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CHINA'S STATE ENTERPRISES
—
Nine Case Studies

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Forward

This study uses a case-by-case analysis of nine enterprises to identify the major issues involved in reforming China's medium to large state-owned enterprises (SOEs). Dr Yin H. Mai conducted interviews with SOE managers and workers during factory visits in mid 1996; these form the basis of the case studies. Interviews with academics, government officials, bank managers, and managers and workers in other types of enterprises such as township enterprises, private companies and joint ventures provide further support. The study consists of two parts; a summary report of the major common problems and policy implications and the SOE nine case studies.

The summary provides an overview of the common issues confronting SOEs in the process of reform. A survey of recent SOE reforms and the nature of SOEs prior to reforms is followed by an analysis of some of the main problems facing SOEs. Finally the summary draws policy conclusions.

The case studies provide detailed examination of the approaches 9 large and medium sized SOEs are taking to cope with reforms and survive in the increasingly competitive Chinese market. The summary draws conclusions from these case studies regarding productive approaches to SOE reform.

Summary report

State-owned enterprises in the Chinese economy

State-owned enterprises, SOEs, play a central role in the Chinese economy, employing 70 per cent of urban workers and producing 33 per cent of industrial output in 1995. In 1994, China had more than 102 000 SOEs, representing only 1 per cent of the total number of enterprises, but employing 75 of the urban industrial workforce (43 per cent of industrial workforce including township and village enterprises), 57 per cent of new investment and 70 per cent of bank loans. The overall performance of SOEs has been extremely poor relative to the non-state sector. Indicators of this performance include high and growing debt to asset ratios, an inefficient use of capital compared with non-state enterprises, low value added per worker, large increases in the number of loss making enterprises, and low growth in output and employment ((East Asia Analytical Unit, 1997, Chapter 10). In 1994, for example, the growth of industrial output in SOEs was around 20 per cent that of non-state enterprises. Productivity growth in the SOE sector has been virtually zero in recent years (Perkins, 1994). Given the importance of SOEs in the economy, this poor performance inhibits China's long term growth prospects.

An overview of SOE reform in China

By 1996, half of China's SOEs reported losses. Chinese academics and officials estimate that a further one third of SOEs actually make losses although they report profits (Ma et al, 1996). Estimating the number of loss making SOEs is difficult because their managements have control over whether to report profits or losses. There is much scope for creative accounting.[1] Different sources report different numbers of loss making SOEs, but all agree that the number of loss making SOEs and the value of losses made are increasing rapidly and those that survive operate under considerable constraints.

Both SOE managers and workers are told they are the owners of state-owned assets. But, in fact, SOE assets do not belong to any individual worker or manager and no one in SOEs or their governing departments takes responsibility for growth in the value of state-owned assets in the enterprise.[2] Managers are rewarded for making profits but are not punished for making losses.[3] As a result, asset stripping has become a serious problem.

Many loss making SOEs have stopped or partly stopped production. Workers in these SOEs receive a minimum living allowance of around ¥ 200 (about $A31) per month, or a proportion of a basic wage (which could be lower than the minimum living allowance) from the SOEs. These SOE workers have become a new sub-culture of urban poor. To prevent further escalation of the problems of SOEs, the Government is introducing more market oriented reforms into the economy.

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[1] For example, *People's Daily* (4 May 1996) reported that four state-owned construction companies in a city were found making losses of ¥ 30 to 80 million (about $A4.7 to 12.5 million) after the managers of these companies left. The losses were huge compared with their fixed assets of about ¥ 30 million to 50 million (about $A4.7 to 7.8 million). These companies had been reporting profits. Furthermore, relevant government departments' audits also supported the myth that these companies had been making profits.

[2] Except in a few SOEs experimenting with enterprise reform where the growth of state-owned assets is linked with the income of the SOE employees (for example, case 6).

[3] Managers making losses are normally moved to other SOEs or government departments but they can retain similar remuneration packages.

Since 1992, China's economic reform has gained momentum, fuelled by further liberalisation outlined during Deng's 1992 Southern Tour speech and in the decision of the third Plenary session of the Fourteenth National Party Congress in 1992. The Congress adopted the concept of establishing a complete market structure, a 'socialist market system'(State Statistical Bureau, 1995).

Recent economic reforms are more systematic and fundamental than the economic reform of the 1980s. Instead of partial liberalisation in areas that require urgent attention, the Government has adopted a package of policy changes including reform of property rights, SOEs, factor markets, prices, goods distribution, social security, foreign trade, government functions and other important aspects of the economy (East Asia Analytical Unit, 1997).

Since the end of the 1970s, government ideology has shifted from central planning of the production and distribution of goods and services, to more indirectly controlling the economy, using market discipline and macroeconomic instruments. This ideology has shifted even further since the early 1990s. The policy of the State owning 100 per cent of assets and having 100 per cent administrative control of enterprises has been superseded by a policy of using state capital to control key enterprises in key economic sectors where the Government becomes a shareholder.

The Government has made an inventory of the stockpiles and capital equipment and other assets of SOEs and claimed ownership of these assets. It has established State-Owned Asset Management Committees in central and local governments. These committees register state-owned assets in SOEs and monitor the growth in the value of these assets. The Government also has established companies charged with managing state-owned assets. These companies are solely owned by the Government and are instructed to deliver a certain rate of growth in state-owned assets in SOEs and other enterprises with government investment (for example, case 6).

The government has allowed alternative owners of capital, such as individuals, groups of individuals and foreigners, entry into joint ventures with the state sector to introduce effective sources of discipline into SOEs.[4] Local governments are encouraged to conduct experiments in SOE reform, introducing multi-ownership into the state sector. Mistakes are permitted but experiments in reform are compulsory. The Government has also conducted experiments in 100 large and medium sized SOEs, setting the trend towards reforming thousands of SOEs. Furthermore, the Government has been undertaking an overhaul the state sector in Shanghai, one of China's oldest and largest industrial production bases.

In this move, small SOEs are being leased out, merged with more profitable SOEs, bankrupted, or sold to the employees of the enterprises, transforming them into various joint-stock companies. Some small to medium SOEs were sold partly to foreign investors. For example, Huafeng in Zhuhai city[5] sold more than 50 per cent of its shares to a Hong Kong based company (Ma, et al, 1996).

Some small cities have completely overhauled their state sectors and provided supporting reforms in social security, labour markets and government functions. For example, out of 274 SOEs in Zhuchen city in Shandong province, 9 SOEs were transformed into limited liability joint-stock companies, 209 were transformed into joint-stock partnership companies, 18 were sold at auction, 30 were leased out, 5 were merged with other

[4] Some SOEs listed on the Shanghai stock market made losses in 1996. The trading of their stocks was immediately stopped and their boards of directors were asked to explain and provide plans to deal with the situation.

[5] Huafeng is a joint-stock company producing fast noodles with a sales income of ¥ 630 million (about $A98.4 million). Before selling shares to a Hong Kong company, the local government owned 50 per cent of the shares. Now the local government owns 35 per cent of the shares while the foreign investor owns 51 per cent. Zhuhai is a special economic zone near Macao.

companies, and 3 were bankrupted (Ma, et al, 1996). Shunde city in the Pearl River Delta, Guangdong Province undertook a similar experiment. Virtually all reformed former SOEs were making profits and paying taxes after a year of their ownership change and redundant workers were absorbed quickly into the non-state sector (East Asia Analytical Unit, 1997).

To transform a SOE into a joint-stock partnership company, the Zhuchen city council first sold the state-owned assets in the SOE to the employees of the enterprise.[6] The employees, as shareholders of the company, held a shareholders' meeting electing a board of directors. The directors then elected a chairperson of the board, and the board appointed a general manager and other senior management staff to be responsible for the operation of the enterprise. Shareholders also elected a board of inspectors to monitor the performance of the directors and managers.

The Zhuchen city council found that the attitude of managers and workers to the enterprises changed completely from 'no-one cares' to 'everyone cares' about the value of the enterprise's assets. The reform effectively turned these SOEs into independent entities responsible for their own profits and losses. The separation of government control from the functions of the enterprise also was very effective. The Government no longer participated in the enterprises' business decisions, even important ones. This released government resources, enabling them to concentrate on other key functions such as infrastructure development and the provision of social services. Most importantly, enterprise performance has improved dramatically and in particular, the pace of technology and equipment upgrading has accelerated rapidly. Employees who were made redundant no longer complain because they hold shares in their companies; consequently, they are concerned now about the efficient operation of the enterprises.

Other medium to large SOEs were corporatised into limited liability companies; some remained solely owned by the government and others became joint-stock companies. After a rigorous selection process, a small number of these joint-stock companies were listed on the stock exchange. Many medium to large SOEs were corporatised or merged into enterprise groups that engage in a range of industries across several regions. Each transformed medium to large SOE is supposed to be managed by a general manager responsible to a board of directors. Although a board of directors was established in each SOE, the decision making mechanism and people involved are very much the same as before the reform. This is because most of these SOEs are still solely government-owned. It is more difficult to find partners for medium to large SOEs than for small SOEs because of the magnitude of investment needed to rehabilitate them and the heavy debts many carry.

While multi-ownership can improve the performance of SOEs, the Government is reluctant to relinquish control over large and profitable SOEs. Therefore, it will offer financial and policy support for the restructuring, upgrading, and debt relief for some large and promising SOEs. The small SOEs will have to survive by themselves.[7]

Although various reforms have been trialed, an effective and commonly agreed approach has not emerged. However, the approach of Zhuchen city and Shunde in Guangdong achieved the objectives of SOE reform the Fourteenth National Congress of the Communist Party set. These were to clarify ownership of property, clarify responsibilities, stop government involvement in enterprise operations, and improve the management of SOEs (State Statistical Bureau, 1995). However, the Zhuchen experiment was criticised as completely privatisating SOEs, therefore deviating from the principal of mainly state ownership. Some argued that state-owned assets were under-valued and stripped in the Zhuchen reforms. Others argued that, on the contrary, the reforms effectively stopped the stripping of state-owned assets because the workers

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[6] Includes both managers and workers. Managers purchased more shares than workers.

[7] For a fuller discussion of the policy of 'grasping the big and enlivening the small', see EAAU, 1997, Chapter 10.

ceased to maximise short term income from their SOE and worked towards long term income maximisation. Furthermore, the Government collected revenue from the sale of assets which could be invested in profitable enterprises with mixed public, private and collective ownership or into urgently needed social and physical infrastructure. Had state-owned assets not been sold to employees, the lack of responsibility for state-owned assets would eventually have reduced these assets to a minimal value. In many cases, the debt accumulated by SOEs exceeds the value of assets in the enterprises, and SOEs merely drain capital from the banking system and reduce national wealth. If this situation is allowed to continue, it could even undermine the viability of the banking system.

SOE reform entails wider economic reform, such as in government functions, social security and factor (labour and capital) market reform. Due to slow reform in social security and government functions, implementing SOE reform has been very difficult. In places where social security reform is more advanced, SOE reform is easier.

Also importantly, SOE reform is closely linked to the pace of change in the ideology of SOE employees and government officials from a central planning mind set to a market oriented attitude. In places where economic reform started earlier and the ideology is more market oriented, such as Guangdong province, the process of SOE reform is more advanced and effective. In the southern coastal area, the attitude towards economic reform is 'running while the light is green, walking while the light is yellow and experimenting while the light is red'. However, in most inner and north east provinces, the central Government pushes reforms. Overall, it is likely to be a long time before the blueprint envisaged by the Fourteenth National Party Congress is achieved throughout the country.

The operation of SOEs under a centrally planned economy

The Government administers SOEs through a system of governing authorities. The State Council representing the central Government, governs more than ten general corporations in natural gas, shipbuilding, tobacco, ferrous metals, textiles, petrochemicals and other important industries. Each of these general corporations, in turn, governs scores of enterprises in the corresponding industry. These enterprises, in turn, may have subsidiaries and act as their governing authorities. Some large SOEs were attached directly to the industrial ministries and were later assigned to provincial or municipal governments. Each provincial and municipal government also governs its own SOEs either directly or through general corporations in each industry.

Instructions from government are passed to SOEs through this chain of command. The implementation of the instructions by each level of SOE is supervised by the superior governing authority. Also through the chain of command, requests from SOEs are passed up to the relevant government departments, subject to the approval of each superior governing authority.

Before 1978, SOEs used to be treated as extensions of government bureaucracy. Each SOE was assigned an administrative level similar to a government department. The higher the administrative level of an SOE, the fewer layers of authority it was subjected to and the more autonomy it had. Some very large SOEs were assigned a level of a ministry; the heads of these SOEs enjoyed the treatment and a remuneration packages of a deputy minister. Similarly, SOEs assigned an administrative level of a division (or bureau) enabled the heads of these SOEs to enjoy the treatment of division chiefs. Seniority of the middle and lower level SOE managers also ranked according to a system applied in China's civil service.[8]

Under central planning, the central Government set production and distribution plans.

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[8] In recent years, the government has tried to establish a different system of seniority among SOEs and SOE managers from the one applied in public service; however, it will take some time before that change will be fully incorporated in practice.

SOEs were production or distribution agencies; they received allocated materials, capital goods and workers, and organised production to achieve instructed output targets. The output was then sold to the Government at a planned price. The management of SOEs was not concerned about what their input or output prices were, where to buy materials, what and how much to produce, and where to sell their output. Similarly, they were not concerned about cost control or bankruptcy. Production facilities were designed to fulfil output targets, rather than to be cost efficient. This focus led to the establishment of large production support teams in each SOE, such as building construction teams in petrochemical enterprises. Resources occupied by these production support activities in each SOE were typically under-used (see case 1).

As SOEs' governing authorities handed over SOEs' profits to the Government, if an SOE needed funds for investment, it had to apply for approval of the investment project and an allocation of funds through the government budget. However, since the management of SOEs did not have to face market competition, they had little incentive to update existing technology so long as they continued to meet production targets. As a result, out-of-date technology and equipment is prevalent in most SOEs.

Wages paid to SOEs employees were low and all employees with similar qualifications, sex and seniority received a similar level of remuneration regardless of their productivity. In the 1950s, many were motivated by their apparent change in social status from labourers to the masters of the SOEs, and their enthusiasm for socialist construction. Many SOE employees truly believed that the enterprises were their home as SOEs provided them with housing, medical care, retirement benefits, work injury compensation, education and employment for their children, and even hairdressing services. As a result, SOEs in China have a legacy obligating them to deliver many social services. Under central planning, these services were not regarded as a burden, but as the rationale for SOEs. However, in a more market oriented system, they are a huge financial cost to SOEs that is not borne by non-state sector competitors. Furthermore, the relative size of these welfare payments in SOEs' total wage packages has increased rapidly since the mid 1980s (Meng and Perkins, 1996).

SOEs in transition

Towards the end of the 1970s, the Government started to introduce market competition into the state sector, allowing non-state firms to enter many manufacturing and service sectors. From 1978 to 1983, SOEs were allowed to sell part of their output and purchase part of their inputs in open markets.[9] While in 1983, 80 per cent of commodities were still subject to central planning, by the end of 1992, this had declined to less than 10 per cent of all commodities.

