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SOE Restructuring in China

Ross Garnaut*

Ligang Song**

Yang Yao***

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*Professor, Asian Pacific School of Economics and Management, Australian National University

**Fellow, Australia-Japan Center, Australian National University

***Professor, China Center for Economic Research, Peking University
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Ross Garnaut
Professor
Asian Pacific School of Economics and Management
Australian National University

Ligang Song
Fellow
Australia-Japan Center
Australian National University

&

Yang Yao
Professor
China Center for Economic Research
Peking University
Beijing 100871, China

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Abstract. Based on a recent 683-enterprise survey done in 11 cities, this paper reviews the recent history of state-owned enterprise (SOE) reform, the forms of restructuring, the handling of state assets, reemployment of workers, and firm performance after restructuring in China. Restructuring in many cases involves privatization. The process has been a result and part of the market liberalization process dating back to the mid-1980s. The most popular way to privatize has been employee shareholding, but open sales and leases have become more frequent in recent years. Considerable discounts on privatization prices are often given to buyers in exchange for fewer layoffs of workers. The outcome of restructuring is encouraging. Restructured firms have been found to have higher productivity and profitability than the SOEs.
The transformation of China’s state-owned enterprises over the past decade has resulted in remarkable changes to the structure of the Chinese economy. Gaizhi, the Chinese term meaning “transforming the system,” has become a major phenomenon in most parts of the country and in many cases has involved full privatization. Unlike the massive privatization programs that occurred in Eastern Europe and the former Soviet Union, the Chinese government’s gaizhi programs have been gradual and low profile. But the significance of the Chinese reforms should not be underestimated. In many ways they have been as far-reaching as and generally more economically productive than those in Eastern Europe and the former Soviet Union.

Based on a recent 683-enterprise survey done in 11 cities, this paper reviews the recent history of enterprise reform, the forms of gaizhi, the handling of state assets, reemployment, and firm performance after gaizhi. The 11 sample cities are, from north to south: Harbin, Fushun, Tangshan, Lanzhou, Weifang, Xining, Zhenjiang, Huangshi, Chengdu, Hengyang, and Guiyang. They represent a wide spectrum of regional diversity in terms of population, level of economic development and the viability of their SOEs. With the rich data provided by the survey, this paper provides a contribution to the understanding of the Chinese privatization process, which until very recently has been opaque to the outside world.

Starting in the mid-1990s, about 40 to 50 percent of government controlled SOEs have been privatized. The process started spontaneously with local initiatives. It resulted from and was part of the market liberalization process dating back to the mid-1980s. In addition, the commercialization of the banks and subsequently hardened budget constraint on the firms were also major causes for privatization. The most popular way to privatize has been employee shareholding, but open sales and leases have become more frequent in recent years. The central government puts paramount concern on social stability, so minimizing massive unemployment has become a major goal of local governments in the process of privatization. In order to induce insiders and outsiders alike to buy a firm, local governments give the buyers considerable discounts on privatization prices.

The outcomes of privatization are encouraging. Restructured firms have been found to have higher productivity and profitability than the SOEs. But the sample selection problem --- better performing firms may be restructured first --- may bias the results. After controlling for sample selection is controlled, the finding is that restructuring improves efficiency only when the number of private shares passes a certain threshold.

The paper is organized as follows. Section 1 reviews SOE reforms in China since the mid-1980s; Section 2 presents data on the forms of restructuring, or gaizhi; Section 3 discusses the ways that restructuring handles state assets; Section 4 describes the settlement of employees in the process of gaizhi; Section 5 presents evidence for the positive results of privatization; Section 6 then concludes.

1. Recent SOE Reforms in China

Reforming China’s state-owned enterprises has been a major aim since urban reforms
began in 1984. Although there were early calls for privatizing the SOEs, the government’s initial emphasis was on boosting performance by changing the SOEs’ internal governance and improving the market environment in which they operated. Inspired by the success of the rural household responsibility system, the government introduced a contracting system into the state sector, requiring SOE managers to meet targets for sales, profitability, capital accumulation, and so on, in return for a share of the profit. The main problem with this system was that managers were rewarded for their successes but not credibly punished for their failures. The success of the enterprise depended on the efforts its managers expended. By the end of the 1980s, the government had decided that the best way to reform small SOEs was to lease them out, with the manager turning in a fixed proportion of the firm’s profit. The first significant lease contract was to the Wuhan Motor Engine Factory in 1986, when three people put up collateral of 34,000 yuan to lease the factory. In May 1998 the State Council issued a regulation on the leasing of small SOEs.\(^1\) A direct consequence was that managers could be recruited from outside the enterprise. In many cases leasing led to the privatization of township and village enterprises (TVEs). After several years, the manager’s capital would outweigh that of the local government and the manager would become effectively the owner of the firm.

Incorporation was another significant measure that led to privatization. At first the government restricted incorporation to the exchange of shares among the SOEs, but soon private shareholding was allowed. The first cases of private shareholding were in three Guangzhou SOEs in 1986, when the employees bought 30 percent of their firms’ shares. The first large SOE to be incorporated was the Shenyang Motor Corporation, which became Shenyang Jinbei Motors when it issued shares to the public in August 1988.

The opening of the Shenzhen Stock Exchange in 1990 and the Shanghai Stock Exchange in 1991 enabled SOEs to issue shares to the public. However, the Chinese government ensured it would not lose control of listed SOEs by requiring that a proportion of the state’s shares in the firm could not be sold.

Privatization started in earnest after Deng Xiaoping’s visit to southern China in 1992. As with many other reform initiatives, privatization started at the local level and was later sanctioned by the central government. The most important impetus for privatization in the localities, and especially in the small cities, was the large amount of debt built up by the state sector. For example, in Zhucheng city, Shandong province, 103 of the 150 SOEs were in the red at the end of 1992, with losses amounting to 147 million yuan – equivalent to the city government’s revenue over 18 months (Zhao, 1999). The Shunde government was also encountering a debt problem when it first started privatizing its SOEs in 1992. Most local governments decided only to privatize the small firms, but Shunde and Zhucheng went further by privatizing almost all of their state and collective firms (Huang and Wei, 2001; Yao, 2004).

In 1995, after extensive discussion, the central government adopted the policy of “zhuada fangxiao,” or “keep the large and let the small go.” The state decided to keep 500 to 1,000 large state firms and to lease or sell smaller firms.\(^2\) There were good reasons for

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2 In 1994 the ministry in charge of government economic affairs, the State Economic and Trade Commission, sent a
this decision. In 1997 the 500 largest state firms held 37 percent of the state’s industrial assets, contributed 46 percent of taxes collected from state firms, and earned 63 percent of the state sector’s profits. Small firms owned by local governments had been performing poorly. In 1995, 72.5 percent of local firms but only 24.3 percent of central government firms were unprofitable (Zhao, 1999). As then Vice-Premier Wu Bangguo said in a speech in December 1997, “Control of the (500) largest firms means we have a control of the largest chunk of the state economy” (Zhao, 1999).

