University of Alberta

Law and Privatization:
Global Experiences and Their Application to China

by

Wei Xiang ©

A thesis submitted to the Faculty of Graduate Studies and Research in partial fulfilment of the requirements for the degree of Master of Laws.

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Name of Author: Wei Xiang

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Wei Xiang

Wei Xiang
Room 6, 10924 – 87 Avenue
Edmonton, Alberta, Canada
T6G 0X3

Date Submitted to FGSR: 2002 01. 15

University of Alberta

Faculty of Graduate Studies and Research

The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies and Research for acceptance, a thesis entitled ***Law and Privatization: Global Experiences and Their Application to China*** submitted by **Wei Xiang** in partial fulfilment of the requirements for the degree of **Master of Laws**.

Frederick C. DeCoste - Supervisor

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Richard W. Bauman

Richard Bauman

Rolf Mirus

Rolf Mirus

This thesis is dedicated to –

China and her people, who have been long struggling towards privatization and the rule of law.

Abstract

International experiences indicate that to launch a privatization program whether at the enterprise level or at the economy level, two kinds of laws are needed: laws that together facilitate an overall legal environment favourable to the private investor, and specific enabling laws that provide authorization and organization for privatization process. This thesis reviews these international experiences and explores their application to China. The conclusion is twofold: first, as both an element and an outcome of the market economy, privatization requires the rule of law supported by a democratic system; and second, all future changes to Chinese law must serve these ends.

Preface

After a long period characterized by nationalization and growth of the size of the public sector in the economy, privatization has become a striking wave since the early 1980s when the UK Margaret Thatcher administration initiated the reform in 1980. The phenomenon has spread all over the world. Almost all the important economies on all continents, whether they are developed countries or developing countries, whether the economy is market based or in transition, have added privatization to their agendas and enacted a mass of legislation for this purpose. Regardless of the debate concerning the effects of privatization, privatization itself has proven to be an essential ingredient of the total economic reforms. The global surge of mergers and acquisitions which has occurred in recent years is another expression and one of the results of the privatization program across the world.

The term 'privatization' may have different meanings in different reform settings. Most of the time, it has something to do with the transfer of ownership, permanent or temporary, or at least of operation right, from public owners to private control. Privatization may be implemented at an enterprise level. Depending upon whether a government retains the control of an enterprise after the completion of the program, practices of privatization may be broken into two patterns: partial privatization and complete privatization. 'Partial privatization' occurs when only part of the economy is privatized and the government still holds the control of the privatized enterprise by means of special-share arrangements. In contrast, if all the controls of the privatized enterprise are transferred to private hands, the result is 'complete privatization'. Privatization also refers to those reforms implemented at a sector level and even economy level which aim to develop a more liberalized economy by abolishing public monopolies to promote private entry. Tactics vary as well. Some countries such as China and Vietnam adopt a moderate reform conducted on a gradual basis. Others take the radical step of allocating all of the shares in State-owned Enterprises (hereinafter 'SOEs') to citizens in an attempt to establish a market economy within a short time from scratch. Russia is the leading example of the latter. Whatever approach is adopted, privatization programs depend upon certain radical changes to existing legal frameworks. Required legal changes are of two sorts, facilitating laws and enabling laws. Facilitating laws aim to create an external legal environment favourable to private business. To this end, changes to constitutional law and most business laws are necessary. For example, constitutional laws or similar legal documents must provide protection for private ownership and give political legitimacy to a privatization program. The governance structure provided by company law must also recognize the role of shareholders in decision-making; the foreign investment laws must facilitate the purchase and acquisition of targeted enterprises by foreign investors; and a social welfare system must be established beforehand to provide living assistance to laid-off workers affected by enterprise restructuring.

Legal change also takes the form of enabling laws which are designed to organize the process of privatization. These laws specify the steps and techniques to be taken in the privatization program; create an institutional set-up to execute the program; define the responsibilities of various actors; and provide principles to protect and sustain the interests of new shareholders, governments and other stakeholders. In a word, to initiate a privatization program, a legislative foundation must be laid beforehand not only to remove all the legal obstacles but also to facilitate the specific process by defining the respective competencies within the government and ensuring the transparency of decision-making and the legal security of transactions.

The degree of legal change for the privatization of a given economy will depend on the extent of prior state ownership and control and the scope of the reform program undertaken. In a developed market economy, facilitating laws are already in place and no large change is necessary. In transition countries and the remaining socialist countries, more change, some of it radical, is necessary. This is because in these countries, mature market rules have not been established, sound regulation experience is missing, and enterprises are always subject to governmental intervention in their business operation. Therefore, a transition country has first to finish the process of transiting its economy from non-market to market status. In order to do this, it must establish a legal infrastructure under which a market economy can run and operate. Consequently, in such a country, legal changes to the existing legal framework will be complex and burdensome. China has not escaped the influence of the world-wide wave of privatization. Beginning in 1978, the government of China has taken measures to open its economy to the outside world. First, farm land was allocated to peasants for planting, though the land is still held by collective ownership. Following that, the agriculture and service sectors were opened to private capital, and with that, the first batch of individual employers appeared in China. As more and more joint ventures were set up, a wider sector was opened to both domestic private investors and foreign investors. Since 1979, a series of laws and regulations, including the *Law of Chinse-Foreign Joint Ventures,* has been enacted. In March 1993, China's Constitutional Law was amended to provide, for the first time, some degree of protection to the 'individual' economy (which is China's expression for 'private economy'). In 1997, China's *Partnership Law* was enacted to encourage and facilitate the development of private business. A mass of rules and policies recently promulgated by the State Economic and Trade Commission have further encouraged private business. A '*Law of Individual's Company*' is now under discussion and its imminent enactment will greatly promote the development of private business. Along with the promotion of the development of private business, measures have also been taken to reform the SOEs. Some initiatives such as corporatisation and 'employee ownership' were explored with an attempt to resolve the problems associated with SOEs. State shares, which used to be un-tradable on the securities market, are now tradable to the public or institutional investors, although the tradable amount is still limited to 10% of the total.

Needless to say, all these legal reforms or policy reforms have achieved sorts of effect of privatization, although in China the term of 'privatization' has been replaced by 'corporatisation' or 'commercialisation' or other terms. Indeed, in the past decades, privatization has taken place in China in a silent and gradual way. Now this trend is gathering momentum since China has to keep pace with the accelerating economic globalization, particularly China has to face the direct challenges arising from its recent admission to the World Trade Organization (hereinafter 'WTO').[1] China is neither a traditional capitalist country with a developed market economy nor a transition country which is undertaking a radical and revolutionary transformation from planned economy to a complete market economy and from Communism to democracy politics. China, however, is one of the few socialist countries which, on the one hand, is undertaking economic reform in a gradual 'step-by-step' way and which, on the other, has shown much reluctance in initiating political reforms to establish a more democratic regime. China requires more radical and much broader legal change. Though not all privatization experiences accumulated across the world

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[1] China's entry into the WTO was officially approved at the meeting held on November 11, 2001 in Doha, Qatar. See "China officially joins WTO", online: cnn.com <http://www.cnn.com/2001/WORLD/asiapcf/central/11/10/china. WTO / index.html>(date accessed: 12 November 2001).

may be applicable to China, it is evident that exploitation of certain of these experiences, especially in the areas of legal change for privatization, is of great significance to the on-going privatization program in China.

This thesis aims to formulate a legal framework for the privatization of SOEs in China. Focussing on international experience and its application in China, the thesis organises its argument and discussion mainly from two perspectives: facilitating laws and enabling laws for privatization. With this focus in mind, the thesis has two parts. The first part - Chapters 1, 2, and 3 - is mainly about international experience. Chapter 1 provides a general overview of privatization practices across the world, discusses different tiers of privatisation, and analyses the reasons for this global movement. Chapter 2 explores the sorts of legal change required during the process of a program, particularly, the facilitating laws, which have indirect but important links with a successful implementation of privatization. The laws covered include constitutional requirements, company law, foreign direct investment laws (hereinafter 'FDI'), securities laws and other law sectors. To illustrate the points in Chapter Two, a number of cases from other countries, including the UK, Latin America, Eastern Europe, Russia, East Asia as well as Canada and America, are analysed. In Chapter 3, the thesis turns to another cornerstone of legal change, enabling laws. Detailed review of the forms and content of enabling laws is undertaken. Many important legal arrangements including institutional set-up, regulatory bodies, and techniques for both enterprise-level privatization and economy-level privatization, are all canvassed. The second part of the thesis - Chapters 4, 5, and 6 - has as its concern the application of international experience in China. Chapter 4 reviews the evolution of China's economic policy and explores the right way for China to privatize its economy. Chapter 5 analyses Chinese facilitating laws, and puts forward a number of suggestions for their improvement in light of the requirements of privatization. Similarly, Chapter 6 explores the application of the experiences with respect to enactment of enabling laws in China in an attempt to achieve privatization at enterprise level. Chapter 7 is the conclusion. It speculates on the changes that privatization may bring to China's legal systems in the future.

Since there is no uniform model of privatization for all countries, this thesis tries to factor China's specific situation into its discussion of the application of the global experiences in legal changes for privatization. For example, with respect to the facilitating laws, the thesis highlights the importance of setting a social safety net beforehand, since China has peasants as the majority of its population and those peasants have no insurance programs to rely on. With respect to privatization strategies, the thesis points out that China should put more emphasis on the promotion of private entry than on the retreat of public ownership in a speedy way. Among the specific techniques, the thesis also prefers the option of developing securities markets as a strategy to dilute the State's ownership rather than of selling the SOEs to the private sector directly, since compared with the securities market with sound regulation and public supervision, direct sale will provide less fairness and transparency for the transactions under current legal conditions.

However, even the most careful and delicate designs for legal change cannot guarantee the success of a privatization program if that change lacks the support of the rule of law. The most important issue in a privatization program is not the efficiency, but the fairness and safety the ownership transfer must have in all aspects of the process. In other words, all legal changes, especially enabling laws, must be targeted to provide mechanisms to protect the interests of all actors in the program. However, this objective can only be satisfied under a true 'the rule of law' which calls for a radical political reform towards democracy as well as more liberalized economic reforms in China.

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Chapter One: Privatization: The Global Trend

1.1 The Global Trend

Privatization as a significant phenomenon started in Britain in the early 1980s. Since then, it has spread all over the world, affecting more than 100 countries, touching every continent, every political system, and every economic sector. Its emphasis has moved gradually from the industrial, commercial, and financial sectors to infrastructure and then to municipal services; it has only recently started to reach education, health, and administrative activities.[1] In fact, it is hard to find an economy which has not been influenced by privatization.

1.1.1 Privatization: Historical Waves

Privatization in one form or another has been undertaken at all times. One of the first attempts of privatization originated in the UK, where in 1953 *The Transportation Act* was enacted to privatize roadway transportation and in 1960 *The Civil Aviation (Licensing) Act*

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[1] In the past 20 years. Britain has sold most of its large state-owned industries including British Aerospace. Britoil. British Telecom and a number of others; beginning in 1988. France embarked upon a massive program involving the sale of 65 million pounds of public sector industries; Canada has sold airframe manufactures and some arms and mining concerns; Japan has privatized its railways and telecommunications; in USA. the privatization has extended to highways. ports. waste-water facilities. gas utilities. and many local government services such as parking garages and golf courses and even prisons and correction bodies. Not only industrialized countries but also the newly developing nations. such as the Pacific Basin and Latin American countries as well as some eastern European countries. also have initiated privatization programs in fields from manufacturing industries to banking and infrastructure sectors. For example. Hungary has sold the telecommunications company. MATAV. the airline MALEV. and a large lighting products company. Tungsram. Argentina. by the end of 1996. had sold 45% of the oil and gas company YPE. its airline Aerolineas Argentinas. and the Telecom Company. China in recent years has also taken some measures to encourage private capital to participate in joint ventures with SOEs in a limited number of fields. See R. Fraser & M. Wilson. *Privatization : The UK Experience and the International Trends* (Essex: Longman. 1988) at 18ff.

ended the monopoly of the state-owned airlines.[2] In West Germany, as early as 1959, the government sold the state-owned shares of a power company (Dreussag) to the public, with the employees being encouraged to hold the shares. In Canada, in the 1970s, a privatization program led to the sale of five large-sized enterprises including Petro-Canada. Also in Canada, in another trial, the Province of British Columbia in 1979 allocated the shares of an SOE to all eligible citizens. Similar attempts at privatization can be found in other countries, but all these efforts were limited and failed to develop as a comprehensive political and economic movement.[3] The British Program launched in 1980 by Margaret Thatcher, however, is the major forerunner of the current privatisation phenomenon, and since then, there have been three waves of privatization.[4]

Encouraged by the success of privatisation in the UK and some other European countries, most Latin American countries and some others undertook sizeable privatisation programmes during the 1980s. They used wide-ranging methods, including sale of shares through the stock market, outright sale of net assets, and employee buy-outs. Some carried out large-scale restructuring of public enterprises before they were privatised. Many sold a high share of their public enterprises to foreign buyers.

The second wave of privatisation came in Eastern and Central Europe in the early 1990s, and despite its complexity, it has achieved positive results in many instances. These

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[2] O. Letwin, *Privatizing the World: A Study of International Privatization in Theory and Practice* (London: Cassell, 1988) at 7. [hereinafter *Privatizing the World*].

[3] P. Guislain, *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience* (Washington: World Bank, 1997) at 8 [hereinafter *Privatization Challenge*].

[4] S. Aziz, *Privatization in Pakistan* (Paris: OECD, 1996) at 9-10.

countries did not have many potential buyers in the form of large business communities backed by a financial market to support the privatisation of such sizeable segments of their national economies, often involving thousands of state-owned enterprises. The Czech Republic and the Russian Federation adopted a voucher allocation scheme to create demand for mass privatisation.

The countries of South Asia, namely India, Pakistan and Bangladesh, joined the privatisation bandwagon somewhat late, after 1991, and they had the advantage of the experience of others from which to learn. Successive trends or waves are still underway world-wide. For example, in China, a movement to retreat SOEs from the national economy has just started recently.[5]

Depending upon its stage of development, privatization has different focuses. At the beginning of the movement, privatisation focussed largely on industrial, financial, and commercial ventures. Infrastructure sectors and activities followed in next period, starting near the end of the 1980s. A third trend, touching municipal or local services, is recently gaining strength. The next wave is only starting to emerge, reaching the social sectors, including health and education, and administrative activities.

1.1.2 Privatization: Wide-reaching and Deep-going Social Change

First of all, the privatisation phenomenon has appeared in virtually every sort of country, geography or economy notwithstanding. It has not been confined to countries with a liberal ideology and a long capitalist tradition, but has also been undertaken in countries with centralised to market economies, as well as in developing countries, including some that

[5] See details in Chapter Six below.

remain under communist regimes, such as China and Cuba.

Moreover, privatization affects practically all economic sectors. Even activities traditionally reserved for the public sector or those considered as natural monopolies are increasingly being entrusted to private operators. Almost all large transactions have occurred in 'strategic' sectors that were traditionally publicly controlled: utilities, such as telecommunications, power or gas; natural resources; railways; steel; and financial services, including banking and insurance.

The privatization wave has even spread to such state functions as education, health, social security, justice, and national defence. For example, the Netherlands has already privatised KPN, a holding company that includes the postal service as well as the telecommunications company[6]. In France, the United Kingdom, the United States, and other countries, privatization has spread to the administration of justice[7] and the management of prisons. Private security companies are growing at a rapid pace all over the world, often substituting for or complementing the state's police force. Publication of a country's official gazette is another example of an activity that can be privatized. Social security, air traffic control, or regulatory activities provide other illustrations, as does tax or customs

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[6] Argentina, Germany, Lebanon, the Philippines, the United Kingdom, and other countries are also working on the privatisation of their postal systems; and, on March 1, 1994, Sweden abolished its postal monopoly and opened the sector, including basic letter delivery, to competition; five private companies have since been registered and entered the market to compete with the incumbent SOE. See *Privatization Challenge, supra* note 3 at 25.

[7] Privatization of administration of justice, a seemingly perfect example of a pure state function, is evidenced by, for example, the frequent recourse to private arbitration and other alternative dispute resolution mechanisms. *Ibid.* at 26.

administration.[8]

Privatization is striking not only in terms of the vast area it sweeps and the sectors it involves, but also in terms of the sheer volume of transactions involved. For example, the government of France received an income of 4 billion US dollars from the disposal of Paribas; the UK 12 billion US dollars from the sale of British Gas; and Japan, 15 billion US Dollars from the sale of NTT (Japan Telephone and Telegraph Company).[9] To cite another example, in 1994 and 1995, annual gross revenues from privatisation world-wide were estimated to be on the order of $80 billion.[10]

Finally, a variety of strategies have been adopted and implemented in privatization programs. A wide range of techniques has been used, most drawn from experience with corporate mergers and acquisitions, though some are truly new techniques designed to meet specific privatisation objectives. Widespread share ownership has thus been promoted directly or indirectly through mass privatisation programs in transition countries and through financial incentives offered to employees and small shareholders in many countries.[11]

Despite this world-wide explosion of privatisation, the state sector remains strong in many countries, in particular in developing countries where SOEs drain national budgets and

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[8]Customs administration was privatised in Indonesia and Latvia. Customs warehouses are managed by private operators in an increasing number of countries. In Mexico, "banks are entrusted with being the sole receivers of tax payments and with putting all the information from the returns on tape. Moreover, the private sector was authorized to print and distribute tax returns, registration and notice forms" against a fixed fee schedule. Withholding of income taxes by employers or of taxes on interest or dividends by financial institutions are other examples of partial privatisation of the tax function. Even tax collection can be privatized in some cases, with public authorities selling their tax claims to private collectors. *Ibid.*

[9] See *Privatizing the World, supra* note 2 at 40.

[10]*Ibid.* at 1.

[11] M.Pirie, *Privatization* (London: Wildwood House, 1988)at 52 - 65.

continue to dominate many activities. Privatisation has been on the agenda of many governments for over a decade now and is likely to remain a key policy instrument in many countries for decades to come.

1.2 What Is Privatization?

1.2.1 Definition of Privatization

The term 'privatisation' can have different meanings at different levels. Legally speaking, it refers variously to an ownership transfer from public to private control through the complete or partial sell-off of a major public enterprise; to the deregulation of a particular industry; or even to the liberalization of an entire economy.[12] While the very term 'privatisation' is broad and flexible, what we call privatisation may go by other names in some countries, often because the term 'privatisation' is deemed to be politically sensitive. Some countries, say, China, prefer not to use the term publicly at all even though the policies followed are undoubtedly privatisation policies; others apply the term to programs that do not directly involve the private sector but only mimic its incentives.[13]

Privatization comes in two forms. The distinction between these two forms of privatization mainly comes from their latitude/magnitude, the speed of the programs, and the techniques used. If only part of a country's public enterprises are subject to privatization, the program may be called 'partial privatization'. In contrast, 'mass privatization' refers to

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[12] See *Privatization Challenge*, *supra* note 3 at 10 ff.

[13] For example, one speaks of capitalization in Bolivia, peopleization in Sri Lanka, and equitization in Viet Nam. The terms 'commercialization' of Canadian National (the railway company) and 'strategic consolidation' of Belgacom (the Belgian telecommunication company) were used to refer to the recent privatisation of these companies. In the Netherlands, on the other hand, the term privatisation has been used not only to designate what is classified here as such but also to describe the process of corporatisation of SOEs that continue, however, to be owned by the state. See *Privatization Challenge*, *supra* note 3 at 12.

programs which privatize the questioned enterprises, always large scale and quickly, by means of distribution of vouchers to citizens.

1.2.2 The Three Tiers of Privatization

Enterprise-level Privatization

Enterprise-level privatization refers to the privatisation of a public enterprise, through divestiture and other mechanisms by which ownership or control of an enterprise is transferred from the public to the private sector, temporarily or permanently.[14] From the perspective of the transactions involved, the enterprise-level privatization may adopt different measures in different cases. For temporary transfer of control, measurers adopted may include subcontracting, management contracts, lease, concession etc.; for permanent transfer of ownership along with the control, techniques such as liquidation, trade sale through sealed bids or auction, and floatation are always used.

Sector-level Privatization

In sector privatisation, the government must not only prepare a given enterprise for privatisation but also redesign the entire structure of the sector. The aging paradigm of public enterprise monopolies must be discarded and replaced by a sector structure that is more dynamic, competitive and open to the private sector.[15]

Techniques involved in sector privatization include unbundling of a sector (say, separation of infrastructure and service, breaking of the sole operator into several ones), promotion of new entry through licenses, permits, or authorizations of varying duration

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[14] *Ibid.*

[15] *Ibid.*

granted to private operators, and the establishment of joint ventures with the private sector.

