and a new bank-led conciliation process.</p>
<p>When interviewed in 1990, managers had little doubt about the hard-budget constraint: they believed if they failed to make their firms competitive, the firms would close. Indeed, many of the Polish state enterprises that existed in 1989 had disappeared by the end of 1995. Managers' belief that privatization was just around the corner was very important and stimulated in part the turnaround. General reforms were very supportive of the strategy for state enterprise reform: establishment of an adequate legal framework for private sector development, including introduction of accounting and auditing standards, clear definition of property rights, and antimonopoly regulation; and the creation of a social safety net. Important for preventing asset-stripping and socialization of losses was the financial sector reform and the constructive role of the workers' councils in supervising enterprises.</p>
<p><i>Source:</i> World Bank, "Supervision Report of Adjustment Lending to Poland"; <i>World Development Report 1996</i> .</p>

In principle, *incentive contracts* could be a way to better align the interest of managers and shareholders. Incentive contracts have been used in several countries for this purpose. In China, the first incentive contracts centered on the Contract Responsibility System (CRS), which was introduced in 1988.<sup>8</sup>

From its inception, the CRS has covered 90 percent of China's SOEs, but as other corporatization reforms and other reforms intensified, the utilization of the CRS has begun to decrease. Taking its place are the incentive contracts between SAMBs and SOE boards of directors

International experience in such contracts has been disappointing. An extensive World Bank review of 12 performance contracts in six countries found that while incentive contract plans help clarify goals, increase managerial autonomy, and open a dialogue between management and government, ultimately their benefits are

very limited ("the contracts have frequently been a waste of time and effort").<sup>9</sup> The key problems with incentive contracts are inadequate information about managers' actions and relating their actions to performance. Incentive contracts only work when there are measurable targets used, performance information is easily available, technology is not changing much, the market is competitive and quality of performance is easily compared. Not surprisingly then, worldwide, incentive contracts have been used most effectively in only a few sectors (hotels, agriculture and water), where such conditions are more likely to hold.

In the Chinese environment, with limited and incomplete information about assets' use and true enterprise performance, incentive contracts may be problematic and create opportunities for self-dealing. Empirically, China's SOEs with performance contracts appear to perform no better than enterprises without. In the World Bank survey, for example, the profitability of enterprises with contracts is actually lower than those without (Table 4.1, row 1). Also, among the surveyed enterprises, those with management contracts tend to have lower capital and labor productivity, are less likely to be listed and corporatized, and have more overemployment; furthermore, enterprises with incentive contracts tend to get more bank financing (see Annex 6, regression 7). As with other statistical relationships, there can be simultaneity here as worse enterprises may be more likely to receive incentive contracts. Still, incentive contracts are best used as a complement to other governance reforms for enterprises where ownership diversification is not planned or feasible in the medium term.

*Employee ownership* plans have been used in many transition economies. In China's SOEs they have been used in smaller firms, but rarely in large and medium ones (in contrast, they are commonly used throughout the TVE sector). Workers' shares are typically not tradable (outside the group of employees) and as a group, workers remain minority equity holders. Experience from the former Yugoslavia and other countries suggest that this type of employee ownership does not necessarily lead to improved incentives on the part of workers or better corporate governance of the enterprise. In fact, it can complicate progressive ownership changes, as workers become a (too) powerful voice and create another class of "insiders." On the other hand, providing for employee ownership does help address the equity problem of laid-off workers (as long as the laid-off workers' shares are in enterprises that are ultimately commercially viable). A useful employee ownership model could be the Workers' Councils used in Poland. Such Councils have influence on important decisions of enterprises, but no direct ownership. While the power of workers in Poland to block major decisions has slowed restructuring progress, the Councils have prevented large-scale asset-stripping.

*Listing shares on stock exchanges* is an essential part of the Chinese policy package toward creating a modern enterprise system. Listing can be expected to improve corporate governance as shareholder rights get clarified and information disclosure improves. So far, only about 300 SOEs are listed. Evidence from the World Bank survey shows that corporatized and listed SOEs have significantly higher profits and labor productivity (see Table 4.1, rows 2 and 3). A study using 1994-95 data for 154 enterprises listed on the Shanghai and Shenzhen exchanges found that the proportion of state shares has a

negative relationship with performance; the proportion of legal-person shares has a positive and significant relationship with performance, and that of individual shares has no significant relationship.<sup>10</sup> The positive associations of performance with listing need to be interpreted carefully, however. They do not mean that listing is the answer to the underlying problem. In particular, these relationships may exist simply because the better enterprises are listed, not because of the listing itself. Similarly, the positive relationships between dominant ownership by legal persons and stronger performance may reflect that legal persons were able to acquire larger stakes in more profitable enterprises.

**TABLE 4.1: PERFORMANCE AND CHARACTERISTICS OF CHINESE SOES**  
(Sample of 156 enterprises, 1994 data)

	No. of firms	Profit/Sales (%)	Sales/Assets (%)	Sales/Employment (Y 10,000/Employee)
<b><i>1. Operating Under Management Contract</i></b>				
Yes	55	4.04	170.4	4.26
No	60	4.88	203.6	6.39
<b><i>2. Corporatized</i></b>				
Yes	35	9.60	166.0	7.27
No	80	2.24	192.7	4.65
<b><i>3. Listed</i></b>				
Yes	14	14.50	134.9	1.03
No	101	3.09	192.6	4.62
<b><i>4. Size</i></b>				
Large	81	4.94	173.7	6.23
Medium	29	2.90	185.3	3.09
Small	5	6.18	546.6	3.05
<b><i>5. Affiliation</i></b>				
Central	4	1.23	112.6	5.11
Provincial	23	4.04	281.6	9.66
Municipal	75	4.58	160.2	3.64
County	3	6.76	205.4	3.90

Source: World Bank (1996), *China: Reform of State-Owned Enterprises*.

*Ownership diversification* of SOEs has proceeded rapidly in China, with not only individuals but also local, municipal and provincial authorities becoming the investors. It has improved corporate governance and stimulated enterprise restructuring. But, it has also created some problems. First, it has exacerbated the already arduous process of allocating property rights. This is shown, for example, by the fact that economic property right disputes are on the rise in recent years (Chapter 2). This leads to only more of a corporate vacuum that, in turn, creates further opportunities for insider self-dealing. Second, diversification has to be adequate, not excessive. Ownership diversification only works when shareholders' rights are strong. Common-law countries have, for example, more diversified ownership, but also stronger shareholders' rights.<sup>11</sup> With weak de-facto shareholder rights in China, some degree of concentrated ownership is thus more beneficial, as has been shown for other transition economies.<sup>12</sup>

Available evidence for China confirms the positive link between ownership concentration and performance.<sup>13</sup>

*Decentralized ownership* (which does not necessarily mean diversified ownership) can enhance corporate governance. Local owners have fewer monitoring problems, and locally owned enterprises may thus have better performance.<sup>14</sup> This is shown, for example, in the generally better performance of TVEs and private enterprises. Evidence from the World Bank survey also shows that the more local the affiliation of ownership, the higher the profitability—supporting the beneficial effects of decentralization (see Table 4.1). Other case studies confirm this pattern for China.<sup>15</sup> Yet, there are risks of decentralization. For example, local entities are increasingly controlling large enterprises. But, large enterprises often require management and supervisory skills that are much broader-based and need to reflect other, nationally based experiences. Local ownership also does not allow for any diversification of risks. Decentralization is therefore best for smaller enterprises, where broad-based skills and risk diversification are less of an issue and informational problems are less severe.

### Key Role for Banks

Across market economies, banks are important monitors of enterprises: *ex-ante* —in project evaluation and selection and credit analysis; *interim* —in watching the management and operation of the firm; and *ex-post* —in verification of financial outcomes and applying corrective action in bad outcomes. But in most transition economies, even when banks have been well-capitalized and greatly assisted in their institutional development by international technical assistance, the role of banks in active corporate governance and improving enterprise performance has, to date, remained small (Box 4.5). A combination of a weak legal environment, nascent banking institutions, and often perverse incentives have limited the useful role of banks. In many transition economies, an activist bank governance role has actually been detrimental (see Box 4.2). The most useful role Chinese banks may play in the short run—*on the condition that their own incentive structures and practices can be brought more in line with commercial principles* —is to be "hard-budget" agencies—with strong *ex-post* discipline on loss-making enterprises, and much less active agents for restructuring troubled enterprises. This was the model banks followed in Korea.<sup>16</sup> A useful complementary role for China's banks in this respect would include more intense monitoring and guarding against asset-stripping.

#### BOX 4.5: THE ROLE OF BANKS IN ENTERPRISE REFORM : THE CASE OF POLAND

In 1991 banks were advised not to make new loans to enterprises that were in arrears on past loans, a restriction that was enacted into law with the passage of the Enterprise and Bank Restructuring Program in February 1993. The Ministry of Finance required repeated audits of all banks according to international standards, thus encouraging transparency and exposing the magnitude of the bad loan problem. The restructuring program further required banks to set up workout units and take actions to resolve loans that had been classified as nonperforming at the end of 1991. The program also provided a new bank-led workout process. Indirect incentives were also used (e.g., bank employees were given stock options). And banks were also twinned with foreign banks to accelerate their institutional development.

