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Dedicated to the Tenth Anniversary of the Chinese Economists Society

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INTRODUCTION

I. Background

The Chinese Economists Society (CES), the Shanghai Academy of Social Sciences, and the Shanghai Pudong Institute of Reform and Development jointly held an international symposium on the reforms of state-owned enterprises (SOEs) from July 16 to 20, 1995 in Shanghai. This book is a collection of the many papers presented at the symposium.

The twentieth century has witnessed two rounds of diagonal economic experiments. The first one, started in Russia soon after the October Revolution in 1917, aimed to replace the private ownership and market mechanism by a central-planning system based on public ownerships. This experiment turned out to be a great failure. All the systems thus organized suffered from low efficiency, lack of innovation, and decreasing competitiveness after a brief success at the initial stage of their implementation. In particular, they failed to generate a living standard comparable to that of the economies based on market mechanism.

The second round of experimentation, motivated by the failure of the first one, initially aimed to improve the performance of the central-planning system by introducing various types of market mechanisms into the central-planning system. This experiment started in Yugoslavia, Hungary, and some other Eastern European nations. When China and Russia joined such efforts in the late 1970's and late 1980's respectively, they tried new methods. Russia followed a "Shock Therapy" approach by dismantling its central-planning system and privatizing its state-owned enterprises within a short period of time. China, has been following a gradualist line.

The experience of Russia and some East European nations shows, however, that to some extent, the second round of experimentation may be even more difficult than the first one. The dramatic transformation of central-planning systems into market-oriented systems, at least, did not lead to immediate recession or stagnation, as Eastern Europe and China demonstrated. Going back from a central-planning system to a market-oriented system, however, seems to involve a lot more risks and uncertainties. The most difficult part of this reverse is the reforms of SOEs.

Up to present, China has tried to avoid touching this sector and the related economic issues. Beginning in 1979, it gradually replaced the commune system with

the household responsibility system and privatized the land use rights among farmers. These policies have greatly stimulated agricultural production and released millions of farmers from the farming sector. China then legalized the private sector in urban areas and relaxed the control over migration between rural and urban areas. Meanwhile, China opened its doors for international trade, foreign direct investment, and foreign technology. Within a short period of time, this open-door policy has not only nurtured a booming non-state sector, but also turned China into one of the largest export-oriented economies in the world. It has finally found an outlet for its abundant, talented and well-disciplined labor force by producing labor-intensive products and exporting them to the rest of the world. To a significant extent, China has succeeded thus far in accelerating its economic growth and raising the welfare of its people without fundamentally reforming its state-owned enterprises.

Now, however, China has nothing left to reform but the state sector. China's remaining economic issues are all closely related to the successful reforms of SOEs. These issues include how to modernize the banking system, how to improve the taxation system, and how to reduce unemployment and inflation in order to maintain macroeconomic stability. Equally thorny are questions surrounding the reform of the housing sector, the social welfare system, and the medical care system, and the elimination of the monopoly position enjoyed by SOEs in certain sectors. None of these issues can be solved without reforming SOEs.

The state sector is currently employing more than one hundred million urban workers. It not only receives various types of subsidies, but is also protected by tariffs, distorted prices, and monopoly privileges granted by the government. Nevertheless, only one third of SOEs can break even. The rest are running growing deficits explicitly or implicitly. In short, these enterprises have become China's largest financial burden. It is true that China's non-state enterprises are becoming more efficient and competitive, but they cannot reach their full potential when they have to divert an increasing amount of resources to rescue the state sector. Solving this problem has become not only an urgent policy issue, but also a challenge to modern economic theory. As we pointed out above, there is some experience with transforming a market-oriented firm into a central-planning-oriented one. However, there is little experience with reversing such a process without triggering a social outrage or an economic disaster.

All the issues that we mentioned above have been heatedly discussed in China over the past decade, and consensus has yet to be reached on how to find socially acceptable solutions. Although these solutions should be adaptable to the

Chinese society, they should also be consistent with the laws, rules, and mechanisms of a typical market economy. For this exact reason, the CES has a unique advantage as well as an obligation to contribute its thoughts and expertise on these issues. It is the largest overseas Chinese organization in the area of social sciences with more than four hundred members. The majority of its members grew up in China and can easily and closely follow the new development there. It is not an exaggeration to say that they are in a more advantageous position--having received a rigorous modern economics training and now living and working in the West--to study the market mechanism than their colleagues in China. They often approach these issues from a completely new angle. Not surprising, their active involvement in the deliberation of these issues has been warmly received by economists in China.

