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What Kind of Privatization?

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The Fifteenth Party Congress of the Chinese Communist Party (CCP) attracted worldwide attention by announcing its adoption of the *zhua da fang xiao* ("control the big, while releasing the small") strategy in reforming its 354,000 state-owned enterprises (SOEs), 240,000 of which are small-sized SOEs. A shareholding system (*gufen zhi*) will be a major instrument for SOE reform. *Zhua da fang xiao* means that the government will effectuate a strategic reorganization of SOEs by tightly managing large enterprises while adopting flexible policies toward small ones. It will establish highly competitive large-enterprise groups with transregional, intertrade, cross-ownership, and transnational operations. At the same time, it will quicken the pace toward relaxing control over small SOEs and invigorating them by way of reorganization, association, merging, leasing, contract operation, shareholding partnerships, or sell-offs. The CCP said that it would encourage merging enterprises, standardizing bankruptcy procedures, diverting laid-off workers, increasing efficiency by downsizing staff, and encouraging reemployment projects. This will form a competitive mechanism that selects the superior and eliminates the inferior.[1]

Due to the special political mobilization efforts of the party congress, this policy guideline led immediately to the implementation of shareholding and cooperative shareholding systems in the SOEs. The shareholding system is held to be a panacea for the success of SOE reform in many regions. The intense interest in a shareholding system in many ways resembles the craze in real estate and special economic zones a few years ago in Mainland China. Some counties or cities, which until a few months ago had taken no action in the SOE reforms, suddenly announced that 80 to 90 percent of the SOEs under their jurisdiction had been transformed into shareholding or cooperative shareholding firms. Some foreign scholars have added to this craze by claiming that the shareholding system is a great theoretical innovation of the socialist market economy, and that the cooperative shareholding system for small- to medium-sized SOEs is superior to the Western shareholding system because it adopts a "one shareholder one vote" rather than "one share one vote" approach.

How should SOE reform and its highly publicized shareholding system be evaluated? What form of shareholding should be adopted: One in which the state or the collective has the dominant share, or one in which individual shareholders as a whole have the dominant share? The latter system seems preferable. This chapter argues that with further marketization reforms and improvement of the market system, the shareholding system with individual shareholders holding the controlling rights will be more efficient than the one with the state or the collective holding the controlling rights. Besides the choice of different forms of shareholding systems, what is the appropriate speed and scale for the shareholding system reform and privatization? What are likely to be the concerns and challenges during the process of SOE reforms?

In addition to addressing these questions, this chapter will discuss an important issue that has until now been largely ignored by scholars: the rapid expansion of government employees. By the end of June 1997, the number of employees in government organs and agencies had increased by 1.35 million compared with the previous year. The first half of 1997 alone accounted for an increase of 1.08 million. The growth rate of employees in this sector was 8 percent, and more than offset the decrease in employees working in the SOEs (which was 1.27 million). This means that the gains from SOE reform in terms of reduced employment in the state sector have been completely consumed by the expansion of government organs and agencies. If this situation persists, it will create serious difficulties for smooth systematic transition. This problem is more serious and pressing than the SOE reform. It will be very difficult to solve and it will involve substantive reform in the political structure.

This chapter is organized as follows: the first section discusses the necessity and urgency of SOE reform, and the next section focuses on the forms of shareholding systems. The speed and pace of SOE reform are analyzed in the following section. The last section discusses the problems posed by the expansion of government organs and agencies in recent years and the challenges this presents to China's transition.

The Necessity and Urgency of SOE Reform

The official announcement of the Fifteenth Party Congress, which launched the systematic reform of SOEs by implementing a shareholding system, is of momentous importance and will have far-reaching historical significance. The CCP now considers the well-executed reform of SOEs as the top national priority and of vital importance in building a socialist market economy. As early as March 1997, the adoption of *zhua da fang xiao* as the means to reform the SOEs and the use of a shareholding system as the reform's major policy tool had been set forth by Premier Li Peng in his report delivered at the Fifth Meeting of the Eighth National People's Congress. Since the CCP holds the ultimate power, the resolution of the Fifteenth Party Congress has significant influence and authority. Without doubt, the implementation of SOE reform and shareholding system is a decisive step forward in the transition toward a market economy. It may be regarded as the beginning of privatization, or, using the official terminology, the "diversification of the ownership structure."