Economy-level Privatization

A third level, after privatisation at the enterprise and sector levels, is privatisation of the economy.[16] The degree of privatisation of a given economy will depend on the extent of prior state ownership and control and the scope of the reform program undertaken. The strongest case is the systematic conversion from a command to a market economy that followed the collapse of the centralized planning system developed by the former U.S.S.R. and copied by its satellites. However, privatisation of the economy is not limited to the so-called transition countries, although transition countries have by necessity embarked on the broadest program of this kind, of which enterprise and sector privatisation form an integral part. Many other developing countries that suffered from heavily centralised and bureaucratic economic management have carried out all kinds of reforms towards market economy. Even in industrialized countries, substantial reforms have been made to make their economies more flexible and dynamic, as convincingly demonstrated by the economic reform and privatisation program launched in 1984 by the Labour government in New Zealand.[17]

These three tiers of privatisation are separate yet at the same time interlinked: separate, in that the problems arising at each level differ in nature, and interlinked, in that the success of reforms at each level helps determine success at the other levels. By and large, the truly effective programs are the ones in which the government introduced and coordinated the necessary reforms at each level in a coherent and mutually supportive way. Privatisation is

[16] *Ibid.*

[17] *Ibid.*

thus an instrument of these more comprehensive approaches rather than an end itself.[18]

1.2.3 Mass Privatisation[19]

Mass privatization originated in Canada in 1979,[20] and presently is most prevalent in transition countries, such as the former Soviet block countries, that want to privatize their economics speedily. Designed and implemented in the 1990s, the programs were supposed to deal with specific problems and needs: to transfer a significant portion of public assets to a large and diverse group of new private owners as quickly as possible, in a way that would foster the creation of a sound market economy.[21] Fundamentally, mass privatization involves giving away ownership of SOEs to all citizens rather than the sale of individual companies.[22] Typically, the citizen was given a coupon, which could be used to buy shares in a national auction in any firm included in the program. Citizens could bid to buy shares with their

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[18] See OECD, *Privatization in Asia, Europe and Latin America* (Paris: OECD, 1996) at 17.

[19] See details in *infra* section 3.4.1 "Vouchers Sales and Privatization Funds" in Chapter Three.

[20] Part of the shares of British Columbia Resources Investment Corporation were distributed free of charge to the people of the Canadian province of British Columbia. This distribution took place in response to a wave of public dissatisfaction: people felt that they should not have to buy what already belonged to them, and they had the impression that the government was selling off SOEs for the benefit of the rich. See *Privatising the World, supra* note 2 at 8. Also see R.W. Bauman, "Forward" (2000), 63 *Law and Contemporary Problems* 1 at 3.

[21] For example, in Russia, tens of thousands of local transactions, many of them relating to small business, restaurants, and workshops, together with tens of thousands more enterprises transferred to private shareholders, were implemented under an ambitious mass privatization program. In just over two years, Russia succeeded in privatizing between 12,000 and 14,000 medium-sized and larger enterprises with a total of over 14 million employees, that is, about half of Russia's industrial labour force. In the process, about 40 million Russian citizens became shareholders for the first time. See M. Boycko, A. Shleifer & R. Vishny, *Privatizing Russia* (Cambridge: MIT Press, 1995) at 69 ff.

[22] In some cases, a portion of a firm's shares is reserved for sale using conventional methods. See G. Pohl, R.E.Anderson, *Privatization and Restructuring in Central and Eastern Europe* (Washington: World Bank, 1997) at 11.

coupons in any of the firms. Alternatively, they could decide to turn over their coupons to an investment fund and thus become part-owner of a much larger and diversified portfolio.[23] In addition to economic goals, mass privatization programs typically also seek to meet political objectives (wide popular participation and support) as well as social ones (distribution of shares to the general public).

1.3 Reasons for Privatization: .

Since the early 1980s, economic, political and technological developments, combined with increasingly severe constraints on public finances, have generated the force which pushes the movement to privatization.

Primary among the reasons for privatization is the low performance of the public enterprises. Both theoretically[24] and practically, public ownership cannot yield the same economic benefits as can private ownership. Created to alleviate the shortcomings of the private sector and spearhead the development of the national economy, many SOEs in fact helped stifle the local private sector and fostered economic stagnation. They manage to survive through privileges provided by the state's policies;[25] and they often serve political objectives or purposes and consequently suffer frequent interference by government and

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[23] *Ibid.*

[24] "Private property is an indispensable ingredient of both prosperity and freedom " and "Autonomous, private action promises greater rewards than acts of participation in public life. Under this theory, market discipline is preferable to the use of administrative directions, public ownership, control, plans, or regulations, and from the perspective of agency theory, which takes into account the costs associated with incentives and monitoring, private ownership of an enterprise should provide superior efficiency". See Bauman, *supra* note 20 at 3-7.

[25] These privileges include tariff protection against competing imports, preferences in public procurement, exclusive rights, preferential access to credit (often at state-owned banks), government guarantees, tax exemptions, public subsidies, and so on.

bureaucrats. As a result, almost everywhere, the burden SOEs impose on state finance has become untenable. A key component of any comprehensive reform programme is the release of resources that are stuck in obsolete and inefficient activities and production lines. To achieve the ultimate aim of reform, namely, the generation of growth, these resources must be released and reallocated to more profitable and efficient use. The privatisation of SOEs in order to raise efficiency and relieve public budgets of loss-making enterprises has thus become a popular policy in many countries.[26]

Another important reason for the move to privatisation is that most governments find themselves facing deep budget deficits and a crisis in public finance. The state no longer has the financial resources either to offset the losses or to provide the capital increases necessary for the development, particularly, of the infrastructure sectors which relied until recently almost entirely on public funds to finance their investments. In this condition, private-sector participation has become indispensable and privatisation thus became the answer.[27] A radical reform of public finances, involving an overhaul of the public sector, may also be needed to satisfy international obligations or aspirations. This applies in particular to member states of the European Union (EU), which are constrained by EU rules in their ability to subsidize state enterprises and must comply with strict fiscal requirements imposed by the Maastricht Treaty

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[26]Some may question whether privatisation is the only way to redress this state of affairs. Some reforms designed to give SOEs greater autonomy and expose them to stiffer competition, without privatising their ownership, indicate that despite encouraging results, in most cases, such reforms are impossible to sustain, and after initial improvements the situation of the SOEs consequently deteriorates further. Hence the problem is how to bring about sustainable improvements in enterprise performance, and many governments today regard privatisation as the only means available to accomplish that. See *Privatization Challenge, supra* note 3 at 7-10.

[27] This is illustrated by the United Kingdom, where in 1981 SOEs cost the treasury 50 million pounds a week while these same companies now contribute 55 million pounds a week in taxes. *Ibid.* at 7.

to qualify for membership in the monetary union. It also applies to countries that have committed to structural adjustment programs with the World Bank or the International Monetary Fund.

Thirdly, rapid changes in the international economy have also helped hasten the decline of the typical SOE. Privatisation is an integral part of economic globalization which involves the creation of world-wide markets and complex networks of finance, information, production, distribution and service. The pursuit of a global economic order requires mobility of capital, goods, services, and labour; deregulation; and the push for privatisation schemes, particularly in developing countries. Globalization of the economy, accelerated by technological innovation and the growing integration of markets, compel businesses to adopt highly flexible strategies and continuously adjust them to changing circumstances. That may, among other things, require the formation of alliances with foreign partners in the areas of technology, procurement, or trade, or even through cross-shareholdings or integration in international groups. SOEs are notoriously ill-placed to function so flexibly and to forge such alliances. These include in particular large infrastructure companies, which until recently were almost all national monopolies that invested little if at all abroad but today aggressively invest outside their countries of origin. They also include private investment funds and institutional investors which allocate part, or even the entirety, of their resources to acquiring holdings in privatised companies.

The development of technology is another contribution to the movement of privatization. In some economic sectors, the reasons invoked to justify state intervention no longer exist. For example, in infrastructure sectors such as telecommunications and electricity generation, technological and other developments have made it possible to introduce competition into activities formerly thought to be natural monopolies. In other sectors, such as air transport, the rules of the game have simply changed, and SOEs have been unable to adjust. Another ground on which privatisation has been justified is the recognition that in certain sectors, governments no longer need to protect monopolies. Advances in technology, the ability to raise vast sums of capital to cover sunk costs, and the arrival of multi-national firms, have created new opportunities for competitive entry.

Politically, the ideological debate on economic management and privatisation has evolved substantially in response to the end of the Cold War and the confrontation between socialist and capitalist models of development. And with the globalization of economy, the artificial barriers between protected national territories are steadily falling. This narrowing of ideological schisms has produced a more pragmatic approach to economic reform, of which privatisation forms part. This trend has been strengthened by the positive experience with privatisation.

As a result of these factors, the privatisation strategy becomes a sub-strategy geared to the objective of the broader reform program. For example, Argentina, Chile, Mexico, New Zealand, Peru and the United Kingdom have opted for radical economic reform with privatisation as one of its main pillars; and some transition countries have implemented privatization programs with a view to moving from a command economy to a free market economy, where the sale of SOEs is essential for the formation of a market economy.

1.4 The Effects of Privatization

As discussed previously, most privatization was implemented with economic objectives in mind. In most cases, these economic objectives have been met successfully. Indeed, privatization has brought many changes not only to the economies concerned, but also to other aspects of their societies. For example, along with the whole economy becoming more competitive, social and political cohesion has also been strengthened through the establishment of "Mass Capitalism".[28]

The primary effect of privatization is its contribution to the improvement of operational efficiency and to the condition of fiscal deficits and national debt. In spite of some opinions holding that it was the introduction of competition rather than privatization that brought the increase of efficiency, the fact is, without privatization, competition could not have been promoted in such a radical way.

Moreover, privatization has changed some business rules. Privatization has improved the corporate governance of companies by spreading the ownership and attracting employee participation. Indeed, the employee ownership introduced has become a most striking feature.[29] Privatization has also brought into the open previously hidden and distorted financial relationships between the government and the SOEs, and forced government to abolish hidden subsidies and penalties such as hidden controls on output pricing, artificial supply pricing, and hidden transfers within an industry.[30] This is because once an SOE moves into the private sector, private investors cannot be expected to accept the distortions and new

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[28]See *Privatising the World, supra* note 2 at 25-52.

[29] In many privatization programs, over 90% of employees has received or purchased shares of companies, about 10% of the total shares of the privatized companies. *Ibid* at 47-48.

[30] For example, to support the development of the coal industry, the UK's Central Power Generation Bureau had to reach an agreement with coal industries for the purchase of coal even though their prices are much higher than international level. *Ibid* at 42.

commercial rules have to be applied to the effect that contracts or agreements must be reached on the basis of market rules. In addition, privatization has pushed the fast development of capital markets, particularly the securities market,[31] and, in consequence, has changed the trend of business financing. Direct financing from capital markets thus becomes more popular than debt financing since the former involves less risk and will not generate high equity-debt ratio.

Thirdly, privatization has changed the role of government. Before privatization, a government department in charge of a certain sector or industry used to link its interests with that of the sector or industry, feeling that it must be responsible for the development of the industry. Therefore, the officials tended to make all kinds of decisions for the industry. On the one hand, these decisions interfered in the business of the companies in that industry; on the other hand, the decisions sought privileges for the industry rather than the protection of the interests of general consumers. After privatization, government has retreated from business activity and government officials are no more responsible for the performance of the industry. Privatization also ended the role of the state as a financial sponsor to certain industries, and the investment decision power was shifted from government officials to the enterprises themselves and the financial market. Also, the privatized enterprises became more independent in terms of business operation such as the appointment of directors, with

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[31] In the UK. there were 2 million stock-holders in 1979 before privatization; the number has increased to 9 million 15 years later. In France, securities investors have increased from 1.5 million to 5.5 million during the privatization. and the number of stock-holders in Jamaica has tripled. These figures demonstrate that privatization has been an effective instrument to improve the global securities market. In fact, along with the proliferation of investors, the market itself was being amplified. From the early 1980 to August of 1987, the total capital volume of London Stock Exchange increased seven times! Most of the increase is attributable to the 15 billion pounds of shares issued by the newly floated privatized companies. *Ibid* at 49.

government losing the capacity to make such appointments.

Finally, privatization has had significant impact on regulation, particularly in the case of privatization of public utilities. After a public utility is privatized, it is unlikely for government to allow charges to be made on a completely commercial basis, since that would risk the utilities becoming a natural monopoly and imposing unreasonable charges. To prevent this called for clear and legitimate control to protect consumers and investors. The UK took the lead in setting up a sound regulation system. A charge standard was introduced to provide a price cap using the RPI - X tariff formula.[32] Along with price rules, regulatory frameworks were set up in most of the countries, with the objective of supervising and monitoring the competition rules set for the privatization process.[33]

1.5 Legal Changes for Privatization

Global experiences indicate that legal changes always take place before, during and even after a privatization program. In most cases, legal change, especially towards a market economy, is the prerequisite for a successful privatization program. On the one hand, privatization itself involves redistribution of economic interests such as wealth and other resources. This redistribution needs a set of game rules, a favourable legal framework made up of market-oriented rules. Also, new laws are needed to define, confirm, sustain and protect the new relationships built after the redistribution. On the other hand, rules are required to organize a well-going process of privatization. Therefore, before the launch of a privatisation

[32]RPI - X formula is used to set a ceiling on the authorised periodic price adjustment of a specified basket of services, where RPI represents the inflation rate as measured by the retail index and X the productivity factor initially stipulated in the privatization prospectus. See M.Armstrong & S.Cowan, *Regulatory Reform* (Cambridge: MIT Press, 1994) at 165 ff. Also see *Privatizing the World, supra* note 2 at 43-44.

[33] For detailed discussion, see Chapter Three, below.

program, rules that govern business activity in a country need to be reviewed to determine whether they are compatible with the proposed measures. If the existing legal framework cannot satisfy the needs, it must be modified to allow or facilitate private-sector development in general and privatisation operations in particular. Needed reforms should then be undertaken by directly amending the pertinent legal instruments (so-called 'facilitating law') or by enacting special privatisation legislation (so-called 'privatization laws' or 'enabling laws') to enable the programs to be launched.

First of all, a legal environment that fosters private-sector development is essential to the success of a privatisation program. Since privatisation in itself is not the end but a means to make the whole economy more liberalised and more market-oriented, major adjustments are called for at all levels, to bring in a legislative reform program supported by a strong political commitment to effectively implementing privatisation. Without the appropriate legal climate, privatization will be difficult to launch. Many laws or rules, for example, those defining and protecting ownership and most commercial law provisions, will have a substantial impact on the implementation of the privatisation program.

Secondly, privatization needs a legal framework within which the process can be organized and the responsibilities of the various actors defined. In other words, to initiate a privatization programme, a legislative foundation must be laid before hand, with the authorization granted exclusively by legislation of the country in question. For this purpose, relevant institutions have to be set up, and sound procedures designed. Such enabling legislation can give political legitimacy to privatization, define the respective competencies within the government, and ensure the transparency of decision-making and the legal security of transactions.

Legal changes designed for privatization mainly involve two aspects. One aspect is to amend, suspend or repeal those legal provisions which may hinder the initiation of privatization programs. For example, a privatization programme will change the pattern of shareholding by increasing the private ownership position in the national economy and by contributing to a major increase in share ownership among the public as a whole, which may require substantial changes in constitutional law as regards ownership. Measures in other sub-laws that discriminate against the private sector will have to be abolished. And the role of the state in the economy should also be redefined and shifted from intervention to regulation.

The other aspect is to introduce or establish more market-oriented devices and rules to facilitate privatisation. For example, privatization forwards a requirement for the introduction of typical company law providing a proper power division among shareholder, directors, and officers, a mechanism not fully established in those economies in transition towards the market such as China. The privatized company must operate its business in market conditions and requires a separation between government functions and commercial functions. This requirement sometimes means deregulation. Another example is when a privatization involves the participation of foreign investors: if it is very difficult to obtain the needed capital from domestic sources, a mature legal infrastructure, which is able to promote foreign investment, is urgently needed.

The two aspects reside within the same process. In most cases, when an old law is repealed or amended, a new law or new rules must be created to take its place. For example, when discrimination against the private sector is removed, fair competition among both the private and public sectors will naturally be established and guaranteed by legal rules.

Legal change is a complex phenomenon. The amendments to the existing legal framework are both a cause and the result of the process of privatization. On the one hand, sound legal change will help the implementation of privatisation. Privatization cannot be sustained for very long without effective legislation or new regulatory frameworks to contain natural monopoly and artificial monopoly and to provide institutional mechanisms to protect the interests of shareholders, depositors and consumers at large. Moreover, legal changes, especially the establishment of a well-built regulatory system, will have significance to specific transactions by increasing the buyer's or investor's confidence and thus increasing the selling price. This is because anchored securely in a law, and not in some executive instrument, the regulatory framework will enjoy substantial stability.[34] On the other hand, privatization itself will improve the legal framework in the targeted country and will liberalize the country's laws. Evidence of this symmetry can be found in almost every country which has launched a privatization program.

Conclusion

Privatization is a radical movement not only in economic terms, but also in terms of politics and of most other important aspects of society. Since the first privatization program was implemented in the UK in 1980s, many changes have happened and are still taking place. These include the series of legal and institutional changes initiated by governments to facilitate privatization. These initiatives will be the focus of following chapters of this thesis, which will

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[34] In Venezuela, for instance, the lack of such a law has probably been a factor in the relative instability of the regulatory system. See *Privatization Challenge, supra* note 3 at 46.

illustrate that privatization has brought in-depth changes to current systems and will continue to bear on the ways this world operates.

Chapter Two: Facilitating Laws

2.1 Introduction

Facilitating laws, as opposed to enabling provisions, are those provisions that seek to remedy specific shortcomings in existing legislation and may cover improvement to a bundle of associated laws including constitutional law, labour law, company law, securities law, investment law, and so on. Here improvement means respect for the rules of market economy that alone will facilitate the progress of privatization. Changes pertinent to facilitating laws will be discussed in following sections. Facilitating laws generally do not directly involve the procedures or mandating of privatization, but instead provide a favourable external legal environment for the operation of market economy, which is necessary for the successful implementation of privatization. For example, the equal protection of private ownership provided by constitutional law will set the basic grounds to promote private entry and protect fair competition between private and public sectors. Without the establishment of a social net, privatization will be definitely blocked by the instability arising out of the laying-off of workers. A sound system of corporate governance provided by company law will increase management's accountability and improve an enterprise's efficiency. If a country's foreign investment laws facilitate and promote foreign direct investment, it will be able to attract international capital from around the world to participate in the privatization. And without a developed securities market, any approach to privatization which may be used will have little impact. All existing laws, if they are ineffective or fail to provide the necessary conditions, must be subject to change. The following parts will discuss the most important of these laws, though it should be noted that certain other laws will also affect the result of privatization, if not properly strengthened.

2.2 Constitutional Requirements

A country's constitution law may contain provisions that affect privatisation operations either directly or indirectly. Since privatization involves the transfer of ownership, in preparing a privatisation program, several items must be unambiguous: how ownership rights are defined; how private ownership rights are recognized and protected; what restrictions, if any, are placed on the transferability of those rights; how the titling, registration, and cadastre mechanisms function; what enforcement mechanism exists to protect the rights of individuals, and particularly, how effective the judicial system is; what restrictions may be placed on foreigners with respect to the acquisition and exercise of ownership rights for certain types of property, such as land or other real-estate assets; and so on. To address all of these issues properly requires a constitutional law and the legal framework it underpins which provide both the establishment of the market economy and the rule of law.

Establishment of Market Economy:

In essence, privatisation is the transfer of ownership over given assets from a public entity to a private one. These transfers are conducted not according to the orders from the government, but through market mechanisms, such as bidding, auction sale, and listing on the securities markets. Each of these calls for the establishment of market economy. A market economy requires laws that provide for the following:

(1) All transactions are made under the rules of market, that is, to maximize values and generate profits. Or in other words, the allocation of wealth and resources should be directed

by the market rather than by government.

(2 Parties concerned have their own discretion or rights to sign contracts and all the parties are equal in terms of their intentions and rights to choose a supplier or a seller. No outside force should be in existence to influence the content of contracts, the way they are signed, or their ultimate implementation.