The CES has organized numerous seminars on Chinese economic reform. These meetings, however, less direct impact on the policy-makers in China, because most of them were held in North America, often combined with the American Economic Association's annual conference. In order to make its expertise more accessible in China, the CES has decided to utilize its unique role as an irreplaceable bridge between the modern economic academia and China to organize more international conferences in China. These international conferences provide the best channels for intensive interplays between the economists and policy-makers in China and the overseas economists.

The above-mentioned Shanghai Conference represents the third international conference that is sponsored and held in China by the CES. The other two were the Hainan international conference on the Market-Oriented Reform held in 1993 and Hangzhou international conference on the topic of Township and Village Enterprises (TVEs) held in 1994 respectively.

The theme, timing, and location of the Shanghai Symposium were all perfect. An increasing number of people in China have realized that no matter how successful China's economic reform has been, unless it can transform this sector into one compatible with free-market institutions, the ultimate result of this gradualist reform is still unknown and full of potential crises. The worsening financial situation of the state sector is forcing China to reform, although reluctantly, this sector nationwide. There remain many unresolved issues in the reform of this sector, and policy-makers are definitely looking for new ideas. The CES with its unique background and expertise in modern economics can help shape the path of reforms.

Shanghai is certainly the best choice as the site of the conference. Since late last century, the whole of China has been fascinated by Shanghai for its energy and

adaptiveness in establishing modern sectors of industry, finance, and commerce and in exploring modern culture and technology. Today, Shanghai is still China's largest industrial and financial center. It is an unusual combination of planning economy and market economy. On one side, it has the highest concentration of SOEs, many of which have a high national reputation and carry powerful influence over decision-making at the center and the public opinion; on the other, it has the largest commercial center and an active and rapidly developing stock market, attracting the flow of capital from every corner of the nation. Since the early 1990s, Shanghai has become China's largest special economic zone. In addition, Shanghai has been allowed to go one step ahead of the rest of the nation to experiment with the state sector reforms. For these reasons, Shanghai represents the best choice for the site of the symposium.

This conference has received a lot of attention from scholars working in mainland China, North America, Taiwan, and Hong Kong. Among the participants were Professor Merton Miller, a Nobel Prize laureate from the University of Chicago and an expert on firm finance, Professor Chu-yuan Cheng from Ball State University and Chairman of Asian Studies Committee of U. S. A., Professor Thomas Rawski from Pittsburgh University, a well-known China expert, Professor Ji Liu, Vice President of Chinese Academy of Social Sciences, and many other famous Chinese economists such as Professor Zhongli Zhang, President of Shanghai Academy of Social Sciences, Professor Xitang Yao, Vice President of Shanghai Academy of Social Sciences, Professor Wenda Hong of Fudan University, Dr. Justin Y. Lin, Chairman of the China's Center for Economic Research, Dr. Gang Fan, Deputy Director of the Institute of Economic Research at the Chinese Academy of Social Sciences.

II. Main Issues Discussed at the Symposium

1. The book is divided into five parts to reflect the issues discussed at the Symposium. The first part includes three papers presented at the opening session of the Shanghai Symposium. Miller's paper, entitled "Alternative Strategies for Corporate Governance," raises the core issue in reforming SOEs. In order not to waste capital and other resources, the most important thing is to choose the right corporate governance, i.e., a mechanism to select and evaluate the right managers.

