



Part I

Market Transition in Work Units and  
the Labor Market

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# 1

## Two Decades of Reform: The Changing Organization Dynamics of Chinese Industrial Firms

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### **Introduction**

Urban development under communism followed a path that diverged in significant respects from that taken by predominantly capitalist economies. This divergence which varied among countries and is now being narrowed can be explained by four factors.

First, communist regimes viewed urban development as being led by the manufacturing sector because the objective of planners was to maximize so-called “productive investment.” Economic power and national security were linked with deepening manufacturing capability specifically of the metallurgical and engineering industries. Thus a majority of urban jobs were either directly or indirectly associated with manufacturing or with the administrative functions of different levels of government.

A second, and related, factor was the low priority assigned to the services sector which is a far more prolific source of urban jobs. By deemphasizing services industries, planners in communist countries constrained the principal driver of urbanization and suppressed a wide range of activities that impart dynamism to the economic and social life of cities.

Third, the narrow view of urban development influenced investment in urban housing and infrastructure. Because the scale of service industries and commercial activities remained modest, cities were dominated by administrative and industrial units with investments in urban infrastructure and housing



kept to a minimum to cater to these needs. This made urban areas drab, utilitarian, and uninviting.

Fourth, and finally, a variety of regulations interfered with the free movement of people making it difficult, for instance, for rural residents to find jobs, housing and services in urban areas.

For these reasons, a development strategy focused primarily on industrialization resulted in a narrow and limited form of urbanization. This was more so in countries such as China than in some of the Eastern European economies, in part because the former was at an earlier stage of modernization and in part because in China there was a stronger ideological bias against urbanization and favoring heavy industry.

The reform of the socialist economy started a process of convergence towards the urban norms of market-based economies. China has converged faster because it started from a lower income level than others and its economic growth has been much faster. However, several elements of reform are contributing to the rate of change, in China as well as in other transition economies.

The move towards much greater openness and integration with the global economy has led to a rapid broadening of the industrial base and underscored the role of services. “Narrow” urban development has been succeeded by “normal” urban development with services increasing their shares and generating jobs.

While retaining its developmental role, the Chinese state has adopted a decentralized approach, devolving policy-making discretion to municipalities and dismantling some of the barriers to the flows of labor and capital within the country. This has stimulated the growth of the larger cities, which benefit from agglomeration economies. It has also created numerous other urban foci of growth. Furthermore, by pursuing enterprise reform, the state is providing existing state-owned enterprises (SOEs) and new firms with the incentives and opportunities to grow and to diversify. This is imparting greater impetus to urban development and generating demands that attract workers to urban centers. In response, and recognizing that development is inseparable from urbanization and that livable, well managed cities are key, the state is pouring resources into building urban housing and infrastructure. In China, this big push to urbanization is now interwoven with the overall development strategy. The massive construction activity attendant upon urbanization, coupled with the equally massive migration to urban areas, is adding additional fuel to economic growth.

China’s transition has already lasted more than a quarter of a century and it is far from over. It has now permeated every corner of Chinese life and no organization is untouched. Yet remarkably for an economy where the ratio of trade to gross domestic product (GDP) approaches 65 percent, industrial organization in China – especially in the state sector – has been slow to shed

many of the distinctive structural characteristics of the Maoist era state enterprises. Both SOEs as well as many of the non-state enterprises remain embedded in a web of formal and informal relationships qualitatively different from those of most other East Asian developmentalist states that link producers to the administrative or financial organs of the state. Similarly, while the evidence of change in the urban sector is everywhere and is impinging on organization, notable also is the tenacity of institutions and administrative practices that emerged in the pre-reform era when the Chinese economy was on a different trajectory. China's level of urbanization, which reached 43 percent in 2005, is still significantly below that of countries at comparable stages of development and of developed countries.<sup>1</sup> Many cities continue to enforce *hukou* (residence) based restrictions on permanent migration and have only slowly started to dismantle the plethora of regulatory controls over every form of economic activity that were the hallmark of a communist society.

Chinese policymakers recognize that the urban sector can achieve a "balanced" development that holds poverty and inequality in check only if industrial reforms provide a sufficient growth impetus and jobs for the swelling workforce.<sup>2</sup> The main prong of the industrial strategy in support of urban change is ownership reform that transforms SOEs into corporate entities with majority state ownership or places them wholly into private hands, in the process also bolstering the incentives for and the dynamism of the private sector. While the central government spearheads the ownership reform initiative in the majority of cases, the actual implementation is in the hands of municipal, county, and prefectural governments that must work with other actors influencing urban changes. However, the ultimate success of the reforms rests substantially with the firms themselves, in particular, their managers and directors who must steer these enterprises through an environment that is increasingly competitive locally and integrating rapidly with the wider national and international economies.

The purpose of this chapter is to situate industrial change within the context of urban development and to examine the interplay of the broad reform strategy with local implementation, and its actual practice by the reformed firms themselves.

### *Medium and large state-owned enterprises (MLSOEs) and organizational change*

Since 1997, the authorities have moved aggressively to reform the ownership structure of MLSOEs and to privatize, divest, or close approximately 120,000 smaller SOEs. By introducing new governance and management practices, ownership changes are reinforcing pressures exerted by market competition on the state enterprise sector. Thus, the large economic and social roles of MLSOEs in the urban economy and their exposure to the

global environment, to foreign direct investment (FDI), to new technologies and to reforms, make them a natural focus for research.