(3) Government interference must be minimized. Government must learn to control the economy through macro-management: it must stop interfering with the daily operation of specific enterprises, and become a regulator rather than business manager.[1]

(4) In a market economy, public and private sectors are treated equally and fair competition is guaranteed. Fair competition means not only opening up markets to private investors, including those sectors monopolized by the public investors, but also introducing national treatment for both private and public sectors.

Particularly, constitutional laws defining and protecting ownership[2] have a substantial impact on the implementation of a privatisation program. The constitutions of many socialist countries provided that all productive assets (including enterprises) were the property of the state or of 'all the people', granted the public sector special protection and privileges, or restricted the private sector's activity in what were deemed to be strategic sectors. Provisions of these sorts can clearly hinder privatisation programs and have to be amended or repealed.

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[1] M. Moran & T. Prosser, "Politics, Privatization and Constitutions" in M. Moran & T. Prosser, ed., *Privatization and Regulatory Change in Europe* (Buckingham: Open University Press, 1994)1 at 10-11

[2] Ownership encompasses a bundle of legally recognized rights, in particular the right to use and control assets (including voting rights), to draw economic benefits from ownership (return on assets, including rent, interest, or dividends), to dispose of such assets (for example, by selling, donating or destroying them), and to transfer any of the above rights to others. *Ibid* at 47

Indeed, most of the countries have repealed or amended such restrictions to enable privatization.[3] These sweeping amendments not only happened in most transition countries, but also in other countries moving away from strong state control of a more liberalized economy.

Nondiscrimination against the private sector also means respecting right of private ownership. Some constitutions or legal systems, especially those of communist countries, do not recognize the right to private ownership. In such cases, the constitution will have to be amended to allow privatisation to take place.

The Rule of Law

The success of a privatisation program is often a function of the soundness of its foundation, especially its legal foundation. The objectives of the program must be compatible with the constitutional provisions that underpin the legal framework for business activity in general and privatisation in particular. They must also be compatible with the general principles of law and other norms establishing the rule of law and with certain provisions of international law, which may be binding on the legislator. If these basic legal norms hinder achievement of program objectives, they should be amended.

Separation of powers and a regime of rights are the basic requirements of the rule of law and contribute to a legal environment conducive to private investment and hence to

[3] For example, in Belgium the state's guarantee of the public sector financial institutions was removed and these institutions were integrated in the deposit insurance scheme covering private banks before their privatization. See P. Guislain, *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience* (Washington: World Bank, 1997)at 34 - 36. [hereinafter *Privatization Challenge*].

privatisation.[4] More particularly, these requirements include publicity of laws, a clear and unambiguous legal framework, predictability in applying laws, nondiscrimination in the application of laws, availability of means of legal redress and respect for due process, and stability of the legal, political, and decision-making systems.

The establishment of a market economy offers the private sector equal treatment with public sector. The rule of law provides the procedures needed to bring in such a treatment. Both are prerequisites for a successful privatization. Constitutional law, if it fails to satisfy such prerequisites, must be amended before the launch of a privatization program.

2.3 Company Law

In principle, company law sets the basic rules for establishing, managing, operating, and liquidating companies. The importance of a good legislative framework governing the operation of companies cannot be overestimated.

First of all, a sound company law must provide adequate protection to the interests of investors at large. To this end, the law must have mechanisms established to supervise the behaviour of management in the event that it might operate the company in a way detrimental to the interests of general investors. Particularly, to protect the interests of minority shareholders, provisions must be available to restrict majority shareholder's arbitrary power in the business process. To achieve such protection, the law must set obligations for both management and shareholders; the law must impose liability on them if they are found to have violated their obligations; the law must also provide effective remedies for those whose

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[4] see F.C. DeCoste. *On Coming to Law: An Introduction to Law in Liberal Societies* (Toronto: Butterworths, 2001) at 162-176

interests are hurt or damaged.

Secondly, company law, with appropriate arrangements, may facilitate privatisation in some instances by unbundling the rights deriving from SOE shares, for example, by separating dividend and other income rights from control and voting rights, or by limiting the rights attached to certain classes of shares, which requires some modification to the existing company or securities legislation. In some countries, such as Mexico and Jamaica, different categories of shares have been issued with different rights. For example, some of the holdings retained by the state in partially privatised companies have been stripped of voting rights while they remain in government hands. Likewise although investors may in some instances not wish to mobilize funds sufficient to buy outright control, they may not invest at all unless they have the right to appoint the company's management team and to designate a majority of board members and are protected by other special provisions, such as a higher quorum and qualified majorities for decisions at shareholder meetings.[5] Company law should permit the adoption of such modifications, either by allowing the creation of different classes of shares or through other mechanisms. This technique has been applied in some privatisation of larger infrastructure companies. Examples include the privatisation of Telmex (Mexico), MATAV (Hungary), and CANTV (Venezuela), three telecommunications companies in which, following a competitive bidding process, a private consortium was selected to take over control of the company with a minority shareholding, with the state remaining, at least in the initial stage, the majority shareholder.[6] Another technique is the allocation to the state of

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[5] *Privatization Challenge, supra* note 3 at 57.

[6] *Ibid.* at 58.

'golden shares', which confer powers exceeding those that exist under ordinary company or securities law even though the state may have a minority holding of only one share. Another form of unbundling of rights is the issuing of investment certificates by SOEs, which are used to raise private capital by offering investors an opportunity to share in the enterprise's profits, but without granting them a corresponding share of control.[7]

Thirdly, a facilitating company law must provide minimum obstacles to investment activities. Company law is often unnecessarily complicated, ambiguous, or defective. It may therefore be necessary to redraft, amend, or simplify those laws and regulations to tailor them to the needs of the privatisation program. Changes will sometimes be necessary, for example, to allow a company to be set up speedily. The formalities and administrative delays involved in company incorporation and registration will have to be eliminated. More generally, changes need to be made to provide a favourable framework for the development of enterprises and the protection of the legitimate stakeholders. In some cases, the purpose of the changes will be to remedy difficulties that arose after the start of the program. For example, a Russian presidential decree which took effect in January 1994 abolished restrictions on share transfers that some managers of privatised companies had imposed to prevent external investors form assuming control; it also prescribed that employee-shareholder representatives cannot hold more than one-third of the seats on company boards.[8]

Finally, a facilitating company law should also provide for obligations on the company to release business information truthfully, completely and in a timely manner. It is also

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[7] *Ibid.* n.20.

[8] See M.Boycko & A. Shleifer, *Privatizing Russia* (Cambridge: MIT Press, 1995) at 71.

important that the law protect the freedom of a company to choose its own auditors; moreover, the existence and effective enforcement of accounting rules consistent with generally accepted international accounting principles will improve the prospects for success of the privatisation program by increasing transparency and predictability, and thereby reducing the buyer's risk.

2.4 Foreign Direct Investment Laws (FDI Laws)

<u>FDI and Privatization</u>

Governments decide to privatize SOEs for many reasons, but the desire to raise revenues and to increase enterprise efficiency are the most common. In fact, the privatization of SOEs in many countries, especially the developing countries, has involved a great deal of participation by foreign investors . The reasons for this outside participation can be traced to the need for capital which the governments involved consider to be most easily available abroad, and to the proliferation of multinational enterprises (MNEs).

Indeed, due to various reasons, ,most governments face financial problems such as budget deficit and inflation. Given that most developing countries are poorly endowed with capital, the sale of large SOEs to foreign investors is, of course, a particularly attractive alternative to solve the budget problem and fight against inflation. Specifically, in comparison with the alternative of selling to locals, selling SOEs to foreigners avoids the reduction in private sector investment levels and therefore in the potential rate of economic growth.

Moreover, what the FDI bring with them to the host countries is not only more tax revenue, but also improved technology and management, improvement in the quality of goods and services derived from increased competition as well as new projects and investment opportunities.[9]

FDI laws

A country's FDI-related law always includes two aspects: legal incentives or disincentives to FDI. Legal incentives were designed to attract FDI and they provide FDI with access to tax advantages, attractive infrastructure offers, market reserves by way of agreed customs duty limits, subsidised credit, etc. Legal disincentives were erected as legal barriers to block FDI. They have ranged from ceilings on the stake in local companies foreigners can buy, to 'golden shares' in strategic sectors of the economy or reserved for national security reasons, to restrictions on the repatriation of capital and dividends, and on foreign exchange, among other services.

With the attitudes of developing countries toward FDI changing, the use of the legal incentives or disincentives has undergone a process of change. Resenting the political influence MNEs wielded and the pressure they applied to obtain discriminatory tax benefits or monopoly rights, some countries have passed laws to enable the central governing authority to intervene heavily and arbitrarily in the inflow of FDI. Conditions are now changing and FDI is increasingly appreciated, as a general rule, in the developing world. These changes have mainly to do with the vastly increased number and diversity of MNEs, less personal and more technocratic government intervention, and of course the protection and promotion provisions provided by legislation. As a result, restrictions imposed for national security reasons tend to be limited, and affect only a very few firms. General

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[9] R.J. Luders, "Privatization and the Role of Foreign Investment" in J.Schuijer, ed., *Privatization in Asia, Europe and Latin America* (Paris: OECD,1996) 185 at 185. [hereinafter *Privatization in Asia, Europe and Latin America*].

restrictions such as those on the repatriation of capital or dividends, or those on foreign exchange operations, have either been eliminated or are being phased out.[10]

In the extreme, foreign investment is treated exactly the same as domestic investment, and there is no direct negotiation with foreign entrepreneurs at all: a single set of rules exists, which are the same for local and foreign investors, and the latter must accept them or leave. These rules naturally must deal with capital in such a way as to make it attractive to invest in similar countries, as well as with those of the main capital-exporting countries.

FDI Law and Privatization

If government wants to sell SOEs to foreign investors, either as a way of drawing capital or hard currency, or of attracting new technologies or gaining access to international markets, or for some other reason, the host country must provide a well-established and sound legal framework and a tradition of the rule of law. Only thus will the FDI needed by privatization programs be attracted.

The inflow of FDI calls for a more liberalized economic policy and requires the laws of the host country to strengthen its protection of foreign investment and remove all the restrictions designed specifically for foreign investors. Though in some countries, the privatization process is not the direct consequence of the trend to opening markets to foreign capital, it is clear that a more liberalized investment legal environment will be favorable for the further privatization

Although many countries reserve a number of exceptions to the areas in which foreign investment is allowed, the minimum requirement is that the laws provide national treatment

[10] IFC. *Experience and Lessons: Foreign Direct Investment* (Paris: OECD. 1997) at 73ff

and most favored nations principle to all foreign investors who have entered the market to protect them against any discrimination such as requirements for local content and performance content.[11]

As to the use of legal incentives, many privatization programs have proved that legislation should not provide special incentives, beyond those to which local investors have access, to foreigners interested in buying into SOEs. If, for example, a country grants special income tax advantage to the foreign purchasers of a state enterprise, the result will be a higher purchasing price for the shares in the firm, but also lower tax revenues. On the other hand, if the government negotiates a special market reserve – a form of monopoly privilege – it will also net a higher price for the shares of the privatized SOE, but local consumers will have to pay higher prices for goods and services that will not be produced as efficiently. Therefore, the conclusion is compelled that if a country's legal regime respects property rights and has a tradition of the rule of law, given relatively sound economic policies and a stable political situation in that country, special privileges are not likely to have much effect, but will merely drain precious resources.

2.5 Securities Legislation

International experiences have demonstrated that Initial Public Offerings (IPO) could

[11] For example, in Brazil, Article 5 of the 1988 constitution guarantees a vast array of social, economic, and political rights, including the right of private ownership and the right to fair prior compensation in the event of expropriation by the government, but only for Brazilians and aliens resident in Brazil. Nonresident aliens are not protected. Article 172 of the constitution provides that "the law shall regulate foreign capital investment, encourage reinvestment and regulate the repatriation of profits, all on the basis of the national interest". These constitutional provisions and various other provisions of the privatization laws and regulations that discriminate against foreigners have created difficulties for the implementation of the government's privatization program. In response to the low foreign participation and disappointing receipts of the first privatization transactions, the government relaxed the restrictions on participation by foreign investors. See *Privatization Challenge*, *supra* note 3 at 68, n.37.

be an ideal option to implement privatization, provided that there is a well-developed and well-regulated securities market.

First of all, when the program includes share floatation to the public at large (or at least to a large number of investors), the state should be able to issue SOE shares on a primary market and buyers should be able to trade their shares on a secondary market. Particularly, the secondary market required is a system that allows private parties to transfer shares freely to one another and to obtain registration or recognition of the transfer by the issuing company. Contribution of such a well developed market to a successful privatization program has been proven in numerous countries. For example, in Jamaica where a developed market was absent initially, the speedy development of a stock market made it possible to stand two major privatization programs within a short 18 months.[12] Indeed, development of local capital markets can foster the success of privatisation by boosting the ability to mobilize local savings and therefore reduce dependence on foreign capital. In the U.K and France, where structured financial markets already existed, privatisation was instrumental in further developing and deepening these markets by boosting total market capitalisation, transaction volume, and liquidity and by encouraging participation by new shareholders.[13]

A developed securities market is usually made up of a key-board market, a second board (new and high technology board) market, as well as a number of regional markets and counter markets. For example, the USA has the New York Stock Exchange as its key board

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[12] See O. Letwin, *Privatizing the World: A Study of International Privatization in Theory and Practice* (London: Cassell, 1988) at 50.
[13] *Ibid* at 49.

market and the NSADAQ as the second board market. As the key international financing platforms, both markets are used by companies to find more private investors.[14] But a key board market and a second board market are not enough in some instances and a country may have to consider other possibilities to develop its securities market. Suppose that a country has too many SOEs to be privatized, or that most of the SOEs are not in a position, for reasons of size or financial condition, to be listed in the key board or the second board stock exchange: in such cases, a number of lower-level regional securities markets and over-counter markets are necessary. The regional markets may have lower requirements to list a company. Indeed, it is the international trend that the requirements to admit a listing become lower while the regulation thereinafter becomes stricter.[15] And on over-counter markets, the shares of those companies which have not listed in any market can be traded.

However, it is important not to flood a newly organized and small financial market with shares. The floatation of shares in Poland's Slaski Bank illustrates the point. For lack of sufficient staff, registration of the shares of the Slaski Bank - a prerequisite for the sale of shares - fell far behind schedule, and hundreds of thousands of shareholders found themselves prevented from selling shares when the price of these shares was fluctuating widely. Problems of this kind hurt the credibility of the privatisation process in general, and they may alienate private investors.[16]

In addition to establishing more levels of market, the securities market can also be strengthened by other measures. For example, the law should facilitate privatization by

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[14] Zh.Q.Zhou. *Reading Books for Securities Knowledge* (Beijing: China Finance Press. 1998) at 250.

[15] Q.L Fu & T.J.Shao. *Legal System of China's Securities Transaction* (Beijing: Law Press. 1999) at 420.

[16] R.Frydman&A.Rapaczynski. *The Privatization Process in Central Europe* (London: CEU Press. 1993) at 158. [hereinafter *Central Europe*].

promoting the development of large domestic institutional investors that can participate in the privatisation program as buyers. These institutional investors usually include commercial banks, pension funds, and insurance companies. For example, in Italy, various legislative measures were enacted to allow financial markets to play an increased role in the privatisation process. Private pension funds were authorized; a new Law no.344 of August 14, 1993, regulates the creation of mutual funds; and amendments were made to the 1936 banking law to allow banks to acquire up to 15 percent of the shares of industrial companies.[17] Moreover, reforms that increase secondary market liquidity and remove barriers to corporate takeovers should contribute to better corporate governance. Such reforms may be particularly relevant for countries with large mass privatisation programs or employee ownership schemes, where established management teams may have few incentives to provide value to their atomized shareholders.

A sound regulation of the market is equally important. The stock exchange must work strictly on the basis of transparency and security for the transactors, whether they are seeking or providing capital. Therefore, a government wishing to privatize should take necessary measures to strengthen the regulation of securities market to ensure that adequate protection is provided to investor interests. A central requirement is the existence of independent market supervisory bodies responsible for protecting the savings of those who are publicly encouraged to invest. Moreover, effective mechanisms must be in place to prevent insider trading and strengthen regulations governing the release of information.

2.6 Banking Laws

[17] See R. Fraser & M.Wilson, *Privatization : The UK Experience and the International Trends* (Essex: Longman, 1988) at c.9 at 131-133. [hereinafter *UK Experience*].

A sound commercial banking system is essential for mobilizing savings and financing economic activity. Efficient banking mechanisms make it possible, in particular, for investors to finance their operations by raising working capital and to make speedy payments.

Most privatisation governments have had to strengthen their banking legislation so that commercial banks can play their role in a market economy; stronger mechanisms for bank supervision and adherence to international standards (including key prudential standards established by the Bank for International Settlements) have often been part of such reforms. Banking legislation may also need to be amended to facilitate the implementation of the privatisation program, for instance, by enabling commercial banks to act as financial intermediaries for share issues in countries where no formal securities markets exist.

Furthermore, banking laws may need to be amended to allow the privatisation of commercial banks themselves. In Pakistan, for example, the banking law was amended to allow the privatisation in 1991 of Muslim Commercial Bank and Allied Banks of Pakistan[18]. On the other hand, the 1990 law that authorized bank privatisation in Italy was not followed by much action to remove the Italian banking sector from overwhelming state control.[19]

In most socialist countries, the central bank acted as a commercial bank and no private banks were allowed. New legislation typically removed the central bank's commercial banking activities and transformed state-owned banks into corporations. In Hungary, for example, banking reform was initiated in 1987 with the transformation of the lending departments of the central bank into separate new state-owned banks, which together with two preexisting large state-owned banks dominated the commercial banking sector; 1987

[18] S. Aziz, *Privatization in Pakistan* (Paris: OECD, 1996) at 35.
[19] *UK Experience, supra* note 17, c.9 at 131-133.

also saw the first foreign-owned banks established in Hungary. The new law on financial institutions enacted in November 1991 authorized the privatisation of state-owned banks, while limiting ownership by any one shareholder to a maximum of 25 percent.[20]

Restructuring of the banking sector is often hindered, especially in countries where state-owned banks dominate, by huge nonperforming loans to often insolvent public enterprises and agencies. In such cases, bank reform becomes closely associated with SOE reform in general. SOE rehabilitation or privatisation programs usually call for hardening the SOE's soft budget constraints by ending privileged access to credit from banks controlled or guaranteed by the state and by forcing commercial banks to bear the full risks associated with SOE lending. Restructuring and privatisation the banking sector can therefore greatly facilitate the entire privatisation program by limiting the ability of SOEs to incur additional debt. A solution needs then to be found for the banks' existing portfolio of nonperforming loans. Some countries, including Hungary, have cleaned up their banks' balance sheets by creating special-purpose companies to take over nonperforming loans, either as a self-standing restructuring measure or as a step toward subsequent bank privatisation. Others, such as Slovenia, have created a bank rehabilitation agency to take over all the troubled banks, while yet others have recapitalised the existing banks.[21]

Restructuring and privatising banks should normally take place at the start of the reform program, since a healthy and dynamic banking sector is essential to the development of economic activity. Doing so, however, can be complicated, politically difficult, and expensive, a fact that explains why some governments have preferred to leave the banking

[20] See *Central Europe*, *supra* note 16, at 107 ff.

[21] *Ibid.*

sector untouched in the initial stage. If not properly designed, bank privatisation can cause privatised banks to become overextended, which might prompt another takeover by the state in order to avoid a major crisis in the financial sector, as happened in Chile, for example.[22]

2.7 Other Business Laws

Contract law:

Contract law and enforcement mechanisms for private contracts are a cornerstone of the legal framework of a market economy, because they determine how ownership rights are transferred. Basic to both is the understanding that the parties have the obligation to honour the agreements they make. For privatization, the importance of contract law resides in the principles that all the contracts should be reached on grounds of equality and should be performed strictly. Absent either, the confidence of private sectors will be shaken and their interest in the investment reduced.

