

# The Bankruptcy System of Mainland China's State-Owned Enterprises

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*Beijing has set out two goals for its economic policy in the next fifteen years. One is to transform mainland China's planned economic system into a market system; the other is to change the emphasis of economic growth from quantity to quality. The achievement of the two goals hinges on the success of the bankruptcy system. Nonetheless, the development of the bankruptcy law since it was enacted in 1986 has proven to be a bumpy road. Confronted with flaws in the law, combined with various other obstacles, Beijing has been forced to slow the implementation of the bankruptcy system and resort to enterprise mergers. The strategy for the enterprise reforms for the near future has been shifted to aiding major enterprises while revitalizing small ones through various methods other than bankruptcy.*

**Keywords:** Bankruptcy Law; economic reforms; state-owned enterprise reforms

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Bankruptcy in a society with a market economy is a normal sign of evolution, but it has been regarded as a taboo for decades under mainland China's planned economic system. Even though a Bankruptcy Law was promulgated in 1986, enterprise bankruptcy has proven to be a knotty task that ranks only behind birth control.<sup>1</sup> This paper will use the perspective of economic reforms to examine the development of mainland China's bankruptcy system, its flaws and special features, and its future prospects.

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<sup>1</sup>*Wen Wei Po* (Hong Kong), March 16, 1995, 10.

## The Development of the Bankruptcy System

Bankruptcy takes place when a person's assets cannot cover his liabilities and he finds himself insolvent. His properties are then liquidated through bankruptcy proceedings to pay off the debt. Before 1980, when bankruptcy was still rejected by the socialist ideological line, Beijing relied on four means to handle its unprofitable enterprises: shutdown, suspension of production, and amalgamation with or transfers to profit-making enterprises. In 1962, these four methods helped Beijing resettle a surplus of 120,000 factories which had been built during the Great Leap Forward.<sup>2</sup>

However, after the implementation of economic reforms in the early 1980s, reformers soon realized that the economic environment had to be improved in order to attract foreign investment. A bankruptcy system, for instance, had to be established so as to guarantee economic development by regulating the relationship between debtors and their creditors and maintaining the social and economic order. In other words, it is an unavoidable cost if mainland China wanted to enter the field of commodity economy.

The pilot program of enterprise bankruptcy began in February 1985 in the cities of Shenyang, Wuhan, and Chongqing. All enterprises in those cities on the verge of bankruptcy were given "yellow light" warnings in which they had one year to improve their situation or risk bankruptcy.<sup>3</sup> On August 3, 1986, the Shenyang Explosion-Proof Apparatus Factory became the first state-owned enterprise (SOE) to declare bankruptcy. The city social insurance departments handled the compensation funds for the laid-off workers (equal to 75 percent of their original wages) as well as the old-age pensions.<sup>4</sup>

By the end of 1988, after three of the fiercest debates it had ever had, the Standing Committee of the National People's Congress (NPC) eventually approved the Enterprise Bankruptcy Law.<sup>5</sup> Nonetheless, with the June Fourth Incident in 1989 and the conservative

<sup>2</sup>Cao Siyuan, "Thoughts about the Problems Concerning Bankruptcy and Enterprise Mergers," *Jiangnan luntan* (Jiangnan Tribune) (Wuhan), 1994, no. 3:10.

<sup>3</sup>*Ta Kung Pao* (Hong Kong), June 22, 1986, 3.

<sup>4</sup>Xing Pingan, "Further Reports about the Bankruptcy of the Shenyang Explosion-Proof Apparatus Factory," *People's Daily* (Overseas edition), September 24, 1986, 3.

<sup>5</sup>For the full text of the bankruptcy law, see *ibid.*, December 3, 1986, 4; for more on the debate, see Cao Siyuan, "The Development of Bankruptcy Law in China," *Xueshu yanjiu* (Academic Research) (Guangzhou), 1996, no. 4:15-16.

**Table 1**  
**Bankruptcy Cases Reported in Mainland China (1986-95)**

Year	Cases Filed with the Court		Bankrupted Numbers	
	Totals	State-owned enterprises	Totals	State-owned enterprises
1986-88			3	
1989	98			
1990	32			
1991	117			
1992	428	130	145	11
1993	710		478	
1994	1,625		1,159	395
1995	48		57	

**Sources:** *Jingji cankao bao* (Economic Information Reference) (Beijing), February 28, 1993, 1; Investigation and Study Department of the China Industrial Economy Society, "Build Up the Enterprise Bankruptcy Mechanism," *People's Daily* (Beijing), June 10, 1994, 5; *Ming Pao* (Hong Kong), November 19, 1994, B1; *Guangming Daily*, December 30, 1994, 1 and March 15, 1996, 2; *Wen Wei Po* (Hong Kong), January 23, 1995, 3; Wang Jianping and Gao Hejun, "In the Market Economy, Bankruptcy Is a Must for Enterprises," *Gongshang shibao* (Commercial Times) (Taipei), April 22, 1995, 9.

backlash in its aftermath, the bankruptcy system was soon labeled as a capitalist practice. That year, despite the fact that 400,000 enterprises suffered losses, only 98 filed for bankruptcy.<sup>6</sup> The number decreased even further to 32 in the following year. However, in 1991, thanks to Beijing's efforts to resolve SOEs' heavy losses and the debt triangle (*sanjiao zai*) funds which enterprises owed each other and the banks, the number of filed cases increased to 177. It further rose to 428 in 1992 in the wake of Deng Xiaoping's tour of southern China. According to reports, between 1989 and 1994, some 3,010 enterprises entered legal proceedings for bankruptcy, but only 1,000 were ruled to be bankrupt (see table 1).

