

Transition from Small Society to Market
Economy Unit : Economic Reform of State-
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Transition from Small Society to Market Economy Unit

— Economic reform of state-owned enterprises in China —

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Introduction

According to the 'World Development Report 1996', between 1978-94 years China has increased its GDP at an average annual rate of 8.9% (World Bank, 1996, pp.188-189). This matched South Korea as the highest growth record in the world. Such a rapid growth of the Chinese economy unquestionably could not have been achieved without the spread and permeation of market principles into Chinese society.

The Chinese economic performance may be highly regarded for the two following reasons; one is that China, as one of the developing countries, took off smoothly demonstrating to other countries the effectiveness of market mechanism for economic development. The other is that China has successfully achieved the transformation of its economic system from one based on central planning method to one based on market mechanism. Especially when compared to the former U.S.S.R and Eastern European countries that can't get out of economic stagnation because of failure to switch smoothly over to market mechanism, China's gradual introduction of market mechanism is worth being observed.

Now China is facing the final phases of the reform of its economic system.

After the grand tour of South China by Deng Xiao Ping in support of the process of economic reform in the spring of 1992, the Chinese Government and Chinese Communist Party (CCP) accepted the switch of economic system to a de facto market economy.

This was followed in November of 1993 by the decision of the third plenum of the 14th Central Committee of the Chinese Communist Party (CCP) to proceed with the construction of a socialist market economic system (adopted November 14, 1993). In its decision, the Central Committee stressed that the establishment of a system of modern enterprises was the most pressing problem facing the country and concluded that enterprises should be weeded out on the basis of market competition and priority should be given to efficiency while considering the system of equal distribution of income. That is the CCP took competition as its guiding light and affirmed the bare, primitive market principle of survival of the fittest.

This, accordingly, became affirmed as a national principle and led to the de facto eradication of restrictions on economic activities on the grounds of their infringing upon socialist ideals.

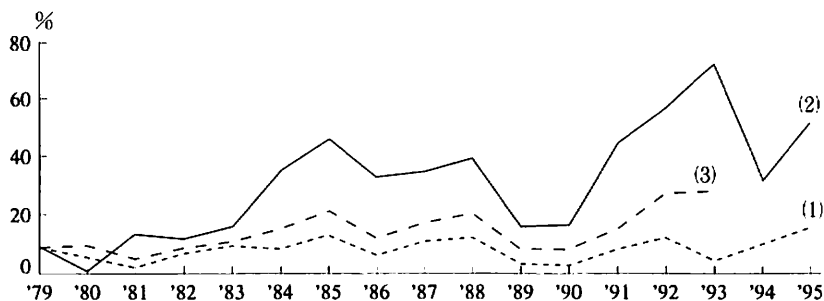
The theme of the current article is to throw light on what kind of market economic system is now growing in China as a result of the past 17 years of economic reforms, starting from 1979, boosted by Deng's tour, and continuing today, and the recent high economic growth. What are the features of the Chinese model of market economics, so pointedly different from those of Japan and other countries? This will be analyzed from the reality and process of reforms of state-owned enterprises system.

Reality and causes of depressions of state-owned enterprises

As is the case with former U.S.S.R and East European countries, in China the reform of economic system of state-owned enterprises is the most difficult problem. The central government began full-scale reforms of state-owned enterprises back in 1984, and fundamental aim of government is to change the basic direction of the reforms to reorganization based on the principles of separation of the enterprises from the government, independent accounting, and individual responsibility for profits and losses. Over 10 years have passed since the start of the reforms. Although some enterprises including Capital Steel Company and Button Electronic Company, have benefited from the effects of reforms, quite a few enterprises continue to be unstable business-wise, despite the elimination of the government subsidies crutch. The anticipated transformation into rational businesses has not necessarily come to pass. To begin with, it is necessary to make sure the reality of depressions of state-owned enterprises.