Meanwhile, a series of policy changes provided SOEs with more freedom to make business decisions. Since the early 1980s, SOEs have been allowed to retain depreciation funds. Between 1985 and 1986, a contract responsibility system was adopted in most SOEs. Under this system, the managers of SOEs signed contracts with their governing authorities specifying profit targets for the SOEs. If an SOE made a profit greater than its target, the SOE retained the difference for reinvestment or for bonus payments to workers. The contract responsibility system, however, resulted in managers over-using facilities and equipment to maximise short-term profits while they were in office.

In an attempt to let SOEs take responsibility for their own costs and profits, the Government stopped allocating investment funds to SOEs in the mid 1980s. Instead, SOEs were required to borrow from banks for investment funds[10] and working capital,

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[9] Market prices are normally much higher than planned prices. Many SOEs benefited from the difference in planned and market prices.

[10] Investment projects must be approved by enterprises' governing authorities and other relevant government departments.

and were expected to repay interest on loans as well as principal. As project appraisals were usually inadequate, and managers did not bear directly any risk in borrowing, this policy has resulted in most SOEs accruing heavy debts that they are incapable of repaying.

In 1992, SOEs were assigned various rights enabling them to operate independently from the Government and more within the marketplace. SOE management could make production plans according to prevailing market conditions and the Government's macroeconomic adjustment policies.[11] SOEs could set prices for outputs; sell outputs and purchase inputs in markets; import and export directly through companies with foreign trade rights; invest using their retained funds or profits; merge or cooperate with other enterprises; employ and dismiss workers and middle level managers; decide upon wage and bonus payments for employees; adjust internal organisational structures; and refuse to pay illegal charges.[12] A comprehensive list of these rights was specified in *Regulations on transforming the operating mechanism of SOEs* (State Planning Commission, 1993).

However, most SOEs do not take advantage of these expanded rights, because the Government has sent a clear message to SOEs through their governing authorities that actions, like labour shedding, likely to cause social and political disruption are not desirable. The Government believes that large scale dismissal of SOE workers is likely to cause social instability, as labour markets are underdeveloped and the social security system is underdeveloped. Consequently, although SOEs were assigned the right to dismiss workers, they are, in practice, not able to exercise this right. Furthermore, many SOE managers feel their main objective is to maximise employment, and are loath to dismiss workers unless the enterprise faces financial collapse (Meng and Perkins, 1996).

In 1992, the Third Plenary Session of the Fourteenth National Congress of the Communist Party of China endorsed a decision to establish a socialist market system and assigned top priority to the reform of SOEs. SOEs were required to establish a modern enterprise system. The main elements of the directive were to clarify ownership of capital in each SOE and allow SOEs to operate independently from the Government. A board of directors is eventually expected to represent the interests of the owners or shareholders in each SOE while a general manager and other senior management staff will be responsible for the operation of the enterprise. The Government now collects taxes from SOEs at the same rate as it does from private and joint venture companies. The Government will also collect dividends from SOEs as a shareholder. Should the SOEs go bankrupt, the government has limited liabilities regarding the debt of the SOEs. As mentioned above, thousands of SOEs across the country have experimented with this so-called process of corporatisation, but there is still a long way before this process is complete and the new system has a significant impact on SOEs' operations (see case 7).

Another important component of establishing the modern enterprise system is to update technology and equipment in SOEs and to aggregate resources to use production resources more efficiently. Each SOE reform has required the updating of existing technology. Smaller SOEs in the same industry have been merged to achieve economies of scale in production. There have also been attempts to utilise idle production support facilities in SOEs.

After about 15 years of economic reform, most SOEs are now able to operate, to a greater or lesser extent, in a market environment. Economic reform has enabled them to make their own production plans, set prices, purchase inputs and sell outputs within a market structure. As a result, many SOE managers have become skilful entrepreneurs.

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[11] The Government reserved the right to issue a mandatory instruction when necessary.

[12] Government departments may see the SOEs they govern as a source of rents. They constantly ask SOEs to donate funds, goods, equipment and manpower to various social projects and occasions.

At the same time, a number of issues have emerged as the main constraints to the development of SOEs. These constraints include continued government involvement in business decisions, heavy social responsibilities or inappropriate incentives to provide excessive benefits for workers resulting in financial burdens for SOEs, inadequate incentives to reinvest in enterprises resulting in outdated technology and equipment, large debt to assets ratio in many SOEs, over-staffing and redeployment problems, and inadequate sources of motivation for managers and workers.[13] These factors all constrain SOE profitability.

Characteristics of the individual case studies

Nine medium to large SOEs situated in different geographic locations - the south east coastal region, the central inland provinces and the north east - were selected to examine the different pace and nature of economic reforms in various regions of China. The south east coastal area is more liberal and advanced in the economic reform process. The inland provinces are less developed and the north east is home to the oldest SOEs, many dating from the 1920s and 1930s which now face the greatest difficulties. The sample also covers a range of industries. Most importantly, the cases selected demonstrate typical issues involved in SOE reform and can thus contribute to the understanding of the process of SOE reform in China.[14]

Case 1 is a typical ‘big and complete’ SOE. It is a town by itself, occupying 36 square kilometres. One-third of its 47 000 employees conducted production support activities and another one third provided services for other enterprise workers. The task of becoming a lean and streamlined enterprise was very challenging for a big SOE like case 1. The major challenge for case 1 comes from its residual role in central plans, its obligation to find redeployment opportunities for redundant workers and the unwillingness of its governing authority to grant case 1 greater autonomy in making business decisions.

Case 2 is a form of holding company through which the Government controls several other SOEs. It demonstrates how the system of governing authorities functions. Representing the Ministry of Forestry, case 2 appoints managers to and collects profits from the SOEs it governs. It is one link in the chain of command that implements government policies such as investment for technological upgraging. Case 2 also supervises the performance of the SOEs it governs, using contracts which define detailed performance indicators for each SOE. Important business decisions made by the SOEs case 2 governs, such as the total wages bill and joint ventures possibilities with foreign investors, are subject to the approval of case 2’s management.

The experience of case 3 indicates the impact of SOEs’ social service obligations on their ability to generate profits. Case 3 would have made a reasonable profit in 1995 if some social services expenses were not included as production costs; for example, retirement benefits costs were at least ¥ 14.6 million (about $A2.3 million), and medical expenditure and other welfare costs were about ¥ 6 million (about $A0.9 million). Without these costs, case 3 would have made ¥ 20 million (about $A3.1 million) profits. Without the costs of providing housing and running a hospital, schools and a sanatorium, case 3’s profits would have been even larger.

However, it could be argued that SOEs have very little incentive to reduce their welfare

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[13] SOEs also have to contend with corruption which can increase business costs and distort policy intentions and implementation.

[14] Despite their many problems, the SOEs in the sample are in fact some of the better ones in China, and the cities are the richer ones in their respective regions. This may give the study an optimistic bias.

expenditures thereby increasing their profits, as workers and managers receive no benefit from paying over profits to the Government, while they do receive benefits from salary and non-salary benefits. Since managers have significant authority to allocate funds between welfare payments and profit remittances, after an agreed (negotiable) minimum, it may not be surprising that they opt for paying as low a level of profits as possible (Meng and Perkins, 1996).

Although case 4, like many SOEs, is subject to operational constraints such as a lack of direct foreign trade rights and controls by its line ministry, it is more streamlined than many of the other case study enterprises. Firstly, case 4 started enterprise reform earlier than most SOEs in China and has adapted fully to market competition. Secondly, the central enterprise of case 4 is a joint venture company with a Hong Kong firm. Thirdly, it has undergone structural change to become a joint-stock company (to be listed on the stock exchange). Finally it has turned most of its social service obligations into revenue generating businesses.

Case 5 has sold the land it previously occupied in central cities to help cover its losses and financial difficulties. Revenue from the land sale has enabled it to repay debts and retrench 400 permanent employees by offering voluntary redundancy packages. However, although it now makes a profit, it risks reversing this because the factors that made case 5 uncompetitive remain. These factors include a non-market oriented operational structure and social welfare payments which lead to much higher labour costs than those faced by its competitors.

In recent years, many management companies of state-owned assets have been established in China; case 6 is a model example. Instead of managing its SOE subsidiaries in a conventional way by being involved in their business activities, case 6 uses an internal financial centre to ensure their assets are increasing in value. Case 6 operates in a more market oriented environment in a special economic zone and provides its managers and workers fewer social welfare benefits and greater financial incentives for higher performance. The experience of case 6 suggests that a market oriented and a deregulated environment as occurs in the progressive provinces is important for SOE reform.

The process of SOE reform in case 7 is typical of the government’s approach to reforming medium to large SOEs. The government first established a joint-stock framework, then appointed an asset management company as the entrusted owner of the state-owned shares in the SOE. Thirdly, the Government sought partners to diversify its ownership. Case 7 is also a typical example of how difficult it is for a new system to be grafted onto the old. During the process of reform, the local government has tried to separate case 7 from the local bureaucratic system and from the administration of a governing authority. A machine tool enterprise group was established to manage case 7’s state-owned assets. However, as interest rates and other indirect macroeconomic control mechanisms have not been fully developed, the Government still expects the governing authority supervising case 7 to implement government policies, such as direct quantitative control over investment, wages and sometimes output levels. Local government attempted to achieve this by old central planning methods through close supervision of the line ministry.

Although case 7 was restructured as a joint-stock company, it will be a long time before it operates effectively under the new system, with full authority resting with its board of directors and enterprise chairman. As the state owns more than 80 per cent of the enterprise, it is likely to continue operating under the conventional governing authority and SOE system. The experience of case 7 indicates the importance of reforming the macroeconomic environment in which enterprises operate, ensuring SOEs are made responsible for investment decisions and reforming the banking sector so that interest rates can effectively allocate investment capital.

Case 8 demonstrates that a market-oriented mind set is crucial for SOE managers to keep their enterprises operating given the many constraints they face, including heavy debt obligations and welfare payments and great pressure to maintain wages to employees.

To met these demands, the management of case 8 built up the enterprise's client base and are expanding its export market by obtaining foreign trade rights for cotton products. Because of its marketing capacity, it has merged with loss-making, state-owned textile mills and absorbed their extra production capacity and workforces.

After more than 15 years of economic reform and rising income levels, China has a large supply of consumer goods. Consumers are now able to demand quality products; poor quality clothing, for example, is no longer in high demand. SOEs must produce better quality goods, and establish exclusive labels to suit changed consumer preferences. Case 9 has attempted to meet this challenge.

The experience of cases 3 and 9 raises the issue of optimal resource allocation. Cases 3 and 9 have received credit for large investments; however, they did not generate commensurate returns. Instead, these injections of funds only enable them to cover their costs and continue operating. A comparison of the management of Case 3 and Case 9 with that of the joint-venture subsidiary of case 3 indicates the latter is more efficient in its use of investment funds.

Common problems

SOEs face many similar problems, resulting from their common historical and ideological roots.

Continued government involvement in SOEs

Although efforts have been made to allow SOEs to operate independently from government, governing authorities and other government departments are still involved in major business decisions of SOEs in a number of ways. This is evident in all the case studies.

First, SOE governing authorities and personnel departments appoint senior managers. Second, although SOEs can determine wages and bonus payments for their employees, the total wage bill of SOEs must be approved by SOE governing authorities.

Third, to secure bank loans to update technology and equipment or to invest in new production lines and factories, SOEs have to apply through their governing authorities and other relevant government departments.[15] The State Economic and Trade Commission and its corresponding departments in provincial and municipal governments approves technological updating projects while the State Economic Planning Commission or the corresponding authority in provincial and municipal governments approves investment in new production lines and factories. Provincial and municipal governments can approve projects valued at less than ¥ 30 million (about $A4.7 million).

Fourth, important business decisions, such as merging with another enterprise or becoming a joint venture business with foreign investors, are subject to the approval of governing authorities and other relevant government departments. Fifth, some commodities are still subject to central planning controls.

Sixth, most SOEs do not have the right to directly undertake foreign trade, but have either to sell their products to a state-owned foreign trade corporation or engage such a corporation to act as their agent. To obtain foreign trade rights, SOEs must apply through their governing authorities and other relevant government departments, such as the Ministry of Foreign Trade and Economic Cooperation, State Economic and Trade

[15] However, some large SOEs can make decisions over smaller investment projects (see case 1).

Commission and their corresponding department in provincial and municipal governments. Since SOE reform began, only a limited number of large SOEs have received foreign trade rights. For example, the Ministry of Foreign Trade and Economic Cooperation granted the right to import and export cotton products to 13 state-owned textile mills in 1994 and to a further 9 mills in 1995. On the other hand, all foreign funded enterprises have foreign trade rights.

Seventh, the central government's macroeconomic instruments still include direct quantitative control of bank lending (and hence investment) and sometimes output levels of SOEs, which the governing authorities of SOEs must implement these controls. Although the central government has tried to establish and develop financial markets, interest rates have not been fully established as an effective macroeconomic control or credit allocation mechanism. In addition banking sector reform cannot be implemented without parallel SOE reform as SOEs are the banks' major borrowers. The massive losses incurred by the SOEs have put the banks in a very difficult financial position. Furthermore, banks themselves are SOEs subject to government intervention in their business activities; although the private sector are often more reliable borrowers, the banks must lend to SOEs. In line with their commercialisation efforts, the banks now prefer to lend to promising SOEs, but must also provide stability loans for wage and welfare payments to some loss-making SOEs.

To reduce government involvement in the operation of SOEs, several government industrial ministries and bureaux have been turned into industry associations or management companies of state-owned assets. For example, industrial bureaux in Shanghai have been transformed into management companies of state-owned assets. The Ministry of Textiles was turned into a textile association and became less directly involved in SOEs management. Instead it now plans the future of the textile industry and liaises between SOEs and the relevant government departments.

One of the practical difficulties in ownership reform is that it is often hard to identify which government department owns the assets in a particular SOE. For example, Wuhan Iron and Steel Corporation received investment from the central government, but was then assigned to the Hubei provincial government. It is not clear whether the owner of Wuhan Iron and Steel Corporation is the State Council, the Ministry of Metals, or the Hubei provincial government. A more complicated example is Zhong Guan Cun, a Beijing street of high-tech electronic companies. These companies took out bank loans guaranteed by the central and local governments. Now they have developed into large corporations. It is very hard to clarify who owns these companies as banks are not allowed to hold shares in enterprises.

The reform process of SOEs is also complicated by the power struggle between different government departments and between SOEs and their governing authorities. The general corporations that govern SOEs want to maintain their superior positions while the enterprises they are governing want to become independent enterprise groups.

Poor people management

One of the core problems of SOEs is their poor personnel management and motivation, due to inappropriate incentives and a misconception of the role of employees in productive enterprises.

Lack of motivation of many SOE managers

The case studies indicate that SOE performance is closely correlated with their senior management's performance. In profit making SOEs, the managers are dynamic, ready to respond to price incentives and take responsibility of making important business decisions rather than leaving this in the hands of their governing authorities.

