



THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

*China's State Enterprise Reform—
An Overseas Perspective*

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Working Paper Number 90
April 1997

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April 7, 1997

CHINA'S STATE ENTERPRISE REFORM - AN OVERSEAS PERSPECTIVE

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Prepared for the International Workshop on Effective Enterprise Reform at the Municipal Level in China, sponsored by the World Bank and held at Central China Polytechnic University, Wuhan, April 28-30, 1997.

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ABSTRACT

After briefly surveying the current circumstances of China's state-owned industrial enterprises, this paper offers a series of policy recommendations organized around two objectives: raising the returns to capital and promoting the development of market-supporting institutions. The author argues that public ownership is not the central cause of weak performance in state enterprises, and that policy analysis should focus on raising returns to capital and building market-supporting institutions rather than on privatization.

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INTRODUCTION

The author is an economist specializing in the study of China. What follows is a personal view of the circumstances of state industrial enterprises that focuses on two key aspects of the present situation: low returns to capital and the process of building market-supporting institutions. The paper includes an initial overview, brief analysis of the two key issues, and a series of possible policy choices for raising returns to capital and accelerating the development of market-supporting institutions.

I. CHINESE STATE ENTERPRISES: AN OVERVIEW OF THE PRESENT SITUATION

1. Many economists view state ownership as inconsistent with good performance. This perspective is somewhat exaggerated. State-owned industrial and commercial firms have contributed to the economic dynamism of Taiwan, Singapore, and Korea. The example of the United States university industry, which leads the world in post-graduate education, shows the capacity of public enterprises to achieve excellence. Students from Hubei province flock to U.S. universities to study Chinese history and literature as well as physics and medicine. The American university industry draws its strength from unlimited competition for faculty, students, and research support among schools that may be private (Harvard, Stanford), public (University of California) or a public-private mixture (Cornell, Pittsburgh).
2. Although state-owned firms sometimes attain excellent performance, this outcome is unusual. There are several reasons for this failure. Governments often shelter state firms from domestic and international competition. Governments also tax strong and successful firms to support weak firms that lack market potential. These shortcomings are rampant in China today. They contribute to the current weak state of China's state enterprises, which is revealed by statistics showing low profits, high debt ratios, low rates of capacity utilization, and large numbers of redundant workers.
3. Excessive protection and uneven taxation are not the only causes of poor performance in China's state enterprises (SOEs). Inadequate management and inappropriate investment choices within state firms contribute to poor results. State firms also suffer from historical burdens, including uneconomic locations, inadequate equity, and unfunded social mandates for housing,

education, health care, and pensions.

4. Statistical information about the performance of state enterprises exaggerates actual difficulties. State firms face punishing tax rates (Jiang Qiangui, 1996). High tax rates encourage many enterprises to conceal profits (Wang Haibo, 1992). Discussions of state enterprise finances emphasize government subsidies to SOEs but ignore what amount to SOE subsidies to the state, such as pension payments that should be funded from profits turned over to the state during the retirees' active working years. Systematic adjustment for the full range of subsidies and unfunded mandates might show that the underlying financial performance of state firms is not notably inferior to the achievements of firms outside the state sector (Shougang, 1994; Rawski, 1997). The success of joint ventures built around facilities and workers formerly part of the state sector shows that the upper tier of China's state industry is rather close to achieving international competitiveness. In many cases, modest injections of funds, equipment, design capability, marketing know-how, or management expertise can rapidly upgrade export capabilities. Despite these observations, there can be no doubt that China's state enterprises face serious difficulties.

5. Many economists regard public ownership as the central cause of poor performance. From their perspective, the transfer of assets to new owners becomes a focal point for policy recommendations. However, the theoretical and empirical foundations of this viewpoint are weak. An expanded role for private business and industry is surely a desirable component of Chinese policy strategies, but privatization need not occupy a central position in the logic of SOE reform efforts. The following discussion focuses on issues that appear more fundamental: raising the returns to capital and building an institutional framework to support China's emergent market system.