Before 1992, most bankrupt enterprises were either collectively owned or had township ownership; there were also a few small state-owned ones. The first medium-sized SOE to declare bankruptcy was the Liaoning Fushun Glass Works on February 15, 1992. The first large SOE to do so was the Chongqing General Knitwear Works (also the third largest enterprise in mainland China) on November 2 that

<sup>6</sup>*People's Daily*, August 18, 1988, 1.

same year. Although the subordinate schools for employees' children were handed over to the city government, all of the latter's assets and land-use rights were sold through auction to the Chongqing Overseas Industrial Company, a Sino-foreign joint venture, for 40.6 million *yuan*.<sup>7</sup> In 1992, 130 SOEs filed to the court and only 11 were declared bankrupt (see table 1).

Economic reforms in mainland China since 1992 have witnessed some major readjustment. Before then, Beijing emphasized delegating more powers to enterprises and conceding profits to lower levels (namely *fangquan rangli*) without reforming property rights ownership. However, this policy encouraged enterprises to seek further development and profit in spite of their growing financial deficits and bank loans, and hindered them from entering and becoming a mainstay of the market. In view of this, after Beijing decided to adopt a socialist market economy in 1992, it began to promote various kinds of property rights reforms, the core of which was to promote bankruptcy and enterprise mergers. At the end of the year, over 10,000 enterprises were merged into other firms.<sup>8</sup>

The calls for mergers and bankruptcy became all the more stronger after Beijing released a macroeconomic regulatory package in July 1993 and many enterprises, stripped of cash, were faced with swelling debt burdens.<sup>9</sup> It was further echoed three months later in a seminar on enterprise mergers and bankruptcy which was jointly held by the Enterprise Department of the National Administration of State Property, the Industrial Economy Society, the Labor Ministry Institute of Wages, the publishers of *Jingji guanli* (Economic Management), and the Beijing Siyuan Merger and Bankruptcy Consultation Firm. The seminar endorsed mergers and bankruptcy as a major means to enhance overall enterprise quality and effectively protect state assets by adjusting the allocation of production factors.<sup>10</sup> Nonetheless, it did not offer emphatic comments about the establishment of an enterprise bankruptcy mechanism. By November, the Third Plenary Session of the Chinese Communist Party's (CCP's) Fourteenth Central Committee

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<sup>7</sup>*Ta Kung Pao*, November 8, 1993, 8; *Zhongguo shibao* (China Times) (Taipei), December 18, 1992, 2.

<sup>8</sup>*Sing Tao Daily* (Hong Kong), October 20, 1993, 8.

<sup>9</sup>Fan Gang, "The Relation between Enterprise Debts and Macroeconomic Fluctuations," *Jingji yanjiu* (Economic Research) (Beijing), 1996, no. 4:6.

<sup>10</sup>*Keji ribao* (Science and Technology Daily) (Beijing), October 25, 1993, 3.

eventually spelled out a new direction for SOE reforms: establish a modern enterprise system with an emphasis on clearly defined property rights, powers and responsibility, separation of government administration from business management, and scientific management.

The macroeconomic system reforms in 1994 were centered on taxation and foreign exchange control. By this time, three different opinions about SOE reforms had come into being. The first supported property rights reform, with an emphasis on the implementation of the bankruptcy system. The second, however, rejected property rights reform as privatization and preferred the strengthening and improvement of management for revitalizing enterprises. The third suggested a comprehensive project of “*san gai yi jiaqiang*” (three reforms and one strengthening): namely, the integration of enterprise reforms with enterprise reorganization, technological renovation, and strengthening management.<sup>11</sup>

Over previous reforms, SOEs had been plagued by their surging financial deficits. In 1993, 49 percent of these firms reported losses with a volume totaling 45.2 billion *yuan*.<sup>12</sup> However, these firms could no longer expect help from the state as before, since the latter also faced a deficit amounting to 500 billion *yuan*. The new tax system implemented in 1994 allots 75 percent of value-added taxes and consumption taxes for the central government. Under the new system, unprofitable enterprises can enjoy tax exemptions from their local governments while receiving subsidies from the latter. To relieve such burdens, some localities have begun to turn their hopes toward mergers and bankruptcy to revitalize their state assets.<sup>13</sup> For this reason, they have allied themselves with like-minded officials in the central government to call for the establishment of a bankruptcy system. Their combined voices were heard at the meeting held by the State Commission for Restructuring the Economy in July at Beidaihe.<sup>14</sup> During the same period, in an economic work meeting involving seven provinces in May 1994, Zhu Rongji, vice premier and the head of the Leadership Group for Pilot Work on the Modern Enterprise System,

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<sup>11</sup>Ma Chuanjing, “What Should the Reform of the State-Owned Enterprises Stress?” *Qiu shi* (Seeking Truth) (Beijing), 1996, no. 10:37-38.

<sup>12</sup>*Wen Wei Po*, November 3, 1994, A2.

<sup>13</sup>*Jingji ribao* (Economic Daily) (Beijing), January 3, 1994, 3.