What makes these firms especially interesting is their ongoing effort to arrive at organizational forms and modes of operation that viably fuse elements of legacy systems with other elements borrowed from East Asian and Western corporate models. All this is occurring in an urban environment in which control exercised by municipal or other agencies of the state is still pervasive and instigates, guides, modulates or obstructs corporate experimentation as MLSOEs venture deeper into the market economy and are exposed to the pressures of globalization. Trends that have surfaced in China during the past decade and international experience both suggest that urban development will be increasingly concentrated in large agglomerations along the East coast.

### **Reforming China's Industry**

China's industrial enterprises in 1980 were the production units in a centralized command economy. The organizational structure of the typical MLSOE was relatively flat. Production, input supplies, and interfirm transactions were regulated by the plan and implemented by the industrial bureaus. Managers enjoyed limited discretion – their job was to ensure that production targets were met – and because all wages were fixed, there were few rewards for initiative at any level in the enterprise. Goods produced were distributed through state-created channels as there were very few markets. Transactions among firms were settled through a mono-banking system<sup>3</sup> and the enterprise was permitted to hold only miniscule cash balances. In effect the purpose of enterprises was to manufacture and to care for their workers from the time they were recruited till the end of their lives.

Enterprise reforms sought to enhance the performance of SOEs by giving them some autonomy to produce for newly expanded markets and permitting the deployment of contract-based incentive schemes for enterprise managers and their workforces. By devolving fiscal responsibilities to sub-national entities, they also encouraged municipal, county, and township governments to act entrepreneurially and promote pre-existing commune and brigade enterprises and new 'non-state enterprises' that would generate revenues and provide jobs.<sup>4</sup> With sub-national, and particularly municipal authorities taking the lead, the incremental elaboration of enterprise and associated price and market reforms continued through the mid 1990s with some improvement in the productivity and profitability of SOEs. The non-state sector benefited even more. Its share of industrial output rose from 24 percent in 1980 to 66 percent in 1995 while that of the state sector fell to 34 percent by 1995.

From the standpoint of the MLSOEs, reforms in four areas were of vital significance.<sup>5</sup> First, the creation of markets and freeing of many hitherto

controlled prices opened a vast range of opportunities for producers and consumers. By the early 1990s, most consumer goods were being distributed through market channels leaving only 89 industrial goods and transport prices set by the state (Lardy 2002).

In parallel with the freeing of markets, a second set of reforms progressively opened the economy to trade, starting initially with producers in four special economic zones (SEZs): Shenzhen, Zhuhai, Shantou, and Xiamen which quickly attracted investment from Hong Kong.<sup>6</sup> Chinese enterprises were encouraged to export in order to enlarge the flow of urgently needed foreign exchange (Lardy 1992).

A third, and related, reform, which coincided with the establishing of the four SEZs and the efforts to develop export-oriented industries, was the proffering of incentives to foreign investors at first in export-oriented industries. By the mid 1990s, FDI was being welcomed into a much broader range of sectors including and in particular, urban commercial real estate and urban infrastructure. A trickle of FDI in the 1980s grew rapidly after 1993 and swelled to a flood in the late 1990s and in 2005 China ranked as the third largest recipient in the world after the UK and the US (UNCTAD 2006).

The gradual integration of the domestic market with the dismantling of many barriers to trade was a fourth reform initiative. This built upon the increasing scope given to market transactions as well as investments by central and sub-national governments in transport and distribution infrastructure.

Together, these four reforms opened new vistas for China's urban economies. FDI became a conduit, mainly by way of joint ventures, for capital, skills, and technology transfers. International trade, a more integrated domestic market, and the emergence of the non-state sector, exposed the SOEs to much needed competitive pressures, in some cases spurring them to adapt so as to make the most of opportunities now within their reach.<sup>7</sup> Other reforms, many introduced by the major coastal municipalities, further stimulated market development, openness, and access to FDI. Municipalities such as Shenzhen, Guangzhou, Dongguan, and Foshan led the way. The purpose was to give enterprises further autonomy and incentives to exploit market opportunities and in the process, to raise often deplorably low levels of efficiency and quality. Management contracts and later, leasing of businesses, bonus schemes for production in excess of targets, greater freedom to determine the product mix, some latitude to adjust the labor force, permission to borrow from banks and implement investment plans, and less oversight by supervisory agencies, were some of the steps taken to motivate the SOEs and make them more responsive to market opportunities.