II.A. ANALYSIS: LOW RETURNS TO CAPITAL

6. Discussion of difficulties confronting Chinese SOE managers invariably emphasize insufficient capital. If capital is scarce, then the returns to new investment should be high. But returns to new investment, much of it concentrated in the state industrial sector, are consistently low. It seems obvious that China's mechanism for allocating new investment funds is seriously flawed. Advocates of continuing the tradition of sheltering SOEs from market pressures complain that profit rates are lower than the lending rates charged by China's banks. But bank lending rates are so low that SOE borrowers often relend loan proceeds to firms outside the state sector at much higher rates (Cao, Fan, and Woo, 1997, p. 33). Low bank lending rates fail to reflect the true (high) cost of capital and sometimes fall below the rate of inflation. If capital is indeed scarce, why do banks lend money for projects with poor profit prospects? Why do governments support projects with low returns? Why do enterprises undertake such projects? Why do so many new projects end up with large amounts of expensive but idle capital? One important source of the difficulties facing China's SOEs revolves around inefficient use of capital - including existing facilities as well as new funds.

II.B. ANALYSIS: BUILDING INSTITUTIONS TO SUPPORT CHINA'S EMERGENT MARKET SYSTEM

7. Economists have developed two visions of economic policy. The first begins with the work of Arthur C. Pigou, a British contemporary of Keynes. Pigou taught that the appearance of market failure calls for government to impose an appropriately designed tax or subsidy. Much of development economics follows this tradition by tending "to emphasize problems of market failure and the need for informed official intervention" (MacKinnon, 1993, p. 1). Both the practice of central planning under socialism and the implementation of economic regulation in major market economies fit this mold. In each case, government must collect and process sufficient information to make informed decisions or to promulgate appropriately designed tax, subsidy, or regulatory structures. From this perspective, we can say that social institutions are "sets of rules that . . . are planned and designed mechanisms given exogenously to or imposed on a society of agents" (Schotter 1986, pp. 117-118).

8. An alternative approach assigns to the state the task of creating conditions that encourage decentralized, unmanaged experimentation in pursuit of new resource combinations to ameliorate economic problems, reduce waste and inefficiency, or find new paths to productivity gain. This perspective is inherent in the so-called "Coase Theorem." Ronald Coase (1960) argued that, in the absence of transaction costs, creation and protection of well-specified property rights will permit interested parties to negotiate efficient solutions to market failures without the participation or knowledge of the state. Although the assumption of zero transaction costs is never attained, Coase's idea is that government efforts to clarify property rights and reduce transaction costs can increase the prospects for resolving inefficiencies through decentralized negotiation among economic agents without direct involvement of the state. From this perspective, economic institutions appear "as unplanned and unintended regularities of social behavior. . . . that no single individual intended to occur. . . . [Institutions] emerge or evolve spontaneously from individual maximizing or satisficing behavior instead of being designed by a social planner" (Schotter 1986, p. 118).

9. China's remarkable economic success of the past twenty years rests mainly on a process of "development from below." The leaders of China's reform wanted better performance, but had no clear idea of how to attain their objective. Rather than attempting to issue detailed instructions, China's reformers enacted "enabling policies" like profit sharing, dual-pricing, and special economic zones. These initiatives expanded the range of choices open to provinces, localities, enterprises, managers, and workers. The new policies allowed expanded entry into formerly closed markets. Competition intensified. Profits fell, slashing the growth of government revenues. The ensuing financial pressures encouraged innovation and cost-cutting, promoted further market-leaning reform initiatives, and changed people's attitudes toward the benefits of a market system (Jefferson and Rawski, 1994ab; Rawski, 1995). The phrase "crossing the river by stepping from stone to stone" (*moshitou guohe*) aptly captures the unplanned, improvised nature of China's reform, in which important outcomes, such as the immense growth of rural industry and the sharp decline in the ratio of government revenue to

total output, were completely unexpected.