A few years ago, one author of this chapter argued that the smooth transition of the Chinese economy toward the market system would go through three stages:[2] (1) economic liberalization, (2) marketization, and (3) privatization.[3] The first stage began in 1979, when economic reform was initiated in the agricultural sector. The main policy slogan at the time was "untying and relaxing," which meant that the central government would give up some decisionmaking authority. The second stage began in 1992 after Deng Xiaoping gave a major speech during his visit to southern China. The Fourteenth Party Congress in 1993 announced that China would make big strides toward establishing a socialist market economy. The last stage is the nationwide privatization of the SOEs, which for various reasons had been put on hold for a number of years. Experiments with diversified ownership structure in selected SOEs started as early as the mid-1980s, with policy options ranging from leasing, bankruptcy, sell-offs, cooperative shareholding, shareholding, reorganization, and mergers to joint ventures with foreign capital. In various experiments, shareholding increasingly gained momentum. In 1994, there were 25,800 shareholding enterprises, 135,700 cooperative shareholding enterprises, and 2,853,300 township enterprises, the total of which accounted for 10 percent of all SOEs in China.

Why should *zhua da fang xiao* be used to reform the SOEs and transform them into a shareholding system on a large scale? The reasons lie in the early success of marketization reform, the rapid growth in the nonstate sector, and the relative inefficiency of the SOEs compared with non-SOEs. Marketization reform has exposed the SOEs to more competition from the nonstate-owned sector. Although efficiency in many SOEs has improved remarkably, most of them lag behind similar nonstate-owned enterprises. There is a widespread belief that the SOEs are not as profitable as the township enterprises, and the latter are not as profitable as private enterprises. In recent years, the number of money-losing SOEs has increased continuously, and they have created grave challenges to the state budget. The losses incurred by many SOEs were not only caused by low efficiency, but also by mandatory planning and ceiling prices set by the state.

The problems of the SOEs have manifested themselves in the following ways:

1. The number of money-losing SOEs and the amount of the losses have been increasing continuously. About two-thirds of the SOEs are operating with losses. When the SOEs are measured as a whole, the amount of their total losses has exceeded their total profits.

2. The contribution by the SOEs to national industrial growth has decreased. At the present time, SOEs only contribute about 5 percent to the total industrial growth in China, while the non-SOE sector contributes about 95 percent. The SOEs as a whole are so inefficient that they produce about 30 percent of the GDP but use about 70 percent of total capital formation.

3. The SOEs have caused huge deficits in the government budget. It has become increasingly difficult for the government to bear the burden of billions of dollars every year to subsidize the money-losing SOEs, and their number has been rising continuously.

4. The living standard of workers employed by SOEs has been dropping in recent years. Many money-losing SOEs can only pay workers the basic wage with no other benefits, while some are in such bad shape that they cannot even pay the basic wage. This has resulted in many workers living below the poverty level, especially those employed by the SOEs whose production has been idle or semi-idle. After the wage increase for government employees a few years ago, the wage level in money-losing SOEs is the lowest in the economy. It is at about 200 yuan (about US$25) per month and is 50 percent lower than that of government employees.

5. There is widespread erosion of state-owned property. Because the market economy is still in its infancy and government regulations are inadequate, state-owned property has been eroding rapidly. According to some reports, an average of about 100 million yuan (about US$12.5 million) worth of state-owned property has disappeared every day since 1980, which amounts to a total loss of about 1 trillion yuan (US$125 billion) by now.

Ensuring the survival of the SOEs has become an urgent task in the economic transition. Because of the dominant role SOEs play in the economy, their reform will remain at the top of the CCP's agenda in the near future.

Conditions for taking bolder steps in enterprise reform have also improved markedly. Liberalization and marketization reforms have transformed the old planned economy with a dominant state sector to a market-oriented economy with a rapidly growing nonstate sector. The reform policies since the late 1970s have granted individuals limited economic freedom, acknowledged the economic interest of individuals, encouraged decentralization and competition, and allowed diverse ownership forms to develop side by side with the SOEs. These reforms have resulted in the vigorous growth of the nonstate sector (including cooperatives, private enterprises, township enterprises, foreign capital enterprises, and joint ventures) and have profoundly changed the economy.