These measures began devolving responsibilities to the SOE and pushing it in the direction of acquiring the organizational capabilities of a firm and away from the status of a simple production unit that also served as the key element in the urban social security system. From the early 1990s, the authorities began

to form enterprise groups modeled on the lines of Japanese *keiretsu* so as to take advantage of scale economies and the benefits of lower transaction costs from intra-group trading and capital markets.<sup>8</sup> By yoking together profitable and struggling enterprises, central and sub-national governments frequently attempted to revive or sustain loss-making firms. One important consequence of the reforms was to reduce the scope of planning by state agencies and micro-level controls over enterprises were both reduced although the process was far from even. At the formal level, planned production targets were attenuated, without the command system being dismantled or the autonomy of enterprises being formally specified in a way that established legal rights. However, the flexibility introduced made it possible for provincial and county level officials – and enterprise managers – to take initiatives. A form of state corporatism began taking root with bureaucrat entrepreneurs essentially commandeering state-owned industrial assets and exploiting the new freedoms afforded to enterprises to redirect their operations (Gore 1998). In many instances, these enhanced the productivity and profitability of enterprises, but just as often, the autonomy for managers and the loosening of rules governing the activities of industrial bureaus led to asset stripping (as was commonplace in other transition economies) or plunged enterprises into deeper losses.<sup>9</sup>

The governance exercised by industrial bureaus or enterprise groups that took over some of the functions of the bureau was inadequate and needed to be supplemented, or displaced, by institutions that defined ownership rights and aligned incentives with the market. A privatization of state-owned industrial enterprises seemed the logical course to take but instead a typically Chinese partial reform was brokered. This reform privatized thousands of the small scale enterprises, and loss-making ones for which no buyers could be found were closed. However, MLSOEs accounting for most of the output of the state industrial sector were either left untouched or converted into limited liability shareholding firms in which the state continues to own the majority of shares and/or to exercise control rights. Thus there are now effectively two classes of state firms: those with some outside shareholders and others that remain pure SOEs. In theory, the former are closer to the threshold of the market system and are subject to governance from supervisory boards or boards of directors and hence more likely to be accountable to shareholders, to maximize shareholder value, and therefore, to take their cues from the market with respect to management, structure, strategy, and technology. In practice, there is a lot of variance with the average shareholding MLSOE not having evolved very far from an unreformed SOE but with some reformed MLSOEs (or collectives) such as CIMC, Lenovo, Changhong Electric, and Haier appearing to be blazing new trails and registering large gains in performance.<sup>10</sup>

Although the central government establishes the broad guidelines for the changes being introduced, much of the initiative and the responsibility for



implementation rest with the urban centers. Before looking more closely at the operation of firms, it is important to take account of both the urban context in which reforms are unfolding and the contribution of the municipal governments to the business environment, the pace of enterprise reform, and to the forces guiding organizational change.

### **Coordinating Urban with Industrial Change**

With urbanization accelerating, the role of China's cities in promoting industrial development is becoming even more critical. Cities provide the matrix of institutions and generate the localized knowledge spillovers that are valuable for businesses. In China, substantial political powers vested in municipal authorities also means that they can take the lead in trying to build what Feldman and Martin (2004) call "jurisdictional advantage" and nudge the business community towards a supportive consensus. Jurisdictional advantage accrues from the unique assets that a particular location bestows on a firm. Many cities, especially coastal ones, have adopted such a proactive stance because they recognize that they must acquire differentiated industrial capabilities in order to sustain competitive advantage. Reliance on low production costs must now be superseded by an approach that is focused more on routinizing productivity gains and innovation in one or more industrial subsectors (Woetzel 2003). This can be a long drawn process and early movers that exercise good strategic foresight can acquire a commanding lead over other urban centers. The municipality can propose broad objectives or a vision but it needs the support of the business sector to realize them. Cities better endowed with locational advantages, human capital, and financial institutions, have an easier time in mobilizing the business community with incentives and through investment in the physical infrastructure and in institutions, but ultimately, it is the vitality of the business sector that is decisive. Whether it is the formation of clusters or the steady creation of high value-adding jobs, it is the actions of a multitude of firms reacting to municipal policies and through their own efforts at enhancing competitiveness by investing in skills, research, local universities, or the urban infrastructure that determine the scale of urban agglomeration benefits.

In this race to widen the margin of competitive advantage, the larger cities such as Shanghai and Guangzhou start with a number of advantages: they have a wider spectrum of industries and such diversity promises larger urbanization economies; they have a broader revenue base and deeper banking and financial resources to support development; some of the ablest party cadres are appointed to manage these cities and through their networks they maintain close ties with the leading policymakers in Beijing, which gives them the latitude to pursue bolder reforms; and they are more attractive to foreign

investors who are sensitive to the scale of agglomeration benefits and are seeking a vibrant urban environment that offers more varied lifestyle choices. These are not necessarily overwhelming advantages but when combined with geographical location and the benefits of an early start, they do favor the major cities in the Pearl River Delta region and the Yangtze Basin region. Shanghai and its surrounding cities not only have an edge in terms of scale, they also command a vast and increasingly affluent hinterland of close to 400 million people. But medium and smaller sized cities are competing fiercely and typically growing much faster than the larger cities because they are readier to absorb the influx of migrants from the countryside,<sup>11</sup> because they enjoy cost advantages, and because they have the leverage that comes from localization economies.

What are the policy and reform options available to China's cities as they scramble to industrialize and how do these impinge upon the performance of the business sector? For most cities with industrial aspirations, the tendency is to use fiscal incentives and bank financing to promote industrial development and to buttress this with investment in physical infrastructure. Where there is an abundant local workforce or a ready supply of migrant workers, such an investment push has frequently been sufficient to initiate an industrial spiral, especially in the medium and small cities and townships. However, for most of the larger cities, the stakes are higher. Generic incentive mechanisms are no longer sufficient.<sup>12</sup> A deepening of industrialization requires a much closer engagement between municipality and firms.