The program halted the portfolio deterioration of the commercial banks, but the degree to which banks improved enterprises' behavior were disappointing. A detailed study shows that the restructuring agreements struck under the bank-led workout process were relatively unsophisticated and included few requirements for operational or management change. The profitability of enterprises involved in the workout process actually deteriorated and very little real privatization took place. The main impact appears to have to give firms a breathing space by reducing debt service. Particularly, the weaker banks appear to have softened the budget constraints on enterprises by granting excessive debt relief and debt-equity swaps.

*Source:* Gray and Holle, 1996.

It was recently announced that a "main bank" system is being actively developed in China for 300 of the nation's "key" large and medium SOEs. These large and medium SOEs are to sign "banking and enterprise cooperation agreements" with their main bank to define the rights, responsibilities and obligations between them. The main bank "is to consider the long-term development of the enterprise, and support most of its reasonable funding needs, according to principles of commercial credit." An enterprise is to "consult with its main bank on its plans for production expansion, product restructuring, technology renovation, property transfer and acquisition."<sup>17</sup> Unlike the Japanese or German main banking system, the Chinese system does not call for banks to sit on SOE boards of directors.

The proposed main bank program may be useful if it leads to more intense monitoring of enterprises. This means that it should not involve much new lending and, in particular, there should not be any *exclusive* one-to-one relationship between a bank and an enterprise. The official goal of "supporting most of [an enterprise's] reasonable funding needs" risks insiderdominated relationships. The experience of Japan shows that main banks were mostly involved in monitoring while a *consortium* of banks was in charge of lending.<sup>18</sup> In other words, in Japan's main bank system, monitoring was exclusive, but lending was not. If a firm failed, however, it was the responsibility of the main bank to take the lead with respect to the restructuring, including repayment of debts to other creditors. This provides the best incentives for the main bank to monitor because it has to intervene when the enterprise runs into severe profitability problems.

Debt-equity swaps have increased in recent years in China, often involving conversions of enterprise arrears. Debt-equity swaps by banks could be useful to diversify ownership, but entail risks. Evidence from Poland, for example, shows that only the weaker banks engaged in debt-equity swaps—as that allowed them more leeway in increasing the value of their claims. Also, the equity went proportionately to other, often passive, creditors (including government), thus mitigating any expectations that these swaps would translate into improved governance (Box 4.5). In general, use by banks of debt-equity swaps for loss-making enterprises amounts to hidden cash flow relief. This weakens external discipline on SOE management and can impede enterprise restructuring. Banks owning large stakes in enterprises can also lead to substantial risks as the financial sector will typically be weakened, independent banking supervision is made more difficult, and disclosure will be limited.

### Conclusions

The relative impact of the specific reforms discussed above will depend on how far other, more fundamental reforms have progressed; advances in the underlying framework will leverage the effects of transitional reforms. Their impact will also be a function of the nature and type of enterprise being reformed: its size; the degree of its diversification; the extent of its overemployment and social burdens; and whether it is in a competitive sector, a natural monopoly sector or a strategic/national security sector. Regardless of the exact mix of reforms implemented, there are three strong lessons for China from the experience of other transition economies with SOE corporate governance reform:

- (a) reforms should try to prevent "dead-ends" in ownership structures (i.e., reforms should provide flexibility for ownership changes in the future, inasmuch as markets inevitably change and political dynamics evolve);
- (b) they need to assure tradability of property rights; and
- (c) there should be as much "outsider" involvement as possible.

These lessons stem from the fact that there is often a profound tension in corporate governance reforms between the need to reward stakeholders and the desire to create good economic outcomes that contribute to SOE restructuring and institution-building, and reinforce the benefits of SOE reform in the public eye (Box 4.6).

### **BOX 4.6: RUSSIA'S INSIDER CONTROL PROBLEM**

Russia demonstrates the risks of allowing insiders to gain too much control and of having in the end no option but to reward strong managers and employees in an ownership diversification and privatization program. During the late 1980s, Russia's enterprise managers had gained increased autonomy and independence from the State. When enterprise reform was initiated, these managers (and workers) proved a strong constituency against a transparent, equal-access privatization program and gained preferential treatment. Russia's mass privatization program of 1992-94, though it used vouchers, was basically a management-employee buyout program, with managers and workers ending up with about two-thirds of the shares in the 15,000 privatized firms. Of the remaining shares, outsiders obtained 20-30 percent (about 10-15 percent each to investment funds and individual investors), and the rest remained in the hands of the Government. The extensive preferences given to managers and workers in order to garner their support, and the inability to install procedures to protect minority shareholder rights and to promote secondary trading, are now proving very costly. Managers control their insider-owned firms with little if any employee-shareholder influence. Some managers have tried, often illegally, to prohibit workers from selling their shares to outsiders. Some have used even less transparent means to block participation by either employees or outsiders or to transfer assets or profits to firms they control. Given the weakness of laws and institutions, the scarcity of information, and in some cases the laxity of competitive pressures (due in part to the incomplete macroeconomic stabilization), there have been few if any outside controls to stop managers from doing these things. This is as much a problem for transparency as for efficiency; restructuring by privatized Russian firms is so far hard to distinguish from that of state firms, while that of new private firms is significantly different from both.

*Source: World Development Report 1996.*

An enduring, self-sustaining program of Chinese SOE reform is not possible without political support of many constituencies—owner-representatives, managers, workers and officials in the (former) line ministries. Accommodating current stakeholders' interests must be handled with care to avoid potential conflicts with longer-run economic and political goals. One such conflict is that firms may fail to restructure because of control ceded to incumbent insiders. Insiders may deter outsiders that could bring fresh skills and capital from investing in the firm, thus blocking further reform. Therefore, efficiency would be best served when ownership structures have the flexibility to evolve, especially through secondary trading, both across sectors and regions.

By the same token, consideration should be given to balancing equity concerns. The benefits of SOE restructuring could be unevenly distributed, especially if only the employee ownership route is taken. Employees in good firms are likely to get valuable assets, while those in loss-making firms would get little or nothing of value. Moreover, the assets belong to the *whole* people, not just employees of the restructured firms. Thus, such schemes could undermine widespread support for the overall reform process.

With these lessons in mind, several specific high-priority policy recommendations can be suggested to strengthen corporate governance in China's SOEs.

#### **Increase Fiscal and Financial Discipline**

The benefits of sound corporate governance structures can only be adequately captured, if not induced, if "hard budget" constraints are fully applied. That is, the enterprises pay full economic costs for all their inputs and charge market-determined prices for their outputs. While there has been progress

in decreasing fiscal and (and to a lesser extent) financial subsidies to China's industrial SOE sector, it is clear from other transition economies' experiences that to prevent erosion of governance reforms, such subsidies should be made transparent and over time eliminated.

With respect to fiscal subsidies for "operational losses," (a) they should continue to be decreased and, within a preannounced time frame so that firms can adequately adjust, eliminated. (b) Equally important, the new set of corporate income tax credits and deductions that have been introduced under the various government-sponsored restructuring programs (Chapter 1) actually *enlarge* rather than limit fiscal subsidies. A time frame for their phaseout should also be devised.

Subsidies provided through the financial system have begun to decrease as a result of more careful management of central bank credit and increases in administered interest rates under the inflation control program. But banks still provide directed credit, priced below opportunity cost, and most often roll-over unpaid credits (principal and interest) automatically. Interest rates are not liberalized enough for banks to differentiate terms among enterprises according to credit risks, giving rise to cross-subsidies. Greater attention should be placed on (a) making financial system subsidies more transparent. One way to help in this effort is to "budgetize" them, i.e., transfer them from the banking system into a special budgetary trust fund account placed under the sole discretion of MOF. This is akin to the French system (see Box 3.3). A prespecified time frame for their phaseout should be devised. At the same time, efforts should accelerate to (b) halt the *flow* of "bad" bank debt to value-subtracting enterprises, and then subsequently, on restructuring the *stock* of "bad" debt. (c) Greater attention should also be targeted to controlling the ways enterprises provide implicit financing to each other ("triangular debt") through receivables that remain unpaid.

The Government may wish to consider establishing a mechanism at the national or provincial level to restructure enterprise debt subsequent to halting the "flow" of bad debt. The function would be to provide financing for uncreditworthy enterprises while isolating them from the banking system, and ensure that any financing provided to them during the transition period does not accumulate as bad debt on the books of the banks. The entity would receive its financing only as transfers from the Government. It would organize the financial restructuring of enterprises with the participation (and financial contribution) of the municipal government, local creditors, and the firm itself.

Banks also need to step up their governance involvement with SOEs, especially in calling on debt-service obligations. More specifically, (d) banks need to feel more empowered to obtain more frequent and better financial information from SOEs, including the requirement to request independent audits. (e) Banks could be prohibited from lending to enterprises that are in arrears for more than, say, 180 days. (f) Banks also could be allowed to automatically provision at greater rates for past-due loans. This will require an increase in the amount (or percentage) of loan-loss provisions (in particular, the loan-loss provisions should not be limited as a percent of the stock of loans; at most, the annual additions to provisions could be limited).