Taxation:

Tax law includes the rules governing transfer pricing between enterprises of a group; those governing the carrying forward of tax losses, which can greatly influence the choice of privatisation technique; those determining tax treatment of loan interest and dividends and the tax implications of employee shareholding plans, leasing, franchising, and other privatisation mechanisms, which in many cases will determine the chosen technique; and finally, those relating to double taxation. Tax law should be applied uniformly to private and public enterprises, and tax advantages granted to SOEs in the competitive sectors of the economy should be abolished. Whether governments should give special tax advantages to

[22] R.E.Saez. "Financial Aspects of Privatization in Chile" in *Privatization in Asia, Europe and Latin America*, *supra* note 9, 171 at 171 ff.

privatisation transactions - for example, in investment legislation or in express provisions of the privatisation law - is a question that might arise. Some countries have granted exemptions from stamp and registration duties on share transfers, and even from corporate income taxes.[23]

Currency and Foreign Exchange:

Restrictions on foreign-exchange transactions, including allocation, availability, convertibility, repatriation, or registration of foreign exchange, will generally hamper efforts to attract foreign investors. In countries that do not have a stable and convertible currency, restrictions on domestic payments in foreign exchange, particularly remuneration of expatriate staff, payments to domestic suppliers, and payments by customers, may also be cause for concern.

Environmental Law:

Environmental law and privatisation interact at several different levels. Uncertainty about the extent of environmental liability caused by the SOEs to be privatised or about the buyers' present or future liability sometimes will slow the start of a privatisation program. The governing legislation therefore has to be amended to allow regional governments to release investors from liability for environmental damage caused by SOEs before they are privatised.[24]

This problem can be resolved in several ways. The first and simplest alternative is to

[23]The latter exemptions was granted, for example, in Tunisia, where article 30 of Law no. 89-9 extends very generous tax benefits to privatised enterprises, notably exemptions from corporate income and capital gains taxes. See *Privatization Challenge, supra* note 3 at 73,n.43.
[24] This is the case in German and Poland. See *Ibid.* at 81. Also see *Central Europe, supra* note 16 at 158 ff.

exempt the privatised enterprises from all liability for the consequences of acts of omission or commission on the part of the SOE, while leaving this liability with the old shareholder, that is, the state. A second alternative is to privatise the enterprise with all its rights and obligations intact, but place a cap on environmental liability, above which the government would compensate the buyers, or else to negotiate some other division of responsibility between government and buyer. In a third scenario, the buyers assume all the obligations of the enterprise they acquire and reflect the contingent liabilities risk by offering a lower purchaser price.[25] These issues will normally have to be dealt with through specific provisions in the environmental legislation, or the privatisation agreements between government and buyers.

The greater the uncertainty, the lower will be the price offered. From this point, privatisation can offer a unique opportunity to modernize a country's environmental legislation by speeding up the replacement of obsolete and polluting technologies with more recent 'green' technologies. Similarly, by eliminating the direct and indirect subsidies often received by SOEs, privatisation can promote more rational utilization of resources with, once again, a beneficial impact on the environment. Moreover, privatisation can foster better compliance with environmental standards; too often, SOEs were exempted from existing legislation or else got preferential treatment through lax enforcement.[26]

2.8 Labour laws and Social Safety Net

The social climate of a country is among the major determining factors in any investment decision, and a country's labour legislation and pension regime will be an

[25] See *Privatization Challenge, supra* note 3 at 82.
[26] *Ibid.* at 83.

important factor in the implementation of privatization programs. More particularly, whether a social safety net is already in place will have a significant bearing on a program's success.

Labour legislation.

Labour law provisions determine the flexibility the investor has to set employee salaries and benefits, to hire and lay off staff and, in general, to manage the enterprise's human resources. If overstaffing is severe, potential investors may well require that the government or the SOE lay off redundant employees before privatisation, or do so after privatization.

The labour regime applicable to SOE personnel can be more or less conducive to implementation of the privatisation program. First, special civil service benefits enjoyed by public sector employees will normally have to be repealed and may be replaced by other private-law benefits granted by the new company. Pension entitlements are a case in point. Similarly, it may be necessary to confirm or modify other contractual or statutory rights of employees, including, in particular, wage levels, seniority rights, and other benefits. In many cases, the relevant legal principle will be whether or not the employment relationship will continue after privatization.

The common principle under existing labour legislation in most countries is that the employment relationship will continue. To protect the continuity of jobs, many laws have restricted the new companies' freedom to lay off the employees.[27] Although this kind of

[27] For example, the Treuland in German has inserted a binding undertaking in many privatization contracts, under which the buyer guarantees to keep or create a specified number of jobs in the privatized company, subject to penalties in the event of default. Such a negotiated formula is generally preferable to protecting jobs by prohibiting all dismissals following privatization. In Pakistan, under an agreement between government and unions, new owners were prohibited from laying off any employees in the 12 months following privatization of an SOE. In Malaysia, buyers could neither modify the terms of the employment contract nor dismiss employees of the privatized enterprise for five years after privatization. Similarly, in Sri Lanka, since

protection was seen by some governments as essential for gaining the labour support deemed necessary to push through privatisation, uniform requirements of this kind make the privatisation process unnecessarily inflexible and expensive. The new company must be provided with the right to lay off redundant staff or change other terms of employment contracts under certain conditions specified by law.[28] The new labour legislation will also address such issues as severance pay and rearrangement of the laid-offs. In some countries, employees can be entitled to severance pay from the SOE, even if they are immediately rehired by the new company. Employees not rehired by the new companies would probably entrusted to a special organization for a temporary period and then pushed to the job market after that period. In some cases, they may continue to be formally employed by the old SOE, which continues to exist legally until it is dissolved even though it does not carry on any activity.

Social Safety Net

A social safety net consists of an unemployment insurance plan, pension funds, and medical insurance. A mature social safety net is one of the prerequisites for the launch of a privatization program, simply because a privatization program is inevitably accompanied by restructuring of the enterprise and the layoff of workers who must then rely on the safety net. In many countries, especially socialist ones, SOE provided employees unemployment insurance and many social services and benefits, including health, education, and housing

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March 1992, new owners have been required to extend the same benefits to employees, up to retirement age, that they enjoyed before privatization. *Ibid.* at 74 - 81.

[28] In Germany, for example, ordinary labour law restricts the acceptable grounds for dismissal; parliament has granted buyers of privatised enterprises temporary exemption from such restrictions, however, to facilitate implementation of the privatization program. *Ibid* at 74.

services. As part of the transition to a market economy, these services and benefits have to be shifted from the enterprises to a national social security scheme, which does not guarantee employment or provide social services but instead guarantees a minimum safety net. Citizens falling below the threshold of the scheme are eligible for support.

Guaranteed jobs provided by SOEs to their employees always result in overstaffing in many enterprises. In order to improve its productivity, a privatized company has to put downsizing on its agenda. How to deal with the laid-offs becomes a very important issue, because it may impact social stability. A national unemployment insurance plan must be in place to provide material provision to those who are out of job temporarily or permanently. Most developed countries have this kind of plan in place; unfortunately some transition countries do not.

A pension fund will also facilitate the successful implementation of privatization. The retired usually get their pension from the SOEs for which they previously worked. Consequently pensions vary with conditions of different enterprises. In extreme cases, the retired can get nothing from the former employer. So putting a pension system in place is the first order of business before the launch of a privatization program. For those countries that have already established their pension systems, if a pension systems is run by the State, a transformation into a private, more decentralized one may deserve consideration, because a private-operated pension fund scheme will bring more advantages to the participants.[29]

[29]Chile has played a pioneer role in this field. In 1981, Chile privatized its pension system and entrusted management of social contributions to private companies (AFPs)owned by domestic and foreign investors. Incumbent workers could opt to stay in the state pension system or switch to an AFP. In 1985, the law on pension funds was amended to allow the AFPs to invest up to 30 percent of their funds in the equity of privatised enterprises. The pension funds became by far the largest institutional purchasers of shares of SOEs privatised between 1985 and 1990. Under this scheme, workers can choose their AFP and freely switch their pension accounts. Competition among funds has kept commissions relatively low and has encouraged good

2.9 Dispute Settlement Mechanisms

Privatization is often contentious and controversial and has inevitably generated many lawsuits, usually filed by political or other opponents seeking to block or annul a privatization program or operation, by would-be buyers whose offers were not selected, or by former owners. Therefore, the existence of fair, efficient and credible mechanisms for settling these disputes is important, not only to resolve problems arising directly from the privatisation itself, but also to create an environment conducive to private sector activity. More generally, the smooth (or poor) functioning of a country's judicial system - and this of course reflects the degree to which the rule of law has been institutionalized - is a major feature of the overall business environment. Potential investors will take due account of the competence and independence of the judiciary, the accessibility and efficiency of the courts and tribunals, and the facilities that exist for settling disputes amicably outside the judicial system.

The way a government handles disputes with investors also determines credibility. A fair settlement of these disputes could only contribute to the country's good image abroad, a prerequisite for attracting new investors.

Among the options available, litigation can be very costly and time-consuming. An alternative can be arbitration, either domestic and international. International arbitration is often the preferred method for relatively large contracts, particularly for transactions involving foreign investors and to which a government is a party.[30] Therefore, a country

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overall performance relative to the stock market. *Ibid.* at 78

[30] The most accepted arbitration machinery was established by the International Chamber of Commerce, Paris, and the International Centre for Settlement of Investment Disputes (ICSID), Washington, D.C. Other notable institutions include the American Arbitration Association (AAA), the Inter-American Commercial Arbitration

should conclude more agreements providing channels for dispute settlement with foreign countries and try to keep a good track record in the adjudication, recognition, and performance of the awards.

2.10 International Law/The Requirements of the WTO

Privatisation should be viewed against the backdrop of the internationalization of the economy, which further restricts the options for resolving the chronic difficulties of SOEs. This globalization, which is reflected in new norms of international law, increasingly renders illegal the subsidies and tariff protection enjoyed by many SOEs, and it fosters the development of flexible enterprises able to adjust quickly to constantly evolving international markets.

First of all, the conduct of privatisation transactions in a given country can be affected by the international treaties or organizations to which it is a party. Many countries, on all continents, have entered into regional agreements or organizations on trade, custom controls, or broader economic integration[31]. The WTO is their representative. Most of these treaties or organizations require among their members the abolition of customs barriers, the liberalization of formerly monopolistic markets, and the imposition of common competition rules on private as well as public enterprises. All these terms have fostered the entry of private operators. The impact on privatisation of legal obligations deriving from the EU

Commission (IACAC), the London Court of International Arbitration (LCIA), and more recently, the Stockholm Chamber of Commerce (SCC). See D.R. Haigh Q.C. *et al*, "International Commercial Arbitration and the Canadian Experience" (1995) 34 Alta. Law Rev.137 - 162.

[31] Examples are the European Union (EU), NAFTA (North America) and ASEAN (Southeast Asia). Others include CACM (Central American), Mercosur (Latin America), Caricom (Caribbean). Such regional agreements often generate supranational law or foster harmonization of legislation in their member countries. See K.W. Abbott & G.W. Bowman, "Economic Integration in the Americas: A Work in Progress", (1994) 14 Northwestern J. Int'l Law & Bus.493 at 493 - 505.

treaty, for instance, is very significant, even though the treaty in itself is by no means hostile to privatization. First, to meet the macroeconomic criteria set by the Maastricht Treaty for joining the new European currency, privatisation is one of the options most governments must consider to reduce public-sector debt and deficits. Furthermore, many provisions of European law will apply to the implementation of a privatisation program. Examples include the rules on merger controls, the prohibition of state aid to enterprises, and the prohibition of discrimination among nationals of member states of the EU, which means, for example, that foreign nationals must be allowed to acquire holdings in the capital of privatised enterprises on the same footing as local citizens.[32]

Moreover, bilateral agreements may also raise special privatisation issues. For example, in the privatisation of airlines, bilateral agreements governing air traffic between the signatory states often require that 'substantial ownership' or 'effective control' of the designated companies be held by a signatory state or by nationals thereof. An airline privatisation that would transfer control to foreign investors could hence block the application of these agreements and result in the loss of some of the airline's main assets, that is, the routes.[33] Bilateral agreements in many other fields concerning matters such as double taxation or investment promotion can also affect privatisation transactions by, say, partly covering gaps in the legislation of a signatory country, at least for investors of the other country.

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[32] For example, Portugal and France had to amend their privatization legislation to abolish limits imposed on shareholdings by investors from other EU member countries. See *Privatization Challenge*, *supra* note 3 at 41.

[33] There are ways to limit this risk. For example, when British Airways was privatized, a golden share was awarded to the government, which allowed it to oppose any foreign acquisition of shares. See D. Clutterbuck, *Going Private: Privatization around the Wold* (London: Mercury, 1991) c.2. at 127 ff.

Summary

To implement privatization, a favourable legal environment has to be created. To try to privatise an enterprise in a general environment hostile to the private sector is to court immediate failure. Facilitating laws may not directly authorize the process of privatization, but will have great impact on the success of privatization.

Specific constitutional provisions might therefore have to be amended, to facilitate implementation of the privatization program. When constitutions allow privatization but make it conditional on particular safeguards, an enabling law is always enacted to authorize the privatisation of SOEs. Where constitutional provisions discriminate against private ownership or prohibit the privatisation of a certain economic sector, suitable legal techniques must be found to allow the government to circumvent obstacles that may appear to be major constraints. In whichever case, the rule of law must be provided by the constitutions.

Other laws that can also contribute to the success of a privatisation program include, among others, property law which defines the transfer of assets from the public to the private sector, corporate law which fosters the creation and efficient functioning of commercial companies, foreign investment law which promotes the inflow of foreign capital to complement the scarce of domestic investment, securities law which facilitates the development of financial markets and provides vehicles for asset sales, and labour and social legislation which help to strengthen social security schemes. Some international treaties and other agreements should not be underestimated either.

Finally, dispute settlement which provides efficient, independent and fair procedures is essential. A sound legal system, predicated on the rule of law and respect of individual rights, is the cornerstone of market economy, and it alone can facilitate successful implementation of privatisation.

Once the major obstacles to privatization are identified, their elimination must be assigned high priority and achieved by repealing or amending the relevant legislation and by inserting specific provisions in a privatization law.

One should, however, bear in mind that it would be pointless to try to document and remedy all the shortcomings identified above. The scope of the reform to be undertaken will depend mainly on each country's specific situation: a country emerging from a centrally planned economic system, for instance, will have to create a whole new framework for economic activity.

Chapter Three: Enabling Laws

3.1 Privatization Law: Content and Form

3.1.1 Introduction

A country's privatization laws always include both an enabling law, which confers authority on the government or privatization agency to privatize and to regulate the process, and detailed laws which address the restructuring and privatization of the sectors in question.Other legal instruments, such as decrees, implementing regulations, directives, and resolutions, as well as sales agreements negotiated directly with buyers, also can be important instruments in the legal arsenal of privatization.

A privatization law must, above all, reflect in legislative terms the strategy and program adopted by the competent national authorities and respond to the specific needs of the country. Whether or not a country needs to enact a privatization law depends on its legal and political situation and the specific characteristics of the enterprises to be privatized. In some countries, the government does not need any special enabling legislation to privatize, either because constitutional principles do not require a law or because SOE legislation or other laws provide the necessary legal framework.[1] In transition countries, however, an enabling law is necessary, simply because such countries lack a sound legal framework to provide the authorization and transparency which privatization programs require.In some

[1]For example, most of the common-law countries, such as Australia, Malaysia, New Zealand, and the United Kingdom, do not legally require enabling legislation. Their constitutions, legislation, or legal traditions may allow the government or other public agencies to privatize without intervention by the legislature. In such systems, it is generally considered that, in the absence of explicit prohibition, the government possesses inherent power to privatize public assets and enterprises without the need of special legislative authorization. See P. Guislain, *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience* (Washington: World Bank, 1997)at 111. [hereinafter *Privatization Challenge*].

cases, even respect for private ownership and permission for private entry have to be established by the enabling legislation. Even where a law is not strictly necessary (legally speaking), political considerations may argue in favour of one. A law offers several advantages: it represents a concrete statement of explicit political support for and commitment to the privatization process, increases the accountability of the executing agency, makes it more difficult to undo the reforms being implemented, and provides an opportunity to change the existing business environment to facilitate privatization. Disadvantages involve often lengthy delays in securing parliamentary approval, the possibility that the law's provisions may be too restrictive or inflexible, and the risk of parliamentary micro-management.[2]

3.1.2 Scope of the Legislation

Because the conditions (legal, political, economic or other) that led to the enactment of laws differ from country to country, it is to be expected that the content of privatization laws may vary substantially. There is no such things as a legal blueprint that can easily be copied from one country to another or a single approach applicable to all countries and all privatization operations.

Though handled very differently from one law to another, the core elements of privatization legislation include the enabling provisions authorizing and organizing the privatization process. It is essential that the law define in clear terms the respective spheres of responsibility of the various authorities that play a role in the privatization process. Mechanisms must be set up that make these authorities accountable for their actions and

[2] *Ibid.*

create appropriate incentives and penalties to ensure proper execution of the privatization program. Many privatization laws also contain some facilitating provisions to remedy specific shortcomings in existing legislation.[3]

Privatization laws often provide for the methods used to implement a program. Except for those techniques such as mergers and acquisitions which are borrowed form common private commercial practices, the methods specific to SOE privatization have to be included in the privatization law.

A good privatisation law must also address those issues which will possibly arise in the process of privatization, including: how to preserve national sovereignty or independence; how to retain national control over certain activities or interests perceived to be strategic; how to safeguard the 'public interest'; how to avoid wealth being concentrated in the hands of a few private parties; and how to avoid the protection of bureaucratic or other vested interests and encourage the entry and protect the interests of the private sector.[4]

No matter what a privatization law contains, the point is that the law should eliminate the most serious legal obstacles and constraints to privatization. If, however, the law does not address these, or even worse, includes additional constraints, restrictions, or conflicting objectives, the privatization process will be more difficult and slower, with lower net benefits to government and society.

Where privatization legislation is required, it may be preferable to limit the provisions of the law to broad principles to the effect that flexibility is achieved. A flexible legal

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[3] *Privatization Challenge, supra* note 1at 111 - 112.

[4] *Ibid.*

framework will allow the government and the responsible agencies to adjust their methods to changing circumstances which cannot be predicted. Flexibility must not be confused with ambiguity, however. The privatization law must be clearly worded, especially with respect to delegation of powers, responsibilities of the various parties involved, scope of the mandate, minimum requirements for transparency and competitiveness of selling procedures, selection criteria, benefits accorded to specific categories of buyers, resources made available to the executing agencies, allocation of privatization proceeds, and controls that will be applied to privatization officials. Furthermore, a law should not be used as a substitute for a proper privatization strategy, lest it be loaded with many considerations better left to subordinate legal instruments. Some aspects of privatization, especially its speed and timing, though essential from a strategic point of view, should normally not be regulated by law. Legislating such matters could easily become a straitjacket: a strategy can be adjusted fairly easily to tailor it to changing circumstances or to factor in the lessons drawn from new experiences; a law cannot.[5]

3.1.3 Forms of Legislation

Two forms of legislation may facilitate privatization. One is to pass enabling legislation for each transaction. However, if a large number of enterprises in the 'competitive' sector are to be privatized, it would be troublesome to require transaction-specific legislation, in which case another form, notably general legislation, has been used as a more flexible

[5] *Ibid.*

method.[6]

General Legislation:

A single act, which lays down the broad lines for all privatization, should be considered if common rules for all privatization transactions are deemed important. Such a law may confer a general mandate on the government or an agency to privatize SOEs. A law that confers broad authorization to privatize without specifying the enterprise in question will generally define its scope of application either by defining 'privatization' or other terms or by prescribing inclusion or exclusion criteria. The privatization mandate may thus be limited by excluding particular sectors or SOEs. Another possibility is to specify the sectors in which privatization is permitted without naming any particular enterprise.[7] A general law may list the SOEs that are to be wholly or partially privatized. The government's authority to privatize is then usually limited to these listed SOEs.[8] However, this listing method is not a good solution, because it limits the government's flexibility. Some countries have issued decrees pursuant to the privatization law that list the enterprises to be privatized. This method offers more flexibility than the designation of SOEs in the law itself.[9]

Specific Legislation

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[6] D.Carreau, "Legal and Institutional Aspects of Privatization"in J.Schuijier, ed., *Privatization in Asian, Europe and Latin America* (Paris: OECD, 1996) at 125.[hereinafter *Privatization in Asia, Europe and Latin America*].

[7] *Ibid.*

[8] Examples are found in Argentina, France, Morocco and Nigeria etc. Particularly in France, article 4 of the privatization law of 1986 states that all the 65 companies listed to be privatized in the annex to the law must be transferred from public to private sector prior to March 1st of 1991. See *Privatization Challenge, supra* note 1 at 116.

