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CHINA'S RECENT STATE-OWNED ENTERPRISE REFORM AND ITS SOCIAL CONSEQUENCES

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Summary

The building of a "harmonious society" has in recent years become a top priority of the Chinese leadership. The leadership under Hu Jintao and Wen Jiabao has been making great efforts to increase social justice. Various measures have been implemented to reduce income and regional disparities, such as special policies aimed at the undeveloped west and the north-eastern "rustbelt", as well as attempt to narrow the gap between the cities and the countryside.

However, the leadership has met strong local resistance in implementing these policies. Chinese society is becoming increasingly "inharmonious" as social protests drastically increase. The Chinese people are beginning to resort to political, legal, or even violent solutions when not able to solve their day-to-day problems through economic means. The leadership faces a dilemma: the faster China has developed economically the more income disparities have grown and the less able the state is to achieve social justice through income redistribution.

Social injustice in China is linked to the country's neo-liberal approach to economic reform. After Deng Xiaoping's southern tour in 1992, China implemented radical decentralisation in order to reform its rigid economic system. Under Zhu Rongji's leadership from the mid-1990s to the early 2000s, the government formulated and implemented the so-called strategy of "grasping the big and letting go the small". In a short period of time, this strategy gave rise to a new economic structure which favoured economic efficiency over social justice.

Under the new economic structure, the state monopolises key industrial sectors that are regarded as strategically significant. Large enterprise groups are formed in order to increase China's international competitiveness. This state monopoly has also taken place at local levels, including provincial, municipal, and county. More often than not, local governments monopolise any sectors which are profitable. When the state occupies most profitable sectors, the private sector often finds it very difficult to sustain its development.

Furthermore, small- and medium-sized state-owned enterprises were privatised through various means. Due to the lack of corporate governance and the authoritarian political setting, privatisation was not well justified and often dictated by enterprise managers having close ties with government at various levels. To a great degree, privatisation in China resembles that of Russia, and is often a means of transferring state assets from the public to individual managers.

While this neo-liberal approach promoted rapid economic growth, it also dealt some serious blows to social justice. Under the new economic structure, wealth is ebbing away from the people to the state; the state is becoming richer as the people become poorer. Furthermore, this strategy is also effectively transferring wealth from the majority to a minority élite.

Since acceding to power in 2002, the Hu Jintao—Wen Jiabao leadership has tried to increase social justice by introducing more reforms to the state sector. However, the result has not been satisfactory. To cope with serious corruption within the state sector, the leadership has placed much emphasis on corporate governance and corporate social responsibility. However, resistance from vested interests has been strong. The close ties between the government and enterprises often render any anti-corruption measures ineffective.

Moreover, while the state monopoly is all-pervasive, the development of the private sector is seriously constrained. Although the private sector now plays an

increasingly important role in China’s economy, it continues to struggle with an unfavourable political and financial environment.

Social injustice in China has structural roots. Without substantial changes to China’s economic structure, any policy aimed at improving income disparities and increasing social justice can hardly be effective. Despite the establishment of the policy discourse of building a ‘harmonious society,’ it is still unclear what effective measures the Chinese leadership will take to realise this ambitious goal.

China's Recent State-Owned Enterprise Reform and Its Social Consequences

Yongnian Zheng and Minjia Chen*

SOE Reform under Zhu Rongji and Its Impact

1.1 The building of a "harmonious society" has in recent years become a top priority of the Chinese leadership. The leadership under Hu Jintao and Wen Jiabao has been making great efforts to increase social justice. Various measures have been implemented to reduce income and regional disparities, such as special policies aimed at the undeveloped west and the north-eastern "rustbelt", as well as attempt to narrow the gap between the cities and the countryside.

1.2 However, the leadership has met strong local resistance in implementing these policies. Chinese society is becoming increasingly "inharmonious" as social protests drastically increase. The Chinese people are beginning to resort to political, legal, or even violent solutions when not able to solve their day-to-day problems through economic means. The leadership faces a dilemma: the faster China has developed economically the more income disparities have grown and the less able the state is to achieve social justice through income redistribution.