The share of the state-owned sector in the whole economy is declining continuously. It was about 80 percent in 1979 and had fallen to about 30 percent at the end of 1997. The nonstate sector has become the driving force behind the rapid economic growth. There has also been impressive progress in establishing a market economy. Price reform has resulted in more than 90 percent of all prices being determined by supply and demand in the marketplace, which has greatly enhanced the competition mechanism of the economy. Markets for stock, real estate, and labor have also been set up, though these are still in their early stages. In addition, the economic growth of the past decade has enhanced the state's fiscal capability to handle more bankruptcies of the SOEs.

In summary, both the grave difficulties facing most SOEs and a better-prepared economy now urgently call for large-scale SOE reform. Although some officials and scholars still believe that the SOEs can perform efficiently in a market economy, the government's policy of "controlling the big and releasing the small" is a bold step in the right direction, for it begins to realize that the relative efficiency of SOEs is going to decline further as the market economy develops. Unless privatized, the SOEs have no chance of surviving. The policy of "controlling the big and releasing the small" is going to pave the way for eventual reform of the large-sized SOEs.

The Forms of the Shareholding System

After deciding to implement the shareholding system, the government faces the issue of which form of the shareholding system to choose. Should it encourage the kind of shareholding system in which the state or the collective holds controlling rights, or the one where individual shareholders hold controlling rights? From the report delivered by Jiang Zemin at the Fifteenth Party Congress, the party seems to favor the former. The leadership has not broken entirely with the old ideology. Jiang stated that the government would retain a dominant ownership position and would develop diverse forms of ownership side by side. The dominant position of the state-owned sector is defined as requiring a dominant position in major industries and other key areas that concern the lifeblood of the national economy. Jiang further elaborated on this point by saying, "The public sector includes not only the state- and collectively-owned sectors, but also the state- and collectively-owned elements in the sector of mixed ownership." The dominant position of public ownership should manifest itself as follows: public assets dominate the total assets of society, and the state-owned sector controls the lifeblood of the national economy and plays a leading role in economic development.[4]

Jiang's report at the Fifteenth Party Congress did show some progress on the issue of ownership, but the party is still fettered by the old ideological constraints. This dilemma is best revealed in Jiang's remarks that

> the shareholding system is a form of capital organization of modern enterprises, which is favorable for separating ownership from management and raising the efficiency of the operation of enterprises and capital. It can be used both under capitalism and under socialism. We cannot say in general terms that the shareholding system is public or private, for the key lies in who holds dominant shares. If the state or a collective holds dominant shares, it obviously shows the characteristics of public ownership, which is favorable to expanding the area of control by public capital and enhancing the dominant role of public ownership.[5]

Thus, from Jiang's report, it is obvious that the shareholding system that the Chinese government wants to implement is one in which the state or collective holds controlling rights. Moreover, the CCP seems to hold the belief that it is possible to run a public economy efficiently under market conditions. Neither economic theory nor practice, however, supports such a belief. Of course it might be possible that the wording in Jiang's report is a tactic to avoid being caught in the tangle with the ideological leftists, which would increase domestic resistance to SOE reform. In practice, the CCP may well be much bolder and less constrained by ideology in implementing the reforms. Nevertheless, the ambiguity in such important issues will add difficulty to the privatization of the SOEs. If the state or collective is going to hold a dominant share (and thus have the decisionmaking authority) in the shareholding system, it will inevitably be a detour on the road to real privatization, where individual shareholders have the dominant share. There are several reasons this is true.

First, to avoid unnecessary confusion, private and public ownership must be defined. From modern property rights theory on ownership, the ownership of an enterprise refers to the contractual relationship that distributes the residual claims and residual controlling rights. Different distributions or allocations of the power and responsibility associated with ownership give rise to different ownership structures and arrangements. Private ownership is clearly defined and it grants an individual the exclusive right to claim ownership. On the other hand, nonprivate ownership is not clearly defined since it does not give exclusive right of ownership to any individuals. Compared to private ownership, public ownership (including state and collective ownership, as well as shareholding by the state and collective in mixed ownership) does not clearly set the boundaries of power and responsibility associated with the ownership arrangement. It is worth mentioning here that a private-ownership arrangement does not

mean that every right relating to the ownership is concentrated in one person's hands. Some rights can be shared by more than one individual, but with a clear division. For example, shareholders own the means of production, the manager has the right to manage the means of production, and the employees have the right to work with the means of production during the period of their contracts.