Cross-country and Chinese experience shows that industrial growth, productivity, and innovativeness as well as the formation of dynamic urban clusters is closely related to the ease with which new firms can enter an industry and on barriers to the exit of failing firms. Smaller firms are also responsible for the bulk of the employment generated in the urban economy. Hence, institutional conditions facilitating entry are among the most effective means for a municipality to induce industrial growth. By streamlining licensing and registration requirements, reducing regulatory impediments, improving access to finance, and providing basic services with the minimum of red tape, one of the essential conditions for a thriving urban market economy can be met. A related requirement is the ease of exit because if failing firms are enabled to continue producing and investing, they divert resources from others and depress the profitability of viable firms. While in some cities such as Shenzhen and Hangzhou, the exit barrier is low, this remains a major problem in other Chinese cities and is related to enterprise reform that we will return to below (Dollar et al. 2003).<sup>13</sup>

One of the main sources of agglomeration economies is the pool of skills available to firms in a metropolitan region. The volume, quality, and depth of skills hugely influences the productivity, and innovativeness of existing firms, the entry of new firms, and the overall flexibility of the urban economy,

in particular its capacity to evolve in new directions to meet demand or acquire new clusters of activities. Cities like Beijing, Chongqing, Hangzhou, Guangzhou and Shanghai have an abundance of skills but firms in other cities cannot draw on a substantial local pool of skilled workers, resulting in sub par performance (Dollar et al. 2003). Most municipalities recognize that to advance to a higher stage of industrialization, they must augment human resources if they have the financing to do so. This is no easy matter especially for the small and medium-sized cities. Investing in universities and other training institutions is only a part of the process, a lot depends on how much the business sector is motivated to invest in formal and on-the-job training as well. There is, in addition, the problem of retaining workers and attracting workers from elsewhere. This depends on the institutions governing the supply and affordability of housing,<sup>14</sup> the supply of municipal services, especially schooling, and the quality of the urban environment.<sup>15</sup> In each of these areas, private providers have a role but in China, the dominant player is the municipal authority that spells out the ground rules and is directly or indirectly the source of a significant part of the financing. Cities like Shanghai, Beijing, and Hangzhou have a lead in this regard, but land use, financing,<sup>16</sup> environmental quality, and other issues relating to the integration of the national labor market continue to bedevil these and other cities whose future prospects depend upon the presence of a broad, constantly refreshed, and sound base of skills.<sup>17</sup>

Another advantage of agglomeration economies is the knowledge spillovers from the investment in research and development (R&D) and in technological extension services provided by firms. With the majority of China's research institutes still in the public sector and either reporting to the municipal government or affiliated with SOEs, the municipality exercises substantial say in the level of research conducted (Sun 2002). Coastal municipalities have taken a lead in attempting both to promote applied research and to push researchers to commercialize their findings by linking with business firms. Municipal bureaus such as in Shanghai have been especially aggressive in this regard, establishing stringent criteria to gauge the performance of universities and research institutes with respect to Science and Technology (S&T) performance. This heightened pressure is a departure from past practice and it runs the risk of diverting too much energy away from teaching and basic research. One can also question the likely short-term gains in the form of useable research findings from a sudden ratcheting up of the effort to produce commercializable findings.<sup>18</sup> Nevertheless, China's national and subnational governments are unequivocally committed to increasing the level and quality of R&D and are encouraging SOEs to view this as the means to long-term competitiveness (Sigurdson 2005).

Cities throughout China have wooed FDI as a means of mobilizing resources, modernizing industry, and increasing exports. More recently, FDI has come to be viewed as one of the primary vehicles for raising industrial

productivity and transferring technology as well as often being the only source of financing available to medium and small-sized firms. Municipal governments are eager to attract FDI in order to set up joint ventures with local firms or wholly-owned foreign subsidiaries that will advance the technological frontiers and through spillovers and demonstration effects, contribute to business practices that will raise industrial productivity.<sup>19</sup> These cities are also using the opportunities presented by the large pool of knowledge workers coupled with other incentives to persuade MNCs to set up research laboratories in China. By 2005, nearly 750 foreign companies had invested in R&D centers in China and while few companies have considered transferring the core research function to China,<sup>20</sup> they are helping to build a capability that is shaping the strategies of firms such as Huawei, Ningbo Bird, and Wanxiang, and will filter into other firms as well. Once again, while the policies of firms are decisive, municipalities play a major instrumental role in attracting FDI and are active in determining its composition with an eye to maximizing the knowledge spillovers.

Building a municipal labor market that will be attractive for dynamic and well-managed firms requires close attention to the urban environment. This is also crucial for pulling in FDI into higher technology activities. The quality of the urban environment, the standard of services, and amenities provided and the level of housing facilities is a function of many factors. Chief among them is administrative capacity and governance, which remains variable throughout urban China and increasingly is at the forefront of the central government's attention. Several cities, especially in the East Coast region, enhanced transparency and eased transaction costs for businesses by introducing electronic websites and permitting electronic processing of certain transactions (see Table 1.1). These changes are mirrored by the business climate in these cities and the entry of firms both local and foreign.