10. China's movement toward a market system, initially slow and now more rapid, did not arise from any reform plan or strategy devised by national leaders. Institutional change in China developed from a decentralized process of experiment and negotiation in which the experiences of countless officials, enterprise managers, and workers encouraged them to make choices that gradually deepened the role of markets, and eventually resulted in today's national consensus favoring continued expansion of the market mechanism. Even though China's economy falls far short of Coase's ideal of clearly-specified property rights and low transaction costs, China's reform experience provides a richly documented illustration of how a Coasian approach can work in practice (Jefferson and Rawski, 1997). Decentralized, unplanned experimentation has repeatedly created new institutions that help to ameliorate, if not resolve economic difficulties.

11. Treatment of redundant labor provides a prominent example. At the start of reform, it was not possible to dismiss redundant workers from state enterprises. Today, nearly two decades later, such dismissals have become politically feasible. Furthermore, their economic necessity is widely understood. The erosion of lifetime tenure for SOE workers was a slow and complex process that involved many experiments -- with bonuses, with the labor optimization system (*laodong youhuazhi*), with the reassignment of workers to ancillary enterprises in the service trade, and with on-the-job furloughs (*xiagang*) -- a genuine institutional innovation that provides some of the benefits associated with labor markets. Bankruptcy, an area in which Hubei initiatives are especially prominent (Zhang Jing, 1996; Hubei, 1996), is another important example of institution-building through decentralized Coasian experimentation.

Analysis of policy initiatives for state enterprise reform can beneficially focus on the potential of government actions for raising the return to capital and accelerating the development of market-supporting institutions. The following sections offer suggestions and cautions in each area.

III.A. REFORM PRIORITIES: RAISING THE RETURN ON CAPITAL

12. One approach to raising the return on capital is to raise its effective cost. This may help the financial system to curtail the flow of funds to bad borrowers and bad projects. Even if the cost of funds lies outside the control of provincial and local governments, there may be ways for sub-national governments to improve the allocation of funds. Reduce the scope and size of officially imposed credit plans, which often force banks to make bad loans and always perpetuate the idea that politics rather than profitability opens the door to bank loans. Do not obstruct the banks' efforts to raise the cost of borrowing - for example by requiring recipients of artificially cheap loans to maintain large deposits. Consider ways of revising the tax system to penalize excessive holding of fixed assets. Avoid special benefits for firms that overborrow or overinvest.

13. At the provincial and local level, the greatest impact on returns to capital may come from

indirect approaches. One promising avenue is to restrict the scope of government economic decisions to matters of genuine strategic importance. There is a trade-off between the quantity of economic decision-making and the quality of decisions and implementation. The withdrawal of government from direct and indirect control over non-strategic capital assets is likely to increase the overall rate of return.

14. Spare government administrators the unnecessary task of managing capital assets that have no strategic importance. Many loss-making state enterprises are small firms in industries like textiles and machine-building. Such firms have no strategic importance, yet their continued presence in the state sector depletes government administrative talent as well as scarce funds. Prompt divestiture of such firms through mergers, acquisitions, auction, or any other convenient method is an option that deserves serious attention. Housing is another asset category in which government management offers little advantage. Consider the simplest possible reform -- transfer ownership of apartments to the current occupants, with or even without compensation. In both cases, the biggest benefit for government is a reduction of non-essential management responsibilities.

15. The trade-off between quantity and quality of decision-making applies to enterprises as well as government. Many of China's best facilities for innovation and technical change reside in the state sector. But state enterprises are diverted from innovation by the crippling financial and administrative burden of unfunded mandates that force them to deal with schools, clinics, hospitals, medical costs, and pensions, responsibilities that rival firms outside the state sector largely avoid. The resulting damage is not limited to the financial results at SOEs. Pushing ahead with the separation of industrial production from the management and financing of social programs can help to increase the returns on production assets.