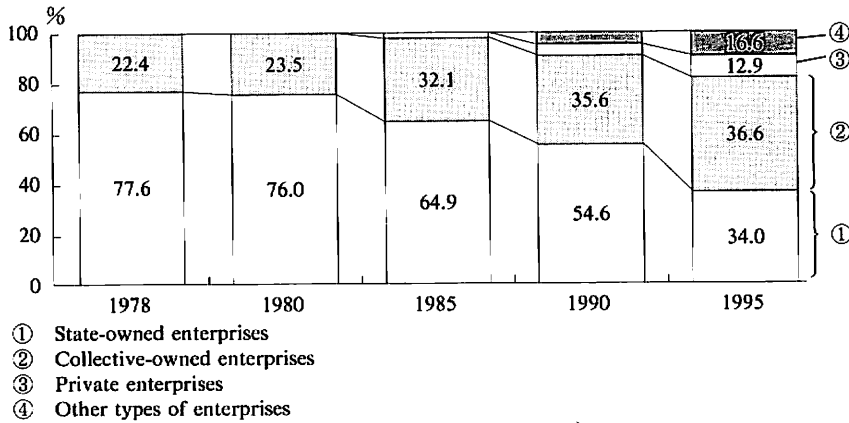
In the process of reform of economic system, there has appeared an increasing variety of types of enterprises not only in the area of ownership but also of management. It is clear that the rate of annual growth of production of state-owned enterprises has been greatly below those of township enterprises and private enterprises. Fig. 1 shows such a tendency based on the results of calculation by Material Production System that was used in socialist countries. As a result, the proportion of product by state-owned enterprises to the total product of national economy has become

Fig. 1 Annual Growth Rate of Industrial Production, 1979-95.
(at current prices)



(1) State-owned enterprises (2) Township enterprises (3) Total Social Product (MPs)
Source: China Statistical Year Book, (1996).

Fig. 2 Changes of Share of Industrial Production by Ownership, 1978, 1980, 1985, 1990, 1995.



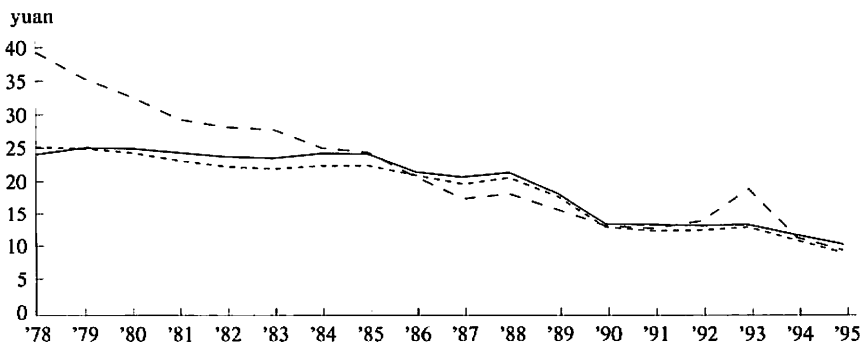
Source: China Statistical Year Book, (1981, 1986, 1991, 1996).

less and less. In 1978, just before starting to shift the economic system toward market mechanism system, the proportion attained 77.6%, then dropped to 54.6% in 1990, and to 34% in 1995. On the other hand, the proportion of township enterprise increased obviously to be almost similar to that of state-owned enterprises (Fig. 2).

In spite of this trend, the role of state-owned enterprises has never lost its importance in the national economy. Most of the typical big scale enterprise have been always state-owned. Particularly in the field of natural sources, energy, and material industry, the state-owned enterprises have almost monopolized the markets.

No matter how we look at it, no one can deny that state-owned enterprises are in trouble. Fig. 3 clearly shows us the fact that the productivity and efficiency of the enterprises are inclined to decline. As the rate of inflation was quite high during these years, the substantial productivity and efficiency must have declined even more than is shown in Fig. 3. In addition to this, we should not overlook the fact that township enterprises show the same declination of productivity and efficiency as state-owned enterprises, while not a few economists in China and elsewhere regard the factor of development of township enterprises as market mechanism. It may be said that devel-

Fig. 3 Trends of Efficiency of Production, 1979-95.



- (1) Profit and tax per 100 yuan Fixed Assets (State-owned enterprises)
- (2) Profit and tax per 100 yuan Funds (State-owned enterprises)
- (3) Profit and tax per 100 yuan Funds (Township enterprises)

Source: China Statistical Year Book, (1996).