What are the benefits of a shareholding system? There are two main benefits. First, it can promote the development of an efficient capital market. Second, it can objectively appraise the economic performance of an enterprise, whereas a supervising government branch usually cannot. Information regarding an enterprise will be more reliably reflected in the price of stocks traded on the stock market. If a firm performs well, its stock price is likely to go up, for more people are willing to buy and hold its stock. Through the trading of stocks, efficient firms will survive, whereas inefficient ones will go out of business. If the state or collective holds the controlling share, the government department responsible for the firm will have the final decisionmaking authority in business management and personnel appointment. Factory directors and managers will be appointed by supervising departments, while smaller shareholders cannot really participate. Since these appointed factory directors and managers do not bear the risks associated with their management, they are less likely to devote all their efforts to increasing the value of their firms. In a market-oriented economy, it is difficult for such businesses to compete with those in which individual shareholders hold the controlling rights and bear the risks of the firms. In other words, because the ownership arrangement is not well defined, firms with the state or collective holding the controlling rights tend to be less efficient than those firms whose ownership is clearly defined. As marketization reform progresses, the relative efficiency of the public-owned sector will continue to fall. Even though the efficiency of some of them may be higher after mergers and acquisitions, their relative efficiency compared with the private sector will be lower as the transition to a full market economy advances.

The evidence is already there. Many SOEs that have been transformed into the so-called shareholding system are examples of "old wine in a new bottle" as they still function in the same old way. Various sources have reported that workers are not very enthusiastic about this kind of shareholding system, especially workers in the money-losing enterprises. Many of them believe that the shareholding system is a way for the government to take their money to pay off the debt accumulated by the money-losing SOEs, because all the debts have been shouldered by the government in the past. Many workers refuse to participate in this type of shareholding system. In response, some firms have threatened to fire those workers who do not want to buy the required amount of stocks. For example, the *Shanghai Interim Procedures for the Shareholding System*, which became effective on June 1, 1997, require that 90 percent of the employees of an SOE must become shareholders when the shareholding system is implemented. As a result, forced participation may emerge when an enterprise wants badly to become a shareholding company and more than 10 percent of its employees do not want to participate.

In many ways, the workers' concerns are justified. Some publicly held companies are big money losers. The mid-year statistical report of Shanghai in 1996 revealed that thirty enterprises listed on the stock market (about 12 percent of the total companies listed) reported losses or earnings of less than one cent per share. The situation seems to be getting worse. According to the newly released report on listed companies in 1996, the money-losing firms increased from eleven in the previous year to seventeen in the Shenzhen stock market, with the loss per share increasing from 0.16 yuan to 0.36 yuan. In the Shanghai stock market, the number increased from six to fourteen, and was 4.49 percent of the total number of firms listed. This represents a 1.4 percent increase over the previous year, and the loss per share grew from 0.29 yuan to 0.49 yuan. The net return on capital, which is a better measure of a firm's performance, has dropped from 12.47 percent in 1995 to 10.15 percent in the two stock markets. It is important to note that all the unprofitable firms were listed on the market before 1996. In addition, it seems that the longer a firm has been listed on the stock market, the worse its losses. For the above two stock markets, the average earnings per share over a five-year period was 0.39 yuan, 0.25 yuan, 0.21 yuan, 0.17 yuan, to 0.15 yuan in Shanghai, and 0.37 yuan, 0.20 yuan, 0.28 yuan, 0.18 yuan, to 0.11 yuan in Shenzhen. In only a few years, many publicly listed companies are facing the possibility of going out of business. Among the two hundred firms newly listed last year, twenty-two had less than 10 percent net return on capital, while others reported very low profits or were on the verge of reporting losses.

Yet most of the listed companies were above-average performers among the SOEs. The original intention of getting these firms listed on the stock market was to attract additional funds and improve managerial efficiency. They were supposed to set examples for other SOEs of how to become modern market enterprises. However, their disappointing performance casts doubt on whether the shareholding system with a dominant public shareholder (be it the state or the collective) can solve China's SOE problem. Such a shareholding system does not provide fundamental changes in the way firms are managed. It only changes the way funds are raised. If the situation continues, inefficiently managed firms will incur losses not only to themselves, but also directly to the general public. This will have far-reaching consequences for SOE reform and the development of the Chinese stock market.