After more than 15 years of economic reform, price incentives have proven to be effective in the economy at large. However, the Government still encourages 'sacrifice' and 'free contribution' from their SOEs' senior management. The income received by good SOE managers is minimal compared with the profits they make and the salaries of

private sector and joint venture managers. The resulting dissatisfaction of SOE managers is reflected in their loose control over operational costs, including business entertainment, executive cars, overseas trips and long distance phone bills. Incentives to make profits are low, when loss making managers earn nearly as much as profit making ones. Allowing SOE managers and employees to own a share in their enterprises and relating their salaries to profits could positively motivate them and reduce the stripping of state-owned assets. A very high proportion of wages could be paid as profitability related bonuses to reward improved enterprise performance as occurs in case 6.

Turning loss making SOEs into profit making ones requires the development of an effective market for senior SOE managers, where profit making managers are rewarded fairly and loss making managers are penalised. To this end, some big corporations recently have tried paying managers a high yearly salary (hundreds of thousands of yuan). Shenzhen is also experimenting with a system of relating mangers' salaries to profits (East Asian Analytical U nit).

Changing ideology of SOE employees

SOE workers are accustomed to their enterprises taking full care of them. They also believe they hold an iron rice bowl as a right and do not need to work hard to earn the wages and benefits they receive. Thus they do not find attractive non-permanent jobs which do not provide subsidised social services. Furthermore, many expect the Government or their enterprises to find jobs for them. As a consequence many non-permanent, labouring positions remain unfilled despite many SOE employees waiting for redeployment.

However, the ideology of SOE workers is changing. Many dynamic people have left SOEs to set up small private businesses. In some areas, such as Liaoning province about one third of SOEs cannot afford to pay their employee wages, forcing workers to accept they had to survive by themselves. Some have left SOEs and become very successful small business people.[16] Most others in big cities can find labouring work or employment in the service sector unless they are unwilling to work.[17]

Overstaffing and social stability

China's SOEs employ about 100 million people or about 75 per cent of the urban industrial workforce. About 30 per cent of SOE employees are considered surplus and should be dismissed in the process of SOE reform. It is estimated that the resultant unemployment benefits would be about ¥ 30 billion ($A4.7 billion), assuming these people can be re-employed within 18 months (Ma, et al, 1996).

Since a fully funded social security system is not yet in place and the Government already runs a large budget deficit, the Government believes paying social security benefits to so many unemployed is beyond its means (Ma, et al, 1996). Consequently, to avoid social instability, SOEs are only allowed to lay off employees if they are in dire financial straits. All the nine case studies have attempted to set up small businesses, mostly in service sectors, to accommodate their redundant employees. Cases 4 and 8 have been successful; case 1 has been ineffective.

In 1993, the Government started a fund to finance the payment of unemployment benefits and the retraining of unemployed people. SOEs and their employees are required to contribute a percentage of the employees' wage to the fund. By the end of 1995, 95 million people had joined the scheme and 2.5 million people drew benefits from it in 1995 (Chen, et al, 1996).

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[16] The local government has created a favourable policy environment and cut down bureaucratic red tape so that it is easier to establish small private businesses.

[17] It should be noted that training and further liberalisation in service markets is important for these SOE employees to have access to decent jobs with career paths.

High indebtedness

Heavy indebtedness due to poor investment decisions is another important effect and cause of weak SOE performance. The debt to assets ratio for the nine case studies ranged from 43 per cent for Case 3 to 78 per cent for Case 6. On average, the debt to assets ratio of China's SOEs in is about 70 per cent (Ma, et al, 1996). Consequently, interest payments represent a large cost for most SOEs.

The level of bank loan debt has increased rapidly since the mid 1980s but frequently has not been used efficiently, with a proportion of bank loans being used to pay wages and welfare benefits to SOE workers. In addition, loans to finance production improvements activities may not have been used efficiently. SOE managers new to a competitive market system in the 1980s made poor business decisions and the banks based their lending decisions on the approval of relevant government departments rather than prudential calculations of returns and risks. SOE managers also bear no personal risk for their borrowing decisions, unlike private entrepreneurs or directors of companies.

Most importantly, many SOE managers still think of bank funds as state-owned assets to which SOEs should have free access. Therefore, SOE managers often do not feel obliged to repay bank loans. To date, SOE managers have not lost their jobs when they build up unsustainable debts, as long as they do not directly expropriate the money.

Although many SOEs make losses and have assets less than their debts, bankruptcies are uncommon because the Government believes they could affect social stability.[18] Combined with increasing unemployment, widespread bankruptcy of SOEs probably would lead to chaos in the banking sector. A bank failure could lead to social instability as household savings have replaced government savings as the main financial source of banks. In 1993, the increase in household deposits and cash in hand was about 60 per cent of the value of investment in fixed assets in that year. In the same year, the total value of household deposits in banks was about 85 per cent of the value of outstanding debt of industrial SOEs (Ma, et al, 1996).

Triangular debt

Another major form of debt is triangular debt. Triangular debt occurs when a SOE purchases materials from an upstream enterprise but fails to pay for the materials. If a SOE cannot collect payment for its output from a downstream SOE, then it cannot afford to pay for the materials bought from its upstream suppliers. As a result, firm A owes firm B money, firm B owes firm C money while firm C owes firm A money. Triangular debt expands when SOE commodities become unsaleable but basically is caused by a failure to enforce payments for goods supplied, ultimately by foreclosure on the debtor company.

Factors contributing to the current severity of triangular debt include the surge of construction projects in 1991. In many construction projects, promised bank funds were not released because of the credit squeeze introduced to control inflation. Construction companies could not afford to pay for ordered building materials. The surge of imports of iron and steel products and oil in 1993, shortly before credit rationing ended the consumption boom meant many iron and steel and oil producers could not sell their products and therefore could not pay the suppliers of their inputs.

However, the real cause of triangular debt is the failure to implement bankruptcy laws. Triangular debt chains do not build up in market economies, which have similar swings in the business cycle, because once a company fails to pay its debts, it is liquidated. Its creditors receive payment (or at least part payment) from the sale of those assets.

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[18] Many SOEs provide employment for the children of their employees. As a result, many families depend on one SOE. For example, the grandfather receives retirement benefits from the SOE, the son and the daughter-in-law work in the SOE, and the children go to schools run by the SOE and expect to find employment in the SOE when they finish school. Therefore, bankruptcy in any SOE is likely to have a significant social impact.

Because technically bankrupt enterprises are allowed to keep operating in economies such as China, spectacular triangular debts accumulate. The level of triangular debt is very high. For example, the overdue accounts receivable from case 1's oil products were more than its annual profits in 1995. Case 8's overdue accounts receivable mounted to more than half the value of its fixed assets. Triangular debt has grown rapidly in recent years. For example, by March 1994, triangular debt was about ¥ 55 billion ($A8.6 billion) in Liaoning province alone, growing by ¥ 9 billion ($A1.4 billion) in the first quarter of 1994 alone (Zhang, 1995). The Government has set up a task force to deal with the problem of triangular debt. In the past its solution has been to pay off a proportion of these debts, but this has only provided temporary relief and probably exacerbated the long term problem by reducing the consequences for managers who run up debts they cannot repay.

Social welfare payments and underdeveloped service markets

In the past, SOEs paid low money wages but provided many free or subsidised social services. Since reforms commenced, SOEs have increased dramatically spending on both wages and welfare services, such as housing, health, education for children and even subsidised food, for their employees. These high labour costs reduce the competitiveness of SOEs as few of their competitors provide them. They also eat into profit payments made to the state.

Wages plus welfare subsidies can amount to ¥ 20 000 ($A3 000) per year for an average worker in an SOE (see case 5) well above the wages of ¥ 6 000 ($A937) per year paid by a typical township enterprise. In addition to housing, health care, education and retirement benefits, other expenditures ('bath and hairdressing' fees and gifts to employees) can be significant. In case 3, for example, expenditures on these items amounted to ¥ 1 million per year in 1995 when profits were only ¥ 28 000.

In all the case studies, reform to reduce social welfare expenditures in housing, medical and educational services has been limited. Some SOEs sought permission to open their hospitals and schools to serve a broader market in order to recover part of their costs (for example, cases 5 and 8). Some tried to sell residential houses to employees at below cost prices to raise funds to construct more residential houses for employees still on a waiting list (for example, case 3). Coordination in these areas at a municipal or national level would lead to increased economic efficiency. First, community access to SOEs service facilities would boost the supply of such services to all people in a region, increasing the scale and efficiency and improving the quality of SOE provided services. Second, allowing entry of alternative suppliers of services, such as private and foreign businesses, could lead to vigorous competition in the supply of services, again improving quality and cutting costs and waste and enabling SOEs to shed non-core activities and turn subsidies into explicit wage payments.

Housing

Most enterprises in China, including SOEs and enterprises run by investors from Hong Kong and Taiwan, provide housing for their employees because affordable alternative housing is scarce.[19] Most urban residents, including those in joint venture or foreign firms earning 6 to 10 times the wage of a SOE employee or a public servant, still live in houses constructed by either a government department[20] or SOEs.

The private property market in China is just starting to emerge. Most residential properties for lease or sale are expensive luxury dwellings for foreigners and the few

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[19] In some cities, the local governments construct housing at the cheaper end of the property market for people who are living in extremely crowded conditions. However, the situation of insufficient supply of low cost housing is far from resolved.

[20] Government departments also provide housing for their employees.

rich Chinese. In the current environment, private developers do not build cheap houses for lease or sale although the financial capacity to buy such housing exists in the private sector.[21] In particular, the rental market for low cost accommodation is underdeveloped. The development of such a rental market requires simultaneous reform in the housing policy of SOEs and government departments to create a willingness to supply and a demand for rental housing. At present, most demand for rental housing comes from rural people seeking employment in urban areas.

If the Government creates a policy environment that allows the entry of alternative suppliers of affordable housing, overall housing prices are likely to decline sharply. Vigorous growth in the private property market could provide the necessary pre-conditions for SOEs to shed their housing responsibilities. At the same time, they could turn part of their expenditure on residential housing into explicit wage payments. Real estate companies run by SOEs would also grow.

Medical care

SOEs provide free medical care, including visits to doctors, hospital care and medicines, for employees. As well as running hospitals, many SOEs reimburse large sums for employees' medical expenses (for example, case 3).

Free medical care for SOE employees results in an alarming waste of resources. The health care facilities usually are not utilised fully as each SOE has its own health facilities operating at an inefficient scale. For example, in east Beijing, three state-owned textile mills on the one street each runs its own hospital. The quality of the service is low because good doctors are attracted to larger hospitals with more patients. Secondly, control on medical over servicing is difficult as the service is free.[22]

Many SOEs (for example, case 3) charge small fees for medical services to reduce wasteful behaviour by employees, such as stockpiling medicines at home. In some areas, such as Hainan province and Zhenjiang city in Jiangsu province, medical care insurance systems have been established. In Zhenjiang city, SOEs and their employees contribute 11 per cent of the employee's wage into a medical care fund (10 per cent by SOEs and 1 per cent by the employee). Half the medical care money goes into a personal account for each SOE employee to pay their medical expenses for small illnesses; half the money goes to a fund managed by the municipal government to pay for serious illnesses. Other insurance funds for work injuries and maternity have also been established.

As with the housing market, not everyone has access good and convenient medical services. In addition to enterprises' medical services, local government health departments provide hospitals, but migrant workers do not have access to these and a visit to the doctor is time consuming and the quality of service is often poor. There are no small private or government-run medical clinics where people can get access to good quality and convenient medical services exist. Introducing proper price incentives into the medical service sector and increasing community access to SOE facilities might help improve competition and thereby the quality and availability of the services.

Retirement benefits

SOEs, especially those established in the 1950s and the 1960s, have many retired

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[21] The private sector has been growing rapidly in the past 15 years. By the end of 1994, the number of registered private businesses had grown to 432 000 and the amount of capital registered by private businesses had reached ¥ 144.8 billion ($A22.6 billion). These private businesses provide employment for about 6.5 million people (Yi, et al., 1995, East Asia Analytical Unit, 1997). Some private entrepreneurs have accumulated assets worth billions of yuan.

[22] As medicines are free, SOE employees may take home medicines they did not really need and sell them to those such as farmers who do not have access to free medical care.

employees. In many old SOEs, numbers of retired employees equal the numbers of working employees. SOE retirement benefits obligations are another large labour cost for such firms.

The Government established an insurance fund to pay retirement benefits in 1991. By 1995, more than 90 per cent of SOE employees had joined the scheme (Chen, et al., 1996). In most areas, the scheme has also been extended to non-SOE employees.

However, at present, most new insurance funds, including the medical, unemployment, work injury and retirement funds, do not have the accumulated assets to function properly. Some SOEs complain that these funds are merely an extra impost and are still waiting for benefits to accrue (for example, cases 5 and 8). The management of these funds and therefore their ultimate value also could be a problem as most funds are managed by government departments rather than by professional fund managers.[23]

Schools and kindergartens

Although SOEs pay an educational tax, they still run schools and kindergartens for their employees. Many SOEs complain that their schools are small scale and inefficient, providing poor quality education (for example, case 4). However, local education departments usually cannot afford to take over all the schools run by SOEs, and for schools that are taken on by local education departments, SOEs sometimes must continue to make financial contributions (for example, case 1).

Out-of-date technology and equipment

Under central planning, the management of SOEs was not motivated to update technology. The contract responsibility system introduced in the mid-1980s has not altered this, although some managers have undertaken longer-term investment when technology upgrading was included as a performance indicator in their contracts (for example, case 2).

As a result, equipment in medium to large SOEs is, on average, 10 to 20 years out of date. In the north east provinces, 70-year old equipment is still operational. Currently, about 19 per cent of equipment (including the ongoing updating projects) in medium to large SOEs is of early 1970s vintage, about 17 per cent mid 1970s, 30 per cent early 1980s, 29 per cent mid-1980s, and only 4 per cent early 1990s vintage (Zhang, 1995). Most technology and equipment in the nine cases studies is 10 to 20 years out-of-date, yet all these SOEs, except case 8, have conducted technology transformation projects in recent years.

Since 1992, the Government has instructed SOEs to update their technology and equipment, offering financial support to many large and well-performing SOEs for this purpose. However, these equipment upgrading projects may not be economically efficient; expensive machines or production lines may be under-used due to non-optimal investment decisions (for example, case 9).

Policy implications

Although different ideological views exist within the top leadership, the Government has made a significant step in SOE reform by accepting the need for partial reform of ownership and corporate structures. However, such partial approaches may not to resolve the serious problems prevailing in SOEs. Short of full privatisation, the performance of SOEs could be improved by introducing price incentives, a liberalised policy environment in the markets for senior SOE managers, housing and medical

[23] In China, skilful fund management is not yet widespread.

services, and by changing the mechanism of implementing government policies, notably the governing authority system.

In the past, liberalisation in goods markets has turned supply of commodities from scarce to plentiful, dramatically improving living standards. Further liberalisation in service markets could relieve SOEs of their social responsibilities and further improve living standards by providing better services and employment opportunities.