<sup>14</sup>*Sing Tao Daily*, July 8, 1994, A2.

disclosed that there would be a wave of bankruptcies in the latter half of the year.<sup>15</sup>

Bankruptcy system supporters' first argument is that the survival of the fittest is an inevitable result of market competition, a reality which cannot be avoided in economic life. Another argument is that if unprofitable enterprises cannot be eliminated, their continual reliance on state subsidies and bank loans for survival will eventually result in monetary and credit inflation. The third point is that the bankruptcy of these enterprises would be conducive to optimizing the allocation of social resources and readjusting industrial and production structures. Finally, the bankruptcy system would place both pressure and restrictions over enterprise behavior.<sup>16</sup>

The strong call of this group succeeded in prompting the State Council to list bankruptcy as a target of enterprise reforms. Furthermore, in June 1994, it raised the percentage of funds earmarked for writing off the debts of eighteen selected cities involved in the pilot program of optimizing enterprise capital structures from .2 percent to .6 percent, a difference of around 7 billion *yuan*.<sup>17</sup> Of the eighteen cities, Wuhan City and Jiangsu Province had been the most active in promoting bankruptcy. The former's large-scale Yangluo Textile and Dye Factory went bankrupt in August that year, an event which involved 3,912 employees and a debt totaling 158 million *yuan*, with assets 69 million *yuan* less than the liabilities.<sup>18</sup> During the same period, Jiangsu also witnessed the bankruptcy of a large-scale enterprise in its Changzhou Glassware Factory, which involved 500 employees and a debt of close to 20 million *yuan*.<sup>19</sup> In an interview with Hong Kong reporters in early November 1994, Wuhan city mayor Zhao Baojiang even declared that 15 percent of the 4,000 SOEs in the city would be either declared bankrupt or put up for auction in 1995.<sup>20</sup>

The two cities' reforms have won applause and further sugges-

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<sup>15</sup>*Ming Pao* (Hong Kong), August 5, 1994, A2.

<sup>16</sup>The Investigation and Study Department of the China Industrial Economy Society, "Build Up the Enterprise Bankruptcy Mechanism," *People's Daily* (Domestic edition, Beijing), June 10, 1994, 5.

<sup>17</sup>Cao Siyuan even suggested raising it to .8 percent in 1995, and then 1 percent in 1996. See *Sing Tao Daily*, August 11, 1994, A2.

<sup>18</sup>*Ibid.*, September 18, 1994, A4.

<sup>19</sup>*Ibid.*, October 7, 1994, A4.

<sup>20</sup>Foreign Broadcast Information Service (FBIS), *Daily Report: China* [hereafter cited as *FBIS-CHI*]-94-224 (November 21, 1994): 68.

tions from academics. For instance, Wei Jie, the director of Chinese People's University Economics Department, suggested reducing 13 percent of SOEs in 1995 by letting 8 percent of them go bankrupt and another 5 percent be auctioned or transferred to other firms.<sup>21</sup> In short, the rationale that SOE reforms cannot continue by relying solely on the improvement of management and without reforming property rights has come into vogue. The effects can be seen from the increase of filed bankruptcy cases: from 710 of 1993 to 1,625 in 1994, the latter of which included 395 from the state-owned sector (see table 1).

The series of bankruptcy cases has incurred strong criticism from the conservatives, who have charged that property rights reform has privatized SOEs, and reiterated the principle of public ownership as the mainstay of the economy. Facing this conservative backlash, on October 25, 1994 the State Council issued a circular concerning some issues in arranging the bankruptcy of SOEs on a trial basis in cities. The circular stressed the proper arrangement of laid-off workers' livelihood as the primary condition for allowing an enterprise to go bankrupt, while its bank debts came in second. In addition, it directed that experimental bankruptcy work be limited to the eighteen cities.<sup>22</sup> The circular not only put a brake on establishing a bankruptcy system, but slowed SOE reforms and bank commercialization.

In their battle against the property rights reforms, the conservatives first launched an attack against the great losses of state assets. The January 1995 issue of *Dangdai sichao* (Current Trends of Thought) pointed out that the phenomenon would quicken privatization.<sup>23</sup> Two months later, in an interview with Hong Kong's *Wen Wei Po*, Wu Bangguo, the newly-appointed vice premier in charge of industry, declared that a common understanding had been reached within the ranking members of the State Council to slow the bankruptcy proceedings of SOEs. Privatization, he commented, was "shock therapy" which had proven to be good for nothing, and the solution for enterprises should be changing their mechanisms. Furthermore, he stated that the task of reviving state enterprises would be placed on 1,000

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<sup>21</sup>*Sing Tao Daily*, November 17, 1994, A4.

<sup>22</sup>*Ming Pao*, December 6, 1994, B1.

<sup>23</sup>Yang Deming, "Problems Concerning Micro-Control in the Modern Market Economy," *Dangdai sichao* (Current Trends of Thought) (Beijing), 1995, no. 1:7.

superior enterprises.<sup>24</sup> This message was soon confirmed by Jiang Zemin after meetings with businessmen in Shanghai and Changchun in May and June respectively, in which he reiterated comprehensive reforms and “*san gai yi jiaqiang*” measures.<sup>25</sup> After that point, SOE reforms were shifted to the annexation of certain enterprises, the technological innovation of key enterprises, and the strengthening of internal management.