It is apparent that the shareholding system with a dominant public shareholder cannot solve the efficiency problem facing the SOEs. There are two solutions to this problem. The first is to implement a shareholding system where individual shareholders hold a dominant share, which in essence privatizes the SOEs. When individual shareholders bear the costs and benefits of a firm's economic performance, they have an incentive to monitor closely the firm's management. The incentive structure is the main reason modern enterprises are more efficient in market economies. If, because of ideology, the government insists that the public has to hold a dominant share in the shareholding system, there is another solution suggested by one author of this chapter a few years ago: the state or collective can be granted a special kind of shareholding that would give it priority in assigning dividends, but the state or collective would not participate in the election of factory directors, managers, or the board of directors.[6] This is a viable way of solving the dilemma of keeping the public as the biggest shareholder while maintaining enterprise efficiency. There have been some local enterprises and some township enterprises that have implemented shareholding or cooperative shareholding systems along this line, and the results are quite encouraging.

Another important issue relates to the cooperative shareholding system, which refers to the kind of shareholding system in which employees own all the equity of a firm. Outsiders cannot own its stock and shares can only be exchanged internally. The distribution of the firm's earnings is made according to one's contribution as a worker and one's shareholding status. Under current political, economic, and social conditions, the cooperative shareholding system has been well received and is growing rapidly. Although it has the advantages of relatively clearly defined ownership and a flexible structure, it also has serious drawbacks. For example, it prohibits outside capital from coming in and reduces capital mobility. It may be suitable only for small-sized enterprises and various service firms. However, as an enterprise grows bigger in size and scale, capital will become a more important element for the further growth of the firm. The need to attract additional capital will eventually lead many cooperative shareholding firms to become publicly listed on the stock market.

The proposition of "one shareholder one vote" is even more problematic. Besides the drawbacks already mentioned above, the proposition makes it possible for shareholders who control relatively fewer shares to make management and administrative decisions, while the shareholders who have more shares bear a bigger portion of the risk. If the rights of decisionmaking do not depend on how many shares one owns, why would anyone want more shares? It is natural that people with fewer shares at stake are more willing to take bigger risks. But, who is willing to let other people gamble with their money? (Imagine, for example, that you and the authors are going to enter into a partnership. Would you be willing to have equal decisionmaking power with us if you contributed $1 million to the partnership, while we only contributed $100?) On the other hand, if it is required that everybody have an equal amount of shares, the result will be that people who want to invest more cannot do so. This will lead to the inefficient use of capital, as well as a waste of entrepreneurial opportunities.

When discussing the relative merits of various forms of shareholding systems, only the criterion of economic efficiency has been used so far. Reform should be concerned not only with improving economic efficiency, but also with other goals such as social fairness and stability. Economic efficiency and equity are two commonly used criteria for evaluating the consequences of economic activities, although from different angles. They embody two different value concerns of human beings. In general, there is a trade-off between efficient allocation of resources and equal income distribution. Because people are different in their capabilities, in order to improve efficiency and encourage hard work, the amount of income each individual gets will inevitably have to be different. If a person's income does not depend on his efforts or his contribution, he would be unlikely to put in his best effort. Although policies aimed at a more equal income distribution often reduce efficiency in order to maintain social stability and correct social injustice, people are generally willing to trade some economic efficiency for a more equal income distribution.

The economic system before reform overemphasized equal income distribution and basically ignored the efficiency of resource allocation. Many SOEs are in the red and are relatively inefficient compared with similar enterprises in the private sector. Also, since China is still in the early stages of economic development, economic growth is its most pressing challenge. Under these circumstances, the task of transforming the old inefficient SOEs into modern market enterprises with clearly defined rights and responsibilities should emphasize breaking the "iron rice bowl" and enhancing the efficiency of resource allocation. As market reform continues, the importance of a clearly established ownership structure will become increasingly important.

Furthermore, the most suitable ownership structure may be different under different economic conditions. State, collective, and private ownership each has relative advantages in different economic environments. In an article on ownership reforms in the transition economies,[7] Guoqiang Tian argues that when economic freedom is very limited and the market is in its primitive stage, SOEs may have a relative advantage over privately and collectively owned enterprises; when the market economy develops to an interim stage, the collectively owned enterprises may have more advantages than the other two forms of ownership; and when the market economy develops to its mature stage, private ownership may be the best ownership structure.[8]

In recent years, the cooperative shareholding system implemented in many township enterprises has been highly praised. However, the cooperative shareholding system is a transitional form of ownership arrangement. Although these ownership arrangements in township and other enterprises have advantages at the present time, as the market reform deepens, more of them will be replaced by modern market enterprises with clearly established ownership.