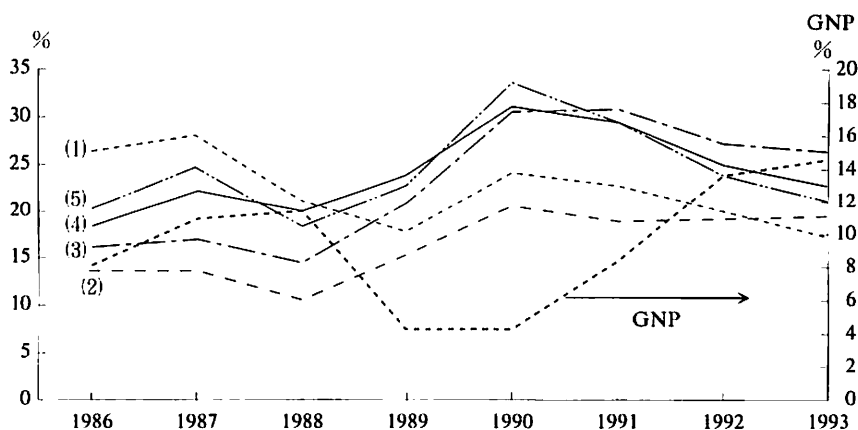
opment of both state-owned and township enterprises have been realized not by improvement of management of enterprises, but by the mere expansion of equipment for production. Such a trend is the just the hot point at issue that Professor Kruguman of Stanford University raised in his "The Myth of the Asia's Miracle" (Kruguman, 1994). This depression of state-owned enterprises leads to a deficit in the balance sheet of enterprises. The problem of the deficit has been regarded as barometer of the need for reform of economic system as far as state-owned enterprises are concerned. Since 1994, the degree of deficit and total number of such enterprises has rapidly increased, and this has resulted in the appearance of serious social problems such as bankruptcy and unemployment.

Some phases of deficits are expressed in the proportion of state-owned enterprises whose balance sheet is deficit (Fig. 4). The increase or decrease of these enterprises is contrary to the overall trend of the GNP. That mechanism is explained as follows; high growth • high income → strict control of money supply → depression of goods → increase of stock → lack of money → deficit. In addition, speed and severity of this phenomenon differs according to the industrial classification. But there are other factors to be explained.

Scholars and others who are concerned with this problem are substantially in agreement that the reasons for these depressions are that the budgetary restrictions of state-owned enterprises continue to be lax. That is, the government has given various types of self-management powers to enterprises while leaving the question of ownership of the enterprise's assets vague, so on the one hand, the government has not stopped intervening in enterprise matters and sometimes continues providing generous support, while on the other hand, the enterprises fail to wean themselves of their reliance on government. In short, we may be able to attribute the trend to the period of transition from central planning system toward market mechanism system. In this paper, this situation will be analyzed a little more closely, based on views expressed by newspaper reporters and other writers.

First, let us consider who is responsible for an enterprise's operations. The line between authority and responsibility of investors is not clear, so while there is some-

Fig. 4 Trends of Deficit of Various Industrial Enterprises, 1986-93.



(1) Coal, (2) Food, (3) Spining, (4) Metal, (5) Electronics
 Source: China Statistical Year Book of Industry, (1994).

one to decide on policies, no one takes responsibility for them. Under this situation, there is 'fraternal competition among budget cutters' As a result, for example, investments are made before markets are sought. Investment therefore often ends up duplicating that of other enterprises, leading to excess investment. Irresponsible, uncontrolled operations continue, enterprises get into trouble, and deficits are produced.

Next, there is the relation between the party and government. Enterprise operations are in actuality subject to the whims of party and government officials. The final decisions in investments are made by party leaders. These works to improve their records during their terms by increasing production and fiscal revenue jobs in order to ensure the stability of the region in question. The money comes from the State and the risk of the investment is borne by the State, so enterprises tend to borrow as much money from the State as possible. In view of this interrelationship, we can regard enterprises as one of possessions to party and government (For these issues, see the special feature in Jingji Ribao [Economic Daily], March 12-15, 1994).