[9] *Ibid.*

Such precisely targeted privatization laws tend to be used where the scope of the privatization program is limited or an SOE or group of SOEs poses special legal problems that cannot easily be resolved in a general enabling law. Particularly they apply to the privatization of an entire sector, especially a highly regulated sector such as the financial, natural resources, or infrastructure sectors, to deal with market structure, competition, and regulation, as well as provisions enabling the privatization.[10] This technique requires not only large-scale restructuring of the sector, but also the creation of a new regulatory framework.[11] Moreover, these laws provide for a restructuring of the industry or a transformation of an enterprise into a company prior to its sale or flotation.Indeed, telecommunications, electricity, gas, water, and transport privatization are usually the subject of specific legislation, which may take the form of sector-or enterprise-specific privatization laws or amendments to existing laws.

In some instances, for example, in Argentina, both general legislation and specific legislation were used: a general law of 1989 applies to the enterprises named therein, followed a few years later by specific laws for certain individual enterprises such as YPE, the oil company, and certain financial institutions.[12]

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[10] *Privatization in Asia, Europe and Latin America, supra* note 6 at 126

[11] Specific laws authorizing the privatization of one or more SOEs or of an entire sector have been enacted in Argentina, Belgium, Brazil, Canada, New Zealand, the United Kingdom, and several other countries. For example, for each privatization in its program, the UK government has passed specific legislation to repeal the existing legislation governing the duties of the enterprises and the responsibilities of the Secretary of State and to provide for the creation of a new regulator and for its duties in relation to the industry. See *Privatization Challenge, supra* note 1at 118.

[12] H.A.Mairal, "Legal and Other Issues in Privatization: the Argentina Experience" in *Privatization in Asian, Europe and Latin America, supra* note 6, 133 at 136 - 137.

3.2 Implementation of Privatization

3.2.1 Implementation Institutions

Specific institutions are often set up for large national privatization programs. These institutions vary in form and structure, from small teams that manage the process but delegate execution of the transactions (such as the privatization units in the Mexican ministry of finance) to large agencies with vast resources and a mandate to implement the program directly.[13] This variety notwithstanding, the following three models can be identified:[14]

1. In the centralized model, all privatization powers belong to a single autonomous institution with a clear privatization mandate. Some countries have entrusted the decision-making power to an existing governmental ministry, while others, especially those in transition, have preferred to set up an independent institution for this goal.[15]

2. In the completely opposite approach, the privatization process is split between the branch ministries responsible for the enterprises in question.

3. In between the two extremes, there are models that combine central co-ordination with sectoral and/or regional decentralization. A privatization commission consisting of representatives from different ministries or sectors is such a model.

Each of the three models has advantages and disadvantages. Model 1 may work

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[13] See R.Frydman & A.Rapaczynski, *The Privatization Process in Central Europe* (London, CEU Press, 1993) at 27ff, 72ff, 126ff, 178ff, & 239ff. Also see *Privatization Challenge, supra* note 1 at 149 - 201.

[14] S.Nestor & M. Nigon, "Privatization in Europe, Asia and Latin America: What Lessons Can Be Drawn" in *Privatization in Asian, Europe and Latin America, supra* note 6, 9 at 14 - 15.

[15] The former case can be found in France and Poland, and the latter in Russia and most of the central and eastern Europe countries. The latter case is also true of Germany, where the Treuhandanstalt was set up and endowed with substantial powers and large resources in order to privatize the economy of the former East Germany. See *Privatization Challenge, supra* note 1 at 154 - 155, 163 - 164, & 167 - 170.

effectively if a large number of transactions is involved. Model 2 may be effective where a few big and highly particular transactions are envisaged, however its drawback is that it might slow down decision-making and may result in incoherence of the privatization program.

Responsibility within an institutional framework has to be allocated in a sound way. Power and responsibility is always allocated between two bodies, a decision-making body in charge of policy making, and an executing agency responsible for the implementation of the specific programs. The decision-making body functions as a supervisory board for the executing agency and its composition is usually more political. It always takes the form of a privatization commission which includes members who represent different interests and always come from different ministries or from different sectors.[16] Another form of delegation is to vest authority over the privatization process in one of the ministries.[17] Whatever form it takes,

[16]For example, in Peru, an inter-ministerial commission (COPRI) consisting of six members of government oversees the work of special committees (CEPRIs) responsible for specific enterprises to be privatized. Most committee members are from the private sector. In Brazil, there is a privatization committee comprising four members of government and seven representatives of the private sector, whose duties include submitting to the president the names of the enterprises to be privatized and approving the main privatization techniques and the selling price. The executing agency for the privatization program is BNDES (the Bank for National Economic and Social Development) which is responsible, as administrator of the program, for managing the privatization fund, for appointing advisers and auditors, and, more generally, for executing the privatization transactions. In Chile, the policy and decision-making function have been carried out by the board of directors of CORFO, the state holding company, which is composed of the ministers of the economy (chairman), finance and planning, the vice minister responsible for CORFO, and one other member appointed by the president of the republic. The board authorized the sales of shares and approved the sale terms and conditions. It was assisted by a committee comprising the members' direct deputies or assistants, plus a small "standardization" unit which managed the entire process, subcontracting the bulk of the work. In the Philippines, the privatization committee is composed of ministers and is chaired by the minister of finance. It is assisted by a privatization bureau within the ministry of finance, which is responsible for implementing the privatization, and a nonperforming assets privatization trust, a special agency set up to manage the liquidation of state shareholdings and debt claims. *Ibid.* at 163.

[17] In France, the minister of the economy takes the decision to privatize the enterprises listed in the annex to the privatization law and sets their selling price, in accordance with the advice of the privatization commission. In Morocco, implementation of the privatization law promulgated in April 1990 is entrusted to a "minister responsible for implementing transfers of public enterprises to the private sector," assisted by an inter-ministerial transfers commission and a valuation commission. In Poland, although the public treasury, an agency with juridical personality placed under the ministry of finance, is legally the owner of the

the power delegating body always defines the privatization program, designs the procedures, sets its priorities, and takes the major decisions, from a high level. In some countries, specific powers, such as deciding on the enterprises to be privatized and approving transfer agreements, may also rest with this body, whose responsibilities often include approving all, or at least the major, privatization agreements.

The executing agencies are those bodies which implement technically the privatization programs. Enjoying a certain degree of autonomy, they always take form as privatization agencies or some kind of committees, supported by certain technical bodies, or other outside contracting experts. In mass privatization, they may include agencies which oversee funds set up to spread ownership.[18]In other cases, they may be public holding companies or financial institutions who have been given responsibility for executing privatization, either by transferring part of their own portfolio holdings or by acting as the agent of government in SOE sales.[19] Usually, the executing agency is supported by a valuation body that has been set up to value the enterprises to be privatized or to determine the share price.[20] While some

SOEs and the government's shareholdings, it is mainly the minister of ownership changes who is responsible for their transfer. In the Czech Republic, privatization was the responsibility of a ministry for administration and privatization of state property, which was in charge of the transfer of thousands of companies to the private sector; it closed its doors in July 1996, its mission having been substantially accomplished; the remaining responsibilities of the privatization ministry were devolved to a special office in the finance ministry. *Ibid.* at 154 - 163.

[18]For details, see *infra* section 3.4.1 of this chapter, "Voucher and Privatization funds".

[19]In Colombia, for example, IFI, the public holding company responsible for industrial development, was given responsibility for privatization in the industrial sector, and Forgafin, the financial institutions guarantee fund, that for bank privatization. See *Privatization Challenge, supra* note 1 at 163 - 164.

[20]For example, in France, the privatization commission has been set up for this purpose. The 1989 Moroccan privatization law entrusted key responsibilities to three different bodies, the privatization minister, the valuation commission, and the transfer commission. In Argentina, the Public Enterprises Auditing Agency and the National Development Bank are responsible for valuing each enterprise to be privatized and setting

countries have set up large technical bodies, others have opted for small units and delegated the main tasks to other institutions having the required skills and experience.[21]

3.2.2 Control of the Privatization Process

Control mechanisms have been set up in practically every country. Some are exercised by the judiciary or regulatory bodies; some pertain to *a priori* authorization of privatization decisions by political bodies and others to prior valuation; in others, control is exercised *a posteriori*.[22]

First of all, *ex post* controls may take the form of audits performed by a national accounting office reporting to parliament. In addition, privatization agencies should normally be required to abide by public disclosure rules and to report periodically to the council of ministers, parliament, or some other body. A balance may have to be struck between the requirement to transmit information to the control agencies and the need to safeguard the confidential nature of the relevant transactions.

Prosecution of fraud and corruption is another important issue which cannot be neglected in the privatization process control. It is essential that public officials, whether SOE managers or directors, civil servants, or any other kind of official, be held accountable for their actions. The creation of a transparent and competitive privatization process should go a long way toward reducing the opportunities for fraud and illegal enrichment. In addition to these

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a minimum sale price. The Belgium commission for the valuation of state assets has similar function. *Ibid.* at 164 - 165.

[21] In Mexico, for example, the government set up in 1988 a small privatization unit within the ministry of finance. This unit was responsible for managing the entire process, but it delegated the main task to commercial banks acting as agents of the government. *Ibid.* at 163.

[22] *Privatization in Asian, Europe and Latin America, supra* note 6 at 131.

preventive rules and policies for good governance, the legislation in effect must deal with the repression of corruption, fraud, misappropriation of public funds, insider dealing, collusion, and similar misbehavior.

Compliance with buyer's obligation cannot be neglected. The privatization process does not end when a contract is signed, as the contract imposes terms that the buyer (and the government) must fulfill. These obligations, which may extend over many years, often concern the maintenance of existing jobs or the creation of new ones, the protection of the environment, and the achievement of specific investment goals. The privatization agency needs to have the resources to monitor the contracts and to institute proceedings, if necessary, to compel buyers to honor their commitments.[23]

Finally, privatization laws and regulations usually contain prohibitions designed to limit the risk of conflicts of interest. For example, the staff of an SOE or privatization agency who are involved directly (or indirectly) in the privatization process are often precluded from acting as buyers of enterprises or shares offered for sale. It may be prudent to impose restrictions applicable after privatization too, for example, prohibiting management staff involved in the privatization process, and particularly in buyer selection, from accepting employment with any of the bidders for a specified period following completion of the privatization operation.[24]

3. 3 Post-privatization Regulatory Framework

Although deregulation is a popular strategy for promoting fast development of the private sector, appropriate regulation of the privatized enterprises is necessary in some cases

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[23] *Ibid.*

[24] *Ibid.*

to protect the interests of consumers, to prevent new monopoly, and to maintain the result of privatization.[25]

Take the UK as an example. When the British Telecom was to be privatized, there were concerns that the number of the public telephone booths might hence be reduced in undeveloped areas. To alleviate this concern, some strict provisions were incorporated into the concession contracts which mandated a certain number of telephone booths reserved to those areas, with the operation cost coming from corporate profits. Also in the privatization of the national bus services company, the central and local governments were required to provide open financial subsidies to the bus service operators to maintain their loss-making services.[26] Another example of protecting the interests of consumers is the use of price regulation mechanisms such as called "RPI - X Principle ", designed for the public utilities in the UK to prevent any possible price increase to the detriment of consumer interest.[27] Numerous other laws and rules were designed to impose "non-commercial obligations "on the privatized companies in the UK.[28] To oversee the behavior of the privatized companies and carry out further regulation of the privatized companies, new positions or new institutional set-

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[25] Actually, "deregulation is often a matter not merely of removing regulations that previously existed, but also of constructing new regulations to change the competitive environment". See O. Letwin, *Privatizing the World: A Study of International Privatization in Theory and Practice* (London: Cassell, 1988)at 82. [hereinafter *Privatizing the World*].

[26] *Ibid.* at 57 - 58.

[27] M.E.Beesley, *Privatization, Regulation and Deregulation*, 2d edition (London: Routledge, 1997) at 354 - 368, 393 - 400.

[28] For example, the legal documents for the privatization of natural gas companies made it mandate that adequate examinations be made on the natural gas facilities and the connection parts. See *Privatizing the World*, *supra* note 25 at 57. Also see Beesley, *supra note 27* at 32.

ups were established.[29]

Regulation has proved necessary for successful privatization. The most important regulatory issue is the creation of a sound regulatory framework, preferably established by legislation and backed by strong political commitment. This framework must effectively be in place before or at privatization. In most of cases, an independent and autonomous regulatory commission is created for this purpose.

The integrity of the regulatory process must be protected by rules guaranteeing independence and transparency, which are the two basic pillars of a proper regulatory framework. Several designs may help to achieve independence. First of all, the mandate that assigns the necessary powers to the privatization agencies must be clearly defined. Secondly, a multi-member commission which includes representatives from different sectors may provide greater safeguards against undue influence or lobbying and may limit the risk of rash or radical regulatory decisions. Thirdly, rules need to be laid down concerning conflicts of interest (for example, by prohibiting former staff of the regulatory agency from working for a regulated enterprise for a specified period after they leave the agency). Fourthly, independence from industry also requires that the regulatory function be clearly separated from the exercise by the government of its SOE ownership functions (the operating functions). An institutional setup that allows the same senior official to be regulator and representative of the state's ownership

[29] In the privatization of natural gas companies, the laws require the establishment of a position of Chief Executive Officer for Natural Gas Supplying to supervise the implementation of these examinations. Also, when the water resources administration was to be privatized, a position of national supervisor was introduced to assess the water quality, and work out protection measures to prevent contamination as well as to impose sanctions on wrongdoers. A similar institutional setup, always called "the administrative office", is also found in the telecommunication sector in the UK. Such offices, originally designed mainly to control prices, later possess more functions such as dealing with complaints filed against service quality and judging if a company's behavior violated the rules for free competition. See *Privatizing the World*, *supra* note 25at 70.

interests in an SOE would not pass muster. Ministerial regulation has been the tradition in numerous countries. It is losing ground, however, and now the trend is clearly toward more autonomous regulatory setups, separating regulatory agencies from government ministries[30]. Moreover, autonomy will be strengthened by granting the regulator financing sources independent of the general budget, typically in the forms of charges, fees, or levies on the enterprises or services subject to the regulation. And, appointment should, ideally, be made by public election. This will help to give the process more stability and authority and avoid undue governmental interference in the regulatory business. If this way cannot be taken, at least some legislative involvement should be considered. For example, the law may specify that, once appointed to a fixed term, regulators cannot be removed at the government's discretion. Finally, some other mechanisms, such as publicity, transparency, and disclosure rules, will also reinforce and protect the independence of the regulator.

Transparency in the regulatory process requires mechanisms to minimize fraud or corruption and suitable procedures must be put in place. Greater disclosure and publicity in the decision-making and implementation processes, for example, can contribute to the transparency required to establish and maintain a reputation. In addition, like any other power bodies, a supervisory mechanism must be established with resources set aside for monitoring the effective implementation of the program (for example, the compliance of buyers with the

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[30]This is illustrated, for example, by conditions placed by the European Commission on the approval of the alliance between Deutsche Telcom and France Telecom, and by the regulatory principles being negotiated at meetings of the WTO on telecommunications. See J.Leanman, "Regulatory Reform and Privatization in Germany" in M. Moran & T. Prosser, ed., *Privatization and Regulatory Change in Europe* (Buckingham: Open University Press, 1994) at 16. Also see D. Parker, "Privatization in the European Union: An Overview"in D. Parker ed., *Privatization in the European Union* (London: Routledge,1998) at 21 - 23.[hereinafter *European Union*].

obligations they have assumed). A sound remedy mechanism should also be in place, such as an appeal procedure. Where traditional courts cannot provide the necessary expertise, integrity, and efficiency to settle appeals on regulatory matters, the appeal procedures set up within a regulatory system become especially important.[31]

However, independent, autonomous regulatory agencies with decision-making powers may not be suitable for all countries. Design and implementation of an efficient regulatory framework needs to take into account national conditions , including administrative and judicial traditions and institutional capacities. The U.K. model, and in particular the decision-making powers given to individual and independent regulators, is attributed to its well-established legal practices and traditions. In many developing and transition countries, the difficulty of designing an appropriate regulatory framework is amplified by civil service regulations, practices, and salary scales; political intervention; weakness of the judicial system; scarcity of trained managers; lack of relevant regulatory experience; and other such constraints. Where this is the case, a gradual approach - which starts by giving an autonomous regulatory body advisory powers and eventually other powers - may often be the preferred approach. By requiring that such a body make recommendations on all key regulatory decisions, the ultimate decision-maker may indeed make better informed decisions and be more reluctant to rule in a way that demonstrates arbitrariness, discrimination, or cronyism. Publicity

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[31] A good example is the the Monopolies and Mergers Commission (MMC) set up by the United Kingdom. Possessing the powers deriving from privatization laws and general competition legislation, MMC has several times been asked to hear disagreements between privatized companies and their regulators concerning amendments to the terms or conditions of licenses. The regulator has to take the recommendations of the MMC into account but is not required to follow them. The regulators may refer companies to the MMC. In addition, the director general of fair trading (OFT) is also allowed to refer privatized utilities to the MMC for anti-competitive or monopoly practice. See P.Cook. "Privatization in the UK: Policy and Performance" in *European Union, supra* note 30. 218 at 225. 229. &233.

of recommendations can further strengthen the commission's influence and the decision-maker's accountability.[32]

There are serval ways to design the regulatory agencies. In Argentina and the United Kingdom, a regulatory body is set up for each sector; in Hungary and the United States (at the federal level), a single agency is established for closely linked sectors such as gas and power; in Bolivia and the United Sates (public utilities commissions at the state level), only one multi-sectoral agency for all or most infrastructure sectors is put in place. At one extreme, no new body set up at all. For example, in New Zealand, the Commerce Commission, the national competition agency, is in charge of economic regulation of the infrastructure sectors on the basis of the country's general competition rules.[33]

However, experience shows that a unified multi-sectoral agency covering all related sectors rather than separate sectoral regulatory agencies would be a better solution in the longer run. This is because a multi-sectoral regulatory agency contributes to a greater degree of coherence or consistency in the regulation of different sectors and can help to apply the experience obtained from one sector to another. Moreover, it can create administrative economies of scope, and may limit the risk of corruption or undue influence by a particular enterprise or ministry. It is particularly well suited for countries that lack the necessary financial, human, and administrative resources to equip separate agencies.[34]

The authority or powers of regulatory bodies vary widely, ranging from purely

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[32] See *Privatization Challenge, supra* note 1 at 271 - 286

[33] *Ibid.*

[34] *Ibid.*

advisory bodies to bodies that award and police licenses, adjudicate disputes, and oversee the sector in general. However, the power to adjudicate disputes between operators or between users and operators may be the most important function of a regulator when a sector is being liberalized and a dominant operator controls bottleneck facilities and tries to use them to keep competitors out or at a significant disadvantage. Disputes on technical, financial, or timing aspects of interconnection are case in point.

Regulators are also normally in charge of verifying compliance with the legislation in force as well as with the terms and conditions of concessions or licenses. To facilitate this task, legislation imposes strict disclosure requirements on regulated enterprises and gives regulators broad investigative powers. They may also have the power to impose sanctions and penalties. Finally, regulatory bodies may be given the power to prepare and enact general norms and regulations applicable to the enterprises operating under their watch.[35]

3. 4 Approaches to Privatization

3.4.1: Introduction To The Approaches

As discussed in Chapter 1, privatization may have three tiers: enterprise-level, sector-level, and economy-level. For sector-level and the whole economy level, privatization is achieved through macro-policy such as unbundling SOEs to break monopolies on one hand and allowing more private entry through introducing competition on the other. For enterprise-level, specific approaches through market tools are applied to transfer ownership from public to private sector.

From the legal point of view, privatization of an enterprise means a transfer of the

[35] *Ibid.*

State's ownership to multiple private ownership. With dozens of techniques available, the most often used methods are: assets sales, initial public offerings (IPO), voucher sales, debt/equity swaps, etc.[36] Sometimes these different techniques are combined within a given privatization operation.[37] Combination of techniques can be achieved simultaneously or in different stages. For instance, certain amounts of shares may be transferred to a private investor first, followed by public offering after a certain period.[38]

Sometimes, a temporary transfer of control or operation right including profit-receiving right, always for a fixed term, is also called privatization. In such a case, lease, contracting, and concessions etc are the means often used. These approaches will not bring about the real transfer of ownership of the existing assets, but may lead to a flowing of part of future-generated profit to the private contractor.

In a third case, merger and joint venture are also regarded as approaches for privatization.[39] Like lease, contracting or concessions, merger and joint venture do not lead

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[36] See S. Nestor & M. Nigon, *supra* note 16 at 11. Also see M. Pirie, *Privatization* (London: Wildwood House, 1988) C2.