Although experiments in SOE reform have been conducted in medium to large SOEs, they have not been very effective in achieving their objectives for several reasons. First, the steps taken so far to introduce shareholding and diversified ownership into medium to large SOEs have been very cautious. While liberalisation in the banking sector requires significant progress in SOE reform, further progress in the liberalisation of stock markets including acceleration of stock market listing of eligible companies would facilitate SOE reform. Second, the reform of medium to large SOEs could benefit from complete reform within selected regions. Successful SOE reform requires successful supporting reform in government functions, social security and factor and service markets, as well as a dynamic non-state sector to provide competition and absorb redundant workers. In all these sectors, more comprehensive reform throughout a region is likely to be more effective than isolated experiments in each individual SOEs. For this reason, SOE reform in progressive coastal provinces and special economic zones has been more effective than in more conservative hinterland provinces.

The nine SOE case studies

Case 1

Case 1, a petrochemical corporation in an inner north province, ranks highly among the 500 strongest industrial enterprises in China. At full capacity, it processes 9.5 million tons of crude oil per year and produces 227 grades of 102 types of petrochemical products. At present, case 1 processes about 6.5 million tons of crude oil per year and produces about 4.5 million tons of various oil products, more than 1 million tons of synthetic and chemical raw materials, and about 5 million square meters of chemical fibre carpet.

Crude oil and some oil products, such as petrol and diesel, are still subject to central planning of output and input prices. Because of this, case 1 receives an allocated amount of crude oil and most of its products are sold through state controlled channels at controlled prices.

Case 1 covers 36 square kilometres and has about 47 000 employees. In 1995, case 1 had about ¥ 12 billion ($A1.9 billion) of fixed capital and its sales income was about ¥ 17.5 billion ($A2.7 billion). Profit for the year was about ¥ 1 billion ($A156 million) or about 8.2 per cent of fixed assets.

Governing authority

Case 1's governing authority is China Petrochemical General Corporation (SINOPEC) which is, in turn, governed by the State Council. SINOPEC governs 14 petrochemical SOEs whose profits it submits to the central Government.

In addition to collecting profits, SINOPEC also allocates raw materials, plans for the centrally controlled items, approves investment projects and funds, and appoints the manager and deputy managers of enterprises under its control. The State Council and relevant Ministries, such as the State Economic and Trade Commission which is responsible for the final approval of technology upgrading projects also approve investment projects and funds and the appointment of managers. Middle level managers are not appointed by SINOPEC but within case 1 itself. The general manager of case 1 proposes candidates for middle level management positions and the suitability of the candidates is then discussed at an expanded meeting of the Communist Party Committee of case 1. Subject to its approval, the candidates are appointed by the manager of case 1.

Despite its huge size, case 1 does not have foreign trade rights. Crude oil used in production is sourced domestically and its products are exported through a foreign trade company which is a joint venture between case 1 and its governing authority, SINOPEC.

Corporate structure

Like many other large SOEs, case 1 was constructed under the principle of 'big and complete' with access to free capital to install almost all facilities it needed. In addition to seven core production factories, it has its own machinery, instrument and overhauling and maintenance factories, three research institutes, a computer centre, petrochemical school, power plant, waste water treatment plant, pipe line network, construction company, telecommunication station and fire fighting services. About 30 per cent of case 1's staff, 14 000 people, work in these support activities, which only service case 1. Consequently, most of these facilities have low capacity utilisation and add considerably to the running costs of case 1.

Case 1 provides full welfare services for its employees, including housing, medical services, and children's education. It has a central hospital, sanatorium, passenger transport company, schools, kindergarten, hotel and dining halls. These service facilities have 13 000 employees (nearly 30 per cent of staff) and provide services at subsidised

prices only to the employees of case 1. Case 1 pays all running costs of the service facilities, including wages and welfare benefits of the 13 000 employees.

Only 40 per cent of staff (about 20 000 people) work in case 1's mainstream activities. However, the seven production factories have only about 8 000 workers. The remaining 12 000 employees form the 'technical and managerial staff' comprising 800 senior managerial and technological employees; 8 000 lower level managers, engineers and technicians; and 2 000 to 3 000 clerks.

Case 1's production factories produce goods; its supply and sales department handles input purchase and sales; while its headquarters with its 45 departments, handles production and investment plans and financial and other matters. The high ratio of support and service employees to core production workers and overstaffing in both production factories and headquarters departments result in case 1's low profitability (measured as profits divided by fixed capital) of 8 to 9 per cent.

The extent of overstaffing is very serious by both local and international standards. For example, when case 1 formed a joint venture with one of its workshops employing 180 workers, the foreign investor required only 30 employees. Case 1 had to redeploy 150 redundant employees to other parts of the enterprise.

In addition to the costs of support and service activities and overstaffing, case 1 also pays retirement benefits, medical expenses and housing subsidies to its approximately 6 000 retired employees.

Debt and triangular debt

In recent years, case 1's debt to assets ratio has hovered between 50 to 60 per cent; most of this debt is in bank loans. Case 1 pays promptly for its raw materials and requires customers of its chemical products to pay on delivery. However, case 1 cannot apply this policy to its oil products due to its limited oil storage capacity. As a result, case 1's oil customers owe about ¥ 1.1 billion ($A 172 million). This is more than the enterprise's total profits in 1995.

Reducing labour costs

Many attempts have been made to reform case 1, aimed in particular at reducing its high cost structure. Case 1 has already made about 9 000 employees redundant, using the staff levels in good local and foreign firms in the industry as reference points for these cuts. Case 1, however, must redeploy the redundant employees because the Government will not tolerate massive unemployment as a result of SOE reform.

To create employment opportunities, case 1 has established some service businesses, such as restaurants and hotels. These service businesses are profit driven entities. They pay higher wage packages to their employees if the businesses are profitable. Gradually, these service businesses have stopped receiving wage and bonus payments from case 1, and even started to pay it some rent for their fixed assets.

Case 1 has also established trading companies and small joint operation factories to employ redundant workers. These businesses can purchase products from case 1 at subsidised prices. Some of these businesses have been successful in their independence and no longer need the subsidy from case 1. In a few years, these businesses may be independent. These and the service businesses that case 1 has set up to redeploy redundant workers are collectively owned either by all of case 1's employees or by the small businesses' employees.

Other measures to reduce overstaffing include early retirements, training, and redeployment through internal and local government career centres. To further reduce running costs, some service facilities, such as the primary and middle schools have been transferred to the education department of the local government. However, because case 1 still has to contribute financially to these schools, this has not resulted in large savings.

To reduce retirement benefit payments, case 1 has joined the local government's superannuation system. Each month, an amount equal to 50 per cent of each employee's

wage is paid into a superannuation fund. Case 1 contributes 45 per cent and employees contribute 5 per cent. Over the long term, these contributions will help case 1 stabilise retirement benefits payments, but currently they significantly add to costs.

To further reduce the costs of support and service activities, case 1 plans to let these activities become independent. Support factories and service companies, such as the construction and overhaul teams and the passenger transport company, will service consumers outside of case 1 and be responsible for their own profits and losses.

Restructuring

Case 1 is in the process of negotiating its reform plan with its governing authority and other relevant ministries, such as State Economic and Trade Commission and State Economic System Reform Committee. So far, they agree that case 1 will undergo restructuring to an enterprise group that is wholly owned by its governing authority, SINOPEC. While case 1 will not become an independent enterprise group, but will remain attached to SINOPEC, case 1 will establish a new internal management system similar to that of an enterprise group. The reform is likely to bring case 1 more autonomy in making internal management and business decisions, although the governing authority will still approve major decisions.

Under the new system, the chairman of a board of directors rather than the manager of Case 1, will be the legal person of the enterprise. The manager will be responsible for operating case 1 under the direction of the board. The board will comprise the manager, deputy managers, chief engineer, communist party secretary, representatives of employees and other key personnel. However, as case 1's governing authority will appoint the chairman of the board, decision making and the staff involved virtually will remain unchanged as long as the government remains its sole investor through SINOPEC. As the sole investor of case 1, SINOPEC retains its responsibility for allocating raw materials, approving the overall wage level, controlling export rights, approving any investments greater than ¥ 5 million ($A0.8 million) and other key business decisions.

Some of the Case 1's petrochemical plants will become independent or evolve into joint ventures. The remaining factories, together with the power plant, research institutes, telecommunication station, and waste water treatment plant, will form the core part of case 1's new enterprise.

Updating production facilities

Case 1's production plants were constructed from 1969 to 1978. The allowable depreciation rate on capital was as low as 3 to 4 per cent, but in recent years, has increased to 11 per cent. Most of the original plant and equipment is still operational, making its capital stock around twenty years old. However, the SOE reform has helped case 1 to update its production equipment. In 1995, case 1 completed a technology transformation project worth ¥ 2.8 billion yuan ($A438 million) in one of its production factories, financed by Bank of China loans.

Difficulties in implementing the reform

Although case 1 has adopted and planned measures to reduce the costs of support and service activities, and overstaffing, it has had only limited success. This is because, in the interests of social and political stability, case 1 has not been allowed to lay-off workers, but has been forced to support them in new activities which are still dependent.

The ability of supporting groups and services to become financially independent from case 1 depends on the skills of their staff. However, the managers of the enterprise construction teams, for example, have limited marketing experience and market oriented management skills and face intensive competition from low-cost contractors from rural areas. If these groups fail to compete, case 1 has to continue subsidising them. This applies to all the small businesses that case 1 has set up. The hotel, restaurant and retail businesses of case 1 have been more successful because they were liberalised and started to integrate into the market place early, and were liberalised early.

Many of case 1's products are subject to central planning, that is, case 1 is obliged to sell certain products to customers appointed by the Government and at prices lower than government determined, ceiling prices. For example, the Government instructs case 1 to supply liquid gas to consumers in the local area. The obligation forms a barrier to the independent operation of case 1; without the obligation, case 1 could charge much more for this gas in the open market. However, the Government believes it is necessary to continue supplying daily necessities such as liquid gas, at subsidised prices to maintain social stability.

Allowing SOEs to operate independently is likely to result in a redistribution of administrative authority and interests and thereby involves lengthy and difficult bargaining processes. A similar situation applies to the removal of the social obligations on SOEs. The most difficult aspect of SOE reform is ownership reform. Allowing employees to own some stocks in case 1, preferably with managers owning more shares than workers, is likely to improve incentives in the workplace. This, in turn, can facilitate personnel management and increase efficiency. Managers in SOEs often fail to apply strict discipline on workers for two reasons. Firstly, because the ownership of SOEs has not been clarified, the workers consider themselves owners as much as the managers. They are all 'masters' of the enterprise. Secondly, the skills and effort of good SOE managers is not fully recognised by the community and is not appropriately reflected in managers' remuneration packages. As a result, many SOE managers lack commitment to their work and tend to extract higher psychic and actual income using their power to allocate SOE resources. This reinforces the disrespect workers feel towards some SOE managers.

As petrochemical products are in high demand in China and imports are restricted, case 1 makes a profit despite its many serious efficiency and human resource management shortcomings. However, if case 1 started to make losses, these entrenched structural problems would make it very difficult for it to re-achieve profitability.

Case 2

Case 2 is a general corporation through which the Ministry of Forestry controls its forestry machinery factories. It is therefore the governing authority of the five factories, five trading companies and two research institutes attached to it. These subsidiaries are in big cities: four of the five production factories are in Jiangsu province. Some of these factories have become joint venture businesses with Japanese and Korean companies.

Case 2's factories produce forestry machinery, such as cutting machines, fork-lift trucks, woods shaving machines, plywood equipment, woodwork machine tools, excavators and motor chain saws. In 1995, Case 2 made about ¥ 70 million ($A10.9 million) profit with a sales revenue of ¥ 1.1 billion ($A172 million).

Equipment and technology

Case 2's production factories were constructed in the early 1960s with original fixed capital of ¥ 270 million ($A42 million). Compared with other companies in the industry, case 2's factories are large scale. The technology and equipment of SOEs in the industry are, on average, 10 to 30 years old. In recent years, case 2 has invested about ¥ 200 million ($A31 million) updating the technology and equipment in its factories, making its technology on average only about 10 to 15 years behind that of industrialised countries.

The production factories need approval from case 2's headquarters to borrow funds for their technology upgrading projects. Once approved by headquarters, the proposal is sent to case 2's governing authority for approval, in this case the forestry industry department of the Ministry of Forestry. If this department approves it, the proposal is forwarded to the State Economic and Trade Commission for final approval.

Before 1985, funds for technology transformation approved by the State Economic and Trade Commission were allocated directly from the budget to case 2's factories. However, in the mid 1980s, the central Government stopped allocating funds to SOEs.

Now SOEs must borrow investment funds and working capital from the banking sector and pay interest on the loans. Once the technology transformation project is approved by the aforementioned chain of command, banks are allowed to lend directly to case 2's factories. Although case 2 has to seek approval from layers of government departments for investment funds, it is in a better position than most private and township enterprises that do not have access to this source of funding. Given the cash-starved situation in all firms in China, access to bank loans is a privilege.

Overstaffing

Case 2 has 6 000 to 7 000 employees. One of its factories has about 800 employees, the other four factories have between 1 000 to 1 600 employees each and the five trading companies each have about 20 employees.

Overstaffing is worst in the managerial and clerical divisions; overstaffing in the production divisions is less serious. Case 2 limits recruitment to only a few graduates from universities and technical schools. The few redundant production workers have been absorbed by moving production workers between production factories.

To deal with overstaffing in the clerical and managerial divisions, case 2's factories have adopted a system called 'optimal combination'. With optimal combination, the senior management of the factory appoints middle level managers. The middle level managers work out the minimum number of necessary work positions to undertake required tasks and appoint staff to fill these positions within the department they manage. The employees that are not selected in this process are identified as redundant. The redundant employees then wait for redeployment. During this waiting period, the employees attend internal training courses and receive base wages, which normally represent only a small part of total wage payments. If the waiting period exceeds a specified time limit, employees are only entitled to part of the base wage.

Some of the factories of case 2 go through an optimal combination every year; however, the headquarters has only gone through the process once. Departments employing optimal combination have significantly improved efficiency within the workplace.

Before the implementation of the optimal combination process, many SOE employees believed they were entitled to a standard level of income, regardless of their low productivity. The unwillingness of some employees to work negatively affected other employees but due to organisational rigidity transfers to other departments were not possible. However, optimal combination provides an opportunity for transfer within the group and has improved the working environment for employees by removing negative influences within the workplace. More productive employees receive higher wages than less productive employees and this maintains the enthusiasm of the active employees towards work. One important feature of the optimal combination process is it links worker productivity with wages and helps break down the myth of the "iron rice bowl".

Partly due to this process, case 2's production factories are making profits while about two thirds of the factories in the machinery industry are making losses. The employees in the four production factories in the inner southern province earn an average income of about ¥ 13 000 ($A2031) per year which is much higher than the national average.

Unlike some other SOEs, case 2 did not use the optimal combination system to reduce absolute staff levels; instead, it used it to combine resources more efficiently in the workplace and to reward hard work. Most employees identified as redundant in the optimal combination process were redeployed so the number of employees in case 2 has not changed over the past ten years. However, output has been rising considerably over this period, so labour productivity has improved.