16. The process of separating production from social affairs puts big pressure on government budgets. Governments at all levels can help to resolve these pressures by cutting their own staffs. Government employment has expanded rapidly during the past two decades even though economic reform has sharply reduced the responsibilities of state agencies. Hubei has followed national trends in this area, with staff levels in government, party, and social agencies increasing by 100 percent between 1980 and 1995 (Labor 1989, p. 61; Yearbook 1996, p. 95).

17. Examine official investment plans and priorities with extreme skepticism. Remember that Japan's system of "administrative guidance" is in decline, and for good reason (see below). Is it possible that public pronouncements about investment strategy serve mainly to divert attention from the poor commercial prospects of favored investment projects? Genuine investment strategy identifies sectors and localities from which investment resources will be withheld as well as areas of high priority. Do Hubei's official investment strategies clearly identify which areas have low priority and should therefore curtail investment spending?

18. Exercise great caution in encouraging investments that anticipate future demand. China's recent development is marred by many episodes of overbuilding. It is not clear that the lessons

of bitter experience in the affected industries - textiles, televisions, refrigerators, etc. - have spread across the economy. Today, motor vehicles represents the most obvious prospect for expensive and wasteful overbuilding. Nearly every Chinese province (not to mention Indonesia, Malaysia, Korea, and many other nations) has selected the automotive sector as a "pillar" industry. There is a high probability that much of current and planned investment in this industry will never achieve the anticipated output timetable. If this happens, the returns to capital cannot increase.

19. Support the growth of private business and industry. Expansion of private enterprises deepens the market environment, pushing firms under all ownership arrangements to reduce costs, explore new technology, and raise productivity, quality, and service. Growth of private business can also reduce the costs associated with the reform of state enterprises. The main constraint on SOE reform is the fear that layoffs and bankruptcies will ignite social unrest. Now that large-scale layoffs of SOE workers have begun, with more to come, everyone recognizes the importance of accelerating the creation of urban employment. The experience of the past ten years shows that private business has an enormous capacity to expand urban employment without large-scale investment. Between 1991 and 1995, private (*siying*) and individual (*geti*) firms, which accounted for only one-eighth of 1995 urban employment, created no less than 61.6 percent of new urban employment throughout China (Yearbook 1996, p. 87).

20. This remarkable achievement occurred with minimal official support. If private business receives access to credit facilities and legal protection, its potential for employment creation will surely multiply. Wuhan recently "passed a regulation governing the collection of fees from foreign-backed companies. Fee rates were publicized and unnecessary fees were eliminated. Complaint centres for foreign business people also were set up" (Wuhan, 1997). Why not implement the same provisions for the benefit of Chinese businesses?

II.B. REFORM PRIORITIES: PROMOTING THE GROWTH OF MARKET-SUPPORTING INSTITUTIONS

21. The economic role of government is a complex and controversial issue. We can ignore many details and nuances by stating that in market systems, government plays a supporting role. This concept is difficult for Chinese leaders to accept, partly because of China's tradition of socialist planning, but also because the highly visible leadership role of government officials in Japan, Korea, and other dynamic Asian economies offers an congenial model that has delivered spectacular results. But the relevance for China of what might be termed "the MITI approach" (MITI refers to Japan's Ministry of International Trade and Industry - *tongchansheng*) is open to serious question. For concreteness, I focus my remarks on Japan.

22. Japan achieved great economic gains under the MITI system, especially during two decades ending in the mid-1970s. The success of this system depends, however, on a special combination of circumstances. These include top-class staff whose work is thoroughly insulated

from the political process as well as sufficient policy tools to compel the business sector to adhere to the strategies developed by the economic bureaucracy. Without these conditions, the MITI system quickly degenerates into a quagmire of rent-seeking and self-interested bureaucratic infighting. This is exactly what we see in Japan today, where the MITI system is in rapid decline.

23. This reversal of fortune is attributable to several factors, including: a) diminished willingness of business sector to accept official guidance; b) increased involvement of domestic enterprises in global business, which reduces the capacity of officials to obtain compliance with economic decisions taken by the Japanese government; c) financial deregulation, which also weakens official power; d) growing intrusion of politics into the planning process.