1.3 Social injustice in China is linked to the country's neo-liberal approach to state-owned enterprise reform (SOE) in the past decades. This approach has been successful and China has achieved great success in improving the productivity and efficiency of SOEs Although China began SOE reforms in the 1980s, radical reforms only took place after Deng Xiaoping's southern tour in early 1992. It was heavily debated whether China should adopt a market economy approach until 1992 when the Fourteenth National Congress of the Chinese Communist Party (CCP) clearly stated that China's economic reform was to establish a socialist market economy. The clarification of "market economy" status provided the necessary conditions for China to begin large-scale economic decentralisation.

1.4 Zhu Rongji was appointed Vice Premier in charge of China's economic reform in 1991. In the mid-1990s, Zhu Rongji formulated a new strategy for SOE reform, which was called "grasping the big and letting go the small" ("抓大放小"). It was officially established as China's new economic reform strategy at the Fifteenth National Congress of the CCP in 1997, when Zhu Rongji became the Premier-select. This strategy gave the SOE reform a clear direction, especially in the case of the large SOEs. After Zhu became the Premier in 1998, this strategy was implemented to its fullest extent.

1.5 "Grasping the big" means making efforts to cultivate strong and competitive large enterprises and enterprise groups and develop them into cross-regional, cross-sectional, multi-ownership and multinational

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big firms. "Letting go the small" implies that the government allows the small- and medium-sized SOEs to face market forces. The government would actively support small- and medium-sized enterprises (SMEs), especially technology companies, to develop and become "specialised, lean, unique and innovative". The government would use various realistic methods, such as joint venture, mergers and acquisitions, leasing, contracting, shareholding and selling-off, to deregulate and invigorate SMEs. The ultimate goal of this strategy was that the government would be able to privatise most of the SMEs and would only control a limited number of large central and local SOEs. The latest policy on big SOEs issued by the Chinese government focuses on seven key areas and industries related to national security and economic lifelines, including military industry, electricity and the electrical grid, oil and the petrochemical industry, telecommunications, coal, civil aviation and shipping.[1]

1.6 When the Zhu Rongji administration initiated and implemented the policy of "grasping the big and letting go the small", it had an ambitious strategic perspective. Most industrialised countries have successfully developed many large enterprise groups. As a big country, China certainly needs to establish enterprise giants to form the pillar of the national economy and to enhance its international economic competitiveness. More importantly, the existence of such large enterprise groups in the critical areas will also provide strong support to national economic security. In designing such a strategy, the Zhu Rongji government aimed to follow the path taken previously by Japan and South Korea.[2]

1.7 Privatising state-owned SMEs was also a rational choice for the Zhu administration. A large number of state-owned SMEs were inefficient and unprofitable. They were not competitive in the market and often became heavy financial burdens on all levels of government. Their ambiguous property rights more often than not caused serious managerial agency problems. According to the international experience, privatisation could be an effective means of restructuring these SOEs and thus improving the efficiency of the whole economy. Moreover, privatising SMEs was also socially and politically significant. SMEs could play a highly important role in the provision of employment opportunities and the rationalisation of income distribution.

1.8 In 1997, the Chinese government set a three-year phased goal for the SOEs to turn around their loss-making condition. In September 1999, during the Fourteenth Plenary Session of the Fifteenth Congress, the government adopted the policy of diversifying SOEs' share ownership to establish a modern corporate system. By reforming, reorganising, restructuring and strengthening management and other areas, the objective of controlling the loss-making of SOEs was largely achieved by the end of 2000. Many previous loss-makers started to make a profit; others went bankrupt and withdrew from the market; and still others were merged and restructured. However, this three-year plan was criticised for its poor efficiency. Although the plan incurred large costs

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[1] *Xinhua* news, 19/12/2006, "SASAC: The State-owned Economy Should Maintain Absolute Control in Seven Sectors", http://www.china.com.cn/policy/txt/2006-12/19/content_7527663.htm, accessed on 24 April 2007.

[2] For a detailed discussion on this strategy, see Zheng Yongnian, *Zhu Rongji Xinzheng: Zhongguo gaige de xinmoshi* (Zhu Rongji's New Deal: A New Model for China's Reform), Singapore and New Jersey: Global Publishing Co. INC, 1999, ch. 4.

and recourses, its implementation was believed to have been in line with the planned economy, and thus was criticised for not being able to make substantial progress in the SOE reform. SOEs continued to be subject to soft budgets.