It is this defective footing of the enterprises that is causing irrational overlapping construction and resulting in the protracted low efficiency of state-owned enterprises despite the massive investments of funds. A recent example of this was given in article in the April 8, 1993 issue of Renmin Ribao [People's Daily]. According to this article, sales of color television sets these past few years have been in the 10 million- set range, yet production capacity of electric refrigerators is 12 million units, while the rate of use is only 40 percent. Among about 70 air-conditioner enterprises, 43 enterprises can produce more than five thousand per year, and only one of the 43 has a profitable production capacity. As to the automobile industry, while there are more than 160 enterprises, only six of them can produce ten thousands vehicles and the production capacity of the majority is less than one thousand. In the spinning industry, these past several years each enterprise has been purchasing more and more equipment one after another and the result is that 1/3 of the equipment is unused and the investment of 120~150 hundred million yuan (Renminbi) has been wasted.

This special organizational feature of state-owned enterprise can be said to be a result of the entanglement of the institutional features inherent in socialism and the spread of the self-management system.

In relation to this, in recent years, there has been the political and social problem of the government demanding that enterprises supply it with money and goods.

The State Bureau of Statistics ran a questionnaire survey of problems faced by state-own enterprises at the end of August 1994, covering 1,270 enterprises. It found that about 80 percent of the enterprises have seen their debts rise in the past two or three years. The main reason has been government demands on these enterprises (Jingji Ribao, Dec. 6, 1994).

The nature of these government demands is diverse. Some are unavoidable at the present time. For example, the leaders of municipal governments trying to renovate a road call upon the top managers of enterprises in the city to contribute several tens of thousands or millions of yuan in accordance with the size and profitability of the enterprises. There are limits to the fiscal capacities of local governments, yet the governments have to proceed with a certain number of projects. There, in quite a few cases, the local governments pass the burden on to the supposed beneficiaries (Jingji Ribao, July 29, 1993). There is, however, major damage being caused by officials

demanding money or goods, in substance bribes, from the staff or persons in charge of related enterprises or units.

Intervention or Partnership?

Seen in this way, it seems self-evident that there is no way to overcome the problems in the organization of state-owned enterprises other than the enterprises declaring complete independence from the government. In Oct. 20, 1984, the CCP adopted the 'Decision on the Reform of Economic System' in the third plenum of the 14th Central Committee, since then party and government leaders have again and again emphasized the importance of this. Contract system has been introduced as a proper method to realize the reform, and various kinds of regulations and acts have been promulgated including the 'Act on the duties of leader of factories of all the people-owned industrial enterprises (at present expressed by state-owned enterprise)' (Sep. 15, 1986), and the 'Provisional act on contract system of state-owned industrial enterprises' (Feb. 27, 1988). On April 1988, as a compilation of these acts and regulations, the 'Law on state-owned industrial enterprises' was enacted. Under this law, the state-owned enterprises have been recognized as subject to economic management which is independent from government. The property of enterprises belongs to all the people and government trust it to enterprises, based on the principle of separation of ownership and right of management (Article 2). No organization must violate the right of economic management which belongs to enterprises (Article 58). However, it should be noted that there is also a clause stating that leader of factory will be selected by the organizations of government (Article 44). This means that party and government have not necessarily abandoned their authority on enterprises, but on the contrary have kept control over them through personnel management.

In July 1992, the 'Articles on Conversion of the Mechanism of Management of Publicly Owned Industrial Enterprises' was promulgated. Those articles have made concrete the contents of the Law of 1988.

The most important point in the Articles is the delegation of 14 types of decision-making powers over production and management to state-owned enterprises so as to enable them to convert to organizations operating on the principles of independent management, independent accounting, and self-responsibility for profits and losses. These were given, however, to the "owners" of the enterprises, that is, the government. Furthermore, the heads of the enterprises and factories were to continue being appointed and dismissed by the government and responsible ministries (Article 42). What this shows is that the government continues to intervene in and regulate many areas.

By way of example, when it comes to the question of how wages and bonuses are to be decided, enterprises are allowed to make decisions on their own within an overall wage fund commensurate with those enterprises (Article 19), but considerably strict restrictions are in fact being placed on wage hikes. The total wage funds of enterprises are decided on in accordance with a formula of linkage with economic efficiency as determined by the government (Article 19). The growth of total wages should be held beneath the growth in labor productivity. The base figure for the total wages is examined by the related authorities. Deficit-running enterprises in

particular are supposed to be subject to monitoring (Article 24).