### **Encourage Competition**

One of the most powerful messages that emerges from China's (and other countries') experience in improving SOE governance is the importance of introducing vigorous competition in both product and factor markets as a mechanism for limiting insider control problems and promoting and sustaining efficiency gains. Chinese authorities have made much progress in promoting the free flow of competitive market forces. However, there remain a number of rigidities in the industrial sector that are still to be tackled, including:

(a) eliminating policy barriers to entry for SOEs and nonstate firms—both domestic and international—into markets that otherwise would be structured competitively (i.e., excluding markets where natural monopoly or oligopoly conditions prevail and thus where appropriate regulation is called for). This can come about by

facilitating business licensing and registration procedures (on the domestic front) and further reducing import quotas and tariffs and rationalizing the foreign direct investment policy regime, such as eliminating "trade-related investment measures" (TRIMs);

(b) promoting competition *across regions*, by opening up wholesale distribution channels to new entrants and breaking the evolved system of uneconomic interlocked supplier–customer relationships; also the VAT and income tax disincentives and the political economy barriers to cross–provincial product trade and business licensing and registration procedures need to be eliminated;

(c) allowing equal access to factor markets, by ensuring there is not discrimination among firms of different ownership forms as regards access to bank credit, fuel and material input prices; and

(d) adhering to the regime for tax neutrality across all firm ownership forms, as embodied in the recent tax reforms.

### **Grant Managerial Autonomy Within a Market–Based Context**

Increasing managerial decision–making autonomy in Chinese SOEs is a policy objective of the authorities, and the granting of the 14 Autonomous Management Rights should indeed proceed. As noted above, where reforms have increased managerial autonomy amidst decentralization, unclear property rights and lack of accountability, a corporate governance vacuum has arisen, creating the opportunity for "insiders" to, in effect, privatize state assets and socialize enterprise liabilities. This outcome has been held in check however where subsidies to the firm have been halted, competition is strong, and debt–service obligations are met. It is in this context that further autonomy should be granted.

### **Diversify SOE Ownership**

China's experience in diversifying SOE ownership (to both individuals and legal–person institutional investors) suggests that ownership diversification is an effective way of improving governance. It is not enough, however, simply to diversify. Without the proper institutional and sociopolitical framework, ownership diversification may compound any existing "insider control" problems and create perceptions of unfairness. Implementing and managing SOE ownership diversification should, therefore, be done with well–defined institutional responsibilities and through transparent and competitive procedures. In this regard, international experience suggests that the keys to success are (a) to ensure ownership diversification is both cross–regional and cross–sectoral (to pool differences in "initial condition" state asset–liability endowments); (b) to ensure transferability of ownership shares; and (c) to ensure that investments on behalf of the State are owned, supervised or managed by independent professionals whose remuneration is incentive–linked to investment performance.

Like other transition economies, *China's Government needs to recognize that there is a trade–off between maintaining control of SOEs and enhancing their asset values. Fundamentally reorienting SOEs' incentives toward the market may well entail reducing the state's involvement in SOEs to passive minority ownership*. The Government will have its hands full in trying to improve the performance and competitiveness of its chosen 1000 priority SOEs. The job is complex, and government's resources in skills and budget are limited.

Within this context, one potential approach for China to consider is based on other transition economies' experience. It is a phased sequence of increasingly broader ownership diversification: In Phase I, all of the 1,000 priority SOEs would undergo corporatization under the Company Law within a prespecified time frame, say one to two years. In Phase II, over a three–year period, on a cross–sectoral and cross–regional basis, a large but not a majority ownership stake of each corporatized SOE is managed by an SAOC, reformed into an independent,

professional investment management corporation. Of the remaining shares of the SOE, some are assigned to other SAOCs and some are traded on the secondary market. In Phase III, after five years, all funds can trade among each other.

### **Foster Market–Oriented Mergers, Acquisitions and the "Market for Corporate Control"**

In general, the increased attention being paid to mergers, acquisitions and other forms of consolidation of *operational enterprises* is to be encouraged—to the extent that the resulting integration of SOEs serves to maximize economies of scale and scope (especially where multiplant schemes can be rationalized under one corporate roof). Such efforts help deal with the problem of duplication of facilities, where many plants throughout China are below minimum efficient scale. It will assist in the desegmentation of the country's market structure.

Two problems are emerging, however, because many of these mergers are administratively arranged, rather than market–determined. One, they do not necessarily lead to rationalization and lower average production costs. Instead, they become a device for saddling more efficient firms with the redundant workers and obsolete equipment of other less–efficient firms. Two, in the absence of a competition policy that facilitates the lowering of entry barriers to new competitors, such integration may create opportunities for the exercise of unchallenged market power by the consolidated firm, leading to prices above competitive levels.

A "market for corporate control" could be fostered that would provide for mergers and acquisitions to be transacted through freely functioning competitive forces, *subject to the condition that a publicly provided social safety net is established to facilitate dealing with redundant workers during a prespecified transition period* . Such a mechanism, which would serve to make the *threat* of potential takeovers of inefficiently managed firms credible, helps ensure that state–owned assets are being deployed to their highest value in use. It would thus be a powerful disciplinary device to enhance enterprise governance. In this regard, the emerging network of property rights transactions centers could be enlarged and strengthened. Such transactions should be conducted through an open, transparent process. Closed negotiated transactions of state–owned assets may well undermine the public's support of the reform program; they may also result in lower market valuations of the assets.

### **Endnotes**

1. See *World Development Report, 1996* .
2. See Chapter 3 in World Bank (1996), *China: Reform of State–Owned Enterprises* .
3. See *World Development Report, 1996* .
4. Qiangui (1995).
5. "State Asset Drain Must End," *China Daily* , December 13, 1995.
6. Broadman and Xiao (1997).

7. See *World Development Report* , 1996.

8. The CRS has employed five types of contracts: (a) "general quota responsibility contracts" for all types of enterprises [principally ceding to managers (and sometimes the entire workforce) control over enterprise operations, including retention of excess profits, in return for meeting profit remittance targets]; (b) "leasing contracts" for collectives and small SOEs (tying leasing fees paid by managers to various measures of enterprise performance); (c) "management responsibility contracts" for large and medium-size SOEs (tying management teams' autonomy, pay and excess profit retention to the meeting of profit and tax remittance targets); (d) "enterprise management responsibility contracts" for large and medium-size SOEs [similar to (c) but covering enterprise directors (and sometimes workers)]; and (e) "asset management responsibility contracts" for small and medium-size SOEs (tying directors' and managers' autonomy, pay and retention of excess profits to enhancement of enterprise asset value). The two most common contract forms; have been (c) and (d).

9. See World Bank (1996), *Bureaucrats in Business* .

10. See Xu and Wang (1996).

11. La Porta et al. (1996).

12. See Shleifer and Vishny (1997). For evidence for other transition economies see, for example, Claessens (1996), Claessens, Djankov and Pohl (1996) and Saba (1996).

13. See Xu and Wang (1996).

14. See Che and Qian (1996).

15. See Qian and Weingast (1996).

16. See Hellman and Murdock (1995) and Stiglitz (1996).

17. See *Economic Daily* , July 12, 1996.

18. See, further, Aoki (1994) and Qian (1994).

## 5—

### **Financial Accounting Systems and Controls**

## Introduction

Accounting reforms are prerequisites for providing SOE owners, boards of directors and managers with reliable information to monitor the performance of SOEs. Without financial information on enterprise performance that is accurate, transparent and prepared in line with commercially meaningful principles, all other aspects of SOE reform could be for naught. Otherwise strong governance, property rights and organizational incentives will be blunted. At the same time, state assets and liabilities will not be valued correctly. The challenge of accounting reform is not only to introduce sound standards on which accounts are prepared, but also to ensure there are adequate incentives so the standards will be implemented in practice.

Beginning with a law in 1985 that amended the country's first accounting regulations introduced in 1952 (largely based on the Soviet model and designed for a planned economy), China initiated deeper reform of its accounting system.<sup>1</sup> However, it was the Accounting Standards for Business Enterprises ("Standards") issued by MOF in July 1993 that first established a conceptual basis for Chinese SOE accounting. The 1993 Standards embody general principles modeled on internationally accepted practices, and are to serve as the basis for more detailed standards to be issued later (see below). Generally departing from the "fund approach" of the old system, the 1993 Standards introduced the requirement that financial statements include assets, liabilities and owners' equity on the balance sheet, and profit or losses on the income statement. Unlike the old system, which did not distinguish between taxable income and profits, the 1993 Standards do, and thus are designed to measure corporate efficiency and performance rather than revenue generation. However, one important remnant of the old system is the accounting for state "investments," which include "funds advanced to enterprises."