1.9 In retrospect, the policy of "grasping the big and letting go the small" was carried out too hastily and was problematic in many ways. In its implementation, "grasping the big" was exaggerated ruthlessly by all levels of government. Government officials tried to use political and administrative means to merge enterprises in order to create giant monopolies, simply for the sake of "big" and regardless of any other economic and social considerations. With the implementation of this policy, various positive aspects of big enterprises, such as the capacity for innovation, efficiency and competitiveness, did not develop as initially expected. Many Chinese SOEs have become internationally famous for their huge size, but their large assets are often assembled by the state in various ways. Furthermore, these giant SOEs are often monopolies and control the upstream supply market for entire industrial chains. Therefore, they earn hefty monopoly profits at the expense of consumers.

1.10 In industrialised countries, privatisation has improved industrial efficiency and kept a balanced public service sector in many cases, such as the UK in the 1980s and 1990s. However, without much experience, the Chinese local governments did not really understand the true meaning and objectives of privatisation, and, thus, did not have a systematic and effective plan for the privatisation process. They simply "let go" the state-owned SMEs to the market. Consequently, sizable state-owned assets were lost due to inappropriate administration and deficient regulations. Enormous numbers of employees were laid off during the process, causing social unrest and even conflicts between the government and the public.

1.11 The aim of privatisation is to improve the efficiency of the economy, provide better services to the public and ultimately increase consumers' overall utilities. However, in China local governments used administrative power to enforce privatisation, in favour of the capital owner rather than the public—the tax payers. Many SMEs, after being privatised, struggle to survive. Since they do not enjoy a supportive financial, legal and policy environment, their development has been greatly constrained.

1.12 The number of SOEs and employees has decreased dramatically since the "grasping the big and letting go the small" policy was put into force. The Chinese government has often emphasised that the SOEs' economic efficiency and competitiveness are improving and the quality of the state-owned assets is being enhanced. However, these assessments, which are based on numerical evidence, have to be treated with caution. The overall improvement of the SOEs' profitability is very likely due to the exclusion of many badly-performing SMEs under the "letting go the small" policy, but not due to higher efficiency amongst existing firms. Also, the increase in SOEs' profits very likely comes from the monopolistic income of those newly merged large firms under the "grasping the big" policy, rather than from SOEs' better performance in the market.

Wen Jiabao's New Initiatives

2.1 At the Sixteenth National Congress of the CCP in 2002, when the Chinese government led by Hu Jintao and Wen Jiabao came to power, the direction of SOE reform was further re-adjusted. The government continued to make efforts to restructure the state-owned economy and reform the state assets management system. According to new policy initiatives, except for a handful of SOEs to be run solely by the state, the government would implement a diversified ownership structure in the majority of the SOEs and would control only the important enterprises. Governments at the central, provincial and municipal levels were required to set up special institutes to represent the state as performing investor's responsibilities.

2.2 In the first half of 2003, the State-owned Assets Supervision and Administration Council (SASAC) of the State Council was established. SASAC supervised 196 central SOEs and RMB 6.9 trillion (US$ 0.9 trillion) state-owned net assets.[3] Since then, local SASACs have been gradually established. This arrangement was intended to solve three key problems concerning the implementation of property right liabilities. First, vertically, it clearly defined the property right liabilities among governments at different levels. Second, horizontally, responsibility was localised, which was not the case while many government departments had administrative authority over the enterprises. Investors' rights were centralised to SASAC from various departments, including the Ministry of Finance, the Central Work Commission of Enterprises, the Financial Work Commission, the State Economic and Trade Committee, the National Development and Reform Commission and the Ministry of Labour and Social Security. Third, the government's executive power and the SOEs' ownership rights would no longer affect each other. These were the major breakthroughs in the institutionalisation of the SASAC system. Currently there are 159 central SOEs supervised by SASAC, down from 196 in 2003. SASAC is aiming to further reduce the number of SOEs to between 80 and 100 by 2010.

2.3 According to the official definition, besides the duty of investor, SASAC is also responsible for guiding the reform and restructuring of the SOEs, forming the board of supervisors in large SOEs on behalf of the state, human resource management, supervising and managing state-owned assets by statistical and audit means, and developing relevant regulations and laws.[4] The establishment of SASAC indicates that the Chinese government has realised the significance and urgency of the low efficiency and asset drainage of SOEs.