From the “let the small go” part of the policy came the term “gaizhi”, meaning “changing the system.” In many cases, gaizhi led to privatization. By the end of 1998, more than 80 percent of state and collective firms at or below the county level had undergone gaizhi, which involved direct privatization in most cases (Zhao, 1999). Figure 1 shows the trend of privatization in the whole country and in the 11 sample cities for 1996–2001. The figure takes the number of state-controlled firms --- defined as those with more than 50 percent (inclusive) of their shares controlled by the government --- in 1996 as 100 percent and shows the percentage of the remaining state-controlled firms in each subsequent year. Treating the lost firms as being privatized, one realizes that about 40 percent of Chinese SOEs were privatized during 1996-2001. The pace of privatization was even faster in the sample cities. Only about half of the state-controlled firms of 1996 remained so by 2001.

![Figure 1 Dynamics of firms controlled by state shares](image)


This trend of privatization is also confirmed by other survey studies. A national survey in 1998 showed that a quarter of China’s 87,000 industrial SOEs had been through gaizhi and another quarter planned to take some measure of gaizhi. Among the gaizhi firms, 60–

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3 Such treatment is subject to two qualifications. First, some firms might have vanished not because of privatization but because of simple closure, which implies that our measure of privatization is upward-biased. Second, new SOEs might have started up over the period, which implies that the measure is downward-biased.
70 percent had been partially or fully privatized.\(^4\) A 2002 national survey of industrial SOEs estimated that 86 percent had been through gaizhi by the end of 2001 and that about 70 percent had been partially or fully privatized.\(^5\)

2. Forms of Gaizhi

The term gaizhi is used to mean any structural change to a firm, including public offering, internal restructuring (incorporation, spinning off, introducing new investors, and debt–equity swaps), bankruptcy and reorganization, employee shareholding (limited liability companies or cooperatives), open sales (to management, employees, outside private firms, or another SOE), leasing (to management, employees, outside private firms, or another SOE), joint ventures, or a combination of the above.

**Public offering.** Although the firm’s ownership becomes more diversified, public offering maintains the state’s control because Chinese law requires that the state retain the majority of the shares, which cannot be sold on the open market. In addition, SOEs have been the main participants in Chinese stock markets as until recently sales of shares were a low-cost way to finance SOEs.\(^6\) Generally, public offering provides no significant governance restraints on listed companies and is not a means of serious privatization.

**Internal restructuring.** Internal restructuring maintains state ownership of the assets, but is regarded as a type of gaizhi. Incorporation started soon after the Company Law came into force in 1994. The law requires that a company have at least two shareholders, but allows SOEs to register as limited liability companies with the state as the sole owner. Therefore, incorporation may involve no change in ownership.

Another common practice to revitalize an SOE has been to split the firm into several smaller firms that begin to produce new products. The old firm becomes a holding company that owns the new spun-off firms and maintains a contractual relationship with the new firms by charging a fee for the use of buildings and equipment. One form of this practice has been to set up a new company that takes the old firm’s good assets, including buildings, equipment and capable personnel, leaving the old firm with the non-performing assets, bank and commercial debts, retirees, and redundant workers. Creditors, particularly banks, fear this form of gaizhi most. Since spinning off firms and assets does not change their ownership, it can be seen as a form of internal restructuring, although reform measures within the new firms can be quite radical.

New investors may receive shares in the SOE in return for their investment, but the stock of state assets within the firm does not change ownership. This form of gaizhi is therefore also categorized as internal restructuring.

Debt–equity swaps were introduced in 1999 by the central government to alleviate the huge non-performing loan problem. Non-performing loans were officially estimated at 25 percent of outstanding loans by banks, but the true share is likely to be much higher.

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\(^4\) Unpublished report of the National Bureau of Statistics.
\(^5\) Unpublished report of the State Economic and Trade Commission.
\(^6\) The IPO markup in Chinese stock markets is between 50 and 60 times as compared with 5 to 6 times in the US stock markets. In addition, the stock market exerts limited corporate governance on listed firms.
Bankruptcy and reorganization. Although China’s Bankruptcy Law came into force in 1988, it only applied to SOEs and was not widely applied until the mid-1990s, when the central government began to adopt bankruptcy as a means to restructure SOEs (Gao and Yao, 1999).

An ordinary bankruptcy should result in the bankrupt firm being dissolved, but in many cases firms taking this route continue to operate. This “false” bankruptcy involves the firm entering bankruptcy and writing off its debts. It then registers under a new name. Frequently, the local government supports this practice. Bankruptcy often occurs with real gaizhi that diversifies the ownership of the firm. Therefore, bankruptcy and subsequent reorganization often implies partial or full privatization.

Employee shareholding has been by far the most popular form of gaizhi throughout China. Although proven to be a sub-optimal arrangement in other transition countries, this form of gaizhi entailed the least political risk in the early stages of urban reforms. Indeed, many employee shareholding firms were still registered as collectives in the early 1990s. Perhaps it is also the most politically feasible form of privatization in terms of the power structure within a SOE. The central government requires that each gaizhi plan be approved by a conference of employee representatives. Because it allows ordinary employees to have control over the firm and share in its future profits, employee shareholding is the form of privatization most likely to be approved by employees.

To be registered as a company, the maximum number of shareholders must be below 50, as stipulated by the Company Law. Firms with a larger number of shareholders have the status of employee shareholding cooperatives and must register as partnerships. Some have been able to register as companies by forming block shares; that is, groups of employees elect a representative and register all the group’s shares under that person’s name. Many employees gained shares through compensation given by the local government in exchange for the removal of their state employee status. As a result, in the early stages of gaizhi, shares were widely dispersed throughout the firm. In recent years managers have been able to buy a larger number of shares in newly privatized firms and some gaizhi firms have gone through second and third rounds of gaizhi, further increasing the shares owned by managers.

Open sale. This form of gaizhi has become more popular in recent years. The firm is openly sold to insiders or outsiders, perhaps through auction. This is the most radical form of privatization because it can involve the transfer of the firm to a single private owner or a management group.

Leases. The lease contract now commonly used in gaizhi is quite different from that adopted in the early years of SOE reform. The early leases acted as incentives within the SOEs, but leases are now used to break up SOEs. Under current leases the lessee is a legal entity independent of the government. Some lessees are outsiders and own their own firm, while others are ex-employees who set up new companies and lease the buildings, land, and equipment from the government. Leasing is often adopted when the lessee has insufficient capital to buy the firm. It is another radical form of gaizhi.