Social welfare costs

Like other SOEs, case 2's production factories provide many social services for workers. Each factory employs staff to provide services such as a kindergarten, medical clinics and dining halls. However, due to the favourable social and economic environment in Jiangsu province, the burden is not as heavy as that of some other SOEs.

For example, some of the case 2's factories do not have schools attached to them; the children of the employees go to local government schools. One of case 2's factories located in Zhenjiang in Jiangsu province did have a primary school, but it handed this responsibility over to the local government. Also in some of case 2's factories, employees have access to medical insurance and superannuation. Medical insurance is extended to retired workers.

Management of subsidiary prod+uction factories

The production factories of case 2 have become more market oriented in that they purchase most of their inputs from markets (only a small part is allocated to them), set their own production plans and output prices, and sell their output in the marketplace.

Previously, case 2's headquarters and Ministry of Forestry's material distribution department allocated all production inputs, including transport and production equipment. The material distribution department used to be the distribution arm of case 2's output under central planning. Now, this department has been transformed into a company doing wholesale businesses in materials and equipment, using its old contacts. However, it still handles small quantities of centrally allocated items, such as steel, cement, timber, ferrous metals, and transport and other equipment.

As the governing authority of the production factories, case 2 appoints senior managers to its production factories and approves their total wage bill. The factories' senior managers then appoint their middle level managers. Case 2 also approves important joint venture and investment projects involving the production factories. Case 2 also provides guidance to the production factories through contracts with each of them.

These contracts require the production factories to hand in 30 per cent of their profits to case 2. Of this, case 2 passes on 83 per cent to the Ministry of Forestry and retains 17 per cent for itself. The contracts also list detailed performance indicators, such as technical transformation projects completed, new product development, and safety and quality indicators.

Finance for new product development and technological upgrading projects is procured by similar procedures. The factories seek approval through case 2, the Ministry of Forestry, then the State Economic Planning Commission. The local banks will lend to the factories only if the projects are approved through this chain of command. However, the State Economic and Trade Commission handles technology transformation projects; whereas, the State Planning Commission handles new investment projects.

Governing authority

While case 2's governing authority is the forestry industry department of the Ministry of Forestry, it also deals with many other departments within the Ministry of Forestry. For example, the personnel department of the Ministry of Forestry appoints senior management staff and approves the wage level of case 2. The financial department of the Ministry can help resolve temporary shortages of working capital. The appointment of middle level managers, such as the directors of the production factories, is determined within case 2; however, it must inform the Ministry of Forestry of its decisions.

Establishing a modern enterprise system

Case 2's application to commence experimental SOE reform was recommended by its governing authority, and the proposal was subsequently approved by the State Economic and Trade Commission. The Government employs a selective approach to SOE reform, providing some large and promising SOEs with financial support and a favourable policy environment but letting the rest survive by themselves. Case 2 was willing to be selected as an experiment for SOE reform as it believed it would receive government support thereby.

Through the reform, case 2 expects to gain more autonomy in business decisions, reduce some its expensive social services, reduce its debt to assets ratio, and modify its structure to suit the market system.

Case 2's debt to assets ratio was about 73.3 per cent at the end of 1994. Most debt is in bank loans which have accumulated since the mid 1980s. Because updating technology and equipment is one of the important components of SOE reform, case 2 expects an injection of capital from the Government to facilitate technology transformation. Case 2 also expects the Government will turn part of its debt into state-owned shares, thus reducing further its debt to assets ratio.

Case 2 plans to undergo restructuring to become a 100 percent government owned enterprise group. Under this restructuring, the enterprise group will have a board of directors, the chair of which will be appointed by the Ministry of Forestry. A general manager appointed by the board, will be responsible for corporate operations. A state-owned assets monitoring board comprising representatives from the State Economic and Trade Commission, the banks financing the enterprise, the financial and planning departments of the Ministry of Forestry, and the headquarters of case 2 will monitor the value of case 2's assets.

A board of directors will control each subsidiary company of case 2. Some subsidiaries will become limited liability companies owned fully by case 2. The joint venture production factories of case 2 will become joint stock companies. One of them was listed in the stock exchange in mid 1996.

Case 2 is at the stage of planning its reform with its governing authority and the State Economic and Trade Commission. The direction and consequences of the reform are unclear.

Case 3

Case 3, a large cotton mill in an inner northern city, was constructed in the early 1950s. It now has 127 000 ring spindles and 2 000 looms of various widths. It produces more than 40 types of yarns and 20 fabrics. Its main raw material is cotton. Over 80 per cent of its output is exported to Hong Kong, Western Europe, North America, Japan and South East Asia.

In recent years, China's textile industry has suffered from over capacity, forcing up input prices and reducing output prices. With the development of township enterprises in the industry, demand for cotton has increased dramatically. The price of raw cotton has more than 13 times since reforms commenced; however, the average price for cotton fabrics remains low because of excess production capacity and supply.

In 1995, in an attempt to control cotton prices, the Government instructed case 3 to reduce its level of output, and the Government started to recentralise partially the distribution of cotton. Under this government policy, case 3 obtains 75 per cent of its cotton through central plans and the remaining 25 per cent from the marketplace. Case 3 pays ¥ 17 000 per ton ($A2656 per ton) for the cotton supplied by the central planning channel. However, this cotton is low quality, of mixed grades, and unreliable in supply.

Case 3 survived 1995 without making a loss. However, the profit it made was a marginal ¥ 28 000 ($A4.4 thousand). In the first quarter of 1996 it recorded a loss.

Overstaffing and ideology

Case 3's workforce was reduced from 11 000 in 1988 to 8 000 by the end of 1995. In recent years, it has tried to reduce the number of production and staff employees by 400 to 500 per year.

The management of case 3 believes that to become profitable, staffing levels still need to be reduced considerably. They believe too many employees receive wages without contributing to production. The workers' mentality is still that the enterprise could never

go bankrupt, and, even if it did, workers would still be looked after.

Case 3 has about 3 800 production line workers. Temporary contract workers from rural areas occupy most production posts; the workshops are dirty and noisy environment and do not attract many permanent production workers with city resident rights. They prefer to work in office jobs in the enterprise's headquarters. Consequently, case 3 recruits rural workers who work hard in production jobs for more income than they can earn in rural employment.

Another important element of SOE reform is to introduce a mentality of market competition. Many employees were accustomed to achieving simple output targets and were not motivated to successfully manage the change to market conditions. For example, the sales employees waited for customers to come and buy their products rather than seeking out customers.

Those employees who are dynamic or have contacts leave for better jobs or start their own businesses, such as driving a taxi or running a small restaurant. These alternatives provide a much better income than working in an SOE. Taxi drivers in the local area can earn ¥ 3 000 to 4 000 ($A469 to 625) per month; whereas, the average wage of case 3 is about ¥ 600 to 800 ($A94-125) per month.

In 1995, 17 per cent of all case 3 employees worked in the enterprise's headquarters. Ten percentage points of these were clerks and the remaining seven percentage points held management or technical positions. This represents a large share of the workforce compared to a joint venture factory within the same industry which employs only 8.9 per cent of its workforce in its headquarters. Overstaffing reductions therefore started at its headquarters.

As in case 2, case 3 adopted an optimal combination process to reduce overstaffing. As a first step, case 3 restructured its headquarters departments and removed duplicating functions by identifying necessary positions. For example, the number of positions in the office of the Communist Party Committee was cut from 6 to 4. When the director of the office of the Communist Party Committee retires in 1996, the office will be closed altogether and case 3's manager's office will take on any necessary residual functions.

The second step in the restructuring was to appoint new middle level managers. Thirdly non-managerial staff members were asked to nominate the department in which they wanted to work and middle level managers selected their staff on the basis of merit from those available. After the positions were filled, remaining workers were identified as redundant.

To reduce overstaffing in production lines, case 3 also identified necessary positions in the production lines. Production workers' skills were examined. The more skilful were selected to fill production lines positions. Those employees not assigned to a position had a number of options. They could apply for early retirement, find another job if possible, report to the internal job centre and be assigned to a job in other parts of case 3 (such as the service companies case 3 established), or receive a base wage while looking for employment themselves. The base wage was ¥ 210 ($A33) per month.

The optimal combination system rewards the more efficient and hard working employees and introduces a sense of competition within the workplace. Since 1995, the local government has revoked permanent positions in SOEs and all of the employees of case 3 are now on contract.

To introduce a sense of competition, case 3 has also linked income to work results. For example, it linked the income of salespeople to the value of sales they made and the amount of revenue they collected. As a result, the sales employees have changed from sitting salesmen to moving salesmen and case 3's stocks have been reduced.

Production support facilities

Case 3 also has some production support teams, such as vehicle transport and construction teams. To reduce the financial burden and better use these resources, case 3 now contracts out these support teams to other enterprises. They charge market prices and

are responsible for their own profits and losses.

Social welfare expenditure

Case 3 has some service facilities, including a hospital, two guest houses, hairdressers, a kindergarten and dining halls. It is also responsible for the welfare of the retired employees.

Case 3 has about 4 100 retired employees receiving average retirement benefits of ¥ 480 to 700 ($A75 to 109) per month in 1996. The enterprise was forced to pay steep increases in retirement benefits in 1996 due to an increase in local government regulations and the link between benefits and the rate of inflation. Case 3 joined in a local government superannuation scheme in 1993. Even so, the payment of retirement benefits alone cost case 3 at least ¥ 14.6 million (more than $A2.3 million) in 1995, given that only employees retired since 1993 receive retirement benefits from the superannuation scheme. Case 3 also has a committee of retirees employing 7 people. This committee finds retirees part-time employment, such as driving elevators.

In addition to the cost of running a hospital, case 3 reimbursed employees' medical expenses of ¥ 4 million ($A0.6 million) in 1995. Most medical expenses (¥ 3 million, about $A0.47 million) were for retired employees.

Case 3 requires its employees to pay a small part of medical costs to avoid wasteful usage. Case 3 also tried to reform its housing system. It sold some housing to employees at below construction cost prices. By the end of 1994, it had sold 26 237 square meters of housing to employees for ¥ 4.9 million ($A0.77 million). This revenue was used to build more residential units for employees who still live with parents. However, housing reform is not generating savings for case 3; the more housing it sells, the greater the loss it makes.

In addition to expenditures on medical care, retirement benefits and housing, other welfare expenditures are also high. For example, in 1991, case 3 invested ¥ 2.5 million ($A0.39 million) to build a sanatorium for its employees. During 1990-94, case 3 spent well in excess of its total profits, about ¥ 2 million ($A0.3 million) per year on bath and hairdressing fees, child care relief, gifts to employees and other welfare fees. Many such welfare expenditures are non-essential and directly reduce profits available to asset owners, the state.

Alternative sources of revenues

In recent years, revenues from case 3's mainstream activities have not been high enough to generate a healthy profit after welfare expenditures were met.[24] Thus the management has actively sought alternative sources of revenues, taking advantage of its urban location by leasing out nearly all of its properties and commercial land. For example, it leases out its restaurant in a main street and receives ¥ 670 000 ($A105 000) per year from the lease. Also, in 1995 it earned more than ¥ 600 000 ($A94 000) from leases on its two guest houses. In 1996, the two guest house leases earned ¥ 2 million ($A0.3 million) and the tenants paid for the ¥ 16 million ($A2.5 million) renovations. Consequently, case 3 is now using rents from non-core assets to subsidise its unprofitable textile activities.

The service businesses provide redeployment opportunities for 233 employees. The revenue from the service businesses was spent on employee gifts during festivals and business entertainment. In 1995, case 3 changed management and has diversified further into the service industry. It is now looking for partners to lease out its hospital as a health research centre.

Case 3 has also invested in a number of joint venture and joint operation textile mills. These new enterprises have autonomous business operations and only limited social service obligations and debt burdens. Because of this, they are good sources of revenue.

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[24] If Case 3 did not have to pay for its employees' welfare services, it would have made tens of millions yuan of profits in 1995.

Updating technology and equipment

In the early 1990s, case 3 upgraded its key production procedures and equipment to improve its products. Case 3's management believes improving the quality and variety of output will maintain its competitive edge and export position. It has a five-year technology transformation plan costing ¥ 240 million ($A37.5 million).

The technology upgrading process started in 1990 when case 3 imported a third set of blowing roon machines, chute feeding systems, carding machines and a second set of combers. Between 1991 and 1993, the State Council made the city in which case 3 is situated exempt from import tariffs and value added taxes on imported equipment for technology transformation. (The exemption later was extended for two more years.). This policy was originally designed and reserved for China's coastal, open cities. To take advantage of it, case 3 decided to implement the remaining projects of its five-year investment plans in two years. To do this, it quickly prepared feasibility studies and investment proposals and asked for cooperation from various government departments. As a result, it shortened the project approval process from 4 to 6 months to within 2 months. They planned and coordinated the investment projects carefully so they would be completed quickly. As a result, about 70 per cent of the spinning equipment and about 55 per cent of the waving equipment is 1980s vintage. It adopted 13 of the 25 most advanced technologies in textile production, including in printing and dyeing.

However, the investment projects have led to a substantial debt servicing burden. In 1995, case 3's total assets were ¥ 700 million ($A109 million) and total debt was ¥ 300 million ($A47 million). This is a debt to assets ratio of about 43 per cent.

Governing authority

Case 3's governing authority is the local government's Textile General Corporation. The governing authority appoints the enterprises' senior management, subject to the municipal government's approval. The governing authority also provides inspection services for the SOEs attached to it. If case 3's output incurs any penalties due to quality problems, the governing authority pays them.

Case 3's investment projects were approved by its governing authority, the textile association, and the State Economic and Trade Commission. The main role of the textile association is to collate applications for technology transformation in the industry and pass them on to the State Economic and Trade Commission, where the real decisions are made.

Together with 12 other SOEs in the industry, case 3 obtained foreign trade rights for cotton yarns and fabrics in mid 1994. As a result, the governing authority is now substantially less involved in case 3's export and import businesses. The local government selected case 3 for reform and is still negotiating it's reform package. Case 3 would like to become an independent enterprise group because its products sell well in overseas markets. However, the governing authority would like to become a state-owned assets management company with case 3 as one of its subsidiaries.

Case 3's joint operation township enterprise

Partnered by a township government, case 3 established a joint operation textile mill in the 1980s. Case 3 contributed new factory buildings, 40-year old equipment that it no longer uses and the management and technician team. Case 3's partner contributed land and rural workers. Case 3 is entitled to 50 per cent of the profits and recovered its capital outlay within three years

Case 3 and its partner set a profit target of ¥ 1 million ($A0.16 million) for the joint operation business in 1995. If the profits exceeded the target, case 3 and its partner agreed to remit one third of the extra profits to the employees of the joint operation as bonus payments. In 1995, after bonus payments, case 3 received about ¥ 3 million ($A0.47 million) of dividends from the mill.

The joint operation sells mainly to domestic markets. Its customers are from towns or

small cities in the local province. Due to a cotton shortage, the business has used some polyester fibres as inputs to produce cotton blend fabrics.