According to Miller, theoretically there are two types of corporate governance: the British-American model and the German-Japanese model. Since in

Britain or America, a corporate mainly raises funds by selling shares in stock markets, the capability for the top managers to deliver high enough dividends to stockholders determines whether or not they can defend themselves in front of the board and keep their positions. In Germany or Japan, firms mainly obtain their capital from one of the large banks. Consequently, the large banks have a strong influence in selecting the top managers. In general, firms under the British-American model are pushed to be more efficient and more sensitive to the short-run rate of returns. But they tend to underfinance the projects that generate low rates of returns in the short-run and become highly profitable only in the long-run. The German-Japanese model usually does not create such high pressure for the top managers as long as they can convince the large banks of the long-run profitability of their firms. They do not need to generate high dividends in the short-run. Consequently, in Germany or Japan, the low efficient sectors tend to be overinvested over a long period of time. Miller emphasizes that once a corporate governance is chosen in a nation, it is very difficult to switch to another one, as shown by the German-Japanese experience.

Miller's paper is particularly relevant to the reforms of China's SOEs, which are known for their soft budget constraints and chronic overinvestment in sectors already burdened with excess production capacities. He raises an especially important issue to a country like China which is standing at the crossroads of firm governance restructuring and is eager to find a way to reduce waste and inefficiency.

If Miller's paper indirectly touches upon the important issue of what type of corporate governance China should look to when it is moving away from the central-planning system, Ji Liu's paper, entitled "To Separate the Government from Enterprises," directly addresses the crucial issue of why China's current corporate governance is inefficient. No doubt, China represents the third type of corporate governance, under which top managers are selected neither by stock market, nor by large banks, but by the government. Liu is certainly correct in pointing out that the most important issue in reforming SOEs is to separate the enterprises from the government. According to him, the shortcomings rampantly existing in SOEs are all caused by the inseparability of enterprises and government. The central-planning system requires an omnipresent government, which controls not only all the resources, but also the selection of top managers. However, in a market-oriented economy, the individual firms should freely respond to market forces. This means that as China is moving towards a market-oriented economy, the government should realize and accept the changes of its role in the economy, leaving firms to

independently decide their production according to supply and demand conditions.

Gang Fan, in his paper titled "State-Run Enterprises in the Process of the Gradual Reform," discusses the questions surrounding five topics: first, the feasibility of a complete institutional transformation without SOE reform; second, people's need to reform SOEs; third, the gradual move to ownership reform; fourth, the formation of new conditions--emergence of a new economic system and changes in economic structures; fifth, the progress in state-sector reforms and future prospects. His view is quite representative among many economists inside and outside China. He argues that as a result of the rapid growth in the non-state sector and decentralization, the environment for the reforms of the state sector has actually been improving. For example, the non-state sector is creating more employment opportunities, thus absorbing the workers released from the state sector. The non-state sector is also providing more tax revenues to the government at various levels. Overall, he holds a more optimistic view on the issue of the reformability of the state sector. He argues it is possible that over time, the rapid growth of the non-state sector and the continuing decline of the share of the state sector in China's GDP may make the reform of the latter less urgent, or even unnecessary.

2. The second part of the book is centered on two papers which present diagonal views on the priority in reforming the state sector. Shortly before the Shanghai Symposium, Justin Lin and Weiying Zhang had a public debate on this issue in Beijing, which created a strong repercussion among economists and in the news media. Interestingly, they continued their debate at the Shanghai Symposium. Lin's central point in his paper entitled "Creating an Environment for Fair Competition" co-authored with Cai and Li is that in reforming the state sector, the priority should be focused on creating a fair competitive environment for all firms, whether owned by the State or not. With the abolishment of unfair external conditions such as soft budget constraints and a monopoly position that a typical SOE currently can enjoy, a firm will respond by evolving its internal institutions accordingly. In Lin and his co-authors' view, the most important market within a market system is the product market rather than a financial market. If the product market is not perfectly competitive, it is impossible to develop a modern corporate governance. According to them, private ownership of a firm is not a sufficient condition for the enhancement of the firm's efficiency.