Thus, while the government is maintaining a stance of guiding enterprises in a direction increasing their independence as rational organizations through recognition of self-management rights of enterprises and lighting of their burdens, it is continuing to supervise and intervene in management as seen by its placing of a ceiling on wage increases. The stance of the Articles and the current administration toward reforms of the state-owned enterprises is obviously quite contradictory.

The enterprise side, on the other hand, appears wary of continued or augmented intervention by the State in operations. For example, the Corporation Law promulgated on December 29, 1993 promoted the introduction of a joint-stock system, but the giant enterprises, in particular, mostly select the management-contracting system. An official at one enterprise gave as the reason for this negative attitude toward the joint-stock system as follows; if an enterprise decides to introduce the joint-stock system as things now stand, the State might simply buy large amounts of the stock and still intervene in management.

Another important point to observe is that the way the different ministries of the central government and the different local governments treat enterprises in the application of the provisions of the Articles is not uniform.

For example, in the case of Jilin and Hebei provinces, the local governments are able to appoint party secretaries to be concurrently the heads of factories (Guo wu yuan fa zhi ju [Department of Policy and Legislation, etc], shang ce [Part 1] 1993, p.111 & p.42), while in Heilongjiang Province, a person may hold the concurrent post of factory manager and party secretary for enterprises other than especially large ones (Guo wu yuan fa zhi ju, shang ce, p.88). Meanwhile, the role of local government is still portrayed as reducing blindness in the production of goods with market competition (Guo wu yuan fa zhi ju, shang ce, p.61) and they are held responsible for breaking down the divisions between regions and sectors, it being emphasized that they must not construct barriers unsuitable to the establishment of a unified national market and must not restrict the sales and purchasing of any unit or sector to another region or sector (Guo wu yuan fa zhi ju, shang ce, p.62, and p.294).

In a certain sense, the Articles take into consideration the vested interests of party and government officials. On the other hand, they portray it as necessary for the party and the government to intervene and embark on reorganization so as to realize the goal of having the local governments stop the waste of resources caused by the "low level of competition" and improve the competitiveness of enterprises while the market economy is still undeveloped.

But there is still the direct danger that, due to the vagueness of rights over assets, the state-owned enterprises will end up weak in the management of assets and assets will be arbitrarily disposed of by related parties. On top of this, while there are different historical factors at work in each region, the local governments consider themselves to be the masters of everything under their purvey and deem all state-owned enterprises in their regions to be under their protection (Difang zhengfu zai gaige he fazhan zhong de jingji jineng he xingyi keti zu [Research group on the economic role and conduct of local government in the process of economic reform and development], 1991, p.49). This has been one of the key issues behind the economic growth to date.

Seen in this holistic way, in reforming the state-owned enterprises, in China's

case it would be overly simplistic to conclude that ties should be cut with the central and local governments. Rather, it would be wiser to clarify the positive roles of the government. Of course, there is considerable, complex interaction among governments, including the issues of establishing the rules for coordination of interests of the central and local governments, and it can be anticipated that it will not be easy to reach any sort of consensus.

Change from ‘Small society’ to enterprises

In the old socialist society, as everyone knows, the enterprise or organization to which an individual belonged guaranteed all aspects of one’s life from cradle to grave and, further, to one’s children and grandchildren.

State-owned enterprises, universities, and other organizations operated their own non-production facilities such as primary and secondary schools, clinics, dining halls, and dormitories and therefore served as all-inclusive cooperative habitats. “The enterprise shoulders the burden of society” was an apt expression. Of course, not all the people enjoyed the same level of services. There was a difference in the level of services between the urban and rural areas, of course, and, even among organizations belonging to the central government, differences depending on the power of the individual organizations.

In addition to these non-production facilities, enterprises and organizations harbored large numbers of surplus workers in their production divisions and business divisions. This remains a feature of the Chinese economy today. The state of surplus employment, stressing sharing of work, i.e. having “five people do three persons’ work” can be traced back to the artificial policies enforced to hold down wages and achieve high employment in the years just after the founding of the People’s Republic. The number of employees in state-owned enterprises in 1949, when the PRC was established, was 8.09 million. By 1952, this had reached 16.03 million- i.e., it doubled in just four years (Guojia tongji ju [State Statistical Bureau] eds., 1984?, p.152). Later, too, in hiring workers, the policy was consistently followed of giving priority to the creation of jobs, so as not to allow unemployment, rather than to the rational deployment of personnel. This long-term surplus employment practice was made possible by the lax budgetary restrictions placed on state-owned enterprises, i.e., the fact that even if they ran deficits, they would be saved in the end by fiscal outlays by the State.