The joint operation business has 1 660 employees with 90 management and technical staff. The share of managerial and technical staff is 5.4 per cent compared with about 17 per cent in case 3. Unlike managerial staff in case 3, nearly all the managerial and technical staff also work in production posts. The average wage of production workers in the joint operation business is ¥ 600 to 700 ($A94-109) per month. While joint operation businesses' average wages are about the same as case 3, its welfare expenses are much lower and the joint operation business does not have the burden of retirement payments. The workers are young people from rural areas. The joint operation business has asked them to join the local government's superannuation scheme but they are not very enthusiastic about this. When the few managers seconded from case 3 retire, they will retire from case 3 rather than from the joint operation business.

The joint operation does have a small medical clinic with two doctors; it found that running this was more efficient than sending workers to hospital for minor illnesses. The joint operation pays each employee ¥ 23 ($A3.6) per month as medical expenses. Each visit to the clinic costs ¥ 0.2 ($A0.03). For serious illnesses, the employees go to a hospital at their own expense.

The debt burden is also much smaller for the joint operation than for case 3. The total assets of the joint operation business were more than ¥ 50 million ($A7.8 million) in 1995. Its bank loans were between ¥ 10 million and 20 million ($A1.6 million to 3 million) for working capital. The debt to assets ratio was about 30 per cent in 1995. From 1996, case 3 and its partner agreed to let the joint operation business keep ¥ 5 million ($A0.78 million) of profits as working capital.

The joint operation does not have a governing authority and has autonomy in business decisions. Case 3 does not interfere with the operation of the joint operation business. It only collects dividends. Also, the joint operation is not obliged to participate in any social activities organised through governing authorities, such as sending workers to tree planting festivals and dancing in ceremonies on full pay.

The joint operation business does not have a transport team. Instead, clients send trucks to pick up fabrics on agreed delivery dates. The joint operation demands payment before or on delivery of orders. It, therefore, avoids keeping large stock and is not involved in triangular debt.

The joint operation disciplines its workers through a system of individual contracts. Workers who breach their contracts are fired. For example, a worker who stole a small item from the factory was dismissed. In many SOEs, stealing from factories does not cause guilt because for more than 40 years workers have been told that they are the masters of the factory.

In the joint operation, the relationship between employers and employees is clearer than in case 3; therefore, human resource management is easier.

Case 4

Case 4 is an iron and steel corporation in a south east coastal city. Before 1979 it made losses, but in 1979 it pioneered the contract responsibility system, signing a five-year contract with the local government. It initially agreed to submit a profit of ¥ 28 million ($A4.4 million), then increasing by 10 per cent each year. Case 4 was free to allocate profits in excess of this agreed amount. This allowed employees to earn more money through increased productivity. As a result, case 4's performance improved gradually in the 1980s.

In 1989, it became a joint venture company with a Hong Kong enterprise group. With the foreign investment, case 4 updated its production equipment and technology. In 1993, it became a joint-stock company with plans to list on the stock exchange in 1996. About 65 per cent of the stock is state-owned assets, about 28 per cent belongs to the foreign investor, and the rest is held by its employees.

Case 4 has restructured to form an enterprise group. The joint-stock iron and steel company became the main subsidiary of the newly formed enterprise group. The enterprise group is building two more joint venture iron and steel enterprises as subsidiaries. The enterprise group acts as the investor of the state-owned assets in its subsidiary companies. In addition to the iron and steel companies, the enterprise group also has subsidiaries in transport, real estate, trading, storage facilities, and restaurants.

Products

Case 4 produces round bars, high tensile deformed bars, pig iron, iron and steel castings, seamless steel tubes, high-purity oxygen, nitrogen, argon, helium and helium products, coke and chemicals.

Case 4 is now making profits and is among the 500 biggest industrial enterprises in China. Its output in 1996 was 0.9 million tons and it plans to produce 1.2 million tons of iron and steel products in 2000. Case 4 has a longer term target of expanding production capacity to 2 million tons with a sales revenue of ¥ 10 billion ($A1.56 billion).

Case 4 has become fully integrated in the market system. It purchases its raw materials from markets (mainly from inner provinces which are resource rich); makes its own production plans; sells its output in markets (mainly in south China which is economically more developed than the inner provinces), and sets prices according to market conditions.

Overstaffing and social welfare costs

Case 4 has achieved considerable productivity growth, reducing its workforce while increasing its iron and steel output. It used to have 11 000 employees producing 240 000 tons of iron and steel. Now it has 9 000 employees producing 900 000 tons of iron and steel.

Like other SOEs, case 4 suffers from overstaffing and has significant welfare and social costs. However, unlike many other SOEs, case 4 sees its employees as potential markets rather than as a burden. Except its schools and hospital, it successfully commercialised most of its service functions to become sideline businesses. These sideline businesses absorb most of case 4's redundant employees. For example, case 4 used to have a welfare and benefits division that was in charge of distributing goods to employees (a form of bonus payments), running dining halls and other similar services. In 1993, this division was separated from mainstream activities and became a food company, serving internal as well as external customers. After one year, the employees of the food company stopped receiving salary and bonus payments from case 4. After two years, the assets of the food company were evaluated and rent was paid to case 4.

Except for its real estate company, case 4 obtains a positive return from most of its sideline businesses. Most real estate companies in China have experienced difficulties since tight macroeconomic policy settings were introduced in 1992.

Case 4 still has a few hundred service employees on its pay-roll, working in its schools and hospital. The hospital has achieved between 30 and 50 per cent cost recovery. However, case 4 fully finances its schools and kindergarten, due to a slow pace of reform and revenue shortfalls in the local educational system which is unable to absorb these services.

In addition to establishing self-financing sideline businesses, case 4 reduced overstaffing through retirement. It has about 300 new retirees each year and recruits only about 200 graduates from technical schools. Case 4 plans to expand its output without increasing its staff level.

In total, case 4 has about 3 000 retirees. Case 4 pays part of the retirement benefits and a local government superannuation scheme pays the rest. The retirement benefits of new recruits will be paid by the superannuation fund.

Debt issues

Case 4 has financed its investment and operation by selling stocks, attracting foreign

direct investment, using retained profits and bank loans. Data on the debt to assets ratio of case 4 was not available, but the average debt to assets ratio for industrial enterprises in the region is about 68 per cent. Case 4 is not involved in triangular debt as it has a policy of either requiring cash deals or employing barter trade.

Governing authority

The Municipal Economic Commission governs case 4. This governing authority appoints the general manager after the municipal Communist Party Committee and personnel department grant approval. The general manager nominates the deputy general manager; this is approved by the Municipal Economic Commission. The appointment of middle level managers is determined within case 4.

The governing authority was responsible for transforming case 4 into an enterprise group. It helped design and approve the new organisational structure within the policy framework of building a modern enterprise system.

Case 4's investment and technology transformation projects require approval by its governing authority, as well as other related departments, such as the Municipal Economic Planning Commission. However, bank loans obtained through this channel are considerably cheaper than the market cost of credit.

The Municipal Economic Commission is also helping case 4 to apply for foreign trade rights in the context of its reform. However, foreign trade rights are centrally controlled by the State Economic and Trade Commission and the Ministry of Foreign Trade and Economic Cooperation.

Constraints to enterprise operation

Case 4 does not yet have foreign trade rights. It has to apply for quotas to export its products. The allocation of export quotas is centrally controlled by the Ministry of Foreign Trade and Economic Cooperation and applying for them is an arduous process. However, it is worthwhile because when an SOE exports, it is eligible for a rebate on the tariffs it has paid for its imported inputs; furthermore, it may secure a higher import quota for its raw material inputs.

The employees of case 4 are not satisfied with the quality of schooling provided. However, the schools drift along because the local education department does not have the money to take over these enterprise schools. However, many employees would prefer send their children to expensive private schools.

Case 4 is not free to make investment decisions according to market conditions. Investment and bank loans are administered by relevant government departments as instruments of macroeconomic control.

In 1995, case 4 was instructed to reduce its level of output to control inflation. It was not allowed to pay bonuses, a substantial part of total wage packages, if it failed to achieve its target output reduction.

Case 5

Case 5, an electronic company producing radio products in a south east coastal city, was constructed in the early 1960s. At the end of the 1970s and the early 1980s, the electronic products brought in by relatives from overseas and by officials from overseas trips created a great demand for electrical appliances such as TVs, cassette recorders and calculators. Taking this opportunity, case 5 designed and produced the first generation of Chinese made TVs, cassette recorders and calculators. These new businesses made tens of millions of yuan of profits for case 5 until 1986, when township enterprises became strong competitors.

Case 5 found it hard to compete with township enterprises because its management system was still attuned to the central planned system. Although case 5 still obtained cheaper raw materials and funds through central planning, the application procedure for materials and funds was complicated and time consuming.

Case 5 also faced competition from electronic goods smuggled into the country. At the same time, case 5 failed to improve the quality of its products and could not increase the scale of its production due to the lack of freedom in making investment decisions and obtaining funds. As a result, case 5 made losses during the period 1989-93.

In four years of losses, case 5 accumulated debts of about ¥ 130 million ($A20.3 million) while its assets were only about ¥ 50 million to 60 million ($A7.8-9.4 million). Before 1983, case 5's funds were allocated from the budget through central plans, with any shortages in working capital filled by bank loans. Since 1983, the Government has stopped allocating funds and case 5 has borrowed from banks and must repay interest as well as the principal.

Reforms turned losses to profits

In 1993, case 5 employed a new senior management team which decided, in 1994, to cut the production of consumer durables, such as TVs, cassette recorders and calculators, and concentrate on the production of radio products. As a result, about 1 000 employees in the consumer durables businesses became redundant. At that time, case 5 had 2 900 employees.

Case 5's decision was supported by its governing authority, the Municipal Economic Commission, and other local government departments. . It was allowed to sell the land it occupied and move to an area further away from city centre taking a 70-years land use title. The funds received from the land sale were used for moving expenses, settling the 1 000 redundant employees and repaying a debt of ¥ 130 million.

Settlement of redundant employees

Case 5 consulted widely with the redundant employees and their families to work out a detailed plan for their settlement. About 500 employees who were a few years from retirement accepted retention packages that allow them to wait for retirement at home. The retention package was for ¥ 300 to -500 ($A47-78) per month, higher for managers and engineers, and lower for workers.

About 400 younger employees accepted voluntary redundancy packages. The voluntary redundancy package paid ¥ 1 300 ($A203), which is about two months of an average wage, for each year an employee worked in case 5. These employees were also allowed to keep the houses case 5 provided them. Case 5 also reviewed case by case how the employees who accepted voluntary redundancy would survive after separation. This was to ensure that the reform would not cause social instability.

Fewer than 100 employees did not accept either of these two packages. These employees were retained for 6 months to look for other jobs or be absorbed by another factory of case 5. Case 5 stopped renewing the contracts of non-permanent employees. Owing to the efforts of the new management and the favourable economic conditions in the southern coastal area, the settling of the redundant employees did not create any social problems.

Improving internal management systems

Before the reform, employees were paid wages averaging ¥ 200 to 300 yuan ($A31 to 47) per month. Factories that had orders paid bonuses of ¥ 80 to 100 ($A12.50 to 15.60) per month; those that did not have orders paid bonuses of Y 30 ($A4.70) per month. However, employees who worked harder were not rewarded much more than less productive ones.

The new management implemented a new wage policy which linked employee efforts and results with payments. Employees are now paid a basic wage of only ¥ 100 per month ($A15.60). The rest of the wage payment depends on the quantity and quality of an employee's output. Those factories that fulfil or exceed their profit target are allowed to pay higher wages. As a result, income of employees can differ by ¥ 5 000 ($A781) per year. After redundancies, the average income level within case 5 also increased to between ¥ 5 000 to 10 000 ($A781 to 1562) per year.

Each factory or plant of case 5 was granted independent profit accounting and more

autonomy in its business decisions. At the same time, they were integrated further into the marketplace by purchasing raw materials and selling products in the open market, setting their own prices and paying their employee's bonuses.

Restructuring into an enterprise group

Case 5 was also restructured into an enterprise group in 1995. The main body is a limited liability company solely owned by the Government. The limited liability company acts as the investor of state-owned assets in its 20 subsidiaries and 10 joint venture companies.

The enterprise group's board of directors appoints the general manager of the enterprise group and directors are appointed by case 5's governing authority subject to the approval of the other relevant departments of the municipal government. However, since case 5 is solely owned by government, neither directors nor managers are penalised for any reduction in the value of the state-owned assets they manage. Currently, the same person fills both positions of the chairperson of the board and the general manager. Case 5's senior management appoints middle level managers. With the help of its governing authority, case 5 was also granted foreign trade rights by the Ministry of Foreign Trade and Economic Cooperation.

Social welfare costs

Case 5 has been trying to reduce the cost of social services it provides. Like case 5's factories, social service areas are expected to make independent profits. For example, case 5 has about 90 people employed in its dining halls. The dining halls were granted autonomy to operate a business and to become independent within 2 to 3 years. Firstly, the dining halls were expected asked to pay for electricity and water bills and their employee's bonuses. Then they paid their employees' wages and finally rents for the fixed assets they used.

The schools and the kindergarten employ about 100 staff. The schools recover part of their costs (wages and office overheads) by admitting fee-paying students from rural areas. The proportion of cost recovery will increase gradually. Eventually, the schools will be independent financially.

Case 5 provides housing for about 1 500 families at negligible rents. It also has a clinic for emergency and minor medical treatment. The medical clinic is more cost effective than sending employees to hospital for small illnesses as there is a lack of good quality and convenient medical service in the society.

Case 5 has joined the local government's superannuation and medical care schemes. Twenty seven per cent of the wage bill is paid into the superannuation fund, 24 percentage points by case 5 and 3 percentage points by employees, and 17 per cent of wage bill is paid into the medical care fund. However, these schemes create extra costs for case 5, at least at present. This is because case 5 has to contribute to the schemes as well as paying part of the retirement benefits and medical expenses of its employees. To build up the funds, the local government has to asked case 5 to pay more than the relief which the funds offer, at least at present.

Future prospects

Case 5 is trying to diversify its production. It is looking for partners abroad to invest in new technology and develop new products. However, case 5 still faces competition from smuggled electronic products and finds it hard to compete with township and private enterprises. Although improving, its management system is not as market oriented as township enterprises. For example, case 5 still has to apply for funds through layers of government departments; and requires the signature of four managers before any payment can be made. Township enterprises are less constrained. For example, township enterprises may pay commissions to people who purchase their products while case 5 is not allowed to do this.

While employees of case 5 are highly qualified and skilled, its labour costs are also much higher than those of township enterprises. The employees of township enterprises are

normally young and earn between ¥ 400 and 500 ($A62.50 to 78) per month or ¥ 5 000 to 6 000 ($A781 to 937) per year. On the other hand, the employees of case 5 have an average yearly wage of ¥ 8 000 ($A1250). In addition, case 5 pays a large welfare bill, for housing, medical care for both current and retired employees, children's education and bonuses in form of goods. Taking all the welfare expenditures into account, case 5 estimated that its average labour costs per employee are about ¥ 20 000 ($A3 125) per year. It is unsurprising case 5 is having trouble competing in a highly competitive, labour intensive sector like electronics.