Joint ventures. Forming a joint venture with a domestic or foreign firm is another approach to gaizhi. Mergers can also be included in this category. This type of gaizhi helps the firm obtain long-term access to capital and technology.
Table 1. Forms of *gaizhi* by city (number and percentage)

<table>
<thead>
<tr>
<th></th>
<th>Number of <em>gaizhi</em></th>
<th>Public offering</th>
<th>Internal restructuring</th>
<th>Bankruptcy</th>
<th>Employee shareholding</th>
<th>Open sales</th>
<th>Leasing</th>
<th>Joint venture</th>
</tr>
</thead>
<tbody>
<tr>
<td>Harbin</td>
<td>40</td>
<td>7.5</td>
<td>47.5</td>
<td>2.5</td>
<td>22.5</td>
<td>10.0</td>
<td>10.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Fushun</td>
<td>10</td>
<td>0.0</td>
<td>40.0</td>
<td>20.0</td>
<td>20.0</td>
<td>0.0</td>
<td>20.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Tangshan</td>
<td>57</td>
<td>8.8</td>
<td>26.3</td>
<td>10.5</td>
<td>15.8</td>
<td>15.8</td>
<td>17.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Xining</td>
<td>18</td>
<td>11.1</td>
<td>22.2</td>
<td>50.0</td>
<td>16.7</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Lanzhou</td>
<td>11</td>
<td>0.0</td>
<td>9.1</td>
<td>54.5</td>
<td>27.3</td>
<td>9.1</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Guiyang</td>
<td>41</td>
<td>4.9</td>
<td>26.8</td>
<td>7.3</td>
<td>19.5</td>
<td>19.5</td>
<td>17.1</td>
<td>4.9</td>
</tr>
<tr>
<td>Chengdu</td>
<td>21</td>
<td>4.8</td>
<td>14.3</td>
<td>0.0</td>
<td>38.1</td>
<td>38.1</td>
<td>4.8</td>
<td>0.0</td>
</tr>
<tr>
<td>Weifang</td>
<td>34</td>
<td>14.7</td>
<td>14.7</td>
<td>11.8</td>
<td>50.0</td>
<td>2.9</td>
<td>0.0</td>
<td>5.9</td>
</tr>
<tr>
<td>Huangshi</td>
<td>54</td>
<td>7.4</td>
<td>11.1</td>
<td>5.6</td>
<td>38.9</td>
<td>22.2</td>
<td>13.0</td>
<td>1.9</td>
</tr>
<tr>
<td>Zhenjiang</td>
<td>45</td>
<td>8.9</td>
<td>26.7</td>
<td>2.1</td>
<td>44.4</td>
<td>2.1</td>
<td>6.7</td>
<td>8.8</td>
</tr>
<tr>
<td>Hengyang</td>
<td>49</td>
<td>4.1</td>
<td>16.3</td>
<td>16.3</td>
<td>6.1</td>
<td>6.1</td>
<td>49.0</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: From survey data.

In our sample of 683 firms, 375 reported that they had conducted *gaizhi* by the end of 2002. Table 1 provides a breakdown of the *gaizhi* cases by form and city. It is evident that the southern cities, Chengdu, Weifang, Huangshi, and Zhejiang in particular, were more likely to adopt employee shareholding and open sales as the form of *gaizhi* while the northern cities favored internal restructuring and bankruptcy.

Among the *gaizhi* firms, 30 percent went through either a public offering (25 cases) or an internal restructuring (85 cases). A total of 27 percent introduced employee shareholding (103 cases), 28 percent of firms were sold or leased out (105 cases), 11 percent went through bankruptcy (43 cases), and the remaining 4 percent became joint ventures (14 cases). Therefore a total 70 percent of *gaizhi* cases involved the transfer of ownership from the state to private hands.

Of the 85 cases of internal restructuring, 62 percent of SOEs were incorporated, 19 percent were spun off, 8 percent arranged a debt–equity swap, 6 percent attracted new investors, and the remaining 5 percent were unclassified. Other transition economies have established that some incorporated SOEs perform better than other firms. This may be because firm-specific characteristics such as pre-privatization performance and firm size were not controlled for in these studies. It is quite possible that governments are more reluctant to privatize larger and better performing SOEs.

Of the 103 cases of employee shareholding, 53 percent of firms became limited liability companies, 34 percent became cooperatives, and the remaining 13 percent were unclassified. Chinese law does not grant legal status to cooperatives. Interviews with the firms found that most cooperatives wanted to register as limited liability companies, but the limit on the number of shareholders (under 50) prevented them from doing so. Employees in some firms have solved this problem by pooling their shares under the name of an entrusted representative.

Insider control is believed to have been one of the main problems with the Russian privatization program because insiders were reluctant to restructure firms. Chinese firms
have also been criticized as being controlled by insiders. The lack of transparency in privatization programs may mask corruption and create an unjust distribution of shares within firms. The significant presence of employee shareholding firms in the 11-city survey confirmed the popularity of insider control as a means of privatization in China.

Insiders also took over a large proportion of those firms that were sold or leased: 16 of the 26 sales and 15 of the 58 leases involved insiders, mostly managers. Only 16 sales and 20 leases were exclusively directed to a private firm. Overall, sales or leases to an outside private firm consisted of 9.6 percent of the 375 cases of gaizhi. There were 10 sale and 19 lease cases that were classified as “other types” of sales and leases. These cases might be a mixture of insider control and outsider participation. If these cases are included, the share of gaizhi cases that involved at least partial outsider participation rises to 15 percent. This shows that the private sector has become an active player in gaizhi.

3. Handling State Assets

3.1 Methods of selling SOE assets

Local governments have used a number of methods to handle the transfer of state assets in gaizhi. These variations can be attributed to their discretionary power rather than differences in policy frameworks, although there are some policy differences across regions.

The main approach for larger, high-quality SOEs has been to convert their assets into equity to allow them access to finance through the stock market. Firms must meet stringent rules to qualify as listed companies, meaning that only the best performing can list on the stock market. Current regulations stipulate that the state must hold the majority of shares in those listed companies, which restricts firms from becoming true corporate entities (Tenev and Zhang, 2002). The performance of listed firms can be expected to improve as the state’s ownership of shares continues to shrink and stock markets deepen.

The government has also encouraged profitable SOEs to take over poorly performing ones through mergers and acquisitions, which have mainly involved small and medium-sized SOEs. If the firms that are taken over are profitable enough to pay tax, their debts can be gradually repaid from their profits. If not, the SOEs that acquired the poor performers are able to repay the debts from pre-tax profits. When non-state firms take over SOEs, a real transfer of assets from the state to other owners occurs.

If firms have negative net assets but have not qualified for bankruptcy because some of their assets are still valuable, they are allowed to separate out their operating assets and set up a new legal entity. The new firm takes over part of the debts of the old firm in agreement with the major creditors. In most cases the new firm will raise funds for development through allocating shares (based on the assets) to employees, managers, and outside investors.

The government encourages managers to buy the majority of their firms’ shares. A government guideline suggests that shares sold internally should be distributed according to rank in the order of senior management, technicians, and ordinary employees. As a
measure to encourage the purchase of shares, employees are able to defer payment of every two shares for each share that they buy. If shareholders defer payments, they are eligible to receive dividends and exercise voting rights, but have no rights of ownership, heritage or transfer over those shares. The deferred payments have to be settled within five years.

Shares have also been distributed to employees in lieu of unpaid wages or retirement benefits. Government regulations also allow inventions and other intellectual property to be converted to shares, after they have been properly valued and priced, depending on the agreement of the shareholder conference. The principal managers of the new state-controlled shareholding companies can receive loans from the state asset exit funds (see below) to buy up to half of the shares allocated to them and are obliged to pay back the loan and the interest within five years.