The Pace of Transforming the SOEs

Should China implement large-scale privatization of the SOEs at the present time? Have large-scale bankruptcy and ownership structure reforms become imminent? Does the country possess the necessary conditions for enduring the pains associated with large-scale bankruptcy of the SOEs? According to one report, the government plans to take about three years to clean up the money-losing SOEs. However, this timetable may be too optimistic. Due to the lack of the necessary economic and social infrastructure, the pace of large-scale reform in the SOEs must be deliberate and gradual. The reasons are as follows:

1. The government does not have the required financial resources to support the millions of workers who would be laid off. Restrictions set by the government's financial capabilities will limit the pace of reorganization and bankruptcy of SOEs. Even without reorganization and bankruptcy, the government needs to provide assistance to about 50 million people, which include 13 million workers who are in essence already laid off by unprofitable SOEs, 7 million workers waiting for employment, and 30 million retirees.

2. The output value produced by the state-sector is still about 30 percent of the GDP. If China implements the same type of privatization as in the former Soviet Union and eastern European countries, large-scale bankruptcies may significantly lower the GDP, as well as people's standards of living. Many people will lose their jobs, and the real wages of those still employed may drop, at least temporarily. In the process of transition, it is important to reduce social instability and avoid large-scale unemployment, for hardships of many individual workers may turn them against reform.

3. Since marketization is still an ongoing process, the value system and the way of thinking of many people has not fully adjusted to the workings of a market economy, particularly on issues relating to unemployment and inflation.

4. The social security and unemployment benefit systems are in their primitive stages. If a large number of workers are laid off, their livelihood will be threatened. The frustration and difficulty caused by unemployment, as well as lowered social and economic status, may cause resentment on the part of these workers, and therefore, lead to social unrest. Before social security insurance and labor markets are adequately established, forcing

large numbers of SOEs into bankruptcy would be a serious mistake. At the present time, SOEs serve the role of providing a social safety net to those workers who cannot find other employment opportunities.

5. The labor market has not been fully established, so workers who are idle or waiting for employment cannot effectively find jobs for themselves. Even without SOE bankruptcy, each year China faces the task of providing employment to about 20 million people.

6. There are no effective facilities for training and helping unemployed workers find new jobs.

7. Although the government needs to subsidize an unprofitable SOE, the subsidy may in some cases be far less expensive than the required financial resources to support all its employees if the SOE goes bankrupt.

In light of these constraints to rapid SOE reform, it is of great importance that the enterprise reform be taken with appropriate pace and sequence. In particular, the government should set aside sufficient financial resources for an unemployment fund in order to provide temporary financial assistance to those workers who are going to be laid off by bankrupt SOEs. Policies should be aimed at giving the unemployed workers more freedom in their job search, providing them with more job training, and promoting reemployment projects.

An important area of policy action should be targeted at establishing an efficient labor market so that labor can be more mobile. More freedom in job seeking should be granted to workers in the SOEs. In fact, policy should also be directed toward pressing ahead with all the supporting reforms for establishing a market economy. Many of the current difficulties are the result of immature or incomplete markets. A well-functioning modern market system not only means the absence of restrictions on prices and goods traded, but also includes a market-determined price system, an effective macroeconomic management system, modern market enterprises, an efficient and effective tax (and income distribution) system, a social safety net, rule of law, antitrust (anti–unfair competition) provisions, and open labor and capital markets.

The Issue of Rapid Personnel Expansion in the Government

One important issue that has largely been ignored by scholars and policymakers until very recently is the rapid personnel expansion in government organs and agencies. As market reform continues, the number of employees working in the SOEs has been declining continuously, while the number of government employees has been expanding, and now stands at more than 30 million. That means, on average, there is one government employee for every thirty Chinese people, whereas fifty years ago there was

only one for every three hundred people. At the end of June 1997, the total number of industrial employees was about 146.7 million, a reduction of 187,000 compared with the corresponding period of the previous year. On the other hand, government employees increased by 1,352,000. The first half of 1997 alone accounted for an increase of 1.08 million. The growth rate of employees in this sector was 8 percent and more than offset the decrease in employees working in the SOEs (which was 1.27 million). This means that gains from the SOE reform may have been completely absorbed by the expansion of government organs and agencies.