Furthermore, township enterprises can lay-off workers whenever they think that their staff level is too high. This is a freedom that case 5 does not have. Case 5 also suffers from brain drain. Some good technical employees have been attracted by private and joint venture businesses where they can earn a much higher income. Many of them still occupy case 5's housing.

Case 6

Case 6 is a wholesale distribution company in Shenzhen special economic zone. Before being transformed into a wholesale company in the late 1970s, it used to be part of a local government intermediate goods distribution department and was subject to central planning. Because it is in a special economic zone, case 6 is relieved of government administrative and industry association functions. At the same time, it is denied access to the intermediate goods and funds allocated through central planning, except for an initial investment in fixed capital of ¥ 1 million ($A0.16 million) and working capital of ¥ 20 000 thousand ($A31 000).

As a result, case 6 acts like a company rather than a government department was integrated into the market place earlier than similar goods distribution departments in other areas of China. The employees of case 6 also developed a market oriented view and behaviour at a much earlier stage than employees in similar SOEs within the industry. The employees in case 6 are used to the idea of moving in and out of employment, unlike employees in some other SOEs who depend on one SOE for generations. Case 6 does not follow a rigid promotion system based on the Chinese public service; instead, it promotes workers to managerial positions on merit and demotes those who do not perform.

In addition, local superannuation, medical and other insurance schemes were set up earlier in special economic zones like Shezhen than those in other parts of China and have functioned for several years. In such an environment, both senior and middle level managers have substantial freedom in personnel management.

Case 6 does not have heavy social burdens because the whole city was developed from scratch with a view to providing services, such as schools and hospitals, to all its residents. As a result, case 6 did not have to set up service facilities for its employees, except for a kindergarten.

As part of the privilege of being in a special economic zone, case 6 obtained foreign trade rights earlier than similar firms in other parts of China. It obtained trading rights first at provincial level in 1987 and then at a national level in 1992. Trading rights at the national level allow case 6 to trade a wider range of commodities.

Now case 6 has developed into an enterprise group and diversified into a range of businesses including wholesale, retail, import and export, transport and real estate. Its net assets have increased to about ¥ 540 million ($A84.4 million) with a debt to assets ratio of about 78 per cent.

Creating an internal bank

With the approval of the municipal government and the Industrial and Commercial Bank of China, case 6 established an internal financial centre in 1988. This financial centre models the operation of a bank, providing financial services to case 6's subsidiary and joint venture companies. The financial centre facilitates the internal use of funds and

avoids unnecessary interest payments.

Before the internal financial centre was established, case 6's 10 subsidiary companies and 29 joint operation companies opened accounts with different banks, and each deposited and borrowed individually. As a result, case 6 as a whole borrowed ¥ 110 million ($A17.2 million) from banks while it had bank deposits of ¥ 68 million ($A10.6 million) in 1987. Sometimes, its bank deposits were as high as ¥ 90 million ($A14.1 million).

Through the internal bank, case 6 centralised bank borrowing and depositing. Now case 6 deals with one bank representing all its subsidiaries while all of the subsidiaries deal with the internal financial centre. However, case 6 and its subsidiaries still have to apply for approval of investment projects through the chain of command before they can borrow from the bank through the financial centre.

The financial centre saved case 6 more than ¥ 24.6 million ($A3.8 million) in interest payments between 1988 and 1992. Through the internal use of funds, case 6 shortened the loan application and approval procedures for its subsidiaries. Those subsidiaries urgently needing funds can use the internal financial centre rather than start a 7 to 14 days' application procedure for outside bank loans.[25]

The internal financial centre also helps to monitor the financial performance of subsidiaries and effectively manage state-owned assets. This management system is a more market oriented than an administrative approach.

Improving the internal management system

Since 1993, case 6 has been adjusting its operational structure and internal management system to manage subsidiaries through investment rather than administrative links. Firstly it simplified the structure of its headquarters and required all its departments engaged in business to become independent subsidiaries. Thus, its headquarters now only engages in policy making, assets management and investment guidance.

The subsidiaries have considerable autonomy in their daily operations, for example, allocating their middle level management positions. However, each subsidiary is given a profit target, based on the value of the subsidiary's net assets and the average rate of return on capital in the industry and the region, bank interest rates and other relevant information. In the past two years, the return on net assets has been set at about 12 per cent. The subsidiaries can borrow up to the amount of their net assets (50 per cent debt to total assets ratio). Therefore, the profit target is calculated as 2 multiplied by the value of last year's net assets multiplied by 12 per cent[26].

The subsidiaries can retain 20 per cent of their target profits and 80 per cent of above target profits. If a subsidiary achieves a profit exceeding the target, it can pay higher wages to its employees. A subsidiary can determine earnings differentials between managers and workers, senior and middle level managers and between workers.

However, this autonomy in wage payments is subject to two constraints. First, the growth rate of case 6's total wage bill has to be lower than the growth of its total economic gains. Second, the growth of average employee wage has to be lower than the growth of Case 6's labour productivity. The subsidiaries that have more than ¥ 20 million ($A3.1 million) of net assets, ¥ 10 million ($A1.6 million) of profits for two consecutive years, and an annual sales value of more than ¥ 200 million ($A31.2 million) are rewarded as backbone subsidiaries. The managers of these backbone subsidiaries receive more power to make business decisions and higher wages.

However, those subsidiaries that cannot achieve the profit targets are not allowed to pay their employees bonuses or even all of the basic wage. The basic wage, which is ¥ 300

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[25] This time is much shorter than that which is necessary in other parts of China and for those firms which are not as important to the Government as case 6 is.

[26] The value of the total assets of the subsidiaries are twice of the value of their net assets because they are allowed to borrow up to the value of net assets.

($A46.9) per month, is normally a very small part of the total wage package.

This rewards system has greatly increased managers and workers' incentives and productivity. As a result, case 6 has continued to grow in recent years while most other firms in the industry are making losses.

A management company of state-owned assets

Case 6 has a board of directors and a general manager. The general manager is responsible for daily operations under the direction of the board of directors. This structure of management was established before 1989 when the municipal government appointed a new and younger chairman of the board.

Since 1992, the board has started to develop the attitude of investors rather than administrators, and has changed its management system. Case 6's headquarters has, in turn, moved from engaging in wholesale and retail businesses to managing state-owned assets in its subsidiaries.

In 1994, case 6 was selected as one of the three state-owned assets management companies in the city, as part of the Government's attempt to move from being a manager of SOEs to a manager of state capital.

The special economic zone is experimenting with a three layer system of state asset management. The top layer of the state-owned assets management system is the Municipal State-Owned Assets Management Committee. This committee has a higher administrative authority than similar organisations in other parts of China. The State-Owned Assets Management Committee entrusts three state-owned assets management companies (the second layer) to manage the state-owned assets in state-owned, joint operation, and joint venture enterprises (the third layer). One of the state-owned assets management companies manages state-owned assets in high-technology and industrial enterprises; one manages state-owned assets in real estate companies and case 6 manages state-owned assets in wholesale, retail, storage and transport companies.

Case 6 is 100 per cent government owned. Under the new system of management of state-owned assets, the Municipal State-Owned Assets Management Committee appoints the directors and the chairperson of the board to case 6, subject to the approval of the personnel department of the municipal government. The chairperson of the board is legal person of case 6. The board of directors appoints the general manager, who then appoints the deputy general managers and middle level managers with the approval of the board. The Communist Party Committee evaluates the suitability of the general manager nominated by the board and the deputy manager and middle level managers nominated by the general manager and makes suggestions.

To combine the old decision making system of the Party Committee/managers with the new system of board of directors/general manager, case 6 has encouraged members of the Communist Party Committee with appropriate qualifications to take up management positions and include managers with party membership in the Communist Party Committee. For example, the Chairman of the Board is also the Secretary of case 6's Communist Party Committee and the general manager is one of the deputy secretaries of the Communist Party Committee. Another deputy secretary of the Communist Party Committee is appointed as the deputy general manager. Eight managers in the subsidiaries are also party secretaries of the Communist Party Committee of the subsidiaries.

As a management company of state-owned assets, case 6 must:

- ensure the state-owned assets that it manages are safe and achieve the assets growth target that the Municipal State-Owned Assets Management Committee sets;
- report on the operational situation of state-owned assets and provide financial statements of these assets to the State-Owned Assets Management Committee;
- accept the monitoring of the State-Owned Assets Management Committee and inform it of any important investment decisions.

As the entrusted owner of the state-owned assets in its subsidiaries, case 6 can:

- appoint and monitor the performance of senior managers of the subsidiaries;
- determine or approve the management system of subsidiaries;
- clarify the ownership of subsidiaries' assets;
- evaluate and organise the registration of state-owned assets in the subsidiaries;
- determine or approve the development policy of subsidiaries according to the industrial policies of the government;
- determine or approve the form of operation of the subsidiaries, including corporatisation, joint venture, contract out or lease;
- sell partially or completely the subsidiaries;
- determine or approve the establishment, merger, and bankruptcy of the subsidiaries;
- set the growth target of state-owned assets in subsidiaries and monitor the operational and financial situation of the state-owned assets;
- initiate audits of the subsidiaries when necessary;
- provide guarantees for the bank loans issued to the subsidiaries.

Case 6 no longer hands in profits to the Government; it only pays taxes; and is responsible for reinvesting any profits made. It can start new investment projects and purchase other enterprises or the stocks of other enterprises. However, case 6 is obliged to implement any macroeconomic policy measures initiated by the Government.

Case 6's subsidiaries do not have foreign trade rights; imports and exports are handled through case 6. Real estate development of all the subsidiaries is also planned by case 6. For its joint operation and joint venture businesses, case 6 acts as a shareholder according to the 1993 Enterprise Law.

Future prospects

In mid 1994, case 6 was entrusted by the Municipal State-owned assets Management Committee with managing about ¥ 519 million ($A81.1 million) of state-owned assets. Case 6 plans to increase its assets base to ¥ 1.3 billion ($A0.2 billion) by 2000.

As part of the SOE reform package, case 6 plans to update its storage facilities and develop a number of large scale commodity wholesale markets. It also plans to further diversify its businesses into other sectors such as manufacturing, insurance and tourism, and into other countries in South East Asia, East Europe and South America.

Case 7

Case 7, a joint-stock machine tool company in the capital of a north eastern province, was established in 1993 from the merger of four large machine tool factories in the city. The merger was an experiment in SOE reform, financed by World Bank loans.

Before the merger, the four machine tool factories each produced different products; lathes, drilling machines, automatic lathes and numerical control systems. Each of them was equipped with full production support facilities such as a foundry, welding factory, and gear wheel factory. Each machine tool factory separately imported equipment for its production support factory, but none of them had sufficient work to fully employ the support facility.

In 1993, the World Bank agreed to provide loans to upgrade the capacity of machine tool production in the city and recommended the four machine tool factories to be combined into one joint-stock machine tool company. As the World Bank recommendation was in line with the Government's SOE reform objectives, in January 1994, the legal status of the four machine tool factories was removed and they became production divisions of case 7 which was assigned a legal person status in its own right.

A joint-stock company

After the merger, case 7 was restructured into a joint-stock company and is now preparing for listing on the stock exchange. Its stockpiles and capital are valued at ¥ 560 million ($A87.5 million). About 82 per cent (¥ 460 million or $A71.9 million) of the total capital stock was identified as state-owned assets, 5 per cent (¥ 30 million or $A4.5 million) is owned by other institutions or enterprises and the remaining 13 per cent (¥ 70 million or $A10.9 million), belongs to the employees of case 7.

Organisational structure

Following the suggestion of the World Bank, case 7 employed a consultancy company from the UK to design its organisational structure and plans to employ another consultant to help to implement this organisational structure.

Following the consultancy company's advice, shareholders' meetings and a board of directors will act as the decision making authorities. A president and a vice-president will manage the company and a board of inspectors will monitor the behaviour of the directors and senior management staff. The four production divisions will operate independently in purchasing inputs, selling outputs and ensuring quality control. The headquarters of the joint-stock company will provide information, coordination, personnel, finance, strategic planning, investment and technology services.

Before July 1994, the chiefs of the four production divisions (the directors of the four original machine tool factories) were vice chairmen of the board of directors. Following the advice of the consultancy company, the chiefs of production divisions are no longer directors. The board now comprises the president of case 7 as the chairman of the board, the vice-president and the enterprise's chief accountant, a technical expert who is responsible for the design of the technology upgrading projects of case 7[27], a management expert[28], a financial expert[29], and an employee representative. The board of directors was elected at a shareholders' meeting, where the owner of the state's shares was represented by a deputy chief of the Bureau of Machinery in the municipal government, who is also currently the president and chairman of the board of directors of case 7.

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[27] A director at one of the research institutes of the Ministry of Machinery and member of Engineering Academy of China.

[28] A former factory director.

[29] The vice-president of the local industrial and commercial bank. A subsidiary investment company of the bank owns part of the institutional shares of case 7.

Governing authority and management of state-owned assets

The four machine tool factories that formed case 7 used to be governed by the municipal government's Bureau of Machinery. After the reform, case 7 was assigned an administrative level as high as the Bureau of Machinery, relieving case 7 from the administration of its former governing authority and effectively granting it more autonomy.

Originally, the municipal government viewed case 7 as a bureau of machine tools governing the four machine tool factories,[30] appointing a deputy chief of the Bureau of Machinery to be the president and chairman of the board. However, case 7, as a company, should have been relieved from any government functions. In addition, case 7 is a joint-stock company to be listed on the stock exchange, and cannot act as its own asset manager. Therefore, a machine tool enterprise group was established in December 1995 as the management company of state-owned assets in case 7.

The new machine tool enterprise group is a limited liability company solely owned by the Government. It acts as the owner of state-owned shares in case 7, as well as some other businesses, such as the service companies that provided case 7's social services. As a temporary arrangement, it is also acting as the governing authority of case 7 and its subsidiaries.[31]

The personnel department of the municipal government, representing the State-Owned Assets Management Bureau of the local government, appointed another deputy chief of the Bureau of Machinery (who was also the secretary of Communist Party Committee) as the chairman of the board of directors to the new machine tool enterprise group. The president of case 7 was appointed as the president of the new machine tool enterprise group. The State-Owned Assets Management Bureau is the operational arm of the yet to be established State-Owned Assets Management Committee of the local government.

Internal resource reallocation

Case 7 plans to reallocate resources within the company by breaking the boundaries separating the four original machine tool factories. The production support factories will be separated from the production divisions and be combined to achieve economies of scale. For example, the three foundries will be combined into one.

Updating technology and equipment

At present, less than 30 per cent of machine tools produced by case 7 are numerically controlled. With the World Bank loans (more than US$120 million) and supporting domestic funds, case 7 imported production equipment, and plans to increase its production of numerical control machine tools to more than 83 per cent of total output. It also plans to achieve a 15 to 20 per cent share of the Chinese market by 2000.