Insofar as China is now aiming at changing over to a market economic system, enterprises have to restructure to gird themselves for hard budgetary restraints, i.e., the pursuit of the maximum profit. The main means currently being tried out by enterprises and organizations in this restructuring are a change from production contracts to joint-stock systems in the large and medium-sized enterprises, cutbacks in personnel, a reevaluation of the previous employment system (specifically, a change from guaranteeing permanent lifetime employment when hiring new work force to contracting workers for specified periods), and the passing on of the expenses for social welfare to the beneficiaries.

As part of the reform of enterprises, the management contract system introduced in 1984 enables large and medium-sized state-owned enterprises to conclude a

contract with the State in which they promised to turn over to it a certain percentage of their profits in return the enterprises are allowed to retain profit in excess of the stipulated amount for use in both investment and bonuses for workers. The aim was to create incentive in enterprise operations.

As seen in the previous section, however, since the ownership of the assets of the enterprise remained vague, responsibility also was unclear. Many enterprises ended up running deficits, due in part to the changes in the accounting system in the past one or two years. One of the reasons for this has been the strong tendency for enterprises to use their profits for non-productive expenditures such as increasing employee wages and extending bonuses rather than capital investment. That is, since the rights over assets were cloudy and no outside party was checking into the details of operations, people increasingly put the assets of the enterprises to personal use and management tended to become loose.

In the face of this problem, Chinese scholars are now mostly coming out in support of the introduction of the joint-stock system, in other words a change to a system enabling outside checks on management. In such a system, the relationship between stockholders and managers would be based on proper corporate organization, with rights of ownership over assets resting with the enterprises. The central government, on the other hand, is applying pressure on enterprise managers to make improvements using bankruptcy as a threat, as seen by its publicization of the process of closure of what may be called China's "bankruptcy model," the Chongqing Knitting Factory (Xie De Lu, 1994).

Along with the problem of type of management, another of the reforms of state-owned enterprises which is of utmost importance and requires urgent resolution, but is most difficult to tackle, is the issue of personnel cutbacks. When our research group visited the Button Electronic Company in the summer of 1993, those who were related to management commonly pointed out the difficulties of this problem. The previously cited survey of 1,270 state-owned industrial enterprises by the State-Statistical Bureau also found the most serious management problem to be excess employment. Trouble over dismissals of workers is constant. Even the domestic Chinese mass media report cases of workers with poor work attitudes attacking enterprise presidents who have dared to fire them.

The most frequently used methods of cutting back personnel are converting non-productive and service divisions into independent enterprises, encouraging job-hopping to other work, and starting up new tertiary industries to create job opportunities there. As demonstrated by the replacement of Beijing's shortage of taxis by a surfeit in a short period, there are limits to how many people the service sector can absorb. Furthermore, continued restructuring is essential in the main divisions as well. What is needed, without exaggeration, is nothing less than a fundamental change in the face of enterprises themselves and a revision in the way Chinese society is structured.

In relation to this, the number of contract workers has been rising every year, in part due to promotion by local governments. The share of contract workers in the total number of employed is rising as well. For example, in state-owned enterprises in the manufacturing sector, there were 1.55 million contract workers in fiscal 1985 for only 5.2 percent of all workers in the sector. By fiscal 1995, there were 21 million contract workers, accounting for 63.1 percent of the workers in the sector. The same

trend can be seen in other sectors (Guojia tongji ju, 1996, p.108). The standards of remuneration for contract workers and the situation when renewing contracts differ depending on the enterprise, but it is not rare for companies not to renew the employment contracts for workers with poor work attitudes. The central government is apparently dedicated to abolishing permanent employment in the future.

The social security system is also being reformed at the local enterprise, and organizational levels. The point of the reforms is, of course, to have the individual beneficiaries bear the expense of their benefits. People in government organizations which do not have their own fiscal resources say that health care costs will gradually be made payable by the recipient and retirement pensions will be cut. In particular, in relation to reforms of state-owned enterprises, it has recently been frequently stressed that it is necessary to reduce the social burden of enterprises in order to create conditions for fair participation in market competition. And in fact, insofar as enterprise are profit-oriented organizations, it is clear that there are limits to how much of the heavy burden of the various social services they can continue to shoulder.