The efforts to reduce transaction costs are being buttressed by investment in infrastructure and housing. In the highly charged competitive environment, the quality of services provided by public utilities, urban transport, and the abundance of housing can tip the economic balance in the favor of one city over another. As we noted above, the leading cities are able to provide an adequate level of infrastructure services for industry but in many instances, they still fall short of the standard achieved by the industrialized countries. The building of highly capital-intensive physical infrastructure is hampered by the state of the capital markets and in particular by the thinness of structured bond markets that would permit cities to raise funds more efficiently and at lower cost for long-term projects. The full and efficient usage of the infrastructure already constructed is also an issue in many cities because of deficiencies in interagency coordination, regulatory practices and the pricing of services. Thus, sewerage facilities in several cities remain unused because no adequate system is in place to finance their operation, and the disposal of solid

**Table 1.1** Investment climate scores of 23 cities in China

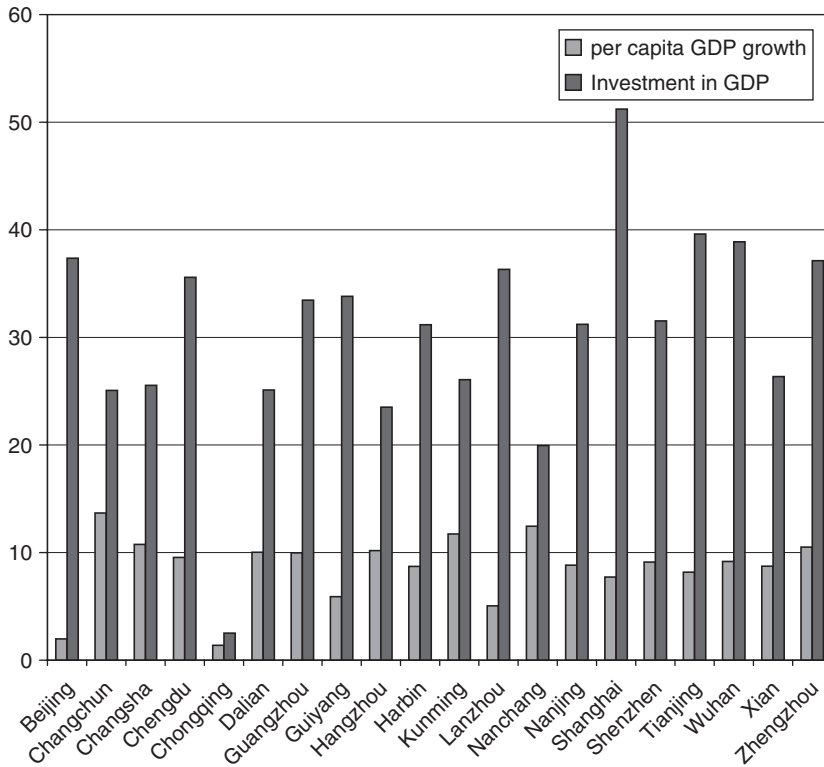
City	ICA score
Hangzhou	A+
Guangzhou	A+
Shanghai	A+
Shenzhen	A+
Chongqing	A
Changchun	A
Jiangmen	A
Wenzhou	A
Tianjin	A-
Dalian	A-
Beijing	A-
Zhengzhou	A-
Wuhan	B+
Nanchang	B+
Xi'an	B+
Changsha	B+
Chengdu	B
Guiyang	B
Kunming	B
Nanning	B
Harbin	B-
Lanzhou	B-
Benxi	B-

Source: Dollar et al. (2003).

waste is becoming a worsening burden as cities run short of landfill sites. Similarly, the regulation of facilities in use remains uneven.

The lag in the development of institutions for long-term financing is almost unavoidable because these markets need time to build up the matrix of skills, depth, experience, rules, and credibility. The same can be said for local regulation. What the lag does though is to widen the advantages enjoyed by the major metropolitan governments. These are able to use their superior bargaining power to bid for the resources that are available in abundance and to invest in and operate urban infrastructure. Such investment has localized multiplier/accelerator effects, stimulates growth, and also pulls in other private investment. This is reflected in the performance of the cities shown in Figure 1.1, especially the large coastal cities.

Improving the business environment is one major strand of the urban economic strategy in China. Equally important is the role of municipal and county governments in modulating and implementing enterprise ownership



Source: Lin and Song (2002).

**Figure 1.1** Per Capita GDP Growth and Investment Ratio of Selected Cities (1991–8)

reforms. Although the overarching guidelines have been determined by the central government, the microstructure of the reforms is in the hands of sub-national governments. It is they that are setting the pace of privatization and it is the local industrial bureaus that determine how much autonomy is permitted to the corporatized state enterprises<sup>21</sup> and the governance structures being crafted to monitor their performance. CIMC (and also Huawei) are striking examples of how the autonomy extended by the Shenzhen municipality has permitted the company's management to achieve dramatic results through horizontal mergers, innovation, and an aggressive strategy to win local and foreign markets. TCL, ZTE, Haier, and Wanxiang are other examples of companies that have autonomy. But there are also numerous instances of municipal governments intervening to prop up failing enterprises, using their ownership clout to force companies to take over loss-making entities, and micromanaging companies under their control, requiring them to maintain jobs and to "contribute" to municipal finances.