Overstaffing and social welfare costs

Case 7 currently has about 24 000 employees. Of these, 2 000 employees work either in the service companies of the four original machine tool factories or in the social welfare areas. These companies with their 2 000 employees were separated from case 7 in 1995 with the expectation they would become independent businesses. However, it may take three years before some of these businesses become fully independent.

Case 7 identified 6 000 redundant employees in 1995 and planned to scrap these positions in two years. In 1995, it cut 2 600 positions with about 500 employees accepting early

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[30] That is, case 7 was responsible for planning the development strategy of, appointing the managers to, supervising the implementation of any government policies by and making other important decisions of the four machine tool factories.

[31] Ideally, enterprises should not be assigned to a governing authority in the Government; however, many government policies, such as investment control as an macroeconomic instrument, are still implemented through the system of government authorities.

retirement. The primary school employing 100 employees was handed over to the local educational department. A few hundred employees were fired because they breached their contracts. The rest were asked to take 'long holidays'.[32] The remaining redundant positions will be vacated in 1996.

An interlude: the bankruptcy of a production division

In the early 1990s, before the merger of the four machine tool factories, one of the production divisions of Case 7 was experiencing serious financial difficulties. The main reason for this appeared to be a business decision made in 1991 when numerical control machine tools were in high demand in China. The production division which was then a machinery tool factory increased dramatically its production of numerically controlled machine tools. However, due to the workers' low skill levels and the low quality of the factory's numerical control tool carriage, the quality of the numerically controlled machine tools produced was very low. Consequently, it received a large number of returned purchases and accumulated stock valuing ¥ 100 million ($A15.6 million) that it could not sell.

These financial difficulties continued after the 1993 merger. By the end of 1995, this production division's situation was so bad that it probably caused case 7 as a whole to post a loss for the year. To allow the reform procedure to continue in case 7, the production division was separated from case 7 and became a legal, independent company at the end of 1995. After six months, the company was declared bankrupt due to its high accumulation of debts.[33]

After bankruptcy, the company will be taken over by case 7. The conditions for the takeover have not been established; however, case 7 expects that the bankruptcy will help to reduce the debts to assets ratio of the production division.

Case 8

Case 8, a textile mill in a north eastern province, was constructed in the early 1920s. It has 107 000 spindles and 1 200 looms, covers an area of 160 thousand square meters and has 6 800 employees. Case 8 uses cotton, staple rayon and polyester fibre to produce various cotton, synthetic and cotton blend yarns and fabrics. Nearly half of case 8's products are exported. Case 8 is solely owned by the Government and is governed by the municipal Bureau of Textile Industry which appoints the factory director.[34]

Before 1990, case 8 operated under central planning and only started to implement a manager responsibility system in 1991. Under this new system, monthly performance indicators were set for each department and workshop. Those departments and workshops that did not meet the performance indicators were not paid. The employees accepted productivity based earnings because they have realised that, like many other SOEs in the region, the factory could not afford to pay wages if they did not adapt to changing market conditions. Under the reform process, the planning department of case 8 was removed and the sales department set production plans according to client orders. Consequently, production plans are very flexible and change with market conditions. The reform in case 8 has greatly changed the outlook of its employees. Before the reforms, employees used to rely on the Government but now they seek out opportunities in markets. Their attitude to work has also changed from demanding payment for no effort to working hard to survive. As a result, each department and workshop is more efficient,

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[32] SOE employees in the region who take long holidays are, in fact, unemployed. These people receive a minimum living allowance or a proportion of a base wage. They may receive nothing at all, especially young people, if their factory is very poor and cannot afford to pay the minimum allowance.

[33] It was chosen as an experiment in the bankruptcy of SOEs.

[34] The middle level managers are appointed by the director of case 8.

purchasing inputs at the lowest prices, minimising waste in production procedures and keeping a minimum of stock of inventories.

However, the distribution of raw cotton inputs is still heavily subject to central planning. The Government allocates purchasing quotas to case 8 through the provincial and municipal Cotton and Linen Corporation. These quotas allow case 8 to purchase cotton from the National Textile Corporation at government set prices. According to case 8, the price of the cotton available through central planning is too high given its variable quality.

Although Case 8 operates its factories at full capacity and the employees have adapted to market conditions well, case 8 only covers its costs. A range of factors have contributed to low profits. Besides high material prices and low output prices (see case 3), case 8, is subject to various operational constraints, is heavily indebted and provides many expensive social services for its workers.

However, like many SOEs, case 8 has made profits from its investment in service industries. Case 8 is located in a central part of the city. Taking advantage of its location, it has established restaurants, hotels and a large recreation complex. It also has a garage and a transport company. Case 8 employs more than 1 000 people in these service activities which provide Case 8 with millions of yuan of profits each year.

Foreign trading rights

In 1993, case 8 applied for foreign trade rights through the municipal Economic and Trade Department. The application was approved by the State Economic and Trade Commission and the Ministry of Foreign Trade and Economic Cooperation within the context of SOE reform. After obtaining foreign trading rights, case 8 earned export revenues of US$2.1 million in 1994, which was four times higher than its planned export target. In 1995, its export revenue grew to US$ 6.3 million, again quadruple its export target.

Although cotton products dominate its output, case 8 was only received foreign trade rights for synthetic textile products (including clothing). To export its cotton products, case 8 has to sell them to foreign trade corporations attached to the Ministry of Foreign Trade and Economic Cooperation. Alternatively, it can use these foreign trade corporations as its export agent.

In the process of granting SOEs trading rights for cotton products, suitable textile mills are selected firstly by the municipal government and recommended to the provincial government. The provincial government, in turn, recommends the mill that it considers are most suitable to the central Government. Case 8 applied for foreign trading rights for cotton products in 1994 and has been actively seeking approval for the application through the municipal Economic and Trade Department. By 1996, Case 8 was positioned close to the top of the provincial government's waiting list.

Technology and equipment

The equipment is 10 to 20 years out-of-date. To secure bank loans to update its technology and equipment, case 8 has to apply for approval through the municipal and provincial Bureau of Textile Industry. The applications are gathered by the National Textile Association and sent to the State Economic and Trade Commission for final approval. However, case 8 is not planning to update its equipment for a number of reasons. Firstly, the fabric market in China is not very profitable. Secondly, case 8 is not able to finance its own investment projects out of retained earnings. It is only meeting its input cost obligations. Even if case 8 made profits, it would prefer to use its retained profits to finance improved social services for employees rather than technological transformation projects. This is one of the reasons why out-of-date technology and equipment prevail in SOEs. Also, the local government or the National Textile Association are unlikely to support case 8's application as its is a relatively small producer, accounting for less than 10 per cent of the total output of the industry in the city. Thirdly, the director of case 8 will retire in a few years and is not an enthusiastic supporter of long term investment. Finally, case 8 could not afford to borrow more funds

because it is already heavily indebted.

Debt

Case 8 has a debt to assets ratio of about 70 per cent. It has borrowed ¥ 100 million ($A15.6 million) from various banks including the Bank of China, the Industrial and Commercial Bank, the Agricultural Bank and the Construction Bank. At present, the interest payments on these loans are about ¥ 3 million ($A0.47 million) per month. Case 8 is also involved in triangular debt. It owes between ¥ 20 million and 30 million ($A3.1 million to 4.7 million) to its suppliers and its clients owe it ¥ 70 million ($A10.9 million). The size of the accounts receivable is very large compared with case 8's ¥ 133 million ($A21 million) fixed assets.

Social welfare expenditure

Case 8 has about 2 500 retired employees including 300 retired managerial and technical staff. The average wage for the retired employees is ¥ 350 ($A55) per month. The retired senior staff are on a higher retirement benefit and also enjoy fringe benefits. Case 8 has been a member of the local government's superannuation scheme for 6 years. However, it still feels that the retirement benefits are a burden.

Case 8 also has a hospital to which it contributes Y 1 million ($A0.16 million) per year; the hospital covers the rest of its costs. Case 8 used to have a primary school but has handed that over to the local education department.

Overstaffing is not a problem for case 8. The employees made redundant in the mill were quickly absorbed in the service businesses.

Taking over loss making SOEs

Case 8 has been asked by the municipal government to take over SOEs which are making a loss. In 1994, case 8 merged with another textile mill, which used to run at a loss. After the merger, the other mill's performance improved, and it has operated at full capacity since 1996. In 1995, case 8 was asked to merge with another loss making textile mill that produced floss. Case 8 has delegated a management team to the mill and expects it operate independently. Prior to these mergers case 8 had about 3 000 employees. After the two mergers, its workforce rose to 6 800, complicating management problems faced by case 8.

Case 9

Case 9, a clothing manufacturing company in a north eastern province, is solely owned by the Government and has 11 000 employees. It produces upmarket clothing and is equipped with advanced technology and equipment imported from Japan, the USA and Germany. Most of case 9's output is exported.

From factory to enterprise group

Case 9 started manufacturing clothing in the 1950s. In 1972, it became an export processing factory for a trading company controlled by the Ministry of Foreign Trade and Economic Cooperation. The trading company supplied case 9 with imported materials and styles requested by overseas clients. Case 9 made garments according to the trading company's requirements and charged processing fees. The export processing business of case 9 has not been very profitable as the trading company paid very low processing fees. Furthermore, export business is influenced by Government's tariff and exchange rate policies. In the 1980s, goods markets rapidly developed following the weakening of central planning. Case 9 capitalised on this opportunity by developing its own domestic and international client base and by developing its own recognised label.

Case 9 has learnt product development skills through joint venture operations with overseas investors. In 1990, Case 9 established a joint venture business with a consortium of four Japanese companies with an of investment value of US$4.3 million. Case 9 owns 49 per cent of the stock in the business. The Japanese consortium have negotiated that 80 per cent of the garments of the joint venture business are exported to

Japan and 20 per cent are sold in China. The garments sold in Japan are made mostly from imported materials and are manufactured under a Japanese clothing label. The joint venture business receives a processing fee of US$10 to 20 dollars per garment for garments exported to Japan. The garments sold in China are made from domestically produced materials and are manufactured under case 9's clothing label. In 1994, the clothing label was recognised as one of the top ten suit brands in China. Domestic sales of the joint venture business generate more profits for Case 9 than the exports to Japan.[35] Although domestic sales only represent a small share of total production in the joint venture, case 9 benefits from the design, marketing, management and quality control skills acquired from its Japanese partners.

While establishing its own clothing label, the management of case 9 became involved in industries related to the clothing industry. To meet to market competition, case 9 actively sought involvement in textile, transport, export and import and retail industries. Case 9 has become vertically integrated by entering into a joint venture with a local transport company and invested ¥ 5 million ($A0.8 million) in an international transport business.[36] Case 9 also sought approval from the municipal government for the right to import and export garments and established a chain of retail shops as outlets for its products in China.

In the early 1990s, the municipal government instructed case 9 to take over a bankrupt SOE wool textile mill in the city. Many better performing SOEs in the north eastern provinces have been asked to take over bankrupt SOEs so that the fixed assets of the bankrupt SOEs can be used and their employees given employment. This mandatory merger, however, suited case 9's strategy of developing a vertical industry structure.

Case 9 purchased the bankrupt wool textile mill for ¥ 10 million ($A1.6 million).[37] It took over the mill's fixed assets including the factory building and became responsible for the 3 900 employees, including 700 redundant employees and 900 retired employees. The equipment of the wool textile mill was about 20 to 30 years out-of-date and it could produce only 58 count yarns. Case 9 estimated that it would cost ¥ 29 million ($A4.5 million) to transform the mill's technology to produce more than 100 count yarns.

To bring the wool textile mill back to full operation, case 9 entered into a joint venture with an Italian company. The Italian company owns 25 per cent of the new wool textile mill and has agreed to develop a new product within 18 months and be responsible for its marketing. Case 9 retains 75 per cent of the new wool textile mill and has applied to the State Economic and Trade Commission for approval of the technology transformation projects. Case 9 expects to obtain this, enabling access to bank loans, as case 9 is in the category of strong SOEs the Government supports. Case 9 also expects the Textile Association to financially support the technology transformation projects.

By 1995, Case 9 handled all the business activities relating to manufacturing clothing, from producing materials to retailing quality garments in its own chain of clothing shops. It also established a number of joint operation garment businesses with various local companies and government agencies. Consequently, in 1995, the municipal government upgraded case 9 to an enterprise group.

Management issues

Case 9 has performed better than many other SOEs in the north-east region. However, while its sales revenue is high, its profit margin is low. Case 9 produces about 210 million garments per year and had a sales revenue of ¥ 186 million ($A29 million) in 1995. However, the profits in 1995 were only ¥ 1.4 million ($A0.2 million). A number

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[35] A new production line started to produce for the domestic market in the second half of 1996. This will increase the share of domestic sales to 30 per cent.

[36] Transport is one of the bottlenecks of economic development in China; therefore, access to transport helps improve a business's competitive edge.

[37] The mill also has dyeing capacity.

of factors have contributed to low profits. Firstly, low profit export processing is still a core business. Secondly, case 9 has to service a heavy debt that has been accumulated as a result of the technology updating projects. The debt to assets ratio was about 67 per cent in 1995. Thirdly, case 9 makes large outlays on wages and benefits for its staff.

Case 9 claims that it does not face problems related to overstaffing because it is operating at full capacity. It plans to employ the 700 redundant employees attached to the wool textile mill in the textile mill. However, case 9 could reduce production costs by reducing overstaffing, if social instability was not a concern.[38]

Use of capital needs to be addressed. For example, Case 9 imported a computerised cutter from the USA which suits large scale cutting jobs; however, it receives small scale orders most of the time, so the cutter is often left idle. Similarly, a set of high temperature shaping machines imported from Japan has not been fully used.

The attitude of the manager

Case 9 performed better than many other SOEs paying wages and welfare expenditures, and meeting its other cost obligations because its manager has a positive and aggressive attitude towards market competition. The manager has a vision about the future development of the company and has been willing to make strategic business decisions and accept responsibility for the consequences of the decisions. Many SOE managers are not willing to take responsibility for making important business decisions because they are afraid of making mistakes and jeopardising their positions. They would prefer to take instructions from their governing authorities or take time to obtain consent from other managers so that responsibility is shared. However, with this approach, business opportunities are often lost.

The manager is also very capable and has obtained support from the relevant government departments. Various government departments are willing to support case 9 because it maintains a successful track record. Because of the dynamic attitude of the manager, case 9 started to develop its own product and client base earlier than other SOEs in the industry. It also used the advantage of joint ventures with overseas investors and developed into an enterprise group earlier than many other SOEs.

Case 9 skilfully manages human resources. Workers are subject to tight regulations designed to stop wasteful production; however, they can earn a higher income through their efforts at work. Case 9 also offers fashion students from France practical experience and sends designers to France for training.

Now case 9 is further strengthening its position as a retailer of quality garments. It plans to establish a larger scale retail outlet (1 800 square metres) and become an exclusive clothing label in China and then overseas.

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[38] At least one third of SOEs in the north east provinces are bankrupt and cannot afford to

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pay wages. This creates strong pressure on the Government.

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