[37] In France, a public offering was typically combined with a separate sale of a core shareholding to a group of strategic or institutional investors. See P. Durand, "Privatization in France" in *Privatization in Asia, Europe and Latin America, supra* note 6, 95 at 97.

[38] The Bolivian capitalization law of March 1994 took an original approach in this respect: a capital increase to be subscribed by strategic investors who where selected competitively, accompanied by a transfer of the existing state shares to a new privately managed pension system. See *Privatization Challenge, supra* note 1at 125, Box 5.1.

[39] Merger means two enterprises combine together, both in terms of their management and operation and of their balance sheets. Merger may take two forms, vertical merger and horizontal merger. A vertical merger takes place when a parent company absorbs all the assets and liabilities of one of its member companies, with the existence of the old company and the dissolution of the member company. A horizontal merger means that two different enterprises combine together and become a new enterprise, with both the old companies being dissolved. In privatization, only horizontal merger can take place where a private company and an SOE may merge into a new venture. Joint venture refers to two companies jointly incorporating a new, third venture

to transfer of ownership. Yet both may give the new enterprise a private nature. For example, if within a new company, the assets of previous SOE are less than the assets of the previous private company (in merger case) or the SOE is only the minority shareholder (in joint venture case), the new venture may be regarded more as a private venture. [40] In addition, in such merger and joint venture cases, the added value or at least part of the value will be accrued to the private investor. When merger and joint venture are used in privatization, rules should be enacted to allow and facilitate the merger and acquisition between SOEs and private enterprises. In some countries, for example, in China, merger and acquisition between SOEs and private enterprises are not allowed, or at least, not encouraged. This is not because of the concern on part of the state about the possible loss of state-owned assets, but because of the concern on the private owner's part about the replacement of excessive staff.

Contracting-out:

Contracting is a kind of privatization where only operation right is transferred to a private operator (always for a fixed term) and the ownership right remains with the government. Taking various forms, for example, lease, management contracting and other specific variations, contracting has proved an ideal option to achieve the privatization of local public services[41] where the local governments still hold the responsibility for the financial condition of the contracted entities by paying the private contractor for the services from tax

in which each invests.

[40] For example, in China, SOEs only refer to those wholly owned by the State or controlled by the State. See J.Ch. Shi, "Legal Issues in Establishing Morden Enterprises System for SOEs "(2000), 1Renmin L.R.322 at 329.

[41] These public services include, among others, rubbish collecting, street cleaning, road maintenance, public transportation, and even prison management.

revenue. In this way, contracting of public services successfully avoids direct charge to consumers.

Concession contract, especially the BOT contract, is a more complex form of contract. In a BOT contract, a private contractor builds a project (always an infrastructure project)in line with a concession granted by government, operates the project for a fixed term and obtains the expected return, then returns the ownership of the project to the government. BOT has been used by many countries to privatize industrial sectors. A BOT contract offers an opportunity for the private sector to build important public infrastructure projects, formerly reserved to government.[42]

Contracting may be undertaken through a bidding process, where preliminary announcement, tender invitation, bidder assessment and selection of the final contractor are involved. The most important point, however, is to set forth specific terms to guarantee the quality of services provided, to specify the allowed fee-charging level, and to provide examination procedures if such obligations are not met.

Assets (Share) Sales

Sale of assets or shares is typically used to divest small or medium sized SOEs, particularly those with unsatisfactory financial conditions. The sale of assets can be done either on a separate parts basis or as a whole.

Firstly, selling assets is the ultimate way to achieve the liquidation and bankruptcy of a SOE. Liquidation and bankruptcy are market-exit mechanisms through which less efficient

[42] Famous examples include Datefud tunnel project in the UK, a brown-coal power plant in North Ireland, a large-sized power plant in Turkey, Sydney Harbour Tunnel Project in Australia, and so on. See IMF, *Lessons and Experiences: Foreign Direct Investment* (Washington: World Bank, 1997) at 56.

enterprises can be wound up and resources released for more productive uses. When liquidation or bankruptcy happens, the owners always dispose of the enterprise by selling its assets, paying off its debts, and sharing the proceeds among themselves *pro rata* to their respective shares. Because liquidation often facilitates speedy and efficient privatisation by avoiding the formalities and complications of bankruptcy, [43] it is the preferred privatisation technique in many countries. Bankruptcy, on the other hand, is not a recommended privatisation technique, because bankruptcy proceedings assume the existence of a smoothly functioning court system, a requirement that is lacking in many developing or transition countries where incompetent, under-equipped, or corrupt judicial institutions often hamstring this critical market-exit mechanism.

Moreover, almost all acquisitions involve this kind of technique. In privatisation cases, where one party to the contract is government or a government agent on behalf of government, the take-over of a SOE by a private company or other private buyers[44] can be realized either through stock markets or outside of the markets. But in both cases, the final transfer of ownership has to be achieved by shares/assets selling and buying. Transactions conducted outside of stock markets are termed as 'trade sales'.[45] In such a case, a SOE may

[43] Bankruptcy differs from liquidation in several ways. First, the bankruptcy procedure is managed or supervised by the courts, usually with the assistance of court-appointed trustees or receivers. Second, bankruptcy usually implies that the company is insolvent.

[44] In some instances, the concern or a part of a larger concern may be sold to the management and/or employees of the undertaking in question.

[45] When conducting a trade sale, governments always provide a detailed and informative memorandum to trigger the interest of the perspective buyers. A typical memorandum will provide all the basic background information of the target enterprise: the company's history, a description of its corporate structure, an analysis of its current business and future prospects , R&D program, information of suppliers, competitive status, relationship with the sponsoring ministry, staff and management, industrial relations, pension plans,

be sold as a whole including the assets and liability to a certain private investor through a common sale contract. If the buyers are selected , usually after party to party negotiations, directly from listed candidates, the sale may be called 'direct sale', which is always used when the enterprises in question are relatively small, other privatization methods are expensive, or if only a few prospective buyers are expected to come forward. In these cases, the most effective way to privatise the firm is to contact directly those buyers with the necessary experience in the field, and enter into negotiation with them. If the final buyer is decided through a bidding process, it is called an 'auctions' which is used for larger firms, in countries whose capital market is not developed, or if the government wants to maximise its fiscal revenue.

Depending on the final buyer, asset sales may have several variations. The perspective buyer may be a strategic investor, a creditor, and, sometimes, the employees and management of the enterprise. The latter case is always called 'management and/or employee buyout'.

Initial Public Offering (Flotation)

Although contracting and asset sale are important privatization approaches, they cannot bring a large-scale privatization within a short time due to their limited capacity. This is because usually there are few private contractors or buyers with enough assets or cash to take over or merge the large sized SOEs.

The most visible aspect of the privatization programme is the public offering on the stock market of nationalized industries and other state-owned enterprises. Involving shares

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insurance arrangements, financial statements, future financial restructuring plan and other information. See *Privatizing the World, supra* note 25 at 87.

issuing and always accompanied by intense media advertising campaigns, public offering results both in a substantial reduction in the State's involvement in industry and a massive increase in the number of individual shareholders who always act as important political supporters for the program. Moreover, public offering means more opportunities to be taken over by private investors though securities markets.

In most cases, public offering is accompanied or immediately preceded by the creation of a special share (the so-called 'golden share'), held by or on behalf of the government and in effect giving the government certain overriding powers relating variously to ownership, to control, to nationality of certain directors or executives, or to disposal of assets.[46]

However, although convenient in the case of large firms in such sectors as infrastructure, public offering requires either well-developed local capital markets and securities exchange mechanisms, or else foreign offerings, conditions many developing countries lack.

Voucher Sales and Privatization Funds

New privatization methods have been devised in recent years to solve specific problems. Voucher sale is an example. The voucher sale approach allocates a certain number of vouchers to each citizen which can then be sold to designated privatization funds in exchange for shares.

This approach has been used in mass privatization programs, for example, in the Czech Republic and other former socialist countries, to create a market economy almost from scratch and to privatise an entire economy. Vouchers sales may supplement the traditional

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[46] For details of 'Golden Shares' see *infra* section 3.4.3 below.

privatisation techniques and facilitate large-scale and speedy transfer of productive assets from the public to the entire population. This practice is inspired by numerous facts: most business belonged to the public sector, few domestic investors have liquid assets, and the government is unwilling to transfer the bulk of its country's productive industry to foreigners.[47]

Privatization funds play an important role in distributing these vouchers. Each voucher stands for a certain amount of shares, which are distributed to the population through an allocation scheme. This scheme may apply to all privatizable SOEs in some cases or only to some of them in others. The vouchers may be nontransferable certificates, freely tradable certificates which can be sold for cash, or registered certificates often with restrictions on resale, depending on specific situations. The scheme has taken different forms in various countries. In Poland and Romania, a portfolio of shares in enterprises to be privatized were first transferred to one or more privatization funds sponsored and set up by the government, then the citizen exchange coupons (sometimes called vouchers or checks) were distributed by the government for shares in the funds of the citizen's choice; in Russia and Czech Republic, the privatization fund, usually in the form of a company, was set up by private parties such as banks, insurance companies, or private individuals, which competed to obtain the coupons distributed to citizens and to use them to acquire enterprise shares at auction sales organized by the government. In many countries, including Russia, citizens can opt to use their vouchers to acquire fund shares or to acquire enterprise shares directly. In Kazakstan, only the funds are allowed to participate in SOE share auctions, and citizens therefore have to choose a fund to

[47] G. Pohl. R.E.Anderson. *Privatization and Restructuring in Central and Eastern Europe* (Washington: World Bank.1997) at 11.

which to present their vouchers.[48]

A key institutional mechanism established to act as intermediary between the public and enterprises being privatized, the privatization fund has played a very important role in mass privatization. First, these funds played a vital role in promoting wide dissemination of shares among the population. They also allowed citizens to monitor the performance of individual companies and to diversify their portfolios indirectly and thereby to lower their risks. Second, privatization funds fostered the development of financial markets. They not only contributed to the creation of financial intermediaries and institutional investors, but also promoted popular participation in capital markets where shareholders in the funds sell or exchange their shares. Third, the existence of privatization funds improved corporate governance by allowing some concentration of voting power in privatized enterprises. Without such funds, shares would be dispersed among a multitude of small individual shareholders, who lack the cohesion to exercise their ownership rights effectively. For example, a fund can ensure that a core of professional investors is represented on the management body of the enterprise, thus minimizing the adverse effects of atomized shareholding.[49]

To guarantee efficient and proper functioning of the funds, a satisfactory regulatory framework is necessary in the case of funds set up by government; and where funds are set up at private initiative, the funds have to be governed by ordinary securities legislation. In both cases, the regulation/legislation of privatization funds must encompass a wide range of issues such as licensing, minimum capital requirements, prudential investment limits, fee structure of

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[48] *Ibid.*

[49] See M.Boycko & A. Shleifer. *Privatizing Russia* (Cambridge: MIT Press. 1995) at 81 - 92.

management firms, corporate governance, information and disclosure requirements, and so on.[50]

3.4.2: Application of the Approaches:

There is no uniform model of privatization for all countries. In any given country, the choice depends on many factors including the country's legal framework and market structure, the program's objective, and other sector-specific characteristics.

For example, in a country whose accounting rules and practice do not conform to international standards, buyers will be less willing to take over the liabilities of an SOE, and the government may have no choice but to privatize the SOE by selling off its assets and liquidating the remaining shell. Similarly, the absence of organized capital markets or weak financial institutions may make it more difficult to privatize by way of a public flotation or even to rely on domestic savings. In countries with nonconvertible currencies, an SOE with foreign exchange earnings will be easier to sell than one with only local currency revenue.

Privatisation methods and techniques must also be well suited to the pursuit of the program's objectives. For example, where efficiency and maximisation of privatisation

[50] It is important, for example, to encourage fund shareholders to exercise their ownership rights and monitor the performance of the fund's management. Funds managers should report regularly to the shareholders on their activities and performance. In many cases, other rules are prescribed to protect the interests of the shareholders, such as the requirement that the funds diversify their investments to limit their portfolio risk; limits may also be imposed on fund managers' fees, and their remuneration may be tied directly to the results achieved. In Russia, privatization funds were not allowed to invest more than 5 percent of their resources in securities issued by any given enterprise; and the total annual remuneration of privatization fund managers may not exceed 10 percent of the aggregate value of the securities held by the fund. In addition, in order to eliminate the risk of conflicts of interests, the law may prohibit fund managers from holding other functions. For example, Romania's August 1991 Privatization law provides that an individual may not be a member of the board of directors for more than one privatization fund, nor simultaneously a member of the boards of a fund and an enterprise whose securities are held by that fund. Also, some countries have introduced provisions limiting the portion of the capital of an enterprise that can be held by any one fund. The Czech law of April 1992 on investment funds sets this limit at 20 percent. In Russia, the limit was first 10 percent and later raised to 25 percent. See *Privatization Challenge*, *supra* note 1 at 181.

revenue are sought, a call for bids is generally preferable to direct negotiations with a single investor. As for privatisation techniques, free vouchers or discounted employee shares may not be appropriate instruments if the major objective is to maximize revenue, but they may well serve the political objectives of the program. Similarly, a public flotation may be the right technique to promote widespread share ownership and stimulate financial markets, but that course involves the risk of diluting share ownership and thus control of the enterprise, and it will not necessarily generate optimal technology transfers. Mass transfers of shares to all citizens may achieve the objectives of widespread share ownership and where appropriate, speed, but not promote those of efficiency, revenue maximisation, foreign investment promotion, or technology transfer.[51]

Furthermore, characteristics specific to an enterprise can also dictate, up to a point, the measures that need to be taken to prepare for and implement privatisation of an SOE. These characteristics include the nature of government ownership, the financial situation of the enterprise, its legal status and size, and any applicable environmental or labour obligations and constraints. For example, in Africa, where most SOEs were in a state of virtual bankruptcy and lacked financial statements worthy of the name, privatisation has often had to be effected through liquidation, thereby allowing buyers to acquire SOE assets without incurring the risks of large, uncertain, or contingent liabilities. Take the size of the enterprise as another example. Issues arising in the privatization of a small restaurant or grocery store are far different from those that arise when a national telephone company or a major cement works undergoes privatisation. In such cases, many transition countries have adopted a two-stage method of

[51] See *Privatization Challenge*, *supra* note 1 at 29.

privatisation, focussing first on small privatization before moving on to larger operations.[52]

Finally, these different techniques may be combined within a given privatization operation. Combination of techniques can be achieved simultaneously or in different stages. For example, certain amounts of shares may be transferred to a private investor first, followed by public offering after a certain period.[53] Through phased privatization, the government gets a share of the usually higher stock price after privatization, distributes ownership of the divested SOE, and contributes to the development of the local stock market. This two-stage approach also has many advantages for investors: it allows the selected investors to restructure the company and enhance its profitability by giving them corporate control; it limits the amount of funds investors need to raise up front; and it allows local investors to become shareholders of the privatized companies.

3. 5 Protection of Special Interests

Privatization has been controversial and widely criticized since its beginning. These criticisms include: the State-owned assets have been sold at a low price; the privatization process is corrupt; foreign involvement will endanger the state's sovereignty; the strategic sectors will lose control and the long-term national investment will eschewed; privatization will

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[52] Czechoslovakia, Ukraine, and other countries have even enacted separate laws providing for different privatisation techniques for each group. *Ibid.* at 123 - 124.

[53] The Bolivian capitalization law of March 1994 took an original approach in this respect: a capital increase to be subscribed by strategic investors who where selected competitively, accompanied by a transfer of the existing state shares to a new privately managed pension system. As a result, in Bolivia, strategic investors are selected competitively to subscribe to a capital increase, and existing shares are transferred from the government to a trust fund that holds shares while the new mechanism for managing the citizens' pension funds is set up. New Zealand used a hybrid formula: following an international call for bids, all shares of Telecom New Zealand were sold in September 1990 to a U.S consortium, with the stipulation that the consortium reduce its shareholding to a maximum of 49.9 percent within three or four years, partly by means of a public offering on the New Zealand market. *Ibid.* at 124 - 125.

lower service quality and security standard; and privatization will reduce employment and provide less pension and other welfare; and so on.[54] To defend against these accusations, appropriate legal arrangements, for example, an effective regulatory system, must be put in place (details have been discussed previously). Certain other legal designs are also appropriate. Golden shares and employee shares-purchasing are examples. Golden shares are used to maintain the State's control in the privatized companies while employee shares-purchasing schemes aim to create a special interest group providing political support to privatization.

Golden Shares

Golden shares (one Pound special shares, in the U.K, and Kiwi shares in New Zealand) are special shares created by law or by the company's articles of agreement for the specific purpose of according their holder(the state or government) special rights that go well beyond those which attach to ordinary shares. This technique has been used by many countries as a way to keep some degree of government control over a privatized company by vetoing some corporate decisions, even though the state is now only a minority shareholder (sometimes with a single share).[55]

Generally speaking, a golden share gives the government the right to intervene to block changes in corporate control, hostile takeover, or foreign participation.[56] It is also used to

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[54] *Privatizing the World. supra* note 25 at 52 - 62.

[55] *Ibid.* at 63 - 68.

[56] For example. in the UK. the one Pound special share was used to ensure that the government would have the right to nominate one director to the company to maintain its control or at least some level of influence over the company. And the articles of Telecom Malaysia provide for a golden share entitling the government

prevent any person from owning or contributing more than a certain percentage of the issued ordinary shares in the company.[57] The rights conferred by golden shares are not, however, necessarily limited to the above mentioned; they can also be extended to other decisions of the company, say, to prevent the position of the chairman of BOD being occupied by a foreigner, to prevent the sale of strategic assets, and to protect the state's interest as creditor of privatized enterprises that have repayment or guarantee obligations to the state, and so on.[58]

It deserves mention that such kind of blocks are achieved not through the "special share " itself, but rather through the articles of association of the privatized companies. For example, a legal provision in the articles of association of the UK Telecom states that anybody who wants to hold 5% or above must notify the company and if a party wants to hold 15% or above, it must be advised to reduce the holding on pain of forfeiting the corresponding voting right.[59] Different wording may be found in different cases, but the general pattern is consistent: the block is placed in the rules governing the companies activities, not in the special right itself. The real objective of the special right is not to block excessive holdings, but to enable the governments to prevent any inappropriate changes in the rules governing the company after privatization. This is achieved by giving the special shareholder a crucial right - namely, a veto over any changes in the blocking Article and in the Article that establishes the

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to oppose any decision that substantially affects the composition of the company's shareholding. See *Privatization Challenge*, *supra* note 1 at 129, n.28&29.

[57] In Italy, a decree-law introduced a provision into the statues of public services companies granting the government a special share entitling it to oppose the acquisition or buildup by any person of shares exceeding 10 percent of the corporate capital of the company. See *Privatizing the World*, *supra* note 25 at 64.

[58] *Ibid.* at 65.

[59] *Ibid.*

special right itself.[60]

The rights attached to golden shares must be described in the prospectus of sale for the SOE They may have no expiration date, a character often motivated by concerns like national security, which explains their use in the case of some telecommunication companies and power generating and transmission companies.[61] In other cases, the rights may lapse at a predetermined date. The fixed-term golden shares were intended primarily to allow time (about five years) for the management of the privatized companies to restructure the company without having to worry about possible takeover.

Simplicity and flexibility are the two advantages of the special share arrangement. Instead of creating a set of elaborate mechanisms, within the rules of the company, to prevent those changes from being changed after privatization, the special right arrangement provides a special class of shareholders who are vigilant and have the power to veto such maneuvers. Moreover, the existence of the special shareholder makes it unnecessary to design a series of complicated and interlocking provisions which usually will lead to interference in the normal business operation of the privatized company.[62] Therefore special shares arrangements have been recognized as one of the best legal designs to solve political obstacles by means of

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[60] *Ibid.*

[61] For example, in the UK, this indefinite golden share has been applied in the cases of Cable & Wireless, British Telecom, British Gas, British Airways, and BBA. See *Privatization Challenge, supra* note 1 at 130.

[62] In Jamaica, to relieve the investors' misunderstanding that government would continue to control the privatized company, the government incorporated a set of very complicate restrictive terms rather than the special right arrangement in the articles of association, which proved to be unwise and unnecessary. *Ibid.* at 132.

financial instruments.[63]

However, where golden shares are needed, they should be defined in the narrowest sense possible by limiting the scope of extraordinary rights they confer on the government to what is strictly necessary, and by restricting the duration of those rights. Golden shares - especially where they are held by governments without solid, credible track records - will likely restrict privatization and reduce privatization benefits, whether in the form of lower proceeds or less-efficient service providers.