In short, the policy discretion enjoyed by municipalities in China's decentralized economic system means that they have a large role in managing local industrial change but that still leaves a large and increasing responsibility for introducing organizational changes, devising strategy, and conducting business in the hands of enterprises.

### **From State-Owned Enterprises to Modern Firms**

MLSOEs are spread across the spectrum performance-wise but are somewhat more narrowly grouped with respect to certain attributes relating to structure and organizational dynamics.

*Governance.* Ownership and governance are the defining characteristics of enterprise reform in China and these are likely to be critical to future success. Starting from a condition of state ownership, plan-based production, and control exercised through industrial ministries and bureaus, reform has created two classes of MLSOEs. One consists of wholly state-owned firms directed either by central ministries or more usually by provincial, municipal, or county bureaus. While the formal structure of governance is usually well-defined, the actual degree of accountability varies by industrial sector, jurisdiction, and bureaucratic entrepreneurship. A second category of MLSOEs consists of enterprises that have been corporatized into limited liability corporations (LLC) and shareholding limited liability corporations (LLSC). Smaller SOEs were converted into LLCs and larger SOEs were commonly converted into LLSCs under the company law passed in 1994. They are accountable, in principle, to the Board of Directors (BOD), a supervisory body, and a public agency responsible for the industry to which an enterprise belongs. The governance structure of the LLC is quite similar to a private company with a BOD providing oversight and day-to-day business conducted by a manager. The LLSC has similar governance structure to the LLC, but, the BOD for the LLSC has a stronger supervisory role than is the case for the LLC (Keister and Lu 2001). However, given the dominance of the government's share, government appointees on the BOD and supervisory agencies provide the framework of accountability. Our research shows that the formation of LLSCs does seem to have a large positive effect on performance, so that ownership reform is having predictable consequences with the change in governance contributing to the improvement.<sup>22</sup> Nevertheless, findings from around the world and the Eastern European countries suggest that fully privatized firms are the ones that are the most efficient manufacturers. The ongoing ownership reform has introduced some elements of modern corporate governance into the SOE sector. The next stage is full privatization and the transfer of the state's control rights in the

majority of the MLSOEs so that firms can truly transform themselves, and acquire professional managers fully accountable to shareholders.

*Structure.* The vast majority of MLSOEs started out as single plant operations with a vertically integrated production system, little outsourcing and a comprehensive suite of internally provided services ranging from schooling to transport. Many still cling to this structure. The more dynamic firms, however, have acquired multiple plants – sometimes as a result of mergers forced upon them by the authorities. They have become allied with enterprise groups,<sup>23</sup> and are divesting themselves of non-core operations, in some instances, to other members of the group, and outsourcing some of the services previously provided in-house.<sup>24</sup> It is too early to tell how far these trends will continue but so far deverticalization, outsourcing of non-core functions, and greater focus on core specialization is the exception in even the leading Chinese firms.

*Labor.* Most MLSOEs now rely more on contract workers and have flexibility in reassigning workers among activities, but some tenured staff remain and many firms continue supporting their pensioners. Even with an increasing share of contract workers, political pressure can make it difficult for firms to lay off workers especially in the smaller cities where alternative employment options are few.

*Innovation.* In sum, the MLSOEs are undergoing a change in their ownership and broader governance structure. They have begun to modify management, strategy, and the internal organization of the firm in response to the reform efforts of national and municipal governments, market pressures, and globalization. However, inertia, continued oversight, and interference from supervisory agencies, and the soft budget constraints, undercut competitive pressures to streamline their activities and focus on core products.

### **Creating a World-Class Corporate System**

Observers of Chinese MLSOEs have remarked that China still lacks world-class industrial companies (Nolan 2001). With the exception of Haier and possibly Huawei and Lenovo, no Chinese industrial firm or enterprise group has the size, management skills, and the mix of capabilities to operate on a global scale. This is not surprising, because the MLSOEs are having to telescope in a few decades managerial and organizational changes that occurred in the US over more than a century.<sup>25</sup> Undoubtedly, the ranks of the handful of leading firms will thicken and FDI will assist in the process, but



much will depend on the future course of state ownership and the state's role in determining industrial organization and maintaining a soft budget constraint. International experience, although grounded in a past and in institutions very different from those of China, does offer some guidance with respect to government policy towards industry and urbanization. From among these offerings, several merit attention by the Chinese.

*Other business models*

The literature on urban economics and on urban geography show that if the diseconomies of urban size can be controlled then scale promises large productivity gains via agglomeration effects.<sup>26</sup> The average size of cities in China is below the optimum and the low Gini coefficient of 0.43, as against 0.65 for Brazil and Japan, indicates that there are a small number of very large urban areas. Thus, from the standpoint of economic advantage, there is potential for urban growth to be exploited. For instance, if the size of a city is 50 percent below the optimum size, then doubling the city size can increase the value-added per worker by 35 percent. But China's expanding cities will have to invest heavily in livability in order to continue attracting industry.