2.4 An important part of the reform directed by SASAC is the personnel system reform as an essential part of building modern corporate governance of SOEs. Managerial positions would be filled through open competition and no longer by administrative appointments. The new system also aims to place an emphasis on the value of talent in an enterprise. From 2003 to 2006, 81 senior posts in 78 central SOEs were

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[3] Data source: *21st Century Economic Report*, 11/12/2006, "Restructuring of Central SOEs Cannot Rely on "Consanguineous Marriage"", http://www.nanfangdaily.com.cn/southnews/spqy/21sjpl/200612110422.asp, accessed on 24 April 2007.

[4] Information source: State-owned Assets Supervision and Administration Commission of the State Council. http://www.sasac.gov.cn/gzwgk/gzwgk_jj.htm.

openly advertised and recruited and 20 deputy senior posts in 10 central SOEs through internal competition. [5]

2.5 All over the world the core issue for SOEs is the problem of soft budget constraints. [6] On one hand, SOE managers do not have the incentive to cut costs and seek to maximise profit simply because the enterprises are owned by the state. On the other hand, if the SOEs perform badly, the state cannot simply let them be eliminated by market competition. Rather, it will find ways such as the provision of financial subsidies and creation of a monopoly environment to help the SOEs out of their predicament. For SOE managers, it is much easier to plead for support from the state than to build up the business in the competitive market. Therefore, there seems no reason to expect these managers to improve the efficiency of firms. In such cases, SOEs rely on the state for survival and often become a heavy burden to public finance. The establishment of SASAC and related institutional adjustments by the State Council transferred the task of state-owned assets management from several government departments into one and, thus, have hopefully reduced the inefficiency caused by bureaucracy. However, greater efforts are needed to solve the soft budget constraints problem.

SOE Monopoly and Its Consequences

3.1 After years of reform efforts, the proportion of SOEs in the whole economy decreased significantly and SOEs' strength increased. By the end of 2006, the number of central SOEs supervised by the central SASAC had decreased to 159 while their total assets reached RMB 12.27 trillion (US$ 1.59 trillion), a 16.2% rise from the previous year. Their sales, realised profits, tax payment and net assets all have strong yearly growths of 20.1%, 18.2%, 20% and 15.2%, respectively. [7] The 1,031 SOEs supervised by the local SASACs also achieved similar outstanding performance.[8] Furthermore, SOEs, especially large SOE groups, tend to monopoly industries. Sectors such as oil and gas, telecommunication and other information transmission services are almost all occupied by state-owned or state-holding enterprises. Some other sectors, such as electricity, heat production and supply, coal mining and washing, transport and transportation equipment manufacture, which are the key industries related to the national economic lifeline, are mostly shared by SOEs.

3.2 The obvious result of such a situation is an enhancement of the profitability of SOEs. One might think that the high profitability of the SOEs would benefit the country's fiscal revenue through taxation. However, while SOEs are increasing their tax contribution to the state,

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[5] *Xinhua* news, 25/10/2006, "Deputy Direct of SASAC: China Will Actively Promote the Reform of Personnel System in SOE", http://www.gov.cn/jrzg/2006-10/25/content_423735.htm, accessed on 24 April 2007.

[6] "Soft budget constraints", a term coined by János Kornai meaning the refinancing of loss-making enterprises, was one of the most widely used incentive problem analyses in socialist, transitional and market economies. For example, Kornai, J., Maskin, E. and Roland, G. (2003), "Understanding Soft Budget Constraints", *Journal of Economic Literature*, Vol. 41, No. 4, pp1095-136

[7] Data source: State-owned Assets Supervision and Administration Commission of the State Council. "SASAC Work Review 2006", http://www.sasac.gov.cn/2006rdzt/2006rdzt_0021/gzw/default.htm, accessed on 24 April 2007.

[8] *Ibid*.

the negative effects of the excessive concentration of SOEs into monopoly areas are greater.

3.3 It is commonly known that due to their low efficiency, SOEs do not have comparative advantages, especially in competitive industries. Therefore, SOEs are continuing to move from competitive sectors to monopoly sectors. These SOEs subsequently claim, proudly, that they are turning losses into profit. This is especially true for SOEs supervised by local SASACs. While the monopoly of central SOEs can be justified for national strategic reasons, local SOEs often exercise monopoly wherever it is profitable. The increase in profits does not stem from the improvement of firm efficiency, but from the benefits of monopoly. SOEs have been strengthening their control of the upstream resources of industrial chains. Their extra profits come at the expense of a loss of utility to the general public.