24. Each of the factors undermining Japan's system of official strategic planning and administrative guidance is already present in China. Furthermore, the MITI system has a record of producing low returns to capital - a particularly unattractive feature for China. Both Japan and Korea face dangerous financial circumstances. These problems result from a system in which big banks pursue expansion rather than asset quality by channeling huge loans to big firms with similar objectives. This is no model for China, which already suffers from extreme shortcomings of exactly the same sort.

25. The conclusion that the MITI model is not suited to China's current requirements pushes our attention back to the role of the state as a supporter of market development. Smoothing the path for further rounds of Coasian experimentation with the development of market-linked institutions may represent the greatest opportunity for government to contribute to China's ongoing economic reform. The task is enormous and challenging. China has made huge strides toward creating a market economy. Newspapers are filled with reports of fresh innovations. Yet the same newspapers contain clear evidence of shortcomings and gaps in China's emergent market system. It seems that the structures and linkages that form the institutional foundation of a market economy are far more numerous, intricate, and subtle than most economists have imagined.

26. The best route for policy may be to focus on the bedrock fundamentals of market economics. A market economy is a system that encourages participants to plan for the future and to keep promises. Policy-makers can support the deepening of market functioning by taking steps that will allow individuals and enterprises to plan for the future, oblige them to keep promises, reward those who plan well and fulfill contractual obligations, and penalize agents who plan poorly or renege on their promises. Policy recommendations follow.

27. Reduce interventions that affect prices of commodities, services, and resources. Distorted prices mean distorted plans. The artificially low price attached to bank loans, for example, encourages firms to lavish funds on facilities and equipment that embody too much automation. The result: unnecessarily low returns to capital and unnecessarily slow expansion of employment.

28. Promote the strengthening of legal systems connected to economic activity. This is a huge task that will require many years to complete. China needs effective mechanisms for managing state assets, protecting the intellectual property rights of Chinese (as well as foreign) inventors and companies, resolving contract disputes, enforcing payment obligations, and liquidating or reorganizing bankrupt enterprises (Wang Bao, 1996). Progress in this area is essential to release assets trapped in loss-making and bankrupt enterprises.

29. China encourages citizens to identify and purchase fake consumer goods and then demand refunds equal to double the amount of the original purchase. This represents an ingenious enforcement mechanism. This system costs the government almost nothing. Furthermore, there is little opportunity for corrupt businesses to use bribery to escape detection. Consider applying the same system to unauthorized collection of fees by government agencies and their employees. If any enterprise that is forced to pay unauthorized fees were entitled to a refund of double or triple the initial payment, attempts to collect unauthorized fees might decline quickly. A reputation for strict punishment of unauthorized revenue extraction could become a valuable marketing tool for attracting Chinese and foreign investors to Hubei. Allow the creation of independent Chambers of Commerce and other business associations. Encourage them to raise questions about policies that hamper the growth of business. Efforts to correct such policies will bring valuable publicity that, again, can help attract resources to bolster Hubei's economy.

30. Strengthen the banking system. In China's emergent market economy, the task of directing funds toward good projects and good borrowers and curtailing funds for bad projects and bad borrowers rests primarily in the hands of the banks. Unfortunately, three decades of socialist planning has created a tradition that places banks in a subordinate position. Chinese bankers have become accustomed to receiving orders from government officials and production managers. For this reason, the quality of bank personnel, particularly among workers outside the headquarters and above age 30-35, remains weak.

31. Raising the return to capital is unlikely in the absence of new behavior patterns that force companies and managers to build reputations for financial probity. This means that enterprises must honor obligations to workers, customers, and suppliers, including prompt repayment of bank loans, or fall into bankruptcy. The banks are working hard to develop a new business culture, but they cannot succeed without strong and sustained support from every level of government. Accounts of China's bank reform identify personal effort by local leaders as a crucial ingredient in this effort (Xie Fangshen, 1996).