According to Weiying Zhang's paper entitled "The Reforms of State Owned Enterprises: Whither to Go," the priority in reforming SOEs lies in reforming their internal institutions, especially their governance. He bases his argument on the

modern firm theory, which emphasizes the importance of property rights and ownership, especially the rights to claim residuals and the rights to control. In Zhang's view, SOEs are very inefficient because the existing manager selection process is ineffective. By simply assigning top managers to its enterprises, the state does not have enough information to supervise managers. Meanwhile, managers do not have enough incentive to make their firms profitable because they are not the residuals claimants. Zhang proposes that the State should play the creditor's role and turn its ownership of enterprises into claims to debts. Then the enterprises should be allowed to issue stocks to raise equity through non-state financial sources. According to him, this is the so-called transforming ownership of state assets into ownership of debt owed by enterprises (*Guoyou Zichan Bian Zhaiquan*), and transforming the non-state assets into equity (*Fei-Guoyou Zichan Bian Guquan*).¹

No doubt, both Lin and Zhang have identified very crucial parts of SOE reforms. In diagnosing the roots of the pervasive inefficiency of SOEs, Lin emphasizes the external causes while Zhang emphasizes the internal causes. A number of papers presented at the Shanghai Symposium are directly or indirectly related to this debate. For example, David Li and his co-author Shan Li, in their paper titled "The Corporate Debt Crisis in China: Analysis and Policy Proposal," point out that China's SOEs are facing a debt crisis. Over 80% of state enterprises have debt/asset ratios higher than 90%, and a large proportion of state enterprises are running deficits and are defaulting debt services. After analyzing the cause and consequence of the debt crisis, they argue that the debt crisis is actually an excellent opportunity for initiating fundamental changes in the state firms' control rights (or property rights) structure. In particular, they propose a reorganization-oriented procedure which encourages all stake-holders in the state firm to negotiate among themselves under a set of pre-defined rules. The outcome of the negotiation will, in effect, generate a more efficient control (property rights) structure for the state firm.

¹In another words, through public bidding the government can assess the actual value of any enterprise that it currently owns. Then the State sells the enterprise to the highest bidder by arranging a written contract between the State and the new owner. The contract should stipulate how the new owner will pay back the debt in the amount of the highest bidding within a given period. The easiest way, of course, is to accept the bonds issued by the new management of the firm. Notice that this idea is similar to "non-cash bidding" adopted in the privatization process in Eastern Europe, or "debt-equity swap" adopted in some Latin-American nations.

By taking existing stake-holders' interests into account, they believe that their procedure bypasses the operational difficulties of other de-facto privatization proposals. They argue that such a procedure is perhaps the most aggressive among all feasible options to reform Chinese state enterprises.

Jianbo Zhang uses the argument of private information to show why the ownership of capital needs to be privatized in order to raise investment efficiency. His paper entitled "Privatization of Capital and Investment Efficiency" studies the role of private capital in generating and communicating information in the investment decision process. He finds that inefficient projects are more likely to be funded in an economy where privately owned capital does not exist. This is because private capital plays two important roles in determining the quality of investments when information is costly to generate (collect), and is not publicly available once generated. First, private capital provides incentives for agents with access to the investment projects to collect more information to ascertain the return of the projects. Second, private capital serves as a credible communication device because putting privately owned capital into a project serves as a credible sign of higher expected return. Jianbo Zhang also discusses the effect of capital distribution across agents on investment efficiency.

Haiying Zhao in her paper entitled "Restructuring Chinese SOEs: the Role of the Financial Sector" discusses the role of the financial sector in reforming SOEs. She first analyzes the characteristics of industrial production, emphasizing their differences from those of agricultural production. She further explains why the contract responsibility system, that has turned out to be a great success in rural areas, does not work in industrial reform. According to her, the responsibility system has marginally improved production efficiency of SOEs, but its effects on preserving value of state's assets have been very limited. Expanded autonomy to enterprises, which leads to the separation of ownership from control, without appropriate monitoring may have even worsened the situation by making it more convenient for some managers to "steal" the state's assets for their own benefit. The costs associated with the separation of ownership from control (principle-agent problem) have been fully demonstrated in China's SOEs. She points out that the director/manager responsibility system is essentially a "rental contract" between the owner and the manager with the separation of ownership from control: the firm manager rents the firm from the owner and obtains reward incentives specified in his/her payments package. The separation of ownership from control in the sense that managers of the company are not major shareholders is not unique in China. There are many such

examples in free market economies as well. Most large publicly listed companies such as General Motors and AT&T fall into this category. In general, investors' (owners') interests can in general be protected in these large publicly listed companies. Then, Zhao tries to use a new contractual approach to answer an interesting question: what is the institutional set-up that has developed in free-market economies that has helped to protect shareholders' interest?