The development of the accounting practice in China parallels the regulatory evolution. Professional accounting organizations were not established until recently. In 1980 the Accounting Society of China (ASC), which is devoted to the development of the accounting profession, was established; it has local branches nationwide. Although a professional organization, ASC does not have the authoritative status of the Financial Accounting Standards Board (FASB) in the United States (or similar nongovernmental, independent organizations in other countries) in developing and ensuring adherence to accounting standards in China. MOF's Department of Administration of Accounting Affairs (DAAA) is the agency officially responsible for developing and enforcing accounting standards and regulations; still, DAAA collaborates with ASC.

## Differences between China's Standards and International Accounting Standards

The authorities' objective is to bring the country's accounting practices into conformity with international norms. Toward this end, attention is focused on the chief differences between the 1993 Standards and international accounting standards. The main differences concern the policy basis of the accounting framework, the audience for which the accounts are intended and the definition and application of terms. Annex 7 contains the 1994 and 1995 summary financial statements of Shanghai Petrochemical Company and its parent, SINOPEC, to illustrate the Chinese Standards and international accounting standards.

## The Policy Basis and Users of Financial Statements

Identification of the users of enterprise financial information reflects the policy basis of a country's conceptual framework for accounting. Most other nations with formalized accounting standards *specifically* identify the *primary users* of accounting information—usually "investors and creditors"—China's standards do not.<sup>2</sup> The 1993 Standards indicate (Article 11) instead a range of users: government, banks and other financial institutions, business enterprises, the general public and enterprise management. The Standards also state (Article 11) that accounting information must be designed to meet the requirements of national macroeconomic control, the needs of all concerned external users and the needs of enterprise management. *The priority the Standards give to administrative and macroeconomic control is in conflict with the aim of "separation" of government and*

*capital—the underlying tenet of state asset management reform as embodied in the Supervision Regulations (Chapters 2 and 3).*

### **Definition of Terms**

The other chief distinctions between the 1993 Standards and international norms arise in the definition of terms. Determining the monetary amounts at which the elements of a financial statement are recognized and presented is a process referred to as "measurement." The bases on which measurement is made include "historical cost," "current cost" "realizable value" and "current value." Under international standards, the most common basis of measurement is historical cost, usually adjusted by the application of one or more of the other bases—most often current value. For historical cost, the chief difference between international and Chinese Standards is that under the international standards, historical cost is the fair market value of the item at the time of acquisition, recognized and entered into the statements on the basis of that cost adjusted for other factors, primarily market value. The lower of the two is generally recognized. Because important features of a market economy—such as well-developed capital markets—are still nascent in China, conditions for measurement are bound to be different in the Chinese context than under international accounting standards. Thus, for purposes of comparison with market-based accounting, book value in China will be problematic even if international principles are used.

Inventories under international standards are normally carried at the lower of cost or net realizable value. The Chinese Standards (Article 19) state that historical cost is to be used for valuation of all assets and liabilities, and rules determine an inventory's historical cost. These rules until recently did not include intermediate production costs or were based on planned, not actual, costs. This is likely to result in a different valuation for inventory as compared with international standards.

Analysis of the difference between financial and physical concepts of capital is also usually carried out under international standards. The selection of the appropriate concept depends on the needs of the users of the statements. In general, the Chinese Standards provide for no such analysis. Only in cases where the shares of Chinese companies are being offered on public exchanges are such differences recognized in the accounts.

### **Application of the Standards**

New and more detailed Chinese standards are under preparation. Examination of drafts of the new standards indicates much greater precision and comprehensiveness relative to the general principles embodied in the 1993 Standards. Their implementation should result in greater convergence between

accounts prepared under Chinese and international standards. MOF indicates it will introduce the new standards on an experimental basis in 1997 for a few selected large enterprises.

While no comprehensive survey of accounting practices was attempted for this study, all enterprises and agencies interviewed indicated that the 1993 Standards have been administered as required by MOF. This finding is consistent with the World Bank survey of 156 SOEs: 96 percent of the respondent enterprises reported they have "fully administered" the new accounting standards; only 3 percent indicated "partial administration."<sup>3</sup>

Despite administration of the Standards, *application* of the accounts produced to reach a commercially meaningful assessment of an SOE's assets and net worth—consistent with international standards—is still problematic. The following are the most pronounced application problems:

*A series of amendments to the definitions in the Standards* . From 1985 to the present, MOF has issued directives that have had a direct bearing on the definition of depreciation and amortization of different forms of assets, such as buildings, equipment and technology. In addition, banks use two different inflation factors, and these are not

always consistently applied;

*Periodic reevaluations of assets values* . In Hubei and Sichuan provinces, among others, some enterprises have been revalued several times, with a resulting increase in equity by a factor of 1 to 3; other firms or even some within a group enterprise have not yet been revalued. As a result, comparisons are difficult to make or ultimately prove irrelevant. In addition, banks often ask for projections for a *project* separate from an analysis of the financial condition of the *enterprise* . The project valuation is often done on the basis of definitions and valuation different from those used for the enterprise's overall accounts. This is, in large part, because the banks still do not use asset-based lending techniques;

*Capacity problems in many enterprises to prepare the accounts using the Standards* . A number of enterprises complain about the complexity of the system and the frequency of changes. As a consequence, additional personnel and further training are sorely needed. At the same time, relatively few accounts are computerized;

*Unclear treatment of tertiary businesses assets, costs and losses as well as implicit liabilities, especially social obligations* . In many cases, enterprises continue to bear the expense of maintenance of even divested holdings, e.g., where housing has been divested but an SOE continues the obligation of maintenance and repair;

*Inconsistencies within a single enterprise group* . International principles exist to guide the presentation of consolidated financial accounts for holding companies (see Box 5.1). Chinese holding companies, however, rarely follow such principles. In Hongquang Industrial Company and Chongqing Iron and Steel Company, for example, "branch companies," which are not independent legal entities, but are independent accounting units, generate reports on a schedule and by methods that differ from other entities in each group; this makes consolidation for annual group planning difficult; and

*Costs are often determined without reference to market price or by arbitrary formulas* . For example, raw cotton prices until recently were low while yarn prices moved slowly to market

levels. But a sudden swing in new raw cotton prices was not matched by yarn prices. The accounting distortions would often result in a cotton mill having a book entry "profit" although value-added in fact was negative.

### **BOX 5.1: INTERNATIONAL EXPERIENCE IN ACCOUNTING FOR HOLDING COMPANIES**

Under international principles, holding companies that are usually 100 percent owners or at least majority owners of their (underlying) enterprises typically are expected to produce consolidated financial statements. These consolidated statements include the financial accounts of the underlying subsidiaries. After netting out intercompany cross-holdings, the equity on these statements would be the aggregate of the equity of the subsidiaries. In addition, the holding companies "own" financial statements may also be prepared, based on its own equity. On the other hand, holding companies that are essentially asset managers, with minority or usually small stakes in their enterprises, are typically not expected to produce financial statements where the equity includes the shares held in subsidiaries. Rather their shares in various enterprises, where tradable, appear as some form of short-term assets. Earnings from these subsidiaries, however, are usually reflected in the form of dividend income, while losses usually appear as a diminution of the total value of the shares held in that enterprise.

In practice, these principles are not always adhered to. In some countries, such as Egypt and

Algeria, even where a holding company has a majority or at least a controlling interest in its enterprises, bona fide consolidated financial statements are not produced; rather "asset management" statements are presented (Kumar 1993). Thus, the real value of the underlying subsidiaries is not known. On the other hand, the provision of consolidated group accounts is required in both the United States and the United Kingdom, although the details of requirements on the presentation of subsidiary accounts differ. In the United Kingdom, separate accounts for each "class of business" are required, but the definition of each business class is left to managerial discretion. The definition in the United States is clearer: any activity comprising above 10 percent of turnover is to be independently reported.

*Source:* World Bank staff.

### Financial Systems and Controls

Because asset–liability ratios are used extensively as performance indicators, as criteria for loan qualification and for employee and management compensation and to meet audit requirements under the Company Law, most industrial SOEs are setting up more modern financial systems and controls to better assess net worth. Several municipal finance bureaus (e.g., Chongqing) have introduced a standard accounting package consisting of officially approved software.

The enterprises examined for this study report varying degrees of such reform. Most report that financial systems are based on a cost–center structure that applies *standard* rather than *actual* costs. In addition, the typical cost systems employed are based on the major cost categories that comprise an enterprise but do not permit analysis of *performance* by product line or workshops or departments. Some enterprises report the introduction of workshop–or department–level cost and profit centers that then will charge a price based on cost–plus profit.

The budgets of the examined enterprises are developed in a *top–down* approach. They tend to rely on forecasts based on historical orders. This creates inflexibility to changes in customers and customer preferences. Budgets prepared during a long forecast period may not reflect difficulties or failures to adjust to variance in actual market conditions. Targets are *imposed* on cost centers, and costs are *assumed* as standard.

Generally, the financial statements and forecasts are not provided to functional departments and workshop managers in a way where they could be used for strategic analysis. The result is likely to be failure to account accurately for actual price or efficiency variations. Where such changes occur unnoticed, they result in liabilities that are not reflected in enterprise statements.