3.2 Asset evaluation and sales prices

The valuation of assets is the key to the gaizhi process and the restructuring of the state sector. If asset valuation is done properly, it provides the basis for establishing a fair transfer price for state assets. If the valuation is inaccurate, it could result in a loss of state assets. Firms must go through the procedures of asset valuation, the demarcation of ownership rights, and the verification of assets when carrying out gaizhi. Although the asset valuation forms the basis for the sale or transfer of assets, discounts are often given by local governments to compensate the buyer or to speed up the gaizhi process.

There are several standard methods for valuing business assets: historical cost and realized incomes; replacement cost and business income; current cash equivalents and realizable income; and discounted cash flows and economic income. However, the lack of development of the capital market and other factors such as controls over interest rates have prevented China from using some of these standard and more sophisticated methods of asset valuation. Firms are required to value assets according to the earnings that assets can bring in or according to their current market value. In some areas, such as Harbin, firms have been able to value assets using the replacement cost method, which estimates the value if assets had to be replaced.

Buyers commonly receive state assets at a discounted price, after the necessary calculations described above. Government regulations in Harbin, for example, allow the government to offer a discount when selling state assets. Buyers who purchase the whole business and make a one-off payment could receive a 30 percent discount. Those making a one-off payment covering 60 percent of the total assets could receive a 10 percent discount. After 60 percent of the value of assets, for every percentage point increase in payment, a half-percentage point discount can be given (a total discount of 30 percent if all the net assets are bought). The first payment should not be below 30 percent of the decided price and payments should be made in installments, with guarantees given before the assets are transferred.

Discounts can also be provided when the officials responsible for the transfer of state assets are authorized to do so by the state asset-management agencies or government administrative departments to which the firm belongs. These agencies or departments are allowed to set the sale price above or below the valuation. Any discount is normally no
more than 10 percent below the valuation. Discounts greater than 10 percent need the approval of the state asset-management agency.

Government discounts on the net assets of gaizhi SOEs result in the loss of state assets, but local governments have to weigh these losses against other objectives such as the need to solve the SOE problem. Table 2 presents data on the discounts given to gaizhi firms by local governments. The percentage of gaizhi cases that involved a discount on the firm’s assets ranged from 6 percent in Harbin to 34 percent in Huangshi. Local governments often took into consideration the buyer’s ability to upgrade technology and provide employment.

Table 2. Discounts provided to gaizhi firms by cities (numbers and percent)

<table>
<thead>
<tr>
<th>City</th>
<th>Number of firms</th>
<th>Number of rebates</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Harbin</td>
<td>35</td>
<td>2</td>
<td>5.7</td>
</tr>
<tr>
<td>Fushun</td>
<td>4</td>
<td>1</td>
<td>25.0</td>
</tr>
<tr>
<td>Tangshan</td>
<td>46</td>
<td>8</td>
<td>17.4</td>
</tr>
<tr>
<td>Weifang</td>
<td>25</td>
<td>7</td>
<td>28.0</td>
</tr>
<tr>
<td>Xining</td>
<td>13</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Huangshi</td>
<td>53</td>
<td>19</td>
<td>35.8</td>
</tr>
<tr>
<td>Zhenjiang</td>
<td>40</td>
<td>12</td>
<td>30.0</td>
</tr>
<tr>
<td>Hengyang</td>
<td>38</td>
<td>4</td>
<td>10.5</td>
</tr>
<tr>
<td>Guiyang</td>
<td>30</td>
<td>7</td>
<td>23.3</td>
</tr>
<tr>
<td>Lanzhou</td>
<td>12</td>
<td>1</td>
<td>8.3</td>
</tr>
<tr>
<td>Chengdu</td>
<td>18</td>
<td>3</td>
<td>16.7</td>
</tr>
<tr>
<td>Total</td>
<td>314</td>
<td>64</td>
<td>20.4</td>
</tr>
</tbody>
</table>

Source: From survey data.

Table 3 reports the distribution of discounts across gaizhi firms. Most firms surveyed declined to report whether they had received a discount in gaizhi, ranging from 74 percent of those firms that underwent restructuring to 48 percent of listed companies, suggesting that some irregularities did exist in government polices on discounts.
Table 3. Distribution of discounts by *gaizhi* form (percent in parentheses)

<table>
<thead>
<tr>
<th>Gaizhi Form</th>
<th>Total Firms</th>
<th>Discount Given</th>
<th>No Discount Given</th>
<th>Unreported</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td># of firms</td>
<td>Amount (mil. Yuan)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Listed on the stock market</td>
<td>39</td>
<td>10 (25.6)</td>
<td>10 (25.6)</td>
<td>19 (48.7)</td>
</tr>
<tr>
<td>Change in asset structure but not ownership</td>
<td>86</td>
<td>16 (18.6)</td>
<td>17 (19.8)</td>
<td>53 (61.6)</td>
</tr>
<tr>
<td>Internal restructuring</td>
<td>43</td>
<td>11 (25.6)</td>
<td>0 (0.0)</td>
<td>32 (74.4)</td>
</tr>
<tr>
<td>Shareholding company or cooperative</td>
<td>103</td>
<td>23 (22.3)</td>
<td>23 (22.3)</td>
<td>57 (55.3)</td>
</tr>
<tr>
<td>Sale</td>
<td>47</td>
<td>9 (19.1)</td>
<td>12 (25.5)</td>
<td>26 (55.3)</td>
</tr>
<tr>
<td>Lease</td>
<td>40</td>
<td>8 (20.0)</td>
<td>7 (17.5)</td>
<td>25 (62.5)</td>
</tr>
<tr>
<td>Combination of sale and lease</td>
<td>2</td>
<td>1 (50.0)</td>
<td>0 (0.0)</td>
<td>1 (50.0)</td>
</tr>
<tr>
<td>Joint venture with foreign company</td>
<td>2</td>
<td>1 (50.0)</td>
<td>1 (50.0)</td>
<td>0 (0.0)</td>
</tr>
<tr>
<td>Other</td>
<td>14</td>
<td>5 (35.7)</td>
<td>0 (0.0)</td>
<td>9 (64.3)</td>
</tr>
</tbody>
</table>

Source: From survey data.

3.3 Enterprise debts

Most SOEs hold large debts and these debts must be dealt with before *gaizhi* is possible. Bank debts make up the main body of enterprise debts, but many enterprises also have unpaid taxes, overdue wages, pensions and social insurance, and other debts. In the survey, the 493 SOEs that were sampled in 2001 owed a total of 25 billion yuan, of which bank loans and interest made up 15 billion yuan, or 59 percent of the total. Most overdue loans were owed to the four state-owned commercial banks and the local commercial banks.

Table 4 shows that more than half the bank loans owed by non-*gaizhi* SOEs were overdue. *Gaizhi* firms have little wish to repay debts that have been accumulated over time, and the banks lack the means to recover these loans. An example is the Hengdong Ceramic Factory, which borrowed 14.4 million yuan from the Industrial and Commercial Bank for investment in 1995. The factory performed poorly and the loan became overdue
in 1997. In 2001, four years and several managers later, the overdue amount, including interest, had risen to 15.9 million yuan.