3.4 Usually, a firm's profitability comes from effective management and an increase in efficiency. In China, there might be a slight improvement in the management and efficiency in SOEs when they become monopolies. However, what firms actually seek for to be monopolies is the price, which brings them the extra monopoly profit. In other words, the profitability of the monopoly sector is not due to its efficiency, but to the nature of monopoly itself.

3.5 Monopolies clearly cause unfair competition in the market. Employees in the monopoly sectors earn extraordinarily high incomes, and this has become a major source of China's widening income gap and is causing serious social tensions. In their own closed-market setting, these conglomerates operate according to their own rules, which are not in line with market principles. Prices are often inflated to feed the needs of the employees of these monopolies. For example, a graduate in a major coastal city earns an average of about 2,000 RMB per month, but a highway toll collector working for a monopoly earns as much as 8,000 RMB per month. An investigation by the Guangdong provincial government shows that in 2006, although many big SOEs in the province were making a loss, the wages for their employees continued to increase.

3.6 Furthermore, the growing trend of monopoly amplifies inefficient economic expansion in China. If this trend is tacitly accepted or even encouraged, then the current problem of China's overheated economy will not be resolved. A vivid example is China's big firms which are ranked in the world's top 500. They are basically monopolies and fundamentally different from the multinational firms in industrialised countries, since China's SOEs do not have strong market competitiveness although they are physically large.

3.7 Ten years ago, China's SOEs struggled to control their expenditure to pay their employees' salary. The Chinese government then tried to "revitalise" and "save" SOEs and helped them out of their trouble. But today, the topics associated with SOEs are "high salary", "huge profits" and "dividends sharing". Price-inflation in SOEs has generated enormous popular dissatisfaction. [9] To deal with these issues, a series of new policies are being put into practice. SASAC, together with labour and

[9] For example, *Xinhua* news, "People's Forum Survey: 96.5% of Responses Indicate Unsatisfaction about Current Salaries and the Wage System in Monopoly Sectors", http://news.xinhuanet.com/fortune/2007-06/05/content_6202484.htm, accessed on 2 July 2007.

social security, finance, and audit departments, has tried to restrict the salary scale of monopoly sectors. [10] Li Rongrong, Director of SASAC, has revealed that from 2007 SOEs will be required to pay their dividends to the state treasury again, twelve years after the suspension of this policy in 1994. [11] However, this policy has also led to the concern that it will intentionally make SOEs' monopoly behaviour justifiable since the monopoly SOEs would argue that their dividend payments contribute directly to the state's fiscal revenue. Furthermore, if there is not a well-designed channel for the government to systematically use this income, for example to subsidise small- and medium-sized firms, or to spend on education and social security funds, then this dividend payment to the government would not fulfil the purpose of income redistribution.

3.8 The question of the government's role should be central to debates on the SOE monopoly issue. SOEs belong to the state and should perform the governmental function of providing public services. The target of the government should not be the maximisation of SOEs' profits or fiscal revenue, or the maximisation of state-owned assets, but the maximisation of social interests, i.e., their utility to the public. In China's transitional economy, the government is both the owner of public firms and the superintendent of society: two opposing roles. The government could easily use the monopoly power from its superintendent role to benefit its role as the owner of state assets. Therefore, to settle the problem of SOEs' monopoly, the function of government has to change. Ironically, on the other hand, government functions will be difficult to change if the problem with SOEs is not solved.

3.9 In a recent policy issued in December 2006, the Chinese government emphasised the promotion of state-owned capital to play a leading role and to strengthen its macro-management of the economy, particularly in important industries and key economic areas. Important industries and key economic areas are stipulated as: those involving national security, major infrastructure and important mineral resources, those providing essential public goods and services, and the key enterprises in pillar industries and high-tech industries.[12] Among these areas, it is really only plausible that the government should be involved in the public goods and services sector. The public goods and services that the government provides are meant to complement the deficiency of the market. The government should only be directly involved in those key areas if they are ones in which the private sector is unwilling or unable to operate. In operating SOEs the Chinese government should aim at social targets, rather than the value-enhancement of state assets. These two types of target are primarily incompatible.