Employee/Management Buy-outs and Preferential Schemes

Privatization laws often allow or require the sale of shares in privatized companies to specific groups, particularly the employees of the companies to be privatized. Many laws grant preferential terms to the employees of privatized SOEs. The reasons vary, but generally include the objective of winning the targeted groups [64] over to the privatization cause. To facilitate employee share purchasing, employee-holding groups are always established to raise the needed funds by self-raising or through debt-financing from commercial banks.[65]

These preferential schemes encompass some free shares, as well as discounts on the share price and deferred-payment. The proportion of sales to employees varies from 100% to

[63] An opposing view should be noted, namely, that golden shares "can diminish incentives for management performance and adversely affect the operating results of the privatized company by interfering with the normal functioning of the market and blocking certain types of takeovers and therefore golden shares are by no means an essential feature of privatization laws." *Ibid.*

[64] There are two major interests group involved in the privatization. One is the vast employees, and another is small or individual investors in securities market boomed by floatation of privatized companies. Both groups played a very important role in the success of privatization process launched by Thatcher government in the UK. See *Privatizing the World, supra* note 25 at 52 - 62, 90 - 96.

[65] *Ibid.* at 91.

1%, depending the size of the target enterprise and the purchasing ability of employees. Some privatization laws encourage employee shareholding by authorizing interest-free loans or deferred-payment plans for the purchase of shares; some even allow shares to be paid for out of future dividends. Moreover, some countries have promoted the outright takeover of enterprises by their employees.[66]

Preferential share schemes for employees may be well suited for large enterprises organized as joint-stock companies, but they are less so for small firms. Employee buyouts, on the other hand, may be put together for small firms more easily than for large ones.

Preferential schemes have been offered not only to employees, but also, for example, to citizens as part of mass privatization program: to lessees, as in Czechoslovakia; or to tenants, as in Hungary. A great many countries have granted such advantages to shareholders as well, including France, Indonesia, Italy, Spain, and the United Kingdom.[67]

However, the privatization legislation should set the minimum requirements applicable to these benefits or schemes, because they involve not only a loss of revenue for the public treasury but also a transfer of resources from the state to specific groups. Although they can help to win the needed support from the relevant targeted groups and can be found in many privatization laws, preferential schemes and their related provisions are not essential features of privatization legislation.[68]

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[66] In the United Kingdom. National Freight was sold to its employees in 1982. In Mexico, the trade unions were given a preemptive right in privatizations that allowed them to buy a company by matching the highest bid obtained in competitive bidding.. See R. Fraser & M.Wilson, *Privatization : The UK Experience and the International Trends* (Essex: Longman, 1988) at 68 & 162. Also see *Privatizing the World, Ibid.* at 91 - 94.

[67] *Privatization Challenge*, *supra* note 1 at 135.

[68] *Ibid.* at 136 - 137.

Conclusion:

When a country wants to launch a privatization program, a privatization law is necessary to generate political support and to provide organization and process, both of which will facilitate the realization of the objectives.

A privatization law usually includes in its provisions the mandate to start the program, the delegation to certain institutional set-ups, the techniques that may be used, the mechanisms to guarantee a fair, transparent and efficient process, and so on. A privatization law may have two forms: general legislation and specific legislation. Whatever the form it takes, privatization law must be both clear and flexible.

To start the process, an implementation agency needs to be introduced. Such an agency, in most cases called the privatization commission, always has two levels: a power delegating body and an executive body. There are several models of such an agency: creating a new body, or placing existing ministries in charge of the programs in their respective sector, or setting up a composite body consisting of representatives from the sectors concerned. Again, whatever model is adopted, the body must be independent and autonomous. Moreover, its mandate must be clear and mechanisms must be in place to control the process and guarantee fairness and transparency.

A sound regulatory framework is particularly important post-privatization. This framework requires both an independent and autonomous regulator and new laws and rules. A regulator is responsible to promote competition and rule out monopoly by issuing or suspending licenses, adjudicating disputes and overseeing the sector in general. New rules always contemplate price control and the imposition of non-commercial obligations.

The privatization law may also recommend the approaches to be used in the program. Certain approaches are suitable to privatizing a single enterprise. These include: assets sales, initial public offerings, vouchers, and so on. Others, for example, unbundling and deregulation to promote private entry, are suitable strategies to privatize or liberalize a whole sector or an entire economy. Mass privatization, as a special approach to realize speedy and large-scale privatization from a planned economy, has proved effective in several former communist countries. Privatization funds play a very important role in mass privatization by accepting the free vouches distributed freely to citizens by government. Despite the variety of approaches, there is no blueprint applicable for all privatization programs. For example, if a country lacks a well-developed securities market, it will be impossible to use initial public offerings. Therefore, the approaches adopted must conform to the specific circumstances at play.

Privatization as a movement has been subject to all kinds of criticisms. As well as a sound regulatory framework, several other legal designs have been incorporated in the privatization laws to defend against these eventualities. Golden Share and Employee Buyouts are the most spectacular ones. Golden Share is used to maintain some degree of government control as a minority shareholder over the privatized company by vetoing some corporate decisions. Employee buyout is used to seek for employee support by providing them with preferential schemes. Thess two important designs have successfully made the privatization law a law 'enabling' the implementation of privatization.

All in all, as distinct from the facilitating laws that mainly seek to create a favourable outside environment, enabling law strives to provide mandate and to overcome specific obstacles to launching the privatization program. In most cases, it has realized that objective.

Chapter Four: Privatizing China - Choosing the Right Way

4.1. Initial Efforts: Privatization in China

Though international experience provides a very useful starting point for planning privatisation in China, China's specific national conditions must be taken into account. Different from the U.K, Australia, Canada and other western countries, China so far has not established a mature market economy, and its political system is still autocratic. China is also different from the former USSR, Poland and other eastern European countries, which underwent a radical transition . There a shock remedy was applied, with the intention of fundamentally abolishing socialism and establishing a totally new system. As a result, the centralized planned economy based on the State's control of ownership was replaced by capitalist market economy. Privatization was just one of the prongs in this remedy.

But the experiences in the former USSR and Eastern Europe have demonstrated that the radical privatization and shock remedy can result in an economic vacuum signalled by neither plan nor market, and productive of an economic recession.[1] In contrast, the reform undertaken by China since 1978 has been a progressive, step-by-step, process of introducing limited market factors into a socialist system. This kind of reform attempts to improve the old system while precluding its replacement by a new one. The history of privatization in China illustrates this well.

In the late 1970s and the early 80s, China undertook to reform its rural land holding

[1] In 1998, 10 years after the transition, the congregate GDP of 27 eastern European countries and the Commonwealth of Independent States was less then 3/4 of that of 1989, the year when the transition began. See G.W. Keluodek, *From the Shock to Remedy*, trans. X.Y.Liu&Ch.Z.Ying (Shanghai: Far East Press, 2000) at 5.

system, under a program called "Land Contracting System", which sought to transfer the right of use of rural land, free of charge, to peasants. At about the same time, Special Economic Zone and Costal Open Cities were introduced to attract foreign investment. From the mid 1980s, policies were adopted to develop county-owned enterprises, which in essence are partnership businesses in most cases. In 1988, the Constitutional Law (1982) was amended to "allow the existence and development of private economy within the limits permitted by law".[2] But the private economy was still regarded as a "complement" to the public economy and subject to "direction, supervision and management by the State."[3] In 1993, a second amendment was made, incorporating the new concept of "state-owned economy" to replace "state-run economy" and specifying that China will develop a "Socialist market economy".[4] In 1999, a third amendment strengthened the role of the private economy by declaring it to be "an important element of socialist economy".[5] According to "state-owned economy", the operation right of SOEs can be transferred in various ways, provided that the ownership is still in the control of the State. From the early 1990s, China began a series of measures to reform the SOEs, including contracting, leasing, corporatization, and so on. In some instances, small SOEs were sold to private investors. In 1991, employee stock ownership plans (ESOPs) were introduced which allowed SOEs to sell a certain portion of shares to their employees.

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[2] Amendments to China Constitutional Law. 1988. Article 1.

[3] *Ibid.*

[4] Amendments to China Constitutional Law. 1993. Article7& 8.

[5] Amendments to China Constitutional Law.1999. Article 16.

Another effort at privatization, a securities market was established in 1990, and a Securities Law was enacted in1999. As at April 2001, about 1210 companies were listed, the majority of them SOEs.[6] During the past 10 years, the market has raised about 400 billion China Dollars.[7] However, state shares in SOEs were not tradable on the market until June 13, 2001, when the State Council promulgated "the rules on reducing State's share to raise money for the National Social Insurance".[8] Almost at the same time, another program auxiliary to privatisation, the reform of the house allocation system, was launched. Under this program, all SOEs and governments at all levels must sell houses to their employees at a discounted price.

Only in the late 1990s, did the Chinese government begin to take measures to break up the monopoly of dominant SOEs in strategic areas such as the telecommunications sector and the electric power sector. But the breaking-up of these sorts of monopoly has not been characterized by the entry of private capital, but instead by a limited competition among the increased players who are still SOEs.

As mentioned above, compared to western privatization, China's reform is slow, progressive and limited, and characterized by continuing State's control of ownership. Experience has shown, however, that without a breakthrough in ownership reform, real privatization cannot be launched. A radical ownership reform is not a difficult task from a

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[6], "Professor Xiao: The State Shares Can Be Sold at Original Price" *China Youth Daily* (11 May. 2002). online: Sina.com.cn <http:// finance.sina.com.cn/y/59441.html> (date accessed: 13. May. 2001).

[7] "The New Features of China's Securities Sector". Xihua Net (14 April. 2001). online: sina.com.cn <http://finance.sina.com.cn/o/52533.html> (date accessed: 14 April. 2001).

[8] P.Li. "Can "Reducing State's Shares" Softland Successfully? "*China News Net* (15. June. 2001). online: sina.com.cn <http://finance.sina.com.cn/t/71935.html> (date accessed: 17 June. 2001).

legal perspective; the real resistance arises from political preservation and redundancy.

In recent years, the development of the private economy in China is due to another form of privatization, namely, illegal 'privatization'. Individuals, most of them government officers or former officers, have used every possible means, including graft and power-money swap, to transfer State assets into their own hands. Although some commentators claim that this phenomenon "has helped the emergence and development of private economy',[9] these 'illegal' transactions have given rise to a number of serious problems, including a heavy lose of State assets, unemployment through the bankruptcy of SOEs, and a deepening gap between rich and poor. In consequence, many people have concluded that in China, power is superior to law, an idea which has compromised the law's authority and shaken the foundation of the existing regime.

But it cannot be denied that China's progressive style of privatization has its advantages. During a certain period, it maintained political stability and avoided social and economic chaos. It also helped accumulate some experiences in market economy and thus established a foundation for further retreat of SOEs in the future.

There are all sorts of indications that, in China, large-scale privatization will not appear in the near future. China may still have to wait several more years. By then, China will have been a member of the WTO for a certain period and China's economy will have become more integrated into the world's economy. The law system will have been strengthened, and the government will be by then more skilful in using market tools to manage the economy.

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[9] H.L. Zhen&L.M. Wang, *Arguments on China's Economy*, vol.5 (Beijing: Economic Management Press, 2000) at 87.

4. 2 Further Objective: - A More Privatized Economy

4.2.1. Choosing the Right Way

Privatization in essence represents two aspects of one process: the retreat of national ownership and the promotion of a private sector. As SOEs' retreat, more fields will be opened to the private sector. According China State's Statistics Bureau,[10] SOEs should retreat from most of industries except radar, raw oil production, gas supply and boat manufacturing. To retreat national ownership, legislation must be put in place to encourage speedy divestiture of SOEs through liquidation and bankruptcy, to allow for direct sale of assets to private buyers, and to facilitate public offerings for an indirect dilution of state ownership. The divestiture and dilution of public ownership is more transactional in nature, and the common approaches have been discussed previously. However, the significance of privatisation cannot be limited only to the transfer of assets from a public sector owner to a new private one. These privatisation programs should be integrated into a much more comprehensive economic reform package for a more liberalized economy which requires encouragement of private entry to all sectors, even those 'strategic ones', by breaking monopoly and introducing competition among private and public sectors.

Such a privatization process is also called 'deregulation', which enables the private sector to participate in sectors to which previously only the public sector had excess.[11]

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[10] L.B.Chen, "State Share's Retreat", online: http://content.sina.com/news/69/54/695477_1_b5gif.html (date accessed: 25 July, 2001).

[11] In 1983, a set of energy laws was enacted in the UK to allow the private-run power plants to compete against the State-owned Central Generation Bureau in the field of power supplying (generation and transmission). In 1985, Japan abolished the monopoly position of Japan Telephone and Telegram by opening to the private sector two business fields: 'line lease' and 'value-added' information services. Also in 1985, Canada declared a policy to deregulate the control of civil-air transportation and open all domestic air services

Deregulation not only requires the abolition of old laws prohibiting the private sector from competing against the state monopoly, but also calls for new laws to improve the competitive environment.[12]

Indeed, compared to privatization of individual enterprises, sector-level or economy level privatization will be much more important for China. Although different privatization programs may have different objectives, [13] in China's case, budgetary matters and short-term revenue maximization should by no means be the major objective. However, raising enterprise then economy-wide efficiency should rank high among the objectives of privatisation. Therefore, the ultimate objective of privatization should be to take this opportunity to establish a developed market economy by privatizing the whole economy. From this point of view, China should take more measures to break the monopoly status enjoyed by SOEs, and further open its market to the private sector. In this way, a dilution effect will be achieved, and the private sector will account for more of the national economy and the rate of the State's participation will decline accordingly.

For China, breaking-up the SOE monopoly may be the first step to implementing economy-level privatization. With the monopoly, private investors do not have fair access to

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to those private companies " qualified, capable and interested". See D.J.Gayle & J.N.Goodrich, *Privatization and Dereguation in Global Perspective* (New York: Quorum Books 1990) at 121- 131.

[12] See O. Letwin, *Privatizing the World: A Study of International Privatization in Theory and Practice* (London: Cassell, 1988) at 82.

[13] Usually, privatization objectives include improving budgetary and financial ability, increasing the efficiency of the enterprise, improving the operation of the whole economy and sometimes, serving political considerations such as changing the income distribution and redistribution and changing the role of the State. See P. Guislain, *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience* (Washington: World Bank, 1997) at 18, Box 1.2. [hereinafter *Privatization Challenge*].

the sectors already dominated by SOEs and fair competition is in consequence just a legal fiction. Therefore, unbundling of the dominant SOEs in some sectors must be introduced at an early date, and market entry, particularly in some 'strategic' sectors, should be widened and offered to private investors with licenses or concession awarding as the specific methods.

Another measure which may promote the economy privatization is the establishment of a securities market. A securities market would permit SOEs to float and to sell state shares to private investors. A securities market will also assist the private sector to raise the fund it needs for its further development.

4.2.2. Creating A Competitive Environment

A free competition environment is the prerequisite for privatization. A more liberalized economy always means privatization at sectoral or the whole economy level. Creating such a legal environment is the most important task facing China's privatization process both presently and in the near future. Competition will give rise to lower prices, higher quality, and more provision of services; monopoly will only lead to the opposite.[14] Hence, to open more sectors for private entry, legal monopolies and other barriers to entry will need to be removed, the creation and enforcement of a level playing field in the marketplace must be guaranteed, and constitutional provisions be amended or abolished. Activities or services that were provided by an integrated, monolithic enterprise have to be unbundled and competition introduced in those segments that can sustain it.

For freer private entry, the first priority is that the discrimination between the private

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[14] See M.E.Beesley. *Privatization, Regulation and Deregulation*. 2d edition. (London: Routledge. 1997) at 28.

and public sectors be abolished in order to allow the private sector to compete with the public sector on an equal footing.[15] Unfortunately, discrimination against the private sector is still very popular in China presently. Removal of such discrimination should be made not only from all existing laws and rules, but also from state practice. In other words, equal treatment in all respects should be granted to both private sectors and public sectors by law. Equality implies, on the one hand, the end to all the preferential policies enjoyed only by SOEs. For example, SOEs always receive visible or invisible subsidies from government; and financial support from the banks is always available for the SOEs, even when they are money-losers and at the risk that the banks themselves will fall into financial trouble. In other matters, such as taxation, environmental protection requirements, and labour resources, the SOEs all enjoy preferential policies intended to maintain their dominant position in the economy. Establishment and maintenance of a level playing field must be protected by law. In some countries, Brazil, for example, this type of guarantee is even found in the constitution.[16]

On the other hand, equality also requires the elimination of the obligations imposed by the law only on the SOEs but not on their private competitors. In China, SOEs have traditionally performed social or non-commercial functions without adequate government compensation, such as supplying goods and services to specific regions or categories of customers at a loss; or providing all kinds of social services to employees and their families

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[15] "Competition is the most important mechanisms for maximizing consumer benefits, and for limiting monopoly power. Its essence is rivalry and freedom to enter a market". *Ibid.* at 29.

[16] Article 173 of the 1988 constitution provides that public corporations, joint-venture companies, and other public entities that engage in economic activity are subject to the same legal system as private companies, including labour and tax rules. In addition, public corporations and joint-venture companies shall not enjoy any tax privileges that are not extended to the private sector. See *Privatization Challenge*, *supra* note 13, at 53 n.14.

and sometimes even to an entire village. For instance, in some cases, a large scale enterprise may operate as a community, running hospitals, kindergartens and high schools, and even police stations in the extreme case.[17] These facilities or services increase management costs and consume a great deal of resources which might otherwise have been used in major business. All these should be contracted out or transferred to the national social insurance schemes.

However, equal treatment does not mean or require providing private investment any additional 'special consideration'. To promote the development of private business, some legal scholars have proposed enacting a "law to promote small and medium-sized enterprises"[18], but such a law will be unnecessary if all privileges enjoyed by the SOEs are removed and private business is given equal treatment in all aspects of business activity. Nor does the removal of discrimination against the private sector mean that the SOEs' function must be weakened in a speedy way. Both public enterprises and private enterprises should compete on an equal footing, with the market as the only judge of who wins and who is eligible to remain. The law should provide an exit mechanisms for those that are defeated, whether it is a public entity or a private entity. In a word, all the enterprises, regardless of their ownership, should be offered the same "national treatment" in all respects.

Moreover, equality entails opportunities for cooperation between the private and public sectors. For example, joint ventures between the two kinds of enterprises can be an

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[17] An enterprise in remote Yimin, Northern China, that engages in coal mining and power producing, has a police station in its organization.

[18] See Zh.K. Duan, *The Impact of the WTO on China's Lawyer's Sector* (Beijing: CPC School Press, 2000) at 40.

important vehicle to achieve economy-level privatization. Laws should promote the development of business jointly run by the SOEs and foreigner investors; and laws should be enacted to allow for the establishment of a new company between the SOEs and domestic private investors. China now has laws to promote the development of joint ventures between China and foreign investors, but no such laws or rules exist to facilitate the establishment of a joint venture between an SOE and a domestic private investor.

4.2.3. Retreating SOEs and Ending Monopoly

SOE retreat should be made in phases and some prerequisites must be met first. For example, before a national social insurance net is institutionalized, mass privatization must not start. Retreat must be made earlier in some sectors and a little later in others. A timetable must be set to ensure a safe and smooth process. Before larger scale retreat, breakup of monopoly may be the preliminary step.

In theory, there are two kinds of monopoly: natural monopoly (or industrial monopoly) and artificial monopoly (or regulated monopoly). Natural monopoly is formed when a producer or seller or service provider has an advantage in the field in terms of technology, production cost, and product price. As a consequence, others are prevented from entering the field to compete against it. If there is more than one winner, certain agreements are always reached among them to partition the market and to maintain the monopoly. Artificial monopoly is formed when government allows only licence-holders to enter a sector. In most cases, these monopoly parties are service or product providers as well as policy makers at the same time. As a rule, no fairness and transparency can be guaranteed where the player is the rule-setter at the same time.

To deter attempts at monopoly, many countries have enacted antitrust laws[19] to prohibit the establishment of cartels, trusts, monopolies, and other restrictive business practices. Some privatisation agreements include specific competition provisions that prohibit or restrict the company's potential for horizontal or vertical integration through takeovers. The introduction of such legislation might block certain privatisation transactions that would have otherwise proceeded,[20] but the privatisation process should not normally lead to the simple conversion of public monopolies into private ones,[21], or to the formation of monopolistic or oligopolistic situations where one or a few companies control the relevant market without any countervailing checks.