The attack was then turned toward the plan of leasing 51 percent of state assets and transforming a portion of state assets into various kinds of shares. It was criticized by the October 1995 issue of *Gaojiao lilun zhanxian* (Theoretical Front of Higher Education) as a sign of privatization.<sup>26</sup> One month after, Jiang Zemin directed the State Commission for Restructuring the Economy to slow bankruptcy practices and promote mergers. Since the merger program would considerably decrease the state’s losses of legitimate rights and interests—merely 30 percent in comparison to the 90 percent resulting from bankruptcy—it immediately obtained support from the State Economic and Trade Commission and the National Administration of State Property.<sup>27</sup> Under such conditions, the NPC’s examination of a new version of the bankruptcy law, which was originally scheduled for March 1996, was also indefinitely postponed.

The increase of state losses over the past two years has been quite alarming. At the end of 1995, about 41,000 SOEs were forced to completely or partially halt production, and 6.65 million staff and workers were laid off and placed on pension. Losses for the year were reportedly 88.3 billion *yuan*, an increase of 34.5 percent from the previous year.<sup>28</sup> Conditions became worse in the first quarter of 1996, as liabilities reached a record 3 billion *yuan* while the number of laid-off staff and workers increased to 10 million.<sup>29</sup> Alarmed by the situation and concerned about the impact on social stability, Beijing

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<sup>24</sup>*FBIS-CHI-95-057* (March 24, 1995): 39-40.

<sup>25</sup>Jiang Zemin, “Strengthen Confidence and Clarify the Task of Actively Promoting State-Owned Enterprise Reforms,” *People’s Daily*, July 13, 1995, 1.

<sup>26</sup>Wu Yifong, “What Is Privatization,” *Gaoxiao lilun zhanxian* (Theoretical Front of Higher Education) (Beijing), 1995, no. 5:17, reprinted in *Dangdai sichao*, 1996, no. 2:5.

<sup>27</sup>*Wen Wei Po*, March 1996, A3.

<sup>28</sup>Li Zhengping, “Enormous Deficits with Widespread Impact,” *Sing Tao Daily*, July 9, 1996, A11.

<sup>29</sup>*Ibid.*, June 22, 1996, A2.



has decided to promote the strategy of “revitalizing large enterprises and letting small ones go” (*zhua da fang xiao*). Such a policy was reaffirmed by Jiang Zemin on May 4 when he reiterated Deng Xiaoping’s three principles for 1996 SOE reforms: benefit the development of productivity, benefit the enhancement of comprehensive national strength, and benefit the improvement of people’s livelihood.<sup>30</sup> The policy, although providing little help to the development of the bankruptcy system, is conducive to the deepening of economic reforms by encouraging localities and small enterprises to adopt various kinds of experimental work other than bankruptcy to restructure their assets.

### **The Flaws and Special Features of the 1986 Bankruptcy Law**

The 1986 bankruptcy law was enacted at a time when the planned commodity economy still held sway. It was formulated without a coherent set of legislative innovations, i.e., regulations clarifying property rights. For this reason, flaws and limitations have become increasingly apparent over the past seven years of experimentation.

The first flaw is government intervention in bankruptcy proceedings. For instance, when the creditor petitions for enterprise bankruptcy, the debtor cannot decide on his own whether or not to apply for reconciliation; that power rests with his supervisory authority. After creditors and debtor reach a reconciliation agreement and apply to the people’s court for permission to terminate bankruptcy proceedings, once again the supervisory authority must take charge of the subsequent reorganization. As for the organization of the bankruptcy liquidating group, the current law stipulates that the liquidators shall be appointed by the people’s court from personnel in the debtor’s supervisory authority, the finance department, and among professionals. All of these arrangements overlook the intermediate role of court and bankruptcy liquidation work.

The second problem is local protectionism, which is mainly due to the stipulation that bankruptcy cases be filed with the debtor’s local court; this has created loopholes for bankruptcy fraud. Thus, a half year before being declared bankrupt, a wholesale enterprise can remove its remaining capital of 20 million *yuan* and its employees

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<sup>30</sup> *Wen Wei Po*, July 4, 1996, B5.

to create a spin-off enterprise. Consequently, even as the old enterprise is declared bankrupt, it might already be a hollow shell without even a legal person. Although the supreme court states that newly-invested enterprises should be included in bankrupt property, local courts can rule them as independent enterprises which cannot be distributed by the creditors.<sup>31</sup> In view of this, Cao Siyuan, a mainland Chinese bankruptcy expert, has urged that enterprise bankruptcy hearings should be conducted under jurisdiction in terms of the common administrative area for the parties involved. For instance, if the parties involved are from two different counties or towns, the case should be heard in the *xian* (county) court. A case involving two different counties of the same area then should be heard in an intermediate people's court of the area; a case involving two different prefectures be handled by a provincial-level court; and a case involving different provinces, municipalities, or autonomous regions should be submitted to the Supreme People's Court.

The third problem is that the provision of the bankruptcy law is too skimpy. The 1986 bankruptcy law consists of only 43 articles with 5,400 characters, and is only applicable to SOEs. Although Beijing added a new chapter titled "Enterprise Legal Person Bankruptcy and Debt Repayment Procedures" to the Civil Procedural Law when it was amended in 1991, thus extending the bankruptcy law to other sectors, the law has proven to be too rudimentary. For instance, there are only general principles about reconciliation, reorganization, and bankruptcy liquidation. There is an absence of a simple and easy bankruptcy procedure, an interim trustee to take care of the debtor's properties, or an administrative system of supervising the debtor and bankruptcy fraud.<sup>32</sup> There is also a need for clear stipulation about the ownership of bankrupt enterprises' welfare facilities (such as living quarters for staff and workers, schools, nurseries, and hospitals), the right of land use, and assets collected from the employees.