Accounting for tertiary or social service businesses is varied. Where these activities are commercially viable, they have been set up as independent accounting units. However, most social services, such as clinics, schools, recreation facilities and the like are often treated inconsistently. Some have their asset values identified but not their costs. Most of the enterprises examined had separated such businesses from core productive operations. Group enterprises have tended to remove them from the more profitable subsidiaries so as to be able to improve those subsidiaries' balance sheets (usually as part of a public listing). However, provision of the social services goes on—in many cases, service contracts are drawn up between the productive subsidiary and the social service subsidiary—but the allocation of the liability is often not transparent. This is most often the case for housing. Box 5.2 shows examples of irregularities in SOE accounts prepared in 1996 for firms participating in reform programs.

### Performance Indicators

A new regime of performance indicators between SAOCs and their underlying operational SOEs is being introduced. As a case in point, the materials examined for this study included the "Experimental Performance

## China's Management of Enterprise Assets

Indicator System" devised by the Shanghai SAOC and the Shanghai First Department Store (Group) Company. The indicators are typically defined on an annual basis. A variety of variables are specified, including rate of return on total assets, asset–liability ratio, and net assets.

Notwithstanding the problems associated with the current use of the accounting standards, they are being used to define the measures incorporated in the new indicators. Since access to finance now depends, in part, on a healthy debt–to–asset ratio, many SOEs, especially loss–making enterprises, exhibit a reluctance to write off bad debits and to allow for depreciation of old machinery and stock. The incentive is to encourage appreciation of certain assets, such as land, which are periodically revalued. In addition, enterprises report a penchant for deferring startup costs for extended periods, while entering into the asset column the value of the construction or project in process. If the Standards' rules are strictly applied, then the performance indicators that use assets as a variable would result in a distorted picture. They would not offer a fair reflection of current performance, since the asset side of the ledger is inflated while the liability side is suppressed.

### Independent Audits

One of the features that has frustrated attempts to improve the efficiency of SOEs is the limited amount of independently verified financial information on the performance of the enterprises. Accounts that are audited and made public by an independent, professional firm abiding by internationally accepted standards can provide SOE owners and boards of directors with reliable information to supplement management accounts and on which a strategy for the enterprise can be developed and monitored. Such information is also a prerequisite for SOEs entering into joint ventures with foreign partners; by the same token, these data are necessary for an enterprise wishing to be listed on international stock exchanges.

<b>B OX 5.2: EXAMPLES OF ACCOUNTING IRREGULARITIES IN ONE EXPERIMENTAL CITY , DECEMBER 1996</b>
1. <b>General</b> . None of the following essential account reconciliations are carried out:
inventory: no physical stock–take verifications;
debtors, creditors: no cross–check with third party accounts;
cash accounts and participation in other companies: no cross–checks with third party accounts;
fixed assets: no verification of individual items.
2. <b>Assets</b>
<b>Fixed Assets</b> . The revaluation of assets in some cases led to equipment being overvalued, e.g., some overly old (over 20 years) machinery still has some book value attached to it although its market value is virtually zero. The accounting treatment of assets transferred to a joint venture is not always transparent. Although the equipment is said to have been transferred to a joint venture, or is clearly being used by the joint venture, the asset value sometimes remains in the accounts of the mother company.
<b>Depreciation</b> . The enterprises follow the depreciation guidelines issued by the State. This often means that the depreciation rate is a long way out of line with real asset life and compared to International Standards, equipment tends to be depreciated over much longer time periods. The book value may well be significantly in excess of market–realizable value.

**Participation in other companies and long-term investments** . The accounting of joint-venture operations is often confused with the parent entity, giving rise to lack of clarity and risk of double counting. In some cases, investments in joint ventures were reported but the corresponding assets (long-term investments) could not be identified. In other cases, it transpired that certain operations carried out on behalf of the joint venture had been included with the main business accounts.

**Inventory** . The provisioning for bad inventory is legally limited but insufficient and stock write-offs are exceptional, despite the sometimes obvious poor state of stocks. Debtor write-offs are similarly rare, resulting in an overstatement of the value of current assets.

**Debtors** . We believe that bad debts are generally underprovisioned. This is due to the legal limit on bad debts provisions that, at the time of our study, was set at 0.5 percent of total receivables, while bad debts are written off only in exceptional cases.

### 3. Liabilities

**Long-term loans** . In most cases, the enterprise expects that these loans will be converted into equity as part of the restructuring into an LLC. This obviously distorts the debt-equity ratios and makes their interpretation difficult.

**Short-term loans** . Although termed "short-term loans," there is a tacit continuation of loans once they expire; the loans are, therefore, effectively used as a source of long-term finance.

**Creditors** . The "other creditors" (the counterpart to "other receivables"—see above) often contain short-term or long-term working capital provided by third companies.

**4. Profit and Loss**. The classification of costs as manufacturing expenses, overheads, financial costs, or selling expenses is often unclear and cost categories are often mixed. The emphasis is on fulfilling superiors' expectations rather than on accurate recording of financial transactions. Cost classifications are often changed from one year to another, so that it is difficult to compare costs over several years and, as cost categories are not clearly delimited, it becomes difficult to identify the causes for variations. Although this does not change the overall financial result, it affects the transparency of accounts and often means that there is no reliable basis for management accounting.

*Source:* Study by Chinese and international consultants of 10 medium and large SOEs participating in reform experiments.

After a 30-year suspension of the auditing function in China, the Audit Administration of China (AAC) was established in 1983. AAC effectively oversees "state auditors," who operate within government departments and are responsible for the official audits of SOEs, and "internal auditors," who operate within enterprises on behalf of management, but can be tasked to carry out a supervisory audit of the enterprise on behalf of the State (thus posing a conflict of interest). There are more than 50,000 state auditors and more than 100,000 internal auditors. Certified Public Accountant (CPA) auditors, which number more than 6,000 persons, are "independent" of the AAC, but regulated by MOF. Although an SOE can hire a CPA firm to audit its accounts, at present most CPA firms serve joint-venture firms. On the other hand, municipalities

and provinces are increasingly requiring CPA audits for large state-owned investment projects, for newly registered enterprises of all types, and for firms seeking to be listed on a stock exchange. Within the past decade, foreign accounting firms have attempted to enter the Chinese market; today, all of the "Big Six" international accounting firms have been allowed by Chinese authorities to establish joint ventures with local firms.

The 1994 World Bank survey revealed that 84 percent of the respondent firms indicated they have had their accounts audited since 1990; 13 percent indicated they had not. Most audits took place in 1990 and 1992, prior to the implementation of the 1993 Standards. Seventy-four percent of the firms indicated their audited accounts are public, and 25 percent said they are not.<sup>4</sup>

### Conclusions

Most of the accounts and the financial control mechanisms in China's industrial SOEs are still aimed at *counting* rather than *financial management*. This detracts from creating strong incentives for efficient management of state assets and liabilities. Without implementation of sound accounting standards and independent audits, the system of checks and balances is undermined.

Accounting reforms in public enterprises have been embarked upon in the last few years in an array of countries, including New Zealand, Italy, India and Canada. The reforms are all targeted at measuring returns on investment using market-based criteria and cash flow methodologies; see Pannier (1996). China can learn from these accounting reforms.

Increased attention should be paid to several financial accounting and related controls that are critical to assessing the strengths and weaknesses of SOEs in China's emerging market system:

#### Introduce Cash Flow Forecasts

These should be issued on a semiannual or quarterly basis (frequent by China's standards). However, this may be inadequate for large group enterprises, such as Shanghai First Department Store (Group) Company or Hongquang Industrial Company, Ltd., where rolling cash flow forecasts could be more helpful.

#### Systematize Working Capital Analysis

Chongqing San Ling Industrial Company is typical in that different independent profit center workshops or production units still rely on an "internal banking system." Each unit writes checks and makes demands on the central finance department with little inter-unit coordination. All units and the "internal bank" must be given information to plan or to deal with working capital shortages, which frequently occur.

#### Improve Financial Controls for Interenterprise ("Triangular") Debt

Many SOEs, such as San Ling, have key customers, like the Jialing Group, that are also SOEs. Jialing's arrears to San Ling have increased almost fivefold in three years. Yet neither firm has in place adequate control systems to manage such debts. Such control systems need to be quickly introduced.

#### Strengthen the Capacity for Assessing Returns on Long-Term Investments

Analysis of investment performance taking into account debt service and utilizing financial modeling skills are still scarce and training is also limited. This capacity needs to be enlarged.

#### Enhance the Role of Independent Accountants

Independent, published audits of SOE financial accounts can be powerful external disciplining tools for management, providing the State as owner with an effective system of "checks and balances" to bolster the state asset management system and help limit asset-stripping. Consideration could be given to establishing a nongovernmental FASB-type organization to set professional standards for accounting and auditing practices, phasing in a self-regulatory role. Under the World Trade Organization, foreign accounting services could be

expanded.