3.10 The most effective way to control monopoly profits is to introduce competition into the industries to let the consumer share the benefit, rather than trying to redistribute the monopoly profits. It seems that the

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[10] *YanZhao Metropolis Daily*, 19/03/2007, "It Is Better to Improve Management Mechanism, Rather Than Adjust the Wage System of SOEs in Monopoly Sectors", http://news.xinhuanet.com/comments/2007-03/19/content_5865109.htm, accessed on 24 April 2007.
[11] *Beijing Times*, 16/02/2007, "SASAC Rigorously Investigates Central SOEs' 'Little Treasuries' to Prepare for the Resumption of Dividends Payments from Central SOEs to the State", http://news.xinhuanet.com/fortune/2007-02/16/content_5745865.htm, accessed on 24 April 2007.
[12] Document source: State-owned Assets Supervision and Administration Commission of the State Council, "Office of the State Council Republish 'The Guidance Notice on Promoting the Adjustment of State-owned Assets and Restructuring SOEs' by SASAC", http://www.sasac.gov.cn/2006rdzt/2006rdzt_0021/gzw/03/200701150235.htm, accessed on 24 April 2007.

Chinese government has realised this and begun to promote the strategic adjustment of China's economic structure by focusing on eradicating monopolies. Chinese Premier Wen Jiabao, in his work report to the National People's Congress in March 2007, stressed that reforming the monopoly sectors means liberalising market access, introducing competition and implementing multi-ownership structures involving a diverse range of investors. [13]

Future Challenges for the SOE Reform

4.1 Due to various institutional defects, corruption is often prevalent in SOEs. In SOEs, the unreasonable corporate power structure and unclear statutory responsibilities and duties prevent the development of an effective system for keeping power in balance. Poor law enforcement and low opportunity cost provide insiders with strong incentives to commit corruption, which results in the huge loss of state assets. Deficiencies in the supervisory and monitoring structure also create opportunities for corruption. SASAC has been making great efforts to deal with this. It is working to improve the investor system, and to legalise and standardise the management mechanisms for state-owned assets, and to incorporate the prevention of corruption into the SOEs' own risk management strategies. [14]

4.2 Two characteristics of the corruption prevalent in SOEs are that the majority of individuals implicated are senior managers, and that the amount of money and assets involved is massive. [15] Senior managers in SOEs normally have unsupervised power over everything within the firm. Consequently, they can abuse this power to illegally obtain benefits for themselves. The Chinese government has also found that monopoly industries have become the area with the most frequent incidences of corruption and bribery. In recent years, the government has targeted the monopoly SOEs in its anti-corruption drive.[16]

4.3 However, no matter how effective the law enforcement departments are in fighting corruption, their actions are merely palliatives if there is no institutional reform alongside. To treat corruption in SOEs at the source, the Chinese government will have to reform the SOE system and break the administrative monopolies.

4.4 Another controversial issue closely related to SOE reform is its impact on the survival and development of small- and medium-sized firms, particularly private ones. SMEs currently contribute about 60% of China's gross domestic product and 50% of the country's tax revenue, and provide over 75% of total urban employment opportunities. SMEs are responsible for about 65% of inventions and patents and over 80% of

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[13] *People's Daily*, 05/03/2007, "Wen Jiabao Stressed: Deepening SOE Reform from Four Aspects and Liberalising Market Access", http://finance.people.com.cn/GB/1037/5439059.html, accessed on 24 April 2007.

[14] *Legal Daily*, 26/09/2005, "Huang Danhua, Secretary of SASAC Discipline Inspection Commission: SOEs' Corruption Stems from Three Main Shortcomings", http://news.xinhuanet.com/lianzheng/2005-09/26/content_3543392.htm, accessed on 24 April 2007.

[15] *Guangming Daily*, 01/02/2007, "How Did SOE Bosses Become the 'Disaster Area' of Corruption?", http://gov.people.com.cn/GB/48380/5354562.html, accessed on 24 April 2007.

