international experiences have shown, assures investors that managers would have the incentives to maximise profits in a prudent manner.

## 7. The Many Disappointments of State Enterprise Reform

When China started its SOE reform two decades ago, it followed the principles of market socialism to motivate the SOE manager to maximise profits. The state entered into a profit-sharing arrangement with the firm, and gave increasing operational autonomy to the manager. The official conclusion is that the decentralisation of decision-making to the firms has failed to improve their performance.

> The current problems of SOEs are: excessive investments in fixed assets with very low return rates, resulting in the sinking of large amounts of capital; and a low sales-to-production ratio, giving rise to mounting inventories. The end result is that the state has to inject an increasing amount of working capital through the banking sector into the state enterprises. (Vice-Premier Zhu Rongji, 1996)[26]
>
> The situation as regards the economic efficiency of [state] enterprises has remained very grim ... And the prominent feature is the great increase in the volume and size of losses. (Vice-Premier Wu Bangguo, 1996)[27]

There has been a steady increase in SOE losses since additional decision-making powers were given to SOE managers in 1985.[28] The

[26] "Guo you qiye sheng hua gaige ke burong huan," (No time shall be lost in further reforming state-owned enterprises), speech at the 4th meeting of the 8th People's Congress, *People's Daily*, *Overseas Edition*, March 11, 1996.

[27] "Losses of State-Owned Industries Pose Problems for China's Leaders," *The Washington Post*, November 3, 1996.

[28] Recent evidence suggest that past reports on SOE losses (e.g. two-third of SOEs make zero or negative profits) may be understated. A national audit of 100 SOEs in 1999 found that 81 falsified their books, and 69 reported profits that did not exist; and an

three most commonly cited reasons for this development are: the emergence of competition from the non-state enterprises, the failure of the SOEs to improve their efficiency, and embezzlement by SOE personnel.

The competition explanation is perhaps the weakest explanation because the profit rates of SOEs in the sectors of industry that experienced little entry by non-SOEs showed the same dramatic drop as the profit rates of SOEs in sectors with heavy penetration by non-SOEs. Fan and Woo (1996) compared the SOE profit rate and the proportion of output sold by SOEs in different sectors of industry in 1989 and 1992. In four of the five cases where the degree of SOE domination was unchanged, the profit rates were lower in 1992, e.g. the profit rate of the tobacco industry dropped 82 percentage points, and that of petroleum refining dropped 13 percentage points. The 1992 profit rates were lower in six of the seven cases where the degree of SOE domination had declined by less than five percentage points.

The failure-to-improve explanation has generated a heated debate in the academic literature. There is a wide range of total factor productivity (TFP) estimates, going from large negative to large positive, and they could be due to a whole array of factors like the possibility of Potemkin data sets, the functional form, the estimation method, and the choice of price deflators.[29] Our reading of the evidence is that any improvements in TFP was minor, and, most likely, temporary.

The attribution of China's SOE losses to embezzlement of profits and asset-stripping by employees (managers and workers) is reminiscent of the relentless escalation of SOE losses during the decentralising reforms in pre-1990 Eastern Europe. With the end of the central plan and the devolution of financial decision-making power to the SOEs, the key

audit of the Industrial and Commercial Bank of China and the China Construction Bank found that accounting abuses involving RMB 400 billion, of which RMB 200 billion was overstatement of assets. ("China: Finance ministry reveals widespread accounting fraud," *Financial Times*, December 24, 1999.) In January 2000, auditors in Hebei caught 67 SOEs covering up losses of RMB 600 million ("Beijing moving to improve quality of statistics," *South China Morning Post*, February 29, 2000).

[29] For a review of the empirical findings, see Huang, Woo and Duncan (1999).

source of information to the industrial bureaus regarding the SOEs were reports submitted by the SOEs themselves. This reduction in the monitoring ability of the state in a situation of continued soft-budget constraint meant that there was little incentive for state-enterprise managers to resist wage demands because their future promotion to larger SOEs was determined in part by the increases in workers' welfare during their tenure. The reduction in the state's monitoring ability combined with the steady reduction in discrimination against the private sector also made it easier for the managers to transfer state assets to themselves.[30]

Besides creating a fiscal crisis for the state, the "disappearing profits" at the SOEs have also contributed to social instability. The increasing public outrage over the inequity of the informal privatisation of the SOE sector is well captured in a recent book by He Qinglian who wrote that the SOE reform has amounted to:

> … a process in which power-holders and their hangers-on plundered public wealth. The primary target of their plunder was state property that had been accumulated from forty years of the people's sweat, and their primary mean of plunder was political power.[31]

There can be little doubt that the Chinese leadership recognises the increasingly serious economic and political problems created by the agency problem innate in the decentralising reforms of market socialism. This is why the debate between the conservative reformers and the liberal reformers has progressed from whether privatisation is necessary to the question of the optimal form and amount of privatisation. The emerging consensus is that all but the thousand largest SOEs and the defense-related SOEs are to be corporatized, with part of their shares sold to employees and the general public. The preferred privatisation method for small and medium-sized SOEs has been employee (insider)

[30] It is hence not surprising that of the 327 cases of embezzlement, bribery and misuse of public funds that were tried in Beijing in 1999, "76 percent took place in SOEs" ("Judicial Attention to SOEs Pledged," *China Daily*, February 19, 2000).
[31] The translated quote is from Liu and Link (1998), p. 19.

privatisation. Even for the larger SOEs that are to be corporatized, the state need not be the biggest shareholder.

The thousand largest SOEs will be given preferential financing to develop into business groups (like the Japanese *zaibatsus* and the Korean *chaebols*) that allegedly will enjoy enormous economies of scale. The truth is more prosaic. Given the co-existence of conservative and liberal reformers, any SOE reform package needs to contain a component that appeases each group. The upshot is dual-track SOE reform: state-sponsored conglomerates for the conservative reformers, and publicly-traded joint-stock companies for the liberal reformers. However, in light of the 1997–98 external debt crisis in South Korea caused by imprudent borrowing by the *chaebols*, one should question the wisdom of creating such large state business groups.

We must emphasise that the key to SOE reform is not privatisation *per se*, but a transparent, legal privatisation process that society at large can accept, at the minimum, as tolerably equitable. Because an adequate privatisation program must compensate the retired and layoff workers, permit takeover by core investors, and respect the rights of minority shareholders, it is important that legal reforms be carried out simultaneously. Without a transparent, equitable privatisation process (overseen by an adequate legal framework), China is likely to repeat the mistakes of the Russian privatisation program implemented by Premier Chernomyrdin. Just as the creation of the new *kleptoklatura* in Russia has robbed the Yeltsin government of its political legitimacy, its occurrence in urban China could be socially explosive.

## 8. Concluding Remarks

We want to highlight one possible negative long-run result from the present reflation package. There is strong evidence that the larger credit growth in the third and fourth quarters of 1998 was achieved only after implicit assurances were given to bank managers that they would not be held responsible if the NPL ratio were to increase. A temporary deviation from the firm policy of cleaning up the balance sheets of the state banks