The fourth flaw is the lack of a prewarning and public notification system. As of this writing, the only information that an enterprise

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<sup>31</sup>"A Discussion about Strategies of Bankruptcy—An Interview with Cao Siyuan," *Jingji guanli* (Economic Management) (Beijing), 1995, no. 5:49.

<sup>32</sup>See Li Shuguang, "Flaws of the Current Bankruptcy Law and Its Further Improvement," *Gaige* (Reform) (Chongqing), 1996, no. 1:36; Chang Min and Zou Hailin, "The Formulation of the PRC's Bankruptcy Law," *Faxue yanjiu* (Studies of Law) (Beijing), 1995, no. 2:76-78.

reveals to the public is its listed capital. All other information, such as its assets-versus-liability condition and current capital, remains confidential. Without an effective public notification system to rely on, creditors cannot take any preventive measure to protect their rights. Thus, the bankruptcy of the Fushun Glass Works could take place in such a situation that only two-thirds of its 700 or so creditors were informed about the bankruptcy; the rest were still in the dark even after the bankruptcy and liquidation proceedings were over.<sup>33</sup>

The fifth problem is the confused guarantee relations. Presently, there are two common practices for guaranteeing the loans taken out by enterprises. The first is the administrative guarantee, in which the guarantor is either a local government or the superior department of related enterprises, and is not enforceable under the law. The second is enterprise guarantors, which are mostly profit-making and appointed by the department in charge as guarantors. Some of them even act as the guarantors for more than one enterprise. Should their guaranteed enterprises go bankrupt, the resulting heavy debts would very likely bankrupt them too.

Because of the above flaws, the following impacts have taken place since the bankruptcy law was implemented. First, most bankruptcy petitions have been filed by debtors rather than creditors, the latter of which can only react passively for lack of exact information about the former's financial situation.<sup>34</sup> Second, contrary to the theory that bankruptcy is the result of market competition, in practice the whole proceedings have been under the sway of local governments. They construct the list of enterprises applying for bankruptcy, promote their bankruptcy with administrative orders, conduct negotiations, and tackle the expected aftereffects. The court, on the other hand, plays only a supporting role.<sup>35</sup>

The third feature has been strong protectionism. Based on the PRC's Supreme Court, bankruptcy cases are conducted by way of adjudication. The parties involved are granted no right to appeal or complain about the court rulings except for those which reject their

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<sup>33</sup>Zhang Ti et al., "After the Bankruptcy Law Has Been Implemented," *Gaige*, 1995, no. 1:103.

<sup>34</sup>The Coordinated Investigation Group on Enterprise Bankruptcy, "The Investigation and Research Report about the Implementation of the Bankruptcy Law in Some Provinces," *Jingjixue dongtai* (Economics Information) (Beijing), 1994, no. 10:22.

<sup>35</sup>Wang Jianping and Gao Hejun, "In the Market Economy, Bankruptcy Is a Must for Enterprises," *Gongshang shibao* (Commercial Times) (Taipei), April 22, 1995, 9.

bankruptcy petitions. Such stipulations provide opportunities for localities to protect their local people's interests at the expense of nonlocal creditors. For instance, according to Article 9 of the Bankruptcy Law, after accepting a petition for bankruptcy, the court should notify related creditors and make a public announcement within ten days. However, some local courts have protected their local creditors' interests by failing to notify creditors from other areas. Thus, when the latter claim their own due debt rights three months later, they are told that they renounced their debt rights because they failed to make the claim before the given due date.<sup>36</sup>

The fourth impact has been the low percentage of debts paid off. Because of the aforementioned partiality of the law toward debtors and local intervention, it has been very hard for mainland Chinese creditors to safeguard their rights and interests. Take the Hunan Xiangtan Aginomoto Mill, for instance; guaranteed by its assets and goods in stock, which totaled 4.82 million *yuan*, the mill obtained a loan of 2.14 million *yuan* from the China Industrial and Commercial Bank. However, by the time it was declared bankrupt, it had paid off only 10.1 percent of the debt; the remaining assets had been taken over beforehand by a telecommunications company run by the Xiangtan city government.<sup>37</sup> Nevertheless, the bank was relatively well-off compared to the norm, as the average percentage of debts paid off is only about 10 percent.<sup>38</sup> The above-mentioned Fushun Glass Works only paid off 6.18 percent of its debts, for example.<sup>39</sup> In some cases, the percentage has been as low as 1 percent.<sup>40</sup>

### Obstacles in Implementing the Bankruptcy System

Since the Enterprise Bankruptcy Law was enacted eight years ago, almost 3,000 bankruptcy cases have been filed with the courts, of which 1,000 have been declared bankrupt. But as mentioned earlier,

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<sup>36</sup>*People's Daily*, October 25, 1995, 9.

<sup>37</sup>Han Ye, "Difficulties in Experimental State-Owned Enterprise Bankruptcy," *Ming Pao*, September 9, 1994, D3.

<sup>38</sup>Research Group, Development Research Center, "Difficulties in State-Owned Enterprise Bankruptcy and Solutions," *FBIS-CHI-96-205* (July 24, 1996): 143-50.

<sup>39</sup>See note 34 above.