### Endnotes

1. All SOEs in China follow a unified enterprise accounting system stipulated by MOF. Until recent accounting reforms, the Chinese accounting system largely followed the Soviet system, which was developed in the context of a highly centralized, planned economy. China's accounting regulations for industrial SOEs were first introduced in 1952. The principles on which this system were based were three: fund, rule and tax. The "fund basis" (until 1989) required each enterprise to maintain a balance sheet of three funds: fixed, current and specific, designed to monitor and control allocations of resources to enterprises and the use of those resources to achieve planned results. The "rule basis" meant that detailed rules for most situations were set by control authorities. These rules related to resource flows in the central budget. The rules were imposed uniformly and were to be followed strictly. The third basis of the old system was revenue generation through taxation. Recognizing the deficiencies of the old system, the accounting system was revised incrementally several times from 1978 to 1985.

2. For example, Canada's standards specify "investors and creditors"; CICA Handbook, Section 100.11

3. World Bank (1996), *China: Reform of State-Owned Enterprises* .

4. World Bank (1996), *China: Reform of State-Owned Enterprises* .

### Annex 1—

## The 100 SOEs Chosen by the State Council for the National Corporatization Experiment

- |   |   |
|---|---|
| 1. Beijing First Light Industry Corp.     | 53. Hainan Tinned Food Factory                          |
| 2. Beijing Chemical Industry Group Corp.  | 54. Guangxi Guigang Sugarcane Chemical Industry Factory |
| 3. Beijing Peony Electronics Group Corp.  | 55. Sichuan Goods and Materials Group Corp.             |
| 4. Tianjin Automobile Industry Corp.      | 56. Sichuan Tuopai Industry Co. Ltd.                    |
| 5. Tianjin Lida Group Corp.               | 57. Chengdu Hongguang Industry Co. Ltd.                 |
| 6. Tianjin Steel Tube Corp.               | 58. Chongqing Iron and Steel Co.                        |
| 7. Hebei Baoding (city) Transformer Plant | 59. Guizhou Kaiyang Phosphorus Mine Bureau              |
| 8. Hebei Tangshan (city) Alkali Plant     | 60. Kunming Heavy Machinery Group Corp.                 |
| 9. Taiyuan Heavy Machinery Group          | 61. State-Run Northwest Cotton Textile Factory          |
| 10. Taiyuan Iron & Steel Group Corp.      |   |

## China's Management of Enterprise Assets

11. Baotou Textile Plant
12. Benxi Iron & Steel Corp.
13. Jinchen Paper Making Limited Liability Company
14. Shenyang Machine Tool Works Ltd.
15. Wafangdian Bearing Plant
16. Tonghau Iron & Steel Company
17. Jilin Chemical Fiber Corp.
18. Changchun Gasoline Engine Company Ltd.
19. Heilongjiang Long Di Company Ltd.
20. Jiamusi Paper Making Company Ltd.
21. Haulin Group Company
22. Shanghai Automobile Industry Co.
23. Shanghai Knitting Group Corporation
24. Shanghai Number 3 Radio Factory
25. Shanghai First Department Store Group Corp.
26. Shanghai Sanwei Pharmaceutical Company
27. Wuxi Weifu Limited Liability Company
28. Xuzhou Engineering Machinery Group Corp.
29. Nanjing Electricity Chinaware General Factory
30. Hangzhou Turbogenerator Group Corp.
31. Shaoxing China Textile City Limited Liability Company
32. Ningbao Dunhuang Group Corp.
33. China Yangzi Electronics Group Corp.
34. Anhui Tire Factory
35. Fuzhou Number 2 Chemical Factory
62. Qinchun Machine Tool Factory
63. China Standard Sewing Machine Group Corp.
64. Lanzhou Number 3 Wool Textile Mill
65. Lanzhou Minbai Company Ltd.
66. Qinghai Xining Steel Factory
67. Northwest Bearing Plant
68. Xinjiang "August 1st" Steel Plant
69. Tibet Lasa Beer Brewery
70. Xinjiang Shihezi August 1st Wool Textile
71. Changchun High-Tech & New-Tech Group Corp.
72. China Number 1 Building Engineering Bureau
73. Fujian Province Electricity Corp.
74. Yianzhou Mine Bureau
75. Rainbow Electronics Group Corp.
76. Wuyang Iron & Steel Company, Ministry of Metallurgy
77. Guizhou Chishui Natural Gas Chemical Fertilizer Plant
78. Dalian Railway Bureau
79. Guangzhou Ocean Shipping Group Corp.
80. Wuhan Telecommunication Equipment Plant, Ministry of Post & Telecommunication
81. Danjiangkuo Key Water Control Project Bureau, Ministry of Water Conservancy
82. China Aquatic Products Corp.
83. China Forestry Machinery Corp.
84. China Electrical and Mechanical Equipment Corp.

## China's Management of Enterprise Assets

36. Xiamen Seagull Industry Corp.
37. Jiangxi Xinyu Iron & Steel Limited Liability Company
38. Yiantai Artificial Leather General Factory
39. Jinan Daguanyuan (Grand View Garden) Limited Company
40. Zibo Chemical Fiber General Factory
41. Qingtao Yiqing Industry Corp.
42. Anyang Iron & Steel Company Ltd.
43. Henan Songyue Textile Industry Group
44. Hubei Chemical Fiber Corp.
45. Taye Special Steel Company Ltd.
46. Wuhan Boiler Works
47. Hunan Province Guoguang Porcelain Company Ltd.
48. Hunan Province Materials Group
49. Guangzhou Monosodium Glutamate Factory
50. Shenzhen Huaqiang Electronic Industry Corp.
51. Guangdong Province Goods & Materials Group Corp.
52. Shenzhen Goods and Materials Corp.
85. China Metals, Electrical and Chemical Products Corp.
86. China Food and Oil Import & Export Corp.
87. China Complete Set of Equipment Import & Export Corp.
88. China Machinery Import & Export Corp.
89. China International Travel Agency
90. Kunming Phosphoric Acid Sodium Plant
91. China Textile Machinery Corp.
92. Beijing New Building Materials Factory
93. China Pharmacy Import & Export Corp.
94. Jiangnan Ship-Building Plant
95. Building Industry Group Corp.
96. Nanjing Chenguang Machinery Factory; Aerospace Ministry
97. Dagang Oil Administration Bureau
98. Beijing Yanshan Petrochemical Industry Corp.
99. Tatong Mine Administration Bureau
100. Xinxing Tube Casting Corp.

*Source:* World Bank mission.

## **Annex 2— Social Assets of a Steel-Making SOE in Southwest China**

### **Education .**

The enterprise owns and operates the schooling system for the children of its employees from ages 6 months to 18 years. Its kindergarten serves 250 children from ages 6 months to 6 years, and employs 41 teachers. Employees pay a nominal fee of Y 20/month. However, rates are often set according to ability of families to pay; concessional rates are given to those who cannot afford the nonemployee surcharge. The elementary school was established in 1972 and today serves 356 students between the ages of 7 and 12. The vast majority of students are factory employees' children for whom schooling is free. All costs are borne by the factory, including the salaries of the 34 teachers. The handful of nonfactory children who attend (about 20) pay Y 40/month. The middle school serves children 12 to 18 years, has 395 students and 49 teachers. High school students pay Y 80/semester, while

fees for the junior high are somewhat less. Books are bought by the parents, but other materials, supplies and operating costs are covered by the enterprise. Teachers at the school receive an average salary of Y 500/month.

### **Health Services .**

Since 1969, the enterprise has owned and operated a hospital for employees and their families. The hospital has a 60-bed capacity and treats an average of 50 people a day on a walk-in basis. It has a staff of 76, of which 2 are physicians and 24 are nurses. There are three other hospitals in the area, one of which is run by the district government. Factory employees depend primarily on the enterprise hospital for their health care as the enterprise subsidizes 85 percent of the costs for health services and medicines; retirees' fees are 90 percent subsidized.

### **Housing .**

Ninety-eight percent of the housing for workers and their families is provided by the enterprise at highly subsidized rates. Beyond the factory walls are scores of apartment buildings that vary in quality and state of repair. There are three types of cofinancing arrangements. The first option is for an employee to pay a monthly rent to the enterprise. The second option is a joint purchasing arrangement between the employee and the enterprise in which the former receives limited property rights. As a case in point, one employee's contribution toward partial ownership is Y 7,000 (\$850). This appears to be a preferred alternative to paying rent by those who can afford it. Employees also have the option of buying their apartments outright from the enterprise. However, in the event that the employee leaves the firm, they are required to sell the apartment back to the enterprise or another employee. Tenants are required to pay for their own water, electricity and heating bills, but again, these rates are subsidized by the enterprise. Retired employees can remain indefinitely in enterprise housing. To this end, the enterprise builds or procures additional housing almost yearly to ensure adequate supply.