[16] *Oriental Outlook*, 26/10/2006, "Monopoly Sector Has Much Corruption and a High Income, and the Central Government Is Targeting Monopoly SOEs", http://news.xinhuanet.com/fortune/2006-10/26/content_5251320.htm, accessed on 24 April 2007.

new product development. [17] Nevertheless, China's industrial and financial policies have long favoured state-owned and large firms. Many studies have found that SMEs in China are much more financially constrained than their larger counterparts.[18]

4.5 Before its reform, China's state-owned banking sector simply took orders from the government to allocate financial resources to the SOEs, while denying the same resources to China's most efficient private SMEs. Official statistics show that although over 99% of the firms in China were SMEs in 2005, they shared only 16% of total bank loans, which are the dominant means of external finance for Chinese firms. [19] The majority of SMEs in China are private firms. As their ownership reform continues, state-owned banks (SOBs) have become increasingly commercialised. They have more independent rights to make rational business decisions, instead of following government instructions. However, due to the information asymmetry problem in the market and traditional bank relations, SOBs still prefer to lend to the large SOEs, not SMEs.

4.6 Although they are the engine of growth in the Chinese economy, SMEs are discriminated against in terms of access to external funding, market opportunity, property rights protection, and taxation. The latter two are expected to be relieved to some extent when China's new *Property Law* and *Corporate Income Tax Law* are put into effect from 1 October 2007 and 1 January 2008, respectively.

4.7 Even in developed market economies SMEs play exceptionally important roles, and they desperately need government support to survive and develop. In China's transitional economy, if the government purely "lets go the small" and puts them entirely at the mercy of the market, then as China becomes a fully open economy according to its WTO obligations, the country would be at risk of losing its most efficient SMEs to foreign and domestic competitors. On the other hand, if China ruthlessly pursues the policy of "grasping the big", it may use its limited financial resources to subsidise and invest heavily in its inefficient large SOE sector, even at the cost of damaging its ability to provide necessary public goods. Consequently, resources would be seriously misallocated. If this becomes the case, China's economic development could not be sustained and social instability would emerge.

4.8 In fact, SASAC itself has also come under criticism for the ambiguous boundary between its own administrative function and its market activities. SASAC specifies its responsibilities as safeguarding the rights and interests of owners and preventing the loss of state-owned assets. On the one hand, as a government agent it fulfils the duty of managing state assets, and as an investor it operates the firms and leads the restructuring of SOEs. On the other hand, as a quasi-governmental body,

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[17] Data source: Department of SME, National Development and Reform Commission of China, "Speech of Vice-Premier Zeng Peiyan on the National SME Forum" 14/09/2006, http://zxqys.ndrc.gov.cn/ldxw/t20061103_91615.htm, accessed on 24 April 2007.

[18] For example, among others, Chow, C. and Fung, M., 2000, Small Businesses and Liquidity Constraints in Financing Business Investment: Evidence from Shanghai's Manufacturing Sector, *Journal of Business Venturing*, Vol.15, p363-83. Guariglia, A. and Poncet, S., 2006, Could Financial Distortions be No Impediment to Economic Growth After All? Evidence from China, GEP research paper 2006/36, University of Nottingham.

[19] Data source: National Development and Reform Commission. *China Business Times*, 20/01/2006, "NDRC: The Ratio of SME Loans is Still Falling", http://www.smegd.gov.cn/news/Article/news/jinmao/200601/20060120095115.htm, accessed on 24 April 2007.

it is responsible for market regulation and control on behalf of the government.

4.9 Because of vague definition and the lack of restraints, SASAC has been given the dual rights of an investor and a supervisor. Power has a self-inflation logic. SASAC has repeatedly emphasised the importance of the growth of central SOEs' profit. This mode of economic development raises doubts over whether SASAC intends to further strengthen the current monopoly profit model of SOEs, whether it might use its administrative power to benefit various interest groups in the course of conducting market operations.

4.10 China has been reforming its SOE sector since 1984, as a key element in its urban economic reform. It has made tremendous achievements, but has also met crucial difficulties. The Chinese government has been endeavouring to optimise the sector. However, it seems unclear to the Chinese leadership what should be the direction of further reforms of SOEs. Should the government try to improve the productivity efficiency of SOEs to make them capable of competing in the open market? Should they try to create and enhance the monopoly positions of SOEs to gain the extra profit, although thereby allowing them to remain inefficient? Though the hypothesis has not been proved, the leadership seems to believe that only a strong central SOE sector will be able to safeguard China's economic security and compete with foreign multinationals. Or should the government's aim be to develop a well functioning SOE sector to provide high-quality public goods and services and thereby eventually benefit the whole of society? To continue the SOE reform, the Chinese authorities need to find answers to these questions first. It will undoubtedly be a tough process of bargaining and balancing among different interest groups. This is one of the most vital problems faced by the Chinese economy today.