<sup>40</sup>*People's Daily*, October 25, 1995, 9.

at the end of 1995, 41,000 SOEs were facing suspension of production without the option of declaring bankruptcy. Some of them have halted production because of the debt triangle, transportation problems, sluggishness in lifeline industries' price reforms, or counterfeited products. Some have been overburdened by welfare facilities and could not compete with other enterprises with much lower costs. Still others have simply been unable to cope with the changing economic environment and failed to raise their product quality. Beijing has been trying to save enterprises in the first two categories by way of merger. Many of the enterprises in the third category would have gone bankrupt but for various noneconomic considerations. Aside from the aforementioned flaws and effects of mainland China's bankruptcy law, the factors hindering debt-burdened enterprises from declaring bankruptcy can be summarized as follows:

### *Difficulties in Resettling Bankrupt Enterprise Employees*

Up to now, the establishment of a social security system in mainland China is still in the embryonic stage. Thus, when an enterprise is declared bankrupt, it at once faces two thorny issues concerning the resettlement of its workers. The first is the huge expenditures required for resettlement and old-age pensions. According to reports, the Ministry of Labor had collected 2 billion *yuan* in its unemployment fund in 1993<sup>41</sup> and 1.8 billion *yuan*<sup>42</sup> in 1994. If accrued interest is added, the sum totaled 4.73 billion *yuan*.<sup>43</sup> However, this would only cover 3 percent of the 20 to 30 million surplus urban workers in 1995. If all of them had been laid off at the same time, each worker would have received merely 10 *yuan* for monthly pension for only four months. Likewise, retirees would have received old-age pension for merely ten months.<sup>44</sup> The high unemployment situation is even worse in Liaoning Province; for example, in 1993 the province had 250 million *yuan* in its unemployment fund, or barely enough to cover the province's unemployment insurance for just one year. It could

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<sup>41</sup>*Sing Tao Daily*, November 29, 1994, A4.

<sup>42</sup>*Zhonggong guangbo jiyao* (A Summary of Broadcasts of Mainland Radio) (Taipei), January 15, 1995, 6.

<sup>43</sup>Zhang Xin, "Unemployment Insurance Helps Those in Difficulties and Enhances the Employment Rate," *Zhongguo jingji xinxi* (China Economic Information) (Beijing), 1995, no. 3:6.

<sup>44</sup>Yin Jianqiang, "Bankruptcy, Bankruptcy, Bankruptcy," *Keji ribao*, February 17, 1995, 5.

in no way handle the unemployment benefits for a huge number of workers.<sup>45</sup>

The second difficulty is the resettlement of incumbent workers. Presently, SOEs have over 30 million surplus workers. According to Beijing's policy, economic growth in the next fifteen years will shift its focus from quantity to quality. Should this policy be implemented, the promotion of automation will inevitably lead to a cutback of personnel. On the other hand, since most enterprises have long been plagued by the problem of surplus workers, few vacancies will be found to accommodate the laid-off workers. The difficulty of resettlement also lies in the fact that most competent workers are recruited by other enterprises before theirs go bankrupt. In other words, those left to be resettled are generally either almost at the retirement age, handicapped, or without skills.

### *Resistance of Localities and Interest Groups*

The resistance of localities has resulted mainly from their lack of understanding about market competition and protecting their own interests. For them, a bankrupt enterprise would only tarnish their job performance. The existence of an enterprise, albeit one with a heavy debt burden, would add luster to local statistics and even their tax turnover. In addition, debt-ridden enterprises are very likely to get back their tax turnover by way of government subsidies. In short, these enterprises have done no harm to the increase of local revenues;<sup>46</sup> on the contrary, they provide local officials ample profit-making opportunities.

Resistance has also come from bank creditors, particularly specialized banks. The first major reason for banks' reluctance to see enterprises saddled with debts go bankrupt is that their performance is evaluated by the sums of loans they have made and their interest income. As long as their debtors do not go bankrupt and can continue to pay on credit, their loan records and interest income will not be affected. Some banks have even been willing to increase their loans to help failing enterprises pay off their interest. Yet another reason is the fear that bankruptcies would expose the flaws in banks' loan procedures and behind-the-scenes deals. A case in point took place

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<sup>45</sup>Zhang, "After the Bankruptcy Law," 102.

<sup>46</sup>See note 38 above.

in Hainan Province in 1991. When an enterprise planned to petition for bankruptcy, as its debt was 50 million *yuan* over its equity, it at once faced a joint opposition from its bank creditors and department in charge. In some places, to stop localities from declaring their debtors bankrupt, some specialized banks have even threatened to discontinue their loans or slash their scale by classifying the localities in question as "loan risk zones."<sup>47</sup>

Finally, resistance has also come from the labor and public security departments for fear of bankruptcy impacts on social stability.

### *The Wave of Malicious Bankruptcy*

Under local protectionism, many enterprises have utilized bankruptcy to shake off their liabilities at the expense of their creditors' legitimate rights and interests. Their tricks include removing their assets to create a spin-off company, illegally transferring their assets to other related enterprises, selling their assets at a low price, and liquidating their debt before the given date.<sup>48</sup> A case in point took place in Huangshi, Hubei Province. Through bankruptcy, an enterprise succeeded in not only evading its debt but creating a spin-off company to continue production. Each of its workers who had already been transferred to the new company received two years' unemployment compensation while retired employees were each paid a pension of up to 50,000 *yuan*.<sup>49</sup>

### *The Threat to Banks' Survival*

There is no doubt that the bank is the biggest loser in malicious bankruptcy, as it has been the chief capital supplier of SOEs since Beijing changed its policy in 1983, forcing the latter to obtain capital through bank loans instead of relying on government interest-free funds. According to statistics, SOEs' assets-liabilities rates have been continually increasing, from 18.7 percent in 1980 to 75 percent in August 1994 (see table 2); the latter figure would surge to 85 percent if 440 billion *yuan* on credit was included. The debt of SOEs in 1995 reportedly totaled over 3.6 trillion *yuan*, of which approximately 80

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<sup>47</sup>See note 44 above; Cao, "The Development of Bankruptcy Law," 17.