Of course, even in the past, enterprises were not disbursing unlimited funds for social services but were supported by various social elements. An important role has always been played by mutual-assistance networks of regional and human contacts, as shown by the saying related to the writer by a friend that "When something comes up, help comes in from all quarters." But most of the more highly educated reportedly feel this social custom to be a burden on them. In rural areas, however such blood and regional ties remain very strong even today as factors helping to support society. The CCP tends to also evaluate this positively. In the decision of the third plenum of the 14th Central Committee, it was stated that "care of the elderly in rural areas is to be mainly guaranteed by their families, with assistance from the local communities." When this author visited a rich rural area in the suburbs of Shanghai, reputedly one of the tops in China, just after Lunar New Year (Feb. 1995), he found the slogan written in large letters on paper plastered on the walls "Let's Keep Up the Spirit of Respect for the Aged Traditional to the Chinese People."

Wherever the case, the Chinese are reaching a consensus that while there are limits to how much the beneficiaries can bear, the level of social services cannot be far from the level of national income and that, accordingly, for the time being, it will be impossible to provide a high level of services or to go after greater cost sharing, and that only a certain extent of government assistance can be expected as well. Self-help is therefore becoming more important. It is for this reason, too, that the government has allowed foreign insurance companies to operate in China.

Issues in Chinese Model Market Economics

In modern China, market functions are being reassessed and an emphasis is being placed on the principle of trying to rebuild finances and revitalize the economy through smaller government and self-help efforts-something reminiscent of the ideas of neo-conservatives in the industrialized countries in the 1980s. The changes in the organization and systems of enterprises accompanying the shift to a market economy will inevitably change the nature of Chinese society, a society in which human relations and social ties have played major roles in the past.

And anyone will not deny that the reform of economic system in China has reached the point of no-return. It may be said that only the market mechanism can solve mountains of problems. But contrary to the expectation of a few Chinese economists, the experiences of developed countries show the market mechanism is never almighty.

I will take again the problem of employment. In the job environment, where it is believed that about 30 percent of the workers at state-owned enterprises are superfluous, insofar as the market mechanism is adopted, continuing restructuring will be unavoidable. Since 1978, however, statistics show about 15 million laborers and peasants have been added to the labor pool (new laborers and peasants minus those who retired), of which only 1,500,000 have been employed in state-owned enterprises every year. This fact simply explains how difficult to realize workforce reduction is.

As for the reforms of the enterprises, these will go beyond mere organizational conversions and will mean dismantling of joint production groups and therefore social reforms. With the eradication of the supremacy of the "group" over the "individual" as boasted under socialism, a change is underway from the emphasis on equality which has been promoted up to now to the acceptance of differences in income and remuneration. Will the general public go along with this? And how can the inward-looking regionalism, a factor inhibiting the formation of a unified domestic market, be overcome.

Whatever the case, solutions to these problems would be difficult by just leaving things up to market principles. The central and local governments can be expected to play their roles.

Leaving aside whether this is good or bad, the roles of the central and local governments should not be distanced from those of the enterprises and private sector in the market economy. Isn't there a need to reconsider a more positive role? There would seem to be room for consideration of the formulation of rules for fair competition and their strict enforcement, of course, and, also, the promotion of policies for the positive protection and growth of fledgling business organizations.

It has become common today to criticize the protection of fledgling industries in developing countries, but this criticism applies to the overprotection and intervention by government which ends up weakening the standings of companies. The need for suitable positive intervention is recognized even in the report of the World Bank on East Asian Economy.

Of course, this assumes that the government has the trust of the people.

* This article is based on the author's two articles; 'Economic reforms of state-owned enterprises' in *The Institute of Comparative Economic Studies*, Hosei University/T. Matsuzaki ed (1996), in Japanese and 'Market economics in China-An overview' in "JETRO China Newsletter", No.118 Sept.-Oct. 1995. He especially thanks to the editor of "JETRO China Newsletter" who admitted him to reuse part of that article.

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