So far, China has not enacted antitrust laws. Artificial monopoly by SOEs is very popular in China. For example, sectors such as telecommunication, electricity, post, oil, gas, banking and financing are all monopolized by public owners. In 1998, China underwent an institutional reform. A number of its governmental miniseries or bureaus were transformed into national companies and administrative powers were transferred to the State's Economic and Trade Commission, a giant ministry called "Mini State's Council". These transformed national companies are all monopolized ones, for example, the State's Electricity Power

[19] Enforcement of the antitrust legislation is often entrusted to a specialized competition commission or office, such as the German federal cartel office or the U.K's Office of Fair Trading and Mergers and Monopolies Commission. Sector-specific competition rules, on the other hand, are often subject to special regulatory bodies. See Beesley, *supra* note 14 at 31, 58-83.

[20] For example, the acquisition of an SOE or other state-owned asset by one of its competitors could result in excessive concentration.

[21] Actually, private monopoly may be worse for the reason that the private monopoly will stop some unprofitable services which may provide social welfare. See Beesley, *supra* note 14 at 48 - 51.

Corporation, the China Petroleum Oil Company, etc. All these companies dominate the production and sales of the market in their respective fields, and entry from the private sector is very limited.

In recent years, efforts have been made to introduce competition into these traditional monopolized sectors. Power sector is one example. China's power sector is a traditional monopolized sector built and owned by the state, mainly by the central government. All the power plants were built and funded by the Ministry of Electricity Power, which has sub-level organizations at all levels. The Ministry was responsible for building and operating the power plants, the transmission lines and dispatch network; it was also a policy maker responsible for administrating the sector by enacting regulations and rules. In 1989, an independent power producer (IPP), China Huaneng Group (HN), was created as a competitor to those power plants owned by the former Ministry of Electric Power. But HN is still a state-owned company which owes its capital mainly to a State's special fund. The only difference is that some funds are raised through multiple channels, for example, from the local governments. Capital from real private sectors is very rare. The creation of IPPs, although bringing with them limited competition into the sector, did not therefore change the situation in a fundamental way. Almost all the IPPs are State-owned or controlled by the State, with all the senior staffs being former officials of the government and appointed by the State. Meanwhile, there exist many legal obstacles to private entry into the sector. Despite the fact that China has stated its intention to introduce BOT methods to build power plants[22], all the BOT projects are still in the trial phase and no uniform rules have been enacted to

[22] Gangdong Shajiao B is the first BOT power plant in China

regulate them.

Similarly, in the telecommunication sector, the reform has not involved any significant participation by real private ownership. For example, China Unicom was created several years ago to be a competitor against China Telicom, but as an SOE, its equity was allocated by government, and the top managers of China Unicom are appointed by government. The same is true of the banking institutions. At present, the four State commercial banks[23] still dominate the market. There is no real competition among the four banks: the interest rate at all banks is the same, and is prescribed and adjusted by the central bank, China People's Bank. Other sectors, including railway transportation, civil air flight, and post service, are all monopolized by SOEs.

The outcome of monopolization in these sectors is also evident: prices remain very high, service quality is low, and operators always violate the interests of consumers by imposing unequal contracts or charging unreasonable fees. Worse still, monopoly has curbed the growth rate of China's economy.[24] China then urgently needs an anti-monopoly law. When such a law is drafted, the experiences in Australia and USA will make a good reference. In Australia, a power company had to divest shares over a specified limit. Limiting shares in this way can create a real sense of competition.[25] A similar case is also found in USA. AT&T was divided into two companies because it was deemed to have

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[23] The four state-owned commercial banks are: China Commercial and Industrious Bank, China Agriculture Bank, China Construction Bank, and China Bank.

[24] See H. Yang, "Forecast on the Growth Rate of China's Economy in the Year 2001" in J.J. Chen, ed., *China Economic Review and Forecast* (Beijing: Statistics Press, 2000) 118 at 120

[25] "Volume 3: Competitive Market", *Final Report for HN Institutional Strengthening*, HN, 2000.

hindered competition in the domestic market.

Before such a law is enacted, other measures should be taken first. Unbundling should be used to break the giant national companies into smaller companies. The breakup of monopolistic SOEs, sometimes called de-monopolization, will make any prospective privatisation much easier.

Unbundling is always used to break monopoly and to introduce competition. Unbundling can be done through vertical separation, which refers to a breakup in the production chain between upstream and downstream activities, or between infrastructure and services.[26] By separating the responsibility for basic infrastructure from service delivery, private-sector entry can be encouraged in commercial activities. Vertical separation always takes place in the power sector,[27] railway transportation,[28] airport, and sometimes even functions traditionally thought as state's functions.[29] Unbundling can also take the form of horizontal separation, where competition is introduced for the right to supply the service on

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[26]Physical infrastructure tends to have monopolistic characteristics. and services competitive ones. The monopolistic characteristics that typically derive from the high sunk costs of infrastructure do not necessarily carry over to the use of the infrastructure. that is. to services. For example. whereas telephone and electricity distribution or rail networks may have strong monopolistic characteristics. their use may be organized on a competition basis. See *Privatization Challenge. supra* note 13 at 212.

[27] In the power sector. such unbundling translates into three or more distinct activities. namely. generation. transmission. and distribution (as well as supply). *Ibid.*

[28] In railways. it may lead to a separation in responsibility between track and transport services. *Ibid.*

[29] For example. Canada. which has forceful policies for overall transport liberalization and privatization. sold its air traffic control system for $1.1 billion to Nav Canada. a nonprofit corporation that on July 1. 1996. took over seven regional air traffic control centres. 44 airport control towers. training facilities. and contracts with over 6.000 employees. Another example is British Gas. which in February 1996 split itself into two companies. separating its trading business from its pipeline. exploration. and international activities. See *Privatization Challenge. supra* note 13 at 227.

a regional exclusivity basis.[30] Unbundling the provision of monopolistic services horizontally among different regional companies multiplies sources of information on the sector, new technologies, and ways of reducing operating costs. This increased information can be used by the regulator as a yardstick to compare the performance of the monopoly operator with that of operators in other regions of country and with international norms. In this way, the regulator can control the operations of the regulated enterprises more effectively and benchmark one operator's performance against that of others.

Unbundling may help to leverage additional financial and human resources, diversify technological and managerial approaches, and spread risk. It may also make it easier to enforce bankruptcy against a defaulting public service provider, because other national companies with relevant expertise could easily take over operations.

Nor should the reform stop at this point. Unbundling will probably give birth to more competitors, but without the participation of the private sector, the added competitors are just new monopolizers, who still can take advantage of their governmental backgrounds to engage in illegal behaviour. Unbundling is always accompanied by concessions-granting and other fixed-term privatization approaches.[31] China should consider granting more concessions or licenses to private investors. For this purpose, China needs to set an entry standard to allow all interested parties to bid for entry. Again, decisions concerning prospective investors

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[30] For example, in USA, pursuant to Judge Greene's "consent decree" in the 1984 AT&T case, AT&T, the private monopolistic operator, was divested of its local service monopoly to seven new, independent regional companies, known as the Baby Bells. *Ibid.*

[31] Terms such as franchises, licenses, authorizations, or permits are sometimes used interchangeably for the similar meaning. To be simple, only 'concession' is used in this thesis.

must ensure that equal treatment is accorded to both foreign investors and domestic private investors.[32] In the past, more emphasis was put on the usage of foreign capital, and domestic private investors were always prejudiced. This situation must be changed, since in terms of safety, domestic private capital will be superior to foreign capital which may retreat at any time.

Concession contract often grants to a private investor an operating license, a limited right over sector assets, falling short of legal ownership. Therefore, under a concession contract, the enterprise or sector assets must be returned to the public authority at a specified date. Concession is particularly well suited in present China, where, for constitutional and political reasons, it is not possible to transfer ownership of strategic sectors to private persons.

Concession contract always grant third-party access to the monopolized sectors. Third-party access to many infrastructure sectors, particularly in network industries, is always the most important part of the licensing terms and conditions under a concession contract. Provisions of third-party access will foster fair access to the network by third parties or force the main operator to lease lines to third parties on reasonable terms and conditions. Rules need to be in place to provide for nondiscriminatory access to the network, which implies in particular that where the dominant operator provides some of its services in competition with

[32]Some progress has been made in this regard. for example. the banks operation tax rate will be reduced from 8% to 5% within three years from the year 2001. and the preferential treatment enjoyed by the foreign banks will be replaced by "national treatment". In the initial stage. when foreign banks entered China's market. some of them such as City Bank and Singapore Development Bank. were exempted from taxation. China will soon open financial retail market to foreign banks. See Q. Li. "Foreign Banks Will Receive National Treatment". *QuanJing Net Securities*. online:<http://finance.sina.com.cn/g/52548.html>.(date accessed: 15 April. 2001).

other operators, it must grant them such access on the same technical and financial terms and conditions that it applies to its own use of the network. Third-party access is especially crucial to the development of privatization, particularly when the third party is from private sector. Without third-party access, a simple unbundling of a monopolizer will not generate wider competition. In concession contracts, the most valuable asset offered is not the physical infrastructure transferred in some cases, but the operating license, the right to provide the service, and ownership of sector assets without the authorization to provide the service would be pretty much worthless.[33]

Concessions and licenses can also be used as regulatory instruments. The offering of concession may be provided through bidding on a competitive basis. The concession may be revoked if the licensee fails to meet its obligations. In this way, concessions provide for oversight, by the public administration or a regulatory agency, of the way in which the company is fulfilling its obligations, and they specify how rights and obligations may be amended to take account of new circumstances. Therefore, in countries with administrative and judicial systems short on resources or credibility, the use of detailed and relatively inflexible concession agreements backed by international arbitration procedures may be more likely to reassure investors than the creation of an autonomous regulatory agency with rule-making powers.[34]

4.2.4. Promoting Private Entry and Developing Securities Market

The retreat of SOEs in an organized way such as unbundling mainly depends on state

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[33] See *Privatization Challenge, supra* note 13 at 260 - 262.

[34] *Ibid.*

policy. However, there is a natural way which may amplify the effect of private entry. That is, to develop a securities market. Securities market not only provides a better platform for merger and acquisition between SOEs and private sector, but also works as a channel for the entry of the private sector into the market. Presently, development of a securities market is the more pragmatic approach to the privatization of China's economy, because under the current political situation, it is unlikely that a large-scale retreat of SOEs will take place in the near future.

The market in China began with the first stock exchange, Shanghai Stock Exchange, established in 1990. A second one was established in Shenzhen in 1991 [35] At present, investors can buy five kind of shares issued by China's enterprises: A share, B share, H share, N share and S share.[36] Only B shares are transacted in foreign currency. After 10 year's development, the market has seen tremendous progress: up to April 6, 2001, the market has 1096 A Share listed companies and 114 B Share listed companies, with the total market value of the listed companies accounting for over 50% of last year's GDP and for more than 60 million investors participating in the market.[37] Despite these achievements, the market remains small

[35] Zh.Q.Zhou, *Reading Books for Securities Knowledge* (Beijing: China Finance Press, 1998) at 1.

[36] 'A share' is the common shares priced at China Dollar, issued on domestic stock exchanges and by the enterprises registered and incorporated in China. 'B share' is priced at China Dollar and issued on domestic stock exchange , but transacted with foreign currency. The first B share was issued in 1991. 'H share' is the shares issued on Hongkong Stock Exchange by those companies registered and incorporated in China mainland. The first "H share" was issued in 1993 by Qingdao Beer Brewery Company. 'N share' and 'S share' refer to the shares issued on New York Stock Exchange and Singapore Stock Exchange respectively. *Ibid.* at 16&17.

[37] "The New Features of China's Securities Sector", Xihua Net (14 April, 2001), online: sina.com.cn <http://finance.sina.com.cn/o/52533.html> (date accessed: 14 April, 2001).

and underdeveloped.[38] Also, the market fails to provide equal opportunities for private enterprises, prohibits the trade of the State's shares, and precludes international capital investment. In short, it is not sufficiently mature for privatization which requires a securities market to facilitate more participation from the private sector.

First of all, the market continues to discriminate against private enterprise. Listing is a privilege primarily enjoyed by the SOEs. Most of the listed companies are SOEs or controlled by SOEs, and few private enterprises can be found listed on the stock exchange. No rule restricts the listing of private enterprises; but, in practice, it is the government that recommends and approves which companies may list on the stock exchange. The number of listings is limited , and an enterprise has to apply for a permit from the government. Since SOEs are the 'relatives' of the government, most quota are awarded to SOEs rather than to private enterprises, even where the private enterprise is more qualified. This of course will hinder the development of privatization. Discrimination against ownership should be removed, and only quality and performance should decide which companies are admitted to the stock exchange. Intermediaries should be established and developed to take the place of the government to assess a company's application and decide if it is qualified.

Secondly, the prohibition against trading State shares must be changed. Currently, the shares of a listed SOE may consist of three components: the state share, the enterprise share, and the negotiable shares or public shares. These three kinds of shares may be of the

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[38] The market is a small one. Though it has 60 million stock investors. that figure accounts for only 5% of the total population. 20% of them urban citizens. The rate is much lower than the rate of 50% of the total families that participate in shares investing in western countries. See "China Securities Market Is Facing Structural Transformation", *China Securities Daily* (29 November. 2000) online: <http://www.colstock.com/public/news_detail.jsp?id=29871> (date accessed: 24 May. 2001).

same class, but they are issued at different prices. For the State shares, the issuance price is one dollar per share, while public shares are issued at five, eight or even ten times the price of the State shares.[39] Among all the shares listed, two thirds are State shares and enterprise shares, however, they cannot be traded on the market.[40] The ratio of the value of tradable shares to the GDP is very low compared with that of western countries. The securities market is one of the best places for merger and acquisitions, and China's SOEs should take advantage of the market to transfer their shares to the hands of private investors for better profit opportunities. Laws are urgently needed to enable the State shares to be tradable, especially by private investors. Otherwise, there will be no real-sense acquisition in China, and the role of the market in allocating the resources will be weakened. This of course will serve as a barrier to implementation of privatization in China.

Thirdly, China's securities market is not an uniform market. First, the A share and B share should be combined although B shares are comparatively small in scale.[41] A company may issue both A shares and B shares, but the two kinds of shares are issued with different

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[39] Y.Ch.Dai, "How to Solve the Problem of the State Shares", *Xihua Net* (21. December. 2000) online: <http://finance.sina.com.cn/y/29378.html> (date accessed: 14 June. 2001).

[40] According to a survey made on 1003 listed companies, by the end of 1999, among the total 281.6 billion shares, 190.2 billion share, or 67.54% of the total, are held by the State, while the sum of enterprise share and public shares is only 32.46%. Another survey shows that in 300 listed companies, the state share-holding exceeds more than 50% and 70% shares are held by the state in half of the 112 list companies that have issued over 400 million shares. See J.Sh.Yang, "Analysis of the Trade of the State Shares", online: < http://finance.sina.com.cn/t/66076.html> (date accessed: 16 July, 2001).

[41] Up to now, the market has A shares issued by over 1000 companies, with market value exceeding more than 1000 billion China Dollar. Compared the A shares, 112 B shares listed with total market value being 6000 million USD is small scale. Chinese residents hold more than 74.9 billion USD foreign currency in deposits. See "Economic Comment: If the Openness of B Shares Market Will Hurt A Shares Market", *China News Agency* (22February, 2001), online: <http://cndaily.sina.com/headline/fnHeadline/2001/0222/2825257.html> (date accessed: 13 July, 2001).

prices, and neither price reflects the real net value of the company. By the end of February 28, 2001, the price of A shares was three times that of B shares in the Shanghai stock exchange and four times as much as B shares in Shenzhen.[42] The rule that China dollar can only buy A shares and foreign currency can only buy B shares should be abolished,[43] otherwise the price difference cannot be removed.. Besides the division of A shares and B shares, the location of the two A share markets also hinders the further development of the securities market. Since the existing rules prohibit a company from listing on two markets at the same time, the separation of the market can only lead to lower efficiency and increased cost not only for the regulator but for the listed companies as well as investors. The government should plan to integrate the two stock exchanges in Mainland China. In the future, this may also contemplate including the Hong Kong stock exchange into the plan .[44] After the unification of the two shares and the integration of the two stock exchanges, uniform rules should be promulgated to regulate the restructured market. Obviously, a unified securities market will bring more convenience for both domestic and foreign investors.

Fourthly, China's capital market should have more tiers. In some developed market economies, not only large amounts of property transaction are completed outside of the securities market, but also many stocks and other securities are transacted outside the formal

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[42] *Ibid.*

[43] Domestic investors have been permitted to access B shares market since Feb. 19, 2001, but they still have to use foreign currency they have to buy the shares. See Y.Bai. "B Shares Market Will Be Open Soon". *Securities Daily* (12 May, 2001) A1.

[44] The integration of the two stock exchanges in mainland China will make China's securities market the third one in Asia, with total market value 500 billion USD. See J.H.Zhao. "The Impact of the Openness of B share Market on A share Market". online: <http://cndaily.sina.com/headline/fnHeadline/2001/0222/2825257.html>. (date accessed: 21 February, 2001).

stock exchanges by way of 'over-the-counter transaction'. In China, in the near future, the most important thing is to deal with the countless medium and small sized SOEs, which all should be subject to privatization. A national market is therefore not enough, because small SOEs cannot list and trade their shares. More attention must be given to local markets as a component part of the national market; these should be connected by computers. Also, since the major board is dominated by SOEs, a second board should be developed for new and high technology companies, which are always established by private investors and of medium and small size.[45] The high-tech board will have special and significant bearing on China's economy-level privatization: not only will it provide an exit mechanism for venture capital, but it will also open a channel for private enterprise to finance the funds the development entails.

Also, to open more channels to promote the sale of stocks for the purpose of privatization, new techniques in stocks issuance and purchase should be designed to attract direct investors. For example, the stocks may be issued by the way of installment payment or through auction. Moreover, legislation should be enacted to promote the development of large domestic institutional investors that can participate in the privatization programs as buyers. Private pension funds, mutual funds, and other open-end or close-end funds need to be developed. In addition, the national pension fund and other social insurance funds should

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[45] According to "the outlined plan for the development of national economy and society in the tenth Five-year " approved by the fourth concession of the Ninth National People's Congress in March.2001. the government must" improve system to set up high-tech board. and encourage the development of medium and small sized with diversified ownership". "Except those should be controlled by the State. all other SOEs are encouraged to transform into limited liabilities companies with diversified shareholders or joint stock companies by the way of floatation. Sino-foreign joint ventures and shares cross-holding".See "The New Features and New Tasks of China's Securities Sector". Xihua Net (14 April. 2001). online: sina.com.cn <http://finance.sina.com.cn/o/52533.html> (date accessed: 14 April. 2001).

be encouraged to invest in the securities market. Particularly, the market needs the participation of commercial banks. Not only must financial institutions including banks be permitted to list on the stock exchange,[46] but also the investment restriction on banks or insurance companies should be removed, as has been discussed in previously.

As discussed in previous Chapters, FDI always plays a very important role in a country's privatization. To attract more foreign investment, China has to make the securities market more open and provide more protection to and promotion of foreign investment. At present, the amount of B shares which can be bought by foreigners is only 1/10 of the A shares.[47] In consequence, some foreigner stock investors who want to invest in the securities maker in mainland China, are confined to H shares or red-chipped shares of those companies controlled by SOE but registered and listed in Hong Kong. Relevant legal infrastructures must be established or improved; foreign securities traders should be allowed to trade China's A shares in the market. The establishment of Sino-foreign capital joint ventures, engaging in securities and funds management business, should be allowed. China's companies should be offered greater opportunities to list on foreign stock exchanges,[48] and foreign companies should be entitled to list on China's domestic markets. New legislation should also be promulgated to enable domestic securities companies to invest or underwrite in foreign

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[46] As of the end of June, 2001, three small state-controlled commercial banks have been listed on the stock exchanges, and the fourth one, Huaxia Bank, is making its preparation right now. "The Road for the Development of Commercial Banks: Views Obtained from Huaxia Bank's Application for Listing", *Economy Daily* (16 February, 2001).

[47] See Y. Bai, *supra* note 43.

[48] For example, by the end of April, 2001, 53 domestic companies have been listed on Hong Kong stock exchange and raised money 17.6 billion USD. *Ibid.*

capital markets .

Finally, to develop a mature securities market which will facilitate privatization, both some 'hard wares' and 'soft wares'must be put into place to prevent and dilute market risks and to safeguard