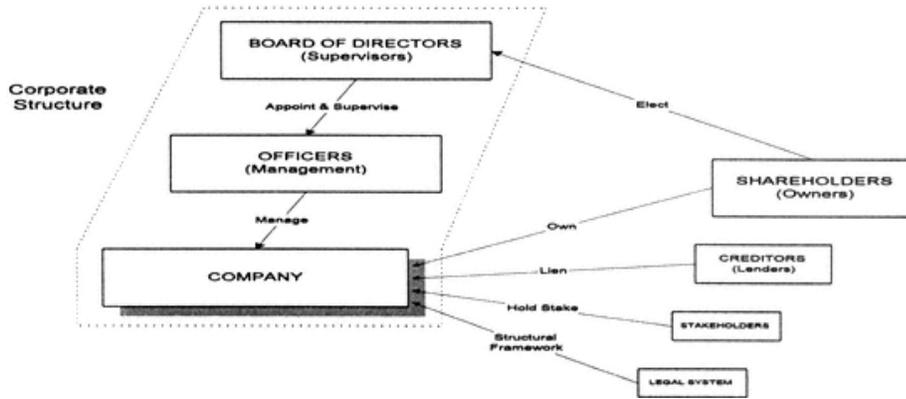
### **Job Training Center .**

The training center provides vocational and skills training to new employees in areas such as machine construction, design, and operation, lathing, milling, etc. The facility is currently operating well below its full capacity, which is 600 students: there are only 100 students enrolled. They are supported by a staff of 47, of which 37 are instructors. The students are the children of employees who are selected for a two- to three-year training program. After completion of the program they are guaranteed a job with the enterprise. Annual enrollment fees are subsidized by the factory, which contributes Y 1,200 per student. Each student is required to pay Y 300/year toward tuition and boarding expenses. The decline in enrollment over the past several years is attributed to the decrease in funding provided to the training center by the enterprise.

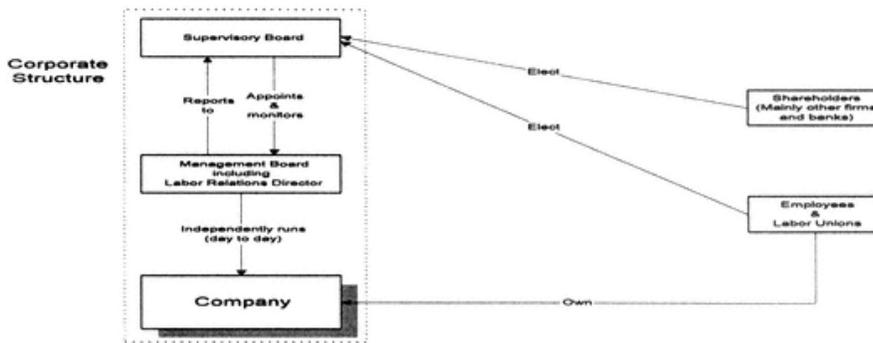
*Source:* World Bank mission.

## **Annex 3— Market-Based Models of Corporate Governance**

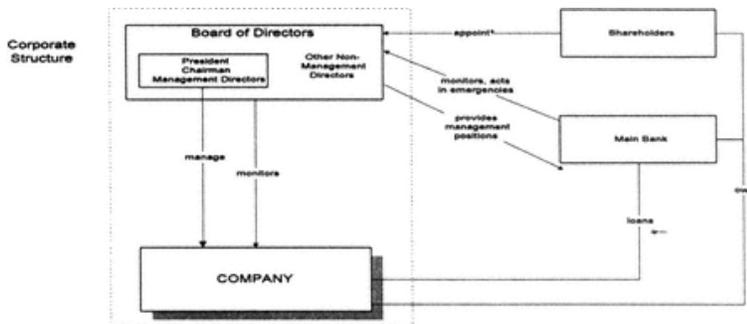
## China's Management of Enterprise Assets



A. Anglo–American Model: heavy reliance on shareholders' actions in stock markets



B. German Model: centered on institutional investors (other firms and banks)



C. Japanese Model: utilizes a bank–based system

Source: World Bank staff.

## Annex 4— Entities Interviewed by the World Bank Mission

Beijing

## China's Management of Enterprise Assets

### **Government Agencies**

State Commission for Restructuring the Economic System

National Administrative Bureau for State–Owned Property

State Economic and Trade Commission

Ministry of Finance

State Administration of Industry and Commerce

State Accounting and Audit Bureau

State Statistical Bureau

### **Banks**

People's Bank of China–Headquarters

Industrial and Commercial Bank of China–Headquarters

### **SOEs**

SINOPEC–China National Petrochemical (Group) Corporation (national–level SOE)

### **Research Organizations and Universities**

Institute of Contemporary International Relations (research arm of State Council)

China Center for Economic Research, Peking University

Unirule Institute (independent research institute)

### **Sichuan Province**

#### **Government Agencies**

Sichuan System Reform Commission

Sichuan State Asset Management Bureau

Sichuan Economic Commission

Sichuan Finance Bureau

Sichuan Administration of Industry and Commerce

Sichuan Audit Bureau

**Banks**

People's Bank of China–Sichuan Branch

Industrial and Commercial Bank of China–Sichuan Branch

**SOEs**

Sichuan Materials Group Company, Ltd. (participant in the "100 SOE modern enterprise system" experiment)

Dongfang Electrical Equipment Group (one of the national 56 Group Enterprise)

**Shanghai Municipality**

**Government Agencies**

Shanghai System Reform Commission

Shanghai State Asset Management Office

Shanghai Economic Commission

Shanghai Finance Bureau

Shanghai Administration of Industry and Commerce

Shanghai Audit Bureau

**Banks**

People's Bank of China–Shanghai Branch

Industrial and Commercial Bank of China–Shanghai Branch

**SOEs**

Shanghai Petrochemical Corporation (listed on the Shanghai, Hong Kong and New York stock exchanges)

Shanghai No. 1 Department Store (Group) Company

**Research Organizations and Universities**

Shanghai Academy of Social Sciences

Shanghai Institute of Modern Economy

Shanghai Institute of Foreign Trade

**Consulting/Law Firms**

Knight Wendling, Ltd. (UK management consulting firm)

O'Melveny and Myers (US law firm)

**Chengdu Municipality**

**Government Agencies**

Chengdu Economic Commission

Chengdu Administration of Industry and Commerce

Chengdu Property Rights Transaction Center

**Banks**

People's Bank of China—Chengdu Branch

Industrial and Commercial Bank of China—Chengdu Branch

**SOEs**

Hongguang Industrial Group Company (participant in the "100 SOE modern enterprise system" experiment)

**Foreign-Invested Firms**

Sichuan Zheng Yuan Pharmaceutical Company Ltd. (wholly foreign-owned company)

*Source:* World Bank mission.

**Annex 5—  
The 57 National Enterprise Groups**

- |   |  |
|---|--|
| 1. China First Automobile Group                         | 31. Tianjin Bo Sea Chemical Industry Group             |
| 2. Dongfeng Automobile Group                            | 32. Nanjing Chemical Industry Group                    |
| 3. Heavy Truck Group                                    | 33. Lehua Film Group                                   |
| 4. Harbin Electric Industry Group                       | 34. New Building Materials Industry Group              |
| 5. Oriental Electric Industry Group                     | 35. Nonmetal Minerals Group                            |
| 6. Shanghai Electric Industry Group                     | 36. Yuehua Glass Group                                 |
| 7. Xian Electric Industry Group                         | 37. Luoyang Glass Group                                |
| 8. Northeast Electricity Transformation Equipment Group | 38. Inner Mongolia Daxinanling Forestry Industry Group |

## China's Management of Enterprise Assets

9. First Tractor Group
  10. Great-Wall Computer Group
  11. Yangtze River Computer Group
  12. Zhenhua Electronics Group
  13. First Heavy Machinery Group
  14. Second Heavy Machinery Group
  15. Silian Industrial Meters Group
  16. Jialing Industry Group
  17. Panzhihua Iron & Steel Corporation
  18. Anshan Iron & Steel Group
  19. Wuhan Iron & Steel Group
  20. Baoshan Iron & Steel Group
  21. Yizheng Chemical Fiber Group
  22. Huaneng Energy Group
  23. North-China Electricity Group
  24. Northeast Electricity Group
  25. East China Power Group
  26. Central China Electric Power Group
  27. North West Electric Power Group
  28. COSCO
  29. Yangtze River Navigation Group
  30. Jilin Chemical Industry Group
  39. Heilongjiang Daxinanling Forestry Industry Group
  40. Heilongjiang Forestry Industry Group
  41. Jilin Forestry Industry Group
  42. Xian Airplane Industrial Group
  43. Shanghai Aviation Industry Group
  44. Guizhou Aviation Industry Group
  45. Guizhou Space Industry Group
  46. Hubei Space Industry Group
  47. China Chemical Industry Import & Export Group
  48. China Minerals and Metals Import & Export Group
  49. North China Pharmaceutical Group
  50. Northeast Pharmaceutical Group
  51. China International Aviation Group
  52. China Oriental Aviation Group
  53. China South Aviation Group
  54. China Gezhouba Hydropower Group
  55. China Shennong Group
  56. China Quandong Nuclear Electricity Group
  57. Nantong Group
- Source:* World Bank mission.