Livability depends on the quality of the physical infrastructure, social amenities, recreational facilities, and the environment. In many Chinese cities, these are barely adequate. In the face of continued migration and the expansion of motor vehicle use, living conditions could deteriorate in the absence of well-planned investment and effective regulation.<sup>27</sup>

Municipal governments must also work to enhance the competitiveness of the local economic environment in order to facilitate the entry and exit of firms. In this regard, their policies towards the SOEs will be important. It is becoming clear that industrial policies that rely on directed credit, subsidies, trade barriers, and government purchases of products to induce the development of targeted industries, are frequently a costly and ineffective approach to local industrialization. Moreover, many of the instruments used in support of such policies are now disallowed by the World Trade Organization (WTO). Government efforts to impose mergers and to create enterprise groups have not yielded robust results anywhere in East Asia. They can burden successful firms with unwanted baggage rather than creating larger and more dynamic entities. It is much better to let market forces do their job, and manage development with the help of a sound competition policy.

Privatization of industrial enterprises has been shown to raise productivity and lead to positive business outcomes in the vast majority of cases.<sup>28</sup> Furthermore, there is little evidence from other transition economies to suggest

that a gradual and elaborately sequenced ownership reform has advantages over a swifter form of privatization<sup>29</sup> nor that a slower pace of reform resulted in the introduction of effective social safety nets.<sup>30</sup>

There can be no denying the contribution of professional management and strategy making to the competitiveness, growth, and profitability of firms. A small number of Chinese MLSOEs have the leadership but few have as yet equipped themselves with the other attributes. The absence of managerial depth also shows up in the structure of MLSOEs. While the trend worldwide is towards flatter hierarchies, large firms with national or international operations must have the organizational resources and managerial hierarchies to deal with complex and widely ramified operations. Privatization can contribute to the strengthening of management and subnational governments can provide an added push by ensuring that the institutions of corporate governance enforce the needed discipline.

Competitive and rapidly growing firms that invest in R&D encourage different forms of innovation. Municipal agencies can support this tendency by making it easier for firms to enter into joint research ventures and to contract with universities and research institutes. Thus far, MLSOEs have rarely adopted these practices. Competing on the basis of technology will become necessary once companies are fully exposed to market pressures and seek to expand overseas.

The leading MLSOEs have begun adopting stronger incentive regimes appropriate for the market environment and with the encouragement of municipal authorities, they are giving more attention to enhancing their human resources, but not enough is known about training practices, pay scales, promotion ladders, and bonus schemes to assess the adequacy of the systems now in place. Similarly, the current composition of the internal labor markets and hiring policies of firms are uncertain. However, the future competitiveness of firms will be increasingly tied to the upgrading of the workforce. This will require the concerted efforts of firms and of the municipalities, which have a big stake in raising the level of skills.

While the internal workings of a firm are certainly key, as MLSOEs deverticalize and outsource, their competitiveness also depends on the efficacy of their cooperative arrangements with partners, suppliers, providers of business services, and buyers. Whether one considers Japanese *keiretsu*, Korean *chaebol*, American auto companies or the leading manufacturers of electronics, garments and machinery, the best firms are ones that have a clear strategy and based on this, have created a support system that leverages the resources, technologies, and innovativeness of others. There is no single best practice but plenty of good models. The vertically integrated and insular MLSOE does not approximate any of these models, nor do the loosely knit enterprise groups created by governmental fiat. If international experience is a guide, building international production networks and alliances to conduct research or

product development will be necessary for the growth of MLSOEs that eventually graduate into the ranks of successful private sector firms.

Finally, as the Chinese economy becomes more integrated domestically and closely linked with the global market, it will be harder to preserve or create sheltered domestic niches. Manufacturing firms across the world are finding that, little by little, local markets are becoming coextensive with global markets as trade barriers recede, transport charges fall, and the Internet enormously enhances the availability of information and cuts down transaction costs. In this kind of environment, survival is coming to depend upon preparedness and flexibility. Much more so than in the past, strategy and innovativeness matter. Also location matters. The ably managed and innovative firms will grow and agglomeration economies can be the springboard to their success.

### **Conclusion**

In this chapter, we have closely examined two interrelated parts of the development strategy pursued by the Chinese state since the start of reforms in the late 1970s. One is the reform of the industrial system and specifically state-owned enterprises. The other is the urban policy context which modulates enterprise reform and the industrialization of Chinese cities.

Enterprise reform is still incomplete and even the most successful of the former SOEs have yet to achieve a structure, governance, and managerial capability comparable to leading firms elsewhere, especially multinational corporations (MNCs). However, the reforms introduced to date have transformed the small and medium SOEs and enormously stimulated the non-state sector. For 25 years, industrial growth has remained in the double digit range with no evidence of the momentum slackening.

Industrial change is being paced by rapid urbanization which is providing industry with the environment and workforce needed to sustain development. Municipal governments have taken advantage of administrative and fiscal decentralization to promote industrialization with larger cities taking the lead. The challenge now is to ensure that urban development is not at the cost of livability and that it is backed by needed fiscal and regulatory measures.