Because banks have tried to recover debts by seizing deposits in the SOEs’ cash accounts, firms have withdrawn most of their money from the banks and retain cash to maintain their cash flow. Many business transactions are conducted in cash. This practice has restricted the development of SOEs. The average cash deposits of a non-gaizhi SOEs are substantially lower than those of a gaizhi firm.

Debt problems have hampered the reform of SOEs but it is no easy task to resolve the multiple and sometimes competing concerns of gaizhi firms, banks and local governments. As one CEO in Harbin pointed out, gaizhi firms are more concerned about debts owed to employees than overdue bank loans, which they see as being owed to the government by the former SOEs. Even if they had originally intended to repay the debt, most gaizhi firms find themselves unable to do so as they would struggle to stay in operation and have difficulty attracting new capital. The government has not gone as far as canceling the debts of small and medium-sized enterprises as it did for the large SOEs. Some medium-sized SOEs in Harbin were delaying their gaizhi programs in anticipation of an extension of government debt write-offs and debt–equity swaps to cover them.

Table 4. Comparison of financial status of gaizhi, non-gaizhi and bankrupt firms
(at year end; RMB million yuan and percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Outstanding bank loans</th>
<th>Overdue loans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>gaizhi</td>
<td>non-gaizhi</td>
</tr>
<tr>
<td>1995</td>
<td>32.69</td>
<td>27.07</td>
</tr>
<tr>
<td></td>
<td>(38.6)</td>
<td>(32.0)</td>
</tr>
<tr>
<td></td>
<td>(30.0)</td>
<td>(34.7)</td>
</tr>
<tr>
<td>1997</td>
<td>32.70</td>
<td>28.39</td>
</tr>
<tr>
<td></td>
<td>(33.9)</td>
<td>(29.4)</td>
</tr>
<tr>
<td></td>
<td>(35.9)</td>
<td>(27.3)</td>
</tr>
<tr>
<td>1999</td>
<td>34.89</td>
<td>28.09</td>
</tr>
<tr>
<td></td>
<td>(35.2)</td>
<td>(28.3)</td>
</tr>
<tr>
<td>2000</td>
<td>33.01</td>
<td>26.75</td>
</tr>
<tr>
<td></td>
<td>(34.0)</td>
<td>(27.6)</td>
</tr>
<tr>
<td>2001</td>
<td>35.82</td>
<td>27.16</td>
</tr>
<tr>
<td></td>
<td>(33.2)</td>
<td>(25.2)</td>
</tr>
</tbody>
</table>
Many *gaizhi* firms have not begun real *gaizhi* because they have refused to take over the debts of the old firm. Firms sometimes take an indirect route to avoid responsibility for the debts, for instance by setting up a new private firm to lease the assets and employ most of the workers, leaving the old firm to carry the bank debts. In many cases, the old firm is left with only a few employees who care for the workshops and equipment, and is likely to go bankrupt eventually.

Many *gaizhi* firms use bankruptcy to escape bank debts. More than 2,000 firms have gone through bankruptcy procedures since the *Bankruptcy Law* was enacted in 1988. In the survey, 90 percent of CEOs of *gaizhi* firms believed that bankruptcy was a feasible option to resolve the problem of their enterprise’s debts. In response banks have avoided losses, preferring that firms not be restructured if that means they will go bankrupt. In 2002 the Supreme People’s Court ruled that the people’s courts would not process bankruptcy cases if the main intention were to escape debts.⁷

Although local banks would like to help *gaizhi* firms out of their debt traps by discounting and rescheduling their debts or reducing interest payments, this would not solve the problems of *gaizhi* firms. Banks have been asked to act as true commercial entities, making it difficult for them to forego their rights as creditors. Banks can sue enterprises to recover loans but lawsuits often end up in a stalemate, with the banks unable to recover the loans and the firms unable to continue with restructuring. Several firms in Harbin said that *gaizhi* programs had stalled pending a court decision over

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repaying bank debts. As one bank manager stated: “We can sue the debtors in court, but it would not do much to get our money back because we can never get a single cent from the gaizhi firms whether we win the lawsuit or not.” Banks are also reluctant to seize the assets of the gaizhi firms, because the revenue would not cover the cost of auctioning the assets. Their only recourse is to refuse to make new loans to firms that default on loan repayments.

When dealing with the debts of gaizhi firms, local governments usually give the greatest priority to employees. They also favor the gaizhi firm over the banks because firms can provide tax revenues and employment opportunities, both key indicators of the performance of local government. Despite the fact that the local government is neither a debtor nor a creditor, it is directly involved in gaizhi as the owner of state assets, and both gaizhi firms and banks prefer to resort to the local government rather than the courts when there is a dispute.

Central government regulations have been promulgated to strengthen the management of debt liabilities and to prevent firms from avoiding their debts. To prevent firms from using gaizhi to discharge their bank debts, banks are required to keep track of firms that have tried to avoid debts and firms are given a schedule for measures to be taken to repay the debt. If firms fail to do so, they will be unable to apply for new loans or open new bank accounts. Financial institutions can reduce the credit rating for certain regions and suspend the reviewing of new projects and the granting of new loans, which will directly affect local government interests.

The survey found that other debts such as overdue wages and pensions were sometimes harder to deal with during gaizhi than overdue bank loans. Many SOEs owing pensions and wages have failed to get approval from the employee committee for their gaizhi proposals. To deal with these issues, it has become common practice for gaizhi firms to compensate employees first by selling assets and, if necessary, land. In dealing with the debt problems of gaizhi firms, the interests of debtors and creditors need to be balanced. In practice, solutions that hurt the interests of either side disproportionately may not be conducive to the process of gaizhi. While the government still needs to tackle the debt problems, it is more important to create an environment that allows gaizhi firms to perform well so that they avoid falling into new debt traps. Keep in mind that “the imposition of hard budget constraints on enterprises in the absence of functioning credit may force even sound firms into insolvency” (Wolf, 1999: 4).

4. Worker Settlement

4.1 The effect of gaizhi on SOE employees

The Chinese government makes the welfare of state employees its first priority in SOE restructuring. It has stipulated that government departments in charge of SOEs, departments for labor administration, and the trade unions have obligations to help SOEs redeploy their excess workers (State Council, 1993a). Detailed regulations outline the

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8 See People’s Bank of China, “Notice on strengthening management of debt liabilities and building a system of preventing and penalizing the behavior of avoiding financing debts,” 7 January 1997.
benefits or compensation that should be given to those who take early retirement, resign, or take unpaid holidays, and for those whose jobs are terminated. Services businesses set up by SOEs to reemploy their redundant workers are given tax holidays and other favorable treatment.

A security fund was set up by a 1993 State Council regulation to cover all those who lost their state jobs, including employees from enterprises that went bankrupt or were restructuring toward bankruptcy, were disbanded by the government, or had halted production while being restructured. The fund also covers those whose employment contracts were terminated, those who were dismissed, and any others who qualify under state laws and state or provincial government regulations (State Council, 1993b). This fund was later replaced by two allowances: unemployment insurance, which pays a benefit to unemployed state and non-state employees, and the xiagang living allowance. Employees who have been laid off are described as “xiagang” if they continue to have links to the enterprise through registration.

An enterprise must set up a reemployment service center before it begins laying off workers and staff. The central government requires SOEs to consult with the employee representative committee or the union at least 15 days before employees are made redundant. Xiagang workers sign a contract with the center to receive a living allowance for the next three years or until they are reemployed. Overdue wages or medical benefits are not affected by their xiagang status (CCP Central Committee and State Council, 1998; Ministry of Labor and Social Security et al., 1998).

The centers are financed equally by three parties: central and local governments, collections of contributions from the public, and the contributions of enterprises themselves. The State Council requires that SOEs run by the central or local governments should be financed solely by them (State Council, 1999). When the state continues to have full ownership or the controlling share in an enterprise after gaizhi, for instance in a joint venture or a firm that has been corporatized, usually a large number of xiagang workers remain in the reemployment service center.

Workers are paid the xiagang living allowance for up to three years (two years in some cases) if they cannot find a job in that time. After this period they become officially unemployed and are entitled to receive unemployment insurance for another two years before they go on to the minimum living allowance, which covers urban residents whose family per capita incomes are below the poverty line. In 1999 the five state ministries and committees decided that these three payments should be increased by 30 percent (Ministry of Labor and Social Security et al., 1999). Reemployment service centers also pay the basic medical insurance of xiagang workers through a levy set at 60 percent of the local average wage in the preceding year that was paid by the firms to which the xiagang workers belonged (State Council, 1998).

The benefit of being described as xiagang rather than officially unemployed is that people are still counted as employees and may have the chance to return to the enterprise, usually in a casual position. They receive a living allowance from the reemployment service center, usually at a slightly higher level than the unemployment benefit. There is no national standard for the xiagang allowance or the unemployment insurance, which vary according to the workers’ previous wage and differ from region to region. The

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government has recently discussed combining the *xiagang* allowance into the unemployment benefit system, meaning that redundant workers would be categorized as unemployed and paid the unemployment benefit instead of entering the reemployment service centers (Ministry of Labor and Social Security, 2001).

During *gaizhi* some enterprise managers and local governments persuade workers to take early retirement to reduce the numbers being made redundant, although this is against central government policy (see State Council office, 1999). The usual retirement age for SOE workers is 60 for male workers and staff, 50 for female workers and 55 for female staff members. Workers who are “internally retired” receive lower wages without having to work and then receive retirement benefits when they reach the legal retirement age.

Firms rarely discharged workers in the early stages of SOE reform, but this has become more common, especially when SOEs are privatized. The central government has accepted the practice, stipulating that a lump sum severance should be paid, usually at a rate of one month’s wage for each year of service (State Council, 1993b). The actual payment varies in different locations. In some places, the compensation rate is two months’ pay for every year of work.

In Harbin, for example, the municipal government set the lump sum compensation at two to three years of wages at the level of the previous year’s city average for all those employed by SOEs before 1986. Those made redundant do not receive the unemployment benefit. Workers employed by SOEs from 1986 onward receive one month’s average wages at the level of the average wage of the enterprise for every working year, and also receive the unemployment benefit. Both types of workers receive the basic pension if they continue to pay their pension contributions until they retire under the new system, which requires workers to contribute to the pension schemes.

4.2 The impact of *gaizhi* on unemployment

Over-employment has created a massive burden on SOEs now trying to shake off some of its excess workers during the *gaizhi* process. The survey in 11 cities found that both pre- and post-*gaizhi* SOEs have lost considerable numbers of employees in recent years, suggesting that market competition has been exerting pressure on all firms. Table 5 shows the share of on-duty employees, and the shares of retired, *xiagang*, and discharged workers in 2001 in both pre- and post-*gaizhi* SOEs.

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9 Staff members are distinguished from workers by their involvement in administrative work.

10 In 1986 new SOE workers were employed on contracts and no longer had lifetime employment status.
Table 5. Shares of on-duty, retired, xiagang and discharged employees (no. and %)

<table>
<thead>
<tr>
<th>Type of firm</th>
<th>No. of firms</th>
<th>Number of employees</th>
<th>On duty (%)</th>
<th>Retired (%</th>
<th>Xiagang (%)</th>
<th>Discharged (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Gaizhi firms</td>
<td>214</td>
<td>308,605</td>
<td>65.1</td>
<td>26.2</td>
<td>16.8</td>
<td>1.0</td>
</tr>
<tr>
<td>Shareholding companies</td>
<td>32</td>
<td>85,713</td>
<td>75.1</td>
<td>16.2</td>
<td>7.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Limited liability companies</td>
<td>119</td>
<td>190,349</td>
<td>62.1</td>
<td>17.5</td>
<td>19.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Partnerships/cooperatives</td>
<td>16</td>
<td>11,256</td>
<td>51.6</td>
<td>24.4</td>
<td>22.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Single-owner private firms</td>
<td>2</td>
<td>717</td>
<td>37.0</td>
<td>9.3</td>
<td>53.7</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>45</td>
<td>20,570</td>
<td>59.9</td>
<td>12.7</td>
<td>27.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Non-gaizhi SOEs</td>
<td>280</td>
<td>209,485</td>
<td>43.9</td>
<td>22.1</td>
<td>32.7</td>
<td>1.3</td>
</tr>
<tr>
<td>Total</td>
<td>494</td>
<td>518,090</td>
<td>56.6</td>
<td>19.1</td>
<td>23.2</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: From survey data.

The gaizhi group includes shareholding corporations, limited liability companies, partnerships, cooperatives, and other non-state enterprises. It also includes limited liability companies where the state holds the controlling number of shares. Note that xiagang workers and retired workers were sometimes included in the enterprises’ statistics of total employment (but in some cases excluded) because these workers were still being partly supported by the firm. The number of retired employees includes all those who retired in previous years. The number of xiagang workers includes those laid off in previous years but still listed by the reemployment service center and therefore still counted as employees. The statistics exclude xiagang workers who had found employment or had been removed from the reemployment service center after three years. The number of discharged employees only includes those who were discharged in 2001.

Xiagang workers made up 33 percent of employees in non-gaizhi SOEs but only 17 percent of employees in gaizhi firms. This is partly because enterprises shed many of their xiagang workers during gaizhi. The research teams found that many gaizhi firms did not register those workers as discharged. Nor is there any detailed data on inflows and outflows of workers in reemployment service centers.

In Table 6 estimates are made of the total number of xiagang and discharged employees in sample enterprises over the period 1995–2001. Again there is a significantly higher share of xiagang workers in non-gaizhi SOEs compared with gaizhi enterprises (69 percent versus 29 percent). The share of discharged workers to total workers is similar in the two groups (at around 5.0 percent) but this may be because gaizhi firms did not record this number accurately.
2. The true impact of the state sector. Some non-
a relative reduction in employ
Over the same percent in the period 1995-2001, but their on-
ufacturers because the years of
Workers complained about being made unem
and protested about the unfair transfer of fi

4.3 Reemployment and compensation to laid-off workers

Between 1995 and 2001, the number of state-owned and state-controlled enterprises fell from 118,000 to 47,000 and total employment in the SOE sector fell by 36 million. The number of jobs lost totaled 15 percent of urban employment in 2001. Information on social instability caused by gaizhi is limited but conflicts were observed in the sample cities, and in some cities petitions were presented frequently to the municipal government. Workers complained about being made unemployed and receiving little compensation, and protested about the unfair transfer of firm assets. During the central planning era, workers and staff were permanently employed by SOEs until they retired and received a
pension from the enterprise. In the mid-1980s, the decision was that new recruits would no longer have a job for life and would be put onto contracts. In practice, the situation changed very little as most contracts were automatically renewed. In the mid-1990s, numerous SOE workers were laid off when enterprises went through gaizhi. Jobs in the new privatized enterprises were no longer as secure. Because many workers have spent most of their past lives working for the state without receiving any government or firm contributions to their insurance, there has been a strong argument that workers deserve to be compensated for the loss of job security and life-time benefits.

Reemployment is always the best solution for redundant workers and staff members of SOEs, and also for the state because it lowers the cost of gaizhi. This is why governments give tax holidays and deductions to former SOE employees who start a business or to new enterprises whose xiagang workers account for 60 percent or more of their workforce. Government departments and banks also assist these firms with registration and access to bank loans. In some cases the government helps redundant workers find other work, but these account for only a small proportion of employee redeployment.

When SOEs are sold local governments can use part of the assets to compensate xiagang or discharged employees or can reduce the price of the assets (including land) to compensate the new owners for taking responsibility for employees who will have to be compensated if they are fired in the future. Many enterprises are sold at zero value, and in some cases the government pays extra subsidies to cover the redeployment of the employees.

In Tangshan City buyers of SOEs must agree to take responsibility for all employees and retired workers.\(^{11}\) The government compensates buyers for the future cost of redeploying workers by reducing the price of the assets on the basis that 10 percent of employees will be made redundant. The new owners frequently reported that the compensation was inadequate as the cost of redeploying workers was much higher. However, there were also complaints from employees that state assets (e.g. land) were being sold off too cheaply.\(^{12}\)

In Harbin the municipal government allows enterprises going through gaizhi to sell part of their assets to compensate employees who are being discharged. Land-use rights can be transferred if funds are inadequate.

In Nan An District, Chongqing City, the employment contracts of all SOE employees are terminated and compensation is given before the enterprises are sold or go bankrupt, regardless of whether workers will be reemployed by the new owners of the enterprises. This made gaizhi much easier and eased the dissensions that occurred after gaizhi. A large percentage of the district’s SOEs have completed gaizhi. The proportion of enterprises that have completed gaizhi is much smaller in the other districts, which adopted a municipal government policy of redeploying employees after the enterprise went bankrupt. In these districts, state assets are used to pay off debt, leaving little for employee redeployment. If governments wish to compensate the employees before gaizhi,

\(^{11}\) Workers and staff members retired from SOE are covered by the new pension system. However, pension payments are low, perhaps lower than the common pension rate in SOE. Enterprises still have to pay the difference between the actual and common pension rate.

\(^{12}\) The research teams found only a few cases in different cities of new owners complaining about the overvaluation of state assets.
they need the agreement of the creditor banks and usually there needs to be a large positive net value of state assets to cover the costs of employee redeployment. In Nan An District, land values are high and the sale of land-use rights has financed redeployment.

In Guiyang, employees would only agree with the decision to terminate their contracts if they received a lump-sum payment of two months’ wages for every year of service. Such generous conditions, which were uncommon elsewhere, make the gaizhi process more difficult, because employees tend to block the decision to undergo gaizhi until the situation becomes so bad that no wages will be paid. These provisions may explain why the private sector in Guiyang was underdeveloped. The development of the private sector in the local economy helps provide employment opportunities for redundant state workers and is a crucial factor for the success of gaizhi.

5. Impacts of Gaizhi on Firm Performance

5.1 Financial discipline

One should expect gaizhi to have an impact on the financial discipline of firms. There are four major areas where problems of the soft budget constraint are most likely to arise: bank loans, interest payments, taxes, and social security. In showing the effects of gaizhi, new overdue loans are a better indicator of financial discipline than the stock of past overdue loans. Comparisons of the financial obligations of gaizhi and non-gaizhi firms are made, and the records of different forms of gaizhi firms are examined. Multivariate regression analysis is conducted to obtain more reliable results.

![Figure 2. Percentage of firms with new overdue loans](image)

Overdue loans. Figure 2 shows that in most years a lower share of gaizhi firms than non-gaizhi firms had problems with new overdue loans. The difference between the two types of firms was 10 percentage points in 1996 and 17 percentage points in 1997. In the late
1990s the gap narrowed considerably and by 2001 gaizhi firms had slightly greater problems with overdue loans. This converging and then diverging pattern was repeated in the data on the average size of new overdue loans. In 1996 and 1997, gaizhi firms reduced their stock of overdue loans while non-gaizhi firms did the opposite. Since 1998 there has been a steady decline in the size of new overdue loans of non-gaizhi firms, but the opposite was the case in gaizhi firms, and by 1999 their new overdue loans were greater in size than those of non-gaizhi firms.

It is unclear whether this is a temporary or a long-term phenomenon. In 1998 China began to feel the impact of the Asian financial crisis. It may be that gaizhi firms were hit more severely than non-gaizhi firms by the squeeze on their cash flows. In recent years, Chinese banks have been very conservative in their lending and in 2001 new overdue loans made to both gaizhi and non-gaizhi firms declined. Without detailed bank data, it is difficult to explain why new overdue loans of non-gaizhi firms fell steadily and those of gaizhi firms rose slightly in the late 1990s. It may be because of the tightened bank lending to non-gaizhi firms or perhaps because of a more relaxed lending stance toward gaizhi firms.

Both gaizhi firms and non-gaizhi firms carry a large stock of overdue loans, although gaizhi firms had less than half of the stock of non-gaizhi firms. The average stock of overdue loans in non-gaizhi firms rose steadily to reach 18 million yuan by 2001. Gaizhi will become more difficult for these firms if their financial burdens continue to grow. The 8.7 million yuan average stock of overdue loans in gaizhi firms in 2001 was not good news either. Gaizhi seemed to improve financial discipline in the early years of reform but not subsequently.

Overdue interest payments. Figure 3 compares the new overdue interest payments in gaizhi and non-gaizhi firms. Gaizhi firms have performed consistently better than non-gaizhi firms, although the gap has narrowed, as in the case of new overdue loans. Interviews with banks and enterprises revealed that the banks were often prepared to extend the term of the loan but insisted that the interest be paid. They were especially keen to enforce this rule on gaizhi firms. Maintaining a steady stream of interest payments is an indicator to higher-level authorities that the loan is still active regardless of whether it was overdue.
Overdue taxes. The trends in overdue taxes matched those of overdue interest payments (Figure 4). The percentage of non-gaizhi firms with new overdue taxes was very high at above 40 percent in most years. The average size of total overdue taxes fluctuated, alternating between high and low years. The percentage of gaizhi firms with new overdue taxes was less than half that of non-gaizhi firms in most years, but the gap narrowed quickly. A total 25 percent of gaizhi firms had new overdue taxes owing in 2001, compared with 42 percent of non-gaizhi firms, but this was more than twice the share in 1996. The average size of new overdue taxes of gaizhi firms steadily increased over the years, although the average began to decline in 2001 and was much smaller than that of non-gaizhi firms over the period, especially in peak years.

Overdue social security payments. The percentage of firms with new overdue social security payments was high throughout the period regardless of whether the firm had undertaken gaizhi (Figures 5). There was no clear indication as to which type of firm performed better in each year. In 1998 the stock of overdue social security payments declined in the case of gaizhi firms, but their new overdue payments were not smaller than those of non-gaizhi firms in other years.

The above analysis suggests the financial discipline of gaizhi firms improved in the early years of reform but has worsened substantially in recent years. Gaizhi firms have had a better record than non-gaizhi firms in paying bank loans and interest, and to some extent taxes, but have been equally bad at making social security payments. Stocks of overdue bank loans, taxes, and social security have been steadily increasing across all firms in recent years, and the main difference between gaizhi and non-gaizhi firms was the speed of the increase. Multivariate regression analysis is needed to confirm why this has occurred and whether any differences between the two types of firms can be explained by other factors that are correlated with gaizhi.
5.2 Performance

*Gaizhi* firms, especially truly privatized firms, were subject to a harder budget constraint than non-*gaizhi* firms. But were they more productive? This sub-section examines statistics on per worker sales, per-worker value-added output, and the return to capital of *gaizhi* and non-*gaizhi* firms.

Figures 6 and 7 present comparisons between *gaizhi* and non-*gaizhi* firms in terms of sales per worker and the growth of sales per worker. *Gaizhi* firms were consistently more productive than non-*gaizhi* firms. Their per-worker sales were on average 25 percent higher than those of non-*gaizhi* firms. However, the growth rates of sales per worker were similar, especially in recent years.
Figure 6. Per-worker sales

![Bar chart showing per-worker sales from 1995 to 2001 for Gaizhi and Non-gaizhi firms.]

Figure 7. Growth rate of per-worker sales

![Bar chart showing growth rate from 1996 to 2001 for Gaizhi and Non-gaizhi firms.]

Value-added data are a more reliable way of measuring productivity because the data are used in value-added tax assessments, which are strictly implemented. Figure 8 gives a comparison of the value added output per worker in gaizhi and non-gaizhi firms. Gaizhi firms performed consistently better than non-gaizhi firms over the period. In 2001, a worker in a gaizhi firm produced three times as much value added as a worker in a non-gaizhi firm. The differences in other years were smaller but still considerable. The productivity of gaizhi firms fluctuated but continued to grow. Productivity in non-gaizhi firms improved before 1998 but then declined.
In terms of pretax profits as a percentage of sales, *gaizhi* firms performed much better than non-*gaizhi* firms (Figure 9). During 1995–2001, the gap between the two groups of firms widened. On average, the profit rate of *gaizhi* firms was 50 percent higher than that of non-*gaizhi* firms.

The above analysis has shown that *gaizhi* firms have performed much better than non-*gaizhi* firms in most aspects. However, one should bear in mind one qualification to these results, which is the impact of the selection of privatization. Researchers have often found in other transitional countries what is also casually observed in China: better performing firms are being privatized first. Therefore, it is important to control for past performance in order to gauge the real impacts of *gaizhi* on firm performance. To that end, a multivariate analysis is deemed necessary. Song and Yao (2003) provide such an analysis and find, among other things, that *gaizhi* improves firm performance only when it is accompanied by genuine privatization.
6. Conclusions

Despite widespread changes to SOE ownership structures throughout China, clearly there is still far to go before gaizhi is completed and many problems need be resolved before a modern enterprise system can fully emerge. First, there are a number of key problems with managing state assets in gaizhi. There are too few channels for transferring state assets. The lack of an open market for trading and transferring state assets means that transparency and fairness cannot be ensured. There is no open market for asset valuation industries, so price signals are lacking. Considerable price differences exist between agencies, which compete with each other to lower their prices. The only way for government to ensure that the trade and transfer of state assets are free from corruption is through an open market for assets and independent assessment of market value.

Second, the costs of gaizhi are unevenly distributed. In some areas, a disproportionately high share of the costs of gaizhi has fallen on employees, who have been inadequately compensated for being laid-off or made redundant. At the same time, the capacity of local governments to bear the costs of gaizhi has varied depending on their fiscal means. The social safety net is relatively poor in some areas, prompting a call from local governments for more central government funding to facilitate gaizhi programs. Given that regions began gaizhi under different initial conditions, the central government has difficulty in designing a uniform plan to provide such support. There is no direct evidence that the buyers of state assets (both private owners and former managers of SOEs) have been overcompensated by acquiring the assets at a discounted price or have obtained free land in return for accepting the responsibility for redeploying workers.

A challenge is to share the costs of gaizhi fairly among the different parties involved. At this stage of reform an imperative is to address the issue of under-compensation for laid-off workers. As Roland (2002: 32) states, “giving compensating transfers to losers from reform to buy their acceptance is an obvious way to help in enacting a reform.”

Gaizhi can increase income inequality to a socially unacceptable extent if laid-off workers are inadequately compensated and/or unsupported by the social security system. Decisions over compensating laid-off workers are complicated by asymmetric information about the losses from reform. “Some of these workers expect to find jobs easily and will not lose much from redundancies, whereas others will have a much harder time and will need to be compensated more heavily to accept being laid off. But if one cannot tell which worker is in which category, then all workers would have to be paid high compensations, because they are indistinguishable and because workers with lower exit costs have an incentive to pretend they have high exit costs. The cost of those compensations would be much higher than in the absence of asymmetric information” (Roland 2002: 32).

Third, there are too few means to finance gaizhi reforms. The two main sources of finance, bank loans and raising funds through the stock markets, are subject to tight limits imposed by current government regulations. For example, since there are no efficient financial intermediaries, bank loans cannot be used to finance mergers and acquisitions.
Similarly, the limits over floating shares on the open market restrict gaizhi firms from obtaining funding from securities markets. As a result, gaizhi is mainly financed with private capital, which limits the scale of the purchases of state assets that can be made.

Fourth, a number of external and internal factors hamper the performance of gaizhi firms. External factors include difficulties in obtaining finance, unequal competition, an unfavorable market environment for their products, and continued government interference in firms. Internal factors include a lack of managerial and technical staff, poor corporate governance, and a lack of product innovation. Potential risks for gaizhi firms also include the fact that employees have been forced to purchase shares without full protection of their property rights. Some gaizhi firms may be unable to fulfill their gaizhi commitments because of unexpected poor performance after gaizhi.

References


State Council (1999a) “Byelaw on Unemployment Insurance,” January 22.