Dianqing Xu and his co-authors Youmin Xi and Gengzhong Feng, in their joint paper titled "Cicada Slough and Reform of SOEs," after a critical discussion on the feasibility of various reform strategies focus on a feasible plan on reforming SOEs. In designing reform policies, they base their main idea on Kaldor Improvement. They notice that policy makers often face the dilemma of how to provide enough reward to those who are productive without making non-productive workers worse-off at the same time. They propose a way to get out of the dilemma: to reform SOEs by following three steps known as "cicada slough". First, SOEs should be divided up into smaller separate sub-accounting units; second, new growth points among these units should be found and nurtured; and third, unfair burdens should be taken off those who are productive. They believe that their proposal will also pave the way for the next step of reform.

The paper titled "The Transition in TVEs' Ownership Structure: A Valuable Reference for the Reform of SOEs," by Hongyi Chen, seems to provide some empirical support for Lin's view. In her paper, H. Chen points out that despite the collective nature of township and village enterprises (TVEs), this sector, in sharp contrast to the state sector, has become the most dynamic part of China's economy. The main difference between a SOE and a TVE lies in the fact that the former is not subject to a hard budget line, while the latter, mainly financed by a village or a township, is. She then argues that the development of a market system is critical in reforming the public sector. Weida He, meanwhile, in his paper titled "An Empirical Analysis of Principal-Agency in SOEs," provides some empirical support to Weiyang Zhang's view.

The debate on the internal and external conditions of firm reforms is provocative and far from conclusive. No doubt, more people inside and outside China will be motivated to find better solutions to many questions raised during the debate. For example, is it possible to establish a modern and efficient corporate governance based on state ownership? When should the non-state owned capital be introduced into the current SOEs? Is it the State that provides others with free rides, or on the contrary, is it the State that is the free rider? Should a creditor just be a

creditor or should s/he be more than a creditor (as the case in current China where the State is both a creditor to and an owner of any firm in the state sector)?

3. Papers collected in the third part either look at the SOE reforms from a historical perspective or an international perspective. Thomas Rawski, in his paper entitled "Implications of China's Reform Experience," notices that "China's unique combination of enormous size, large and unexpected economic gains, unorthodox policies, hybrid institutional structures, and formidable challenges to future economic advance" raises a lot of interesting questions and "adds to the promise of such a review" of China's reform experience over almost two decades. He begins with a summary of reform outcomes, followed by discussions of the reform process, the implications of recent reform experience, and China's economic prospects. He concludes his review with an "excursion" into the realm of "lessons" from China's reform experience. He points out, among other things, that reform means improvement, not perfection; official policy is only part of the reform story; disciplinary tools are inadequate in studying many issues, which have never been studied by the mainstream economics; and research on Chinese experience can strengthen the foundations of economic analysis. His review paper is not only reflective of his knowledge of China, but also provocative.

Guoqiang Tian, in his paper entitled "On the Pattern and Steps of China's SOE Reform and Smooth Transition of Economic System," also draws heavily on China's experience in the past. Based on his observation, he addresses the methods of state-owned enterprises' ownership reform and the smooth institutional transition of the economic system in China. By using the theory of endogenous ownership arrangements developed in his other paper, he proposes a three-stage method for China's economic reform. He shows that a smooth institutional transition to a market economy needs to go through three phases: (1) economic liberalization; (2) marketization; and (3) privatization. In the first stage, the entry and competition of enterprises of all kinds of ownership help the non-state sector develop quickly. In the second stage, competition among enterprises of all kinds of ownership and the introduction and development of the market system lead to reduction of SOEs. In the third stage, SOEs will face large-scale bankruptcy and privatization. The first stage began with rural economic reform in China in 1979. The second stage began in 1992. The third stage has not begun and should not be expected too soon. According to him, it is preferable to wait about 5-10 years until the non-state-owned economy has become a large proportion of the economy, say above 80% of GNP, and the social security network is almost completed.