<sup>48</sup>Li Shuguang, "Several Noteworthy Problems in the Experiment of Bankruptcy," *Faxue* (Shanghai), 1995, no. 4:39.

<sup>49</sup>See note 35 above; Li Yafei and Ren Weidong, "Fake Bankruptcy for Evading Debts," *Gaige*, 1995, no. 1:104; *Guangming Daily* (Beijing), January 6, 1995, 4.

**Table 2**  
**The Total Assets and Liability-Asset Ratio of State-Owned Enterprises**

Year	Enterprises liquidated (numbers)	Total assets (billion yuan)	Total debts (billion yuan)	Ownership rights (billion yuan)	Liability rate (%)
1980 <sup>1</sup>					18.7
December 1992 <sup>2</sup>		3,069.7			
December 1993 <sup>3</sup>		3,495	2,596.8	898.2	74.3
August 1994 <sup>4</sup>	12,400	4,137	3,104.9	1,032	75.0
December 1994 <sup>5</sup>		4,290	3,389.1	900.9	79.0
December 1995 <sup>6</sup>	30,200	7,287.3	5,176.2	2,111	71.0

**Note:** The data of December 1992 includes some 20,000 financial organizations which reassessed the assets.

**Sources:**

<sup>1</sup>*Zhongguo shibao* (China Times) (Taipei), November 12, 1995, 9.

<sup>2</sup>*Wen Wei Po*, February 13, 1995, A3.

<sup>3</sup>Zhou Keren, "The Difficulties of the State Sector's Economy and the Way Out," *Caijing yanjiu* (Study of Finance and Economics) (Shanghai), 1996, no. 4:18.

<sup>4</sup>Zhao Yining, "Thoughts Concerning Revitalizing State-Owned Enterprises Under the New Situation," *Liaowang* (Outlook Weekly) (Beijing), 1995, no. 31:5.

<sup>5</sup>Xiong Yingwu, "On the Theoretical Thoughts about 'Suggestions'," *Xueshu jiaoliu* (Academic Exchange) (Harbin), 1996, no. 1, quoted in *Guomin jingji guanli yu jihua* (National Economic Management and Planning), 1996, no. 5:30.

<sup>6</sup>*Wen Wei Po*, June 5, 1996, A3.

percent (2.8 trillion yuan) was bank loans with annual interest payments of up to 300 billion yuan. At present, 28 percent of SOEs rely on "stability loans" from the bank for their wages.<sup>50</sup> Should these debt-burden enterprises go bankrupt without paying off their debts, these specialized banks would be forced to close down as they themselves have few funds. For instance, in early 1996, the funds they owned accounted for merely 4.74 percent, or 217.3 billion yuan; if 168.7 billion yuan loaned by government is deducted, they had only 48.6 billion yuan. This sum could by no means write off the losses incurred by their bankrupted enterprise debtors.<sup>51</sup>

### *Liquidation Difficulties*

In comparison with banks, other creditors have had more difficulties in protecting their interests. According to Article 23 of the Bankruptcy Law, guaranteed assets should be excluded from liquida-

<sup>50</sup>*Zhongguo shibao*, June 12, 1996, 9.

<sup>51</sup>Ye Wangchun, "Several Thoughts Concerning Solutions to the Worsening Bank Debt," *Jingji guanli* (Economic Management), 1996, no. 5:7.



tion. If this is put into practice, most enterprises would virtually have no assets to liquidate since almost all of their assets have been mortgaged for their bank loans. In fact, some enterprises cannot even afford the various kinds of expenses required for bankruptcy, such as the fees for petition, liquidation, and assessment of assets, which may vary from place to place. In southern China, a canned food enterprise had assets of over 2 million *yuan*, but had to pay 100,000 *yuan* to the court for the petition for bankruptcy and some 400,000 *yuan* for liquidation.<sup>52</sup>

Furthermore, some enterprises, after a long period of suspension from production, have been forced to pay off delayed wages with their stocked goods, and their equipment moved away by their employees. By the time they are declared bankrupt, they have nothing left but a group of workers waiting for replacements. To prevent these occurrences, some nonlocal creditors have been accompanied by the court to detain their debtors' properties, freeze their bank accounts, repossess by force their stocks and equipment, and hold legal persons and employees hostage until the debts are paid off.

### *Ill-Defined Property Rights Ownership*

Clear-cut ownership of property rights is the basic requirement for the success of the bankruptcy system. But after many years of practice, Beijing has still failed to straighten out the ill-defined property rights of SOEs. Thus whenever an SOE goes bankrupt, it immediately raises a string of questions: Who gives the green light of approval? Who should file the application for bankruptcy? Who shall assume the economic risk and absorb the losses? Which creditors should be paid off? The confusion has resulted in a situation in which enterprises have utilized bankruptcy to shake off their debts, but what it is bankrupted is actually state assets since the debts belong to the state-owned bank. In addition, the lack of a property rights market and intermediate organizations offering assets trading consulting services has forced local governments to often intervene in arranging the merger of bankrupted enterprises with competent ones in the same ownership system.<sup>53</sup> This has often given rise to criticism, as the

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<sup>52</sup>Wang Wuyi, "An Analysis of the Factors Concerning Enterprise Bankruptcy in Our Country," *Jingji yanjiu*, 1994, no. 6:46.