### **Annex 6— Regressions Illustrating Relationships Between Corporate Attributes and Bank Financing**

## China's Management of Enterprise Assets

(Sample of 156 enterprises, 1994 data)

Regression	(1)	(2)	(3)	(4)	(5)	(6)	(7)
		Bank Financing/ Fixed Investm't	Bank Financing/ Fixed Investm't	Bank Financing/ Fixed Investm't	Bank Financing/ Fixed Investm't	Bank Financing/ Fixed Investm't	Bank Financing/ Fixed Investm't
RATIO	Profit Sales						
R2	0.18	0.15	0.07	0.03	0.11	0.08	0.09
Number of Observations	76	41	54	56	56	56	56
<b>Explanatory Variables</b>							
Intercept	3.91 (3.34)	58.41 (5.67)	60.41 (10.81)	60.77 (9.56)	61.58 (11.38)	150.08 (3.45)	43.97 (6.06)
Sales/Assets	-1.12 (-2.83)	8.78 1.23					
Sales/Employee	0.425 (3.471)	-2.52 (-1.96)					
Profit/Sales		-0.61 (-0.73)	-1.09 (-1.95)				
Corporatized				-14.59 (-1.29)			
Listed on Stock Exchange					-38.51 (-2.66)		
Indicator for Autonomy						-2.62 (-2.17)	
Under Management Contract							23.99 (2.36)

Source: World Bank mission.

## **Annex 7— Comparison of Chinese Accounting Standards and International Accounting Standards**

### **Consolidated Balance Sheet As at December 31, 1995**

China's Management of Enterprise Assets

**SHANGHAI PETROCHEMICAL COMPANY LTD.**

*Prepared under International Accounting Standards*

(Y thousand)

	1995	1994
Fixed assets	<b>9,711,447</b>	<b>8,892,104</b>
Construction in progress	<b>789,549</b>	<b>1,325,870</b>
Investments	<b>363,333</b>	<b>266,222</b>
Deferred receivable	<b>185,475</b>	<b>231,843</b>
Current assets		
Stocks	2,295,569	1,982,067
Trade debtors	386,411	331,369
Bills receivable	149,774	17,230
Deposits, other debtors and prepayments	659,622	627,677
Amounts due from fellow subsidiaries	172,356	170,687
Tax refundable	16,997	49
Cash at bank and in hand	2,173,665	1,992,432
Subtotal	<b>5,854,394</b>	<b>5,121,511</b>
Current liabilities		
Bank loans	2,929,101	2,581,891
Loans from ultimate holding company	–	129,392
Amounts due to ultimate holding company	50	22,000
Amounts due to fellow subsidiaries	59,731	41,777
Trade creditors	240,531	273,226
Other creditors	721,020	631,879
Provision for repairs and maintenance	–	195,126
Proposed dividend	589,500	556,750
Subtotal	<b>4,539,933</b>	<b>4,432,041</b>
<b>Net current assets</b>	<b>1,314,461</b>	<b>689,470</b>
Long-term liabilities		

## China's Management of Enterprise Assets

Bank loans	1,805,307	2,130,830
<b>NET ASSETS</b>	<b>10,558,958</b>	<b>9,274,679</b>
Representing:		
Share capital	6,550,000	6,550,000
Reserves	3,960,656	2,685,522
<b>Shareholders' funds</b>	<b>10,510,656</b>	<b>9,235,522</b>
Minority interests	48,302	39,157
<b>TOTAL</b>	<b>10,558,958</b>	<b>9,274,679</b>

### **PARENT COMPANY SINOPE**

*Prepared under Chinese Accounting Regulations*

(Y million)

	1995	1994
<b>ASSETS</b>		
<b>Current assets</b>		
Monetary funds	22,270.56	18,967.61
Short-term investment	1,143.80	706.23
Bills receivable	481.88	101.37
Account receivable	16,926.78	20,190.96
Less: Allowance for bad accounts	73.51	85.70
Net accounts receivable	16,853.27	20,105.26
Advances to suppliers	3,796.03	2,987.49
Government subsidies receivable	2.03	45.00
Other accounts receivables	29,926.29	27,715.55
Inventories	28,247.16	26,257.69
Expenses to be apportioned	2,051.71	2,376.82
Undisposed net losses of current assets	14.57	104.21
Long-term bonds investments due within one year	27.81	41.15
Other current assets	136.56	124.14
<b>Total current assets</b>	<b>104,951.67</b>	<b>99,532.52</b>
<b>Lang-term investments</b>		
Long-term investments	8,799.95	6,793.57

## China's Management of Enterprise Assets

<b>Fixed assets</b>		
Fixed assets at cost	170,001.39	135,769.08
Less: Accumulated depreciation	62,543.10	49,674.35
Net fixed assets	107,458.29	86,094.73
Fixed assets in liquidation	54.36	22.57
Construction in progress	38,684.62	34,095.63
Undisposed net losses of fixed assets	-16.66	-403.11
<b>Total fixed assets</b>	<b>146,180.61</b>	<b>119,809.82</b>
<b>Intangible and deferred assets</b>		
Intangible assets	2,311.86	989.90
Deferred assets	10,481.86	
<b>Total intangible assets and deferred assets</b>	<b>12,793.72</b>	<b>15,181.90</b>
<b>Other long-term assets</b>		
Other long-term assets	1,003.36	647.41
<b>TOTAL ASSETS</b>	<b>273,719.31</b>	<b>241,965.22</b>
<b>LIABILITIES AND OWNER EQUITY</b>		
<b>Current liabilities</b>		
Short-term loans	29,632.00	22,374.03
Bills payable	132.27	76.58
Accounts payable	9,592.53	14,670.71
Advances from customers	5,526.37	6,482.67
Other payables	28,330.68	26,890.06
Accrued payrolls	2,784.77	2,819.47
Welfare benefits payable	1,062.92	951.11
Taxes payable	2,635.41	1,792.33
Profits payable	63.15	974.08
Other payables	1,310.98	1,415.14
Withheld expenses	1,227.36	877.76
Long-term liabilities due within one year	1,222.05	930.92
Other current liabilities	219.28	226.41

## China's Management of Enterprise Assets

<b>Total current liabilities</b>	83,739.77	80,481.27
<b>Long-term liabilities</b>		
Long-term debt	73,855.37	59,837.09
Debentures payables	726.23	522.13
Long-term payables	3,698.52	2,443.00
Other long-term liabilities	3,372.60	2,673.36
Include: Housing revolving fund	309.56	518.92
Special accounts payable	2,994.58	1,966.04
<b>Total long-term liabilities</b>	81,652.72	65,475.58
<b>Owner equity</b>		
Paid-in capital	80,277.71	61,917.00
Reserves	10,697.99	23,092.54
Reserved surplus	15,125.21	9,619.05
Include: Public welfare fund	2,591.06	1,483.68
Unallocated profit	2,225.92	1,379.78
<b>Total owner equity</b>	108,326.82	96,008.37
<b>TOTAL LIABILITIES AND OWNER EQUITY</b>	273,719.31	241,965.22

*Source:* Companies' Annual Reports.

### Consolidated Profit and Loss Account for the Year Ended December 31, 1995

#### SHANGHAI PETROCHEMICAL COMPANY LTD.

*Prepared under International Accounting Standards*

(Y thousand)

	1995	1994
<b>Turnover</b>	<b>11,835,433</b>	<b>9,383,621</b>
Profit before taxation	2,515,843	1,779,928
Taxation	(393,669)	(277,704)
<b>Profit after taxation</b>	<b>2,132,174</b>	<b>1,502,224</b>
Minority interests	(5,378)	(8,758)
<b>Profit attributable to shareholders</b>	<b>2,126,796</b>	<b>1,493,466</b>
Transfer to reserves		

## China's Management of Enterprise Assets

Statutory surplus reserve	(212,680)	(149,347)
Statutory public welfare fund	(212,680)	(149,347)
Discretionary surplus reserve	(800,000)	(350,000)
Dividends	(851,500)	(818,750)
<b>Retained profit for the year</b>	<b>49,936</b>	<b>26,022</b>
Retained profits brought forward	80,084	54,062
<b>Retained profits carried forward</b>	<b>130,020</b>	<b>80,084</b>
Earnings per share	0.325	0.232

### **PARENT COMPANY SINOPEC**

#### *Prepared under Chinese Accounting Regulations*

(Y million)

	1995	1994
<b>Sales revenue</b>	211,538.78	159,278.84
Less: Cost of goods sold	164,742.00	124,682.92
Selling expenses	2384.28	1,849.19
Sales tax & Sur-tax	10,609.82	9,164.73
<b>Sales profit</b>	33,802.68	23,582.00
Add: Other business profit	1,221.89	368.37
Less: Administrative expenses	14,963.40	11,949.35
Finance expenses	8,956.87	5,353.81
<b>Operating profit</b>	11,104.30	6,647.21
Add: Investment income	676.85	666.82
Subsidize income	223.08	170.00
Nonoperating income	211.32	257.88
Less: Nonoperating expenses	1,393.58	1,098.51
Add: Prior year adjustment	87.52	23.03
<b>Total profit</b>	10,909.49	6,666.43
Less: Income tax	2,990.82	1,703.85
<b>NET PROFITS</b>	7,918.67	4,962.58

*Source:* Companies' Annual Reports.

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