Xinghai Fang in his paper entitled "Some Sobering Thoughts on China's SOE Reform--From the Experience of Other Countries," analyzes the main measures of China's SOE reform in 1995 in light of international experience. He concludes that these measures are not likely to produce marked positive results due to the very timid nature of the measures which were necessitated by the current political and economic constraints. He then proposes a long-term path for SOE reform in China based on ownership decentralization and promotion of the non-state sector.

Dali Yang's paper titled "Guiding Chinese Industry into the 21st Century: the Dilemma of Industrial Policy in an Era of Partial Reform" also takes an international perspective. He points out that Chinese planners, impelled by systemic changes in the economy and learning from China's East Asian neighbors, have increasingly turned to new industrial policies. After assessing the implementation of China's 1989 industrial policies, he finds that these policies have had an impact on the flow of investment funds and they are likely to be more effective when they conform to market trends. He also finds significant inconsistencies in policy implementation.

Elliott Parker's paper titled "Reform of China's State-Owned Sector: Parallels with the U. S. Regulatory Experience" sheds some new light on China's SOE reforms. The paper points out that China's strategy to maintain state control of SOEs within the emerging competitive market economy raises questions that parallel the U.S. debate over traditionally regulated industries. Successful implementation of the current strategy to strengthen SOE incentives to maximize profit will place SOEs in a position similar to those of U.S. regulated firms prior to deregulation. Despite the fact that these firms were privately owned, with management separated from ownership, and operated within a strong competitive infrastructure, they were unable to resolve the inherent contradiction between their roles as profit-maximizing entities, on one hand, and their government-mandated social responsibilities, on the other. U.S. experience dealing with this issue may provide helpful insight as China seeks to strengthen the SOE's incentive to maximize profit without removing the SOE social service responsibility.

Anne Yaohui Zhao, in her paper titled "The Nature of China's SOEs and its Implications," shows that China's SOEs are similar in nature to labor-managed cooperatives. She analyzes how this nature was acquired and then uses this analysis to explain the troubled economic relationship between the enterprises and the State, and current problems of heavy indebtedness and over-staffing in these enterprises. Her paper certainly represents a new direction to look at China's SOEs.

4. The fourth part focuses on the relationship between macroeconomic stability and SOE reform. There are two papers that are related to this subject. The first one is Gene Chang's paper entitled "Monetary and Financial Policies and the SOE Reforms in China." In his paper, Chang investigates how the macroeconomic policies, in particular, the government's monetary and financial policies, will affect the performance of SOEs. He concludes that a cautious macroeconomic policy creates a better environment for SOE reforms while economic overheating hurts SOE reforms. The paper further discusses the monetary, financial, and taxation measures which could contribute to successful SOE reform.

The second paper in this section, "Unemployment, Redistribution and the Reform of State Firms," by Yashan Wang, raises another important issue--how to reduce the negative impact of large-scale unemployment. She first discusses some distinct features of some centrally planned economies, especially those of developing countries such as China, and explores the implications of these features for reform policies. She then shows that when factor markets are missing or segregated, and are coupled with inadequate alternative redistribution means, an immediate market liberalization would produce massive unemployment, which in turn could cause many social problems if the unemployed cannot be re-employed and compensated. However, when factor markets develop and the government's redistribution tools improve over time, reform of the state sector can be deepened, and the restrictions on private ownership, entry, and exit can then be phased out gradually.

5. The fifth part deals with various issues directly related to SOE reforms, such as reforming the labor market, the housing sector, and the medical care, insurance, and innovation systems. All the papers in this section adopt a sectoral approach. The first paper, titled "The Effects of Institutions on Worker Mobility and Labor Market Efficiency," is given by Dennis Tao Yang. This paper shows that China's inter-provincial wage disparity is much larger than inter-state pay differences in the United States. It argues that remaining institutions from the centrally planned regime--including the household registration system, housing, pension, and social insurance--impose high worker mobility costs, which prevent labor market adjustments toward a spatial equilibrium. He points out that experience from the U.S. labor market suggests positive consequences of labor mobility and directions for further reforms.