<sup>53</sup>*Ibid.*

cost for transferring assets within the same ownership system is much higher than that for a merger.<sup>54</sup>

### Prospects for the Bankruptcy System

Due to the aforementioned flaws and difficulties, most Chinese leaders have been quite reserved about the immediate implementation of the bankruptcy system and hold that the current experimental work should be continued. This opinion is also reflected in a recent survey with 1,200 questionnaires sent out to the enterprise leaders of 69 cities. Of the 1,094 questionnaires returned, 79 percent agreed that the experiment work should be continued; 11.2 percent did not think the conditions were ripe for a bankruptcy system; and only 9.8 percent believed that the time was ripe for immediate implementation.<sup>55</sup>

Judging from the foregoing analysis, it is clear that in order to implement a bankruptcy system with market economic characteristics, mainland China should be equipped with the following seven conditions: (1) a well-established social security system; (2) well-defined property ownership relations; (3) a well-developed market of production essentials; (4) independent economic and legal systems; (5) a great reduction of social responsibility on the part of SOEs; (6) success in the overhaul of government functions and changes of macroeconomic practices; and (7) the continual enlargement of the non-state economic sector. It is, in short, a task full of hardship and involving various kinds of reforms in other sectors. Nonetheless, the chain effects of its success could also be immense. For instance, it would help clarify property and ownership relations, as well as the establishment and perfection of social security, bank commercialization, the labor market, and market management. It would also promote the restructuring of production factors such as manpower, capital, and land. Finally, it would result in a readjustment and optimization of production structure.

Presently, the Beijing leadership has decided to take the middle road, not promoting bankruptcy work extensively while continuing

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<sup>54</sup>Xie Rong, "The Bankruptcy System: Comparison and Choice," *Caijing yanjiu* (Study of Finance and Economics) (Shanghai), 1996, no. 2:9.

<sup>55</sup>*Zhongguo jingji xinwen* (China Economic News) (Hong Kong), 1996, no. 7:15.

experimental work in each province according to its economic development, its progress in market reforms, and the development of its social security system. It was decided that the number of experimental cities for optimizing capital structures, and thus experimental bankruptcy work, would increase from eighteen to fifty in 1996.<sup>56</sup>

As for SOE reforms, Beijing has mapped out a new strategy, i.e., "revitalizing large enterprises and letting small ones go," and starting from July 1996, has allocated one-third of its bank loans to 300 major enterprises.<sup>57</sup> Since this would force many small enterprises to go bankrupt, the central government has also formulated preferential measures to encourage small and unprofitable enterprises to merge with competent ones before they go bankrupt. The measures include waiving 10 percent of their interest payments, allowing five years to pay off their loan principal, and providing three years of loans to enterprises with financial difficulties.<sup>58</sup>

Currently in mainland China, there are over several hundred thousand small enterprises which have halted production and are waiting to be declared bankrupt. Since only a few can be selected to join the program, Beijing has urged localities to enliven unprofitable enterprises through reorganizing their property rights in order to avoid the pressure of huge unemployment payments which would result from bankruptcy. The first kind of reorganization has been through a shareholding cooperatives (joint stock) system which attracts employee share participation. At the end of 1995, around 140,000 and some 3 million township and rural collective enterprises had been respectively reorganized into shareholding cooperatives.<sup>59</sup> Given the current academic advocacy of "better privatization than bankruptcy,"<sup>60</sup> this is expected to be the favorite choice for unprofitable enterprises. Another practice was adopted by Heilongjiang Province in 1995 in which the operating rights of 106 enterprises were entrusted to competent legal persons or natural persons. This succeeded in converting

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<sup>56</sup>*Sing Tao Daily*, May 11, 1996, A2.

<sup>57</sup>*Zhongguo shibao*, July 8, 1996, 9.

<sup>58</sup>*Wen Wei Po*, March 1, 1996, A3.

<sup>59</sup>"Comrade Li Tiejing on Emancipating the Mind, Carrying Out Reform Boldly, and Further Reinvigorating Small Enterprises," *Liaowang* (Outlook Weekly) (Beijing), 1996, no. 21:7.

<sup>60</sup>For instance, assistant professor Gan Peizhong proposed the theory that privatization was better than bankruptcy. See *Wen Wei Po*, December 21, 1995, 15.

76 enterprises from liabilities into profit-makers.<sup>61</sup> A third option is to entrust enterprises on the brink of bankruptcy to the Central Trust Bureau for two years and set up a unified "central entrustment fund" to solve their bank and enterprise debts. Enterprise owners and managers are then requested to improve their conditions within two years, and any petition for debt returns will be suspended. If conditions remain unchanged after two years, these enterprises would be declared bankrupt.

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<sup>61</sup>Cen Hanshan, "The Major Form for the Next Round of Enterprise Reforms: The Reform of Property Rights Ownership," *Jingji daobao* (Economic Reporter) (Hong Kong), 1996, no. 23:21.