Such an expansion neutralizes the effectiveness of reforms in economic and management systems. One reason for such an expansion is the rapid decline of the SOEs. Many people have realized that the "iron rice bowls" that used to be offered by the SOEs have been taken away and workers in the SOEs face insecurity and lower wages. A government job is viewed as secure and prosperous. In response, many people are trying by every means to secure a government position. The second reason for such rapid expansion is the lack of political reform. There has been little progress in streamlining the government. Much of what has been done is essentially window dressing; many units merely reallocated administrative expenses or changed their names. Some units even took the opportunity of reorganization to expand the unit and the number of employees. This poses a more serious problem involving the reform of political structure and is even more difficult to solve. The reason is obvious: state-owned enterprises still create some value, no matter how inefficient they might be; government organs and agencies, however, are totally consumptive units that do not produce any commodities, or create any output value, or involve any competition, but they spend huge sums of money to support their operations. Even if the government is serious about streamlining its operations and cutting positions, most of the people who are cut from their posts will have difficulty making their way into the enterprises due to their lack of the expertise required by those enterprises. Therefore, reform of the political structure should be conducted as early as possible, starting with simplification of organizational structure and considerable reduction of government positions. As long as the current trend continues, the number of government employees will increase and institutional reform will become more difficult. If this problem is not settled properly, the effort to reform SOEs, to a large extent, will be wasted. Hence, reform of government organs and agencies in a smooth and practical way is an urgent issue yet to be addressed. (It is hoped that this chapter will bring more attention to this issue and attract more research in this area, so that the economic system of China can be transformed into a truly efficient market mechanism with free competition.)

After the first version of this chapter was written in October 1997, the Ninth National People's Congress held in March 1998 carried out a government restructuring program by reducing the number of ministries from forty to twenty-nine. The Chinese government also plans to cut 30 to 50 percent of government administrative employees in the next three years. The government, it seems, has finally realized the importance of this issue and made a remarkable step in reforming the government administrative system. Perhaps the government can reach the proposed goal of reducing the number of government administrative employees by 30 to 50 percent in the next three years, although this goal may be too ambitious. But even if it reaches this goal, the government needs to reduce its number of employees further, and to deepen the reform of the administrative system.

Notes

1. Jiang Zemin, *Gaoju Deng Xiaoping lilun weida qizhi, ba jianshe you Zhongguo tese de shehui zhuyi shiye quanmian tuixiang ershiyi shiji* [*Hold High the Great Banner of Deng Xiaoping Theory for All-Round Advancement of the Cause of Building Socialism with Chinese Characteristics into the Twenty-First Century: Report Delivered at the Fifteenth National Congress of the Communist Party of China, September 12, 1997*] (Beijing: Renmin chubanshe, October 6–12, 1997), p. 20. The quotations from this document hereafter will be indicated as "Jiang's report."

2. Tian Guoqiang, "Zhongguo guoyou qiye de gaige yu jingji tizhi pingwen zhuanggui de fangshi he buzhou" ["The State-Owned Enterprise Reform of China and the Mode—Steps for Transforming Economic System Smoothly"], *Jingji yanjiu* (*Economic Research Journal*) 319 (1994): 3–9. Also see Guoqiang Tian, "State-Owned Enterprise Reform and Smooth Institutional Transition in China—A Three-Stage Economic Reform Method," in *The Reformability of China's State Sector,* ed. G. J. Wen and D. Xu (New York: World Scientific Publisher, 1996), pp. 220–240.

3. "Economic liberalization" is defined here as the loosening or elimination of government restrictions on economic transactions, including freeing prices, trade, and entry of various types of new firms. "Marketization" is defined as the developing and creating of market-supporting institutions such as legal, financial, and social welfare security systems. "Privatization" means the privatization of existing state-owned or collectively owned enterprises, land, and other assets.

4. Jiang's report, p. 1.

5. Ibid., p. 20.

6. Tian Guoqiang, "Zhongguo xiangzhen qiye de chanquan jiegou yu gaige" ["Property Rights Structure and Reform on China's Rural and Township Enterprises"], *Jingji yanjiu* (*Economic Research Journal*) 323 (1995): 35–39.

7. Guoqiang Tian, "Breaking Up Is Hard to Do: The Theory of Property Rights in Transitional Economies," Department of Economics, Working Paper, Texas A&M University, 1995.

8. See "Zhengfu jiguan shiye danwei de xunsu pengzhang" ["Rapid Expansion in the Government Organs and Agencies"], *Guangzhou ribao* (*Guangzhou Daily*), October 19, 1997.