Aimin Chen, in her paper titled "A Release of Social Responsibilities of Chinese Enterprises: Urban Housing Reform and Marketization," points out that China's SOEs have been unsuccessful in response to market competition in the

absence of government protection. According to her, the traditional urban-housing system has contributed to the poor performance of SOEs. She analyzes the impact of urban-housing reform and marketization on the restructuring of China's SOEs, and models a dynamic adjustment between rents and prices in the process of developing a fully-commercialized Chinese urban- housing market. After examining the traditional urban-housing system and its consequences, the dual- housing price system, and a segmented urban housing market, she proposes some useful policy recommendations.

Belton M. Fleisher, Stephen M. Hills, and Yong Yin, in their paper, "The Role of Housing in Labor Market Liberalization in China," examine the economic effect of changes in Chinese housing patterns under conditions of gradual market reform. They point out that a key difference between formerly planned economies and those of market-oriented ones is the degree to which individuals are responsible for their own housing. In China, Eastern Europe, and the countries of the former Soviet Union, large numbers of people still live in housing units owned by their employers. The way housing is allocated in China complicates the transition to a market economy. Industrial restructuring through massive shedding of surplus labor in nationalized firms would be difficult in any country. It is particularly difficult in China because of the role that SOEs have traditionally played in the provision of income security, housing, medical attention, and other basic needs. According to Fleisher et al., for enterprise reform to progress significantly, provision of basic services such as housing must ultimately be detached from the employment relationship. Only then can the level and distribution of employment be rationalized without creating socially and politically unacceptable levels of open unemployment and economic insecurity.

Ling Li and Dingbo Xu, in their paper, "How to Reform China's Old-Age Insurance System--What Can We Learn from the US Experience," take a modern accounting approach to the issue of how to reform China's old-age insurance systems. Such an approach departs from those in existing literature and offers new insights on this important topic. Based on a comparison between China and the U.S., they argue that the current pension system in China, which has been redesigned in recent years, not only fails to provide accurate economic information required for efficient decision-makings, but also lacks a competition mechanism that controls the administrative cost. Based on the modern accounting principles, they propose a new old-age insurance program for China. The new program has the following features: 1) separating firms' historical pension burden from their new periodic pension cost;

2) separating each firm from the management of its pension fund but holding the firm ultimately responsible for the funding of its pension plan; 3) adopting modern cost accounting techniques for postretirement benefits; and 4) socializing the administration of pension plans while preserving adequate competitive pressure on the administrative agents. Their proposal certainly deserves to be studied carefully by those who are now designing a new insurance program for the elderly in China.

Wei Yu and his co-author Minghui Ren, in their paper titled "The Important Issue of Enterprise Reform: Health Care Insurance System," notice that the rapid growth of health care expenditure has bankrupted health insurance programs in many SOEs. Their paper reviews the evolution of the labor and government insurance systems and identifies factors that stabilize both insurance systems for the first 25 years and factors that have led to financial crises since the late 1970s. According to them, while the rapid growth of health insurance expenditure is attributed to incentives in both the demand and supply sides, the self-sufficient financing policy, biased pricing structure, and lack of cost-effective analysis are major factors resulting in financial crises in SOEs. They also discuss policy implications from China's experiences in comparison with those of developed countries.

Lan Xue poses another interesting question in his paper titled, "China's Innovation System Reform: A Historical Perspective." He points out that in the discussion about SOE reform, little has been said about reform of China's innovation system and its relationship with the SOE reform.² In a mature market economy, a nation's innovation system is an integral part of its economic system. Given the close link between a country's economic system and its innovation system, few will disagree with Xue when he regrets that economists have not played a prominent role in the reform of China's innovation system. According to Thomas Rawski, if China's SOE reform cannot establish a modern industrial innovation system, then this reform will be a failure. It is difficult to imagine how a modern market economy could function and compete without a dynamic and responsive innovation system based on market principles. Xue's paper focuses on the reforms of its innovation system confronting China's public research institutions (PRIs) at both national and local

¹ Here, innovation system refers to the set of institutions and their interrelationships in a nation that determines the performance of the technological innovation processes by which firms master and get into practice product designs and manufacturing processes that are new to them. See Nelson (1993) at the end of Xue's paper.

levels. According to Xue, one of the critical tasks of the innovation system reform is to make PRIs more responsive to the market needs of science and technology.

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