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## NOTES

- 1 China's modest rate of urbanization stems from past and remaining checks on migration and the low fertility rate in urban areas because of the successful enforcement of the one-child policy and the restriction on migration. For large cities such as Shanghai, the urban growth is almost entirely the result of the inflow of migrants (see Liang, Van Luong, and Chen 2005).
- 2 So far, the Chinese government has been able to reduce the number of absolute poor in the urban areas, an impressive achievement compared to the experience elsewhere. However, inequality within the urban area is rising (see Appleton and Song 2005).
- 3 This was finally dismantled in 1984 with the creation of the People's Bank of China and four major state owned banks.
- 4 For differing perspectives on local initiatives, see Duckett (1998), Gore (1998), and Oi (1999).
- 5 On reforms through the early 1990s see Naughton (1996).
- 6 See Howell (1993) and Wu (1999) on the creation of the early SEZs and the widening of trade channels.
- 7 Such competition also eroded profit margins and tax revenues transferred to various levels of governments. The result was a sharp drop in the tax/GDP ratio, now gradually being reversed through a broadening of the tax base.
- 8 Many of these groups were created out of enterprises affiliated with an industrial bureau. Many industrializing economies have sought to use the creation of enterprise groups as a means of overcoming institutional gaps or missing markets.
- 9 In many instances, mergers not only failed to turnaround loss makers, they also compromised the performance of their profitable partners.
- 10 The profit of CIMC increased by 120 percent for the first 6 months of 2005 compared to the same period the previous year (CIMC Semi-Annual Report 2005). Huawei's profit increased 63 percent from 2003 to 2004 and 10 percent from 2004 to 2005 (Huawei Technologies Annual Report 2005).
- 11 See Zhou and Cai (2005) for a discussion on migrants' lives in a new city.
- 12 A number of studies find that the correlation between the quantity of investment and economic growth is rather weak (Dollar et al. 2003; Lin and Song 2002). Dollar et al. (2003) find that the 23 Chinese cities they studied have built urban infrastructure to a point where shortages no longer constrain the performance of firms.
- 13 Many cities suffer from excess capacity of 20–30 percent or more because too few firms are exiting (Dollar et al. 2003).
- 14 On the issue of housing for migrants, see Wu and Rosenbaum (2005).
- 15 Crime is always high on the list of concerns for people in the larger urban centers. See Messner, Liu, and Karstedt (2005) for the recent trends in crime in urban China.

- 16 Many cities have raised a large volume of funding by repossessing and rezoning surrounding agricultural land from farmers and allocating it for commercial, residential, or industrial use. This provides a one-time fiscal bonus but is not a device for meeting longer-term fiscal requirements. Such encroachment also displaces farmers and runs the risk of exacerbating urban sprawl and eating into the limited supply of arable land.
- 17 Although Beijing, Guangzhou, and Shanghai do not face constraints in terms of supply of skills, performance of firms in these cities can still be greatly enhanced if labor markets are made more flexible (Dollar et al. 2003).
- 18 Without a corresponding increase in supply of experienced human capital to support R&D, a sudden infusion of funds or generous incentives to conduct R&D can lead to misallocation of scarce resources (Yusuf, Wang, and Nabeshima 2005).
- 19 The demonstration effects from FDI seem to be rather strong in coastal cities, judging by the rapid increase in the external design patent applications (Cheung and Lin 2004).
- 20 This reluctance arises from the current limits on research capacity in China and the perceived inadequacy of the protection for intellectual property.
- 21 Corporatized enterprises are those that have sold some of their equity to the non-state sector and have been organized as registered corporate entities with traded shares that are subject to the rules of corporate law.
- 22 Yusuf, Nabeshima, and Perkins (2005) find that former SOEs reformed into LLCs perform the best, followed by joint venture firms. Although former SOEs reformed into LLCs performed better than the non-reformed SOEs, the positive effect stemming from the ownership reform was much smaller than that for LLCs and joint ventures.
- 23 These *'jituan'* were formed after December 1991 following a State Council Directive.
- 24 In the case of First Auto Works in Changchun, the SOE is relocating some of its assembly operations to other parts of the country, including to Guangzhou.
- 25 Ferguson and Wascher (2004) note that before the Civil War in the US, most companies were sole proprietorships or partnerships, but this changed with advances in transport and communications and the growth of markets all of which favored larger hierarchical organizations. Further changes came in the wake of financial market developments, with multi-plant operations, and most recently, the advent of IT.
- 26 Alfred Marshall recognized the externalities associated with co-location of many firms in a city. The agglomeration of business activities often confer benefits to firms located in vicinity through access to specialized inputs, thicker labor markets, better information flow, and knowledge spillovers. See Ottaviano and Thisse (2004) for a recent review on this.
- 27 As migration increases, authorities will need to pay closer attention to the risks from infectious diseases such as HIV and sexually transmitted disease (See Chapter 13 this volume).
- 28 See the reviews by Djankov and Murrell (2002) and Megginson and Netter (2001).
- 29 Both Balcerowicz (2003) and Havrylyshyn (2004) note that fast reformers on balance registered somewhat better performance overall during the 1990s. Slow

reformers have often become bogged down, China included, with new reforms being opposed by strongly entrenched vested interests.

- 30 Traditionally SOEs have been responsible for providing housing, education, health care, and other public services. As SOEs are reformed, many of these functions are now becoming the responsibilities of individuals themselves or of various levels of government in China. So far, there has been no indication that a slower pace of SOE reform has made it possible to reform social policies that other chapters in this volume touch upon (Yusuf, Nabeshima, and Perkins 2005).

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