32. Governments should support the banks in their efforts to enforce collateral obligations and to prevent enterprises using business reorganization as a device to escape the obligation to repay loans (see for example Xi'an, 1996). Governments should recognize that the phenomenon of chain debts (*sanjiaozhai*) threatens the foundation of market operations. China's economy would benefit enormously from the development of a market for commercial paper (i.e. IOUs issued by business enterprises). If governments renege on their own obligations by issuing "white slips" (*baitiao*) in place of cash payments to farmers or by delaying tax refunds, the task

of controlling the practice of *sanjiaozhai* within the enterprise system becomes more difficult.

33. Expand the system of property rights exchanges (*chanchuan jiaoyisuo*) to create a market for control of corporate assets. The world's major market economies operate under two very different systems of corporate governance. The American system has developed a vibrant market for corporate control, with ample opportunity for hostile takeovers as well as cooperative mergers. In Germany and Japan, there is much greater control by corporate insiders, and hostile takeovers are almost unknown. Both systems have proven highly effective. Several American economists, including the Nobel Laureate Merton J. Miller (1996), argue that China can benefit from developing an American-style system. They are probably right, simply because several decades of poor investment decisions have left China with thousands of enterprises that desperately need to be restructured. Traditional systems that organize economic activity according to administrative boundaries (province, prefecture, city, county, etc.) and implement policies along vertical lines within specific sectors or systems (*xitong*) offer no remedy. Indeed, they contribute to the problems of local protectionism, limited specialization, and excessive vertical integration (*daerchuan, xiaoerchuan*).

34. Strive to expand opportunities for small and large transactions that will improve the competitiveness of local business and expand the utilization of local manpower and facilities. Hubei, like China's other major industrial bases, must have an abundance of idle equipment, idle factory space, and idle workers. Encourage individual entrepreneurs or small groups of workers to take over underutilized workshops and equipment to start their own businesses. Look for opportunities to support such initiatives -- for example, consider tax concessions, small loans, free rent, and cheap electricity. Encourage faculty and students of local colleges and universities to help fledgling entrepreneurs overcome technical and management hurdles. The experience of Japan and Taiwan shows that small-scale manufacturing operations, often employing fewer than five workers, can make major contributions to the development of progressive, efficient, and internationally competitive business structures. Tiny enterprises thrive in China's villages. There is every reason for energetic support of such activities in China's cities.

35. The Shanghai Meixu Clothing Company is an export-oriented Sino-Japanese joint venture that operates plants in Qingpu county, Shanghai and in Huangshi, Hubei. Its managers report that wages in Shanghai are four times the figure for Huangshi (1995 interview). This gap in labor costs (and in land costs as well) represents an important economic advantage for Hubei. Shifting operations to Hubei adds extra costs for transport, communication, and border crossings. Every reduction in the time and expenset required to establish and operate businesses or to move goods and information to and from Hubei helps tilt investors' calculations toward outcomes that will strengthen the local economy. To take maximum advantage of such opportunities, encourage new industrial combinations that span traditional industrial and geographical demarcations. Accelerate efforts to improve transport and communication links. Strive to modify systems of taxation and regulation in the direction of simplicity, clarity, and stability.

III. CONCLUSION

The premise underlying policies of reform and deregulation is that most economic choices are best made by the people who are closest to the relevant markets. This paper offers the suggestions of a writer located several thousand miles from the emergent markets of Hubei province. Some of these proposals may be useful, others may be irrelevant. Even if some details are inappropriate, the emphasis on raising the return to capital and encouraging the continued development of market-oriented institutions deserves attention. Whenever government agencies consider the formulation and implementation of economic policy toward state enterprises, it makes sense to ask two questions: "Will this policy help increase the return to capital"? "Will this policy strengthen the development of market-supporting institutions"? Policy proposals that cannot justify strongly affirmative responses to these simple questions are unlikely to contribute to the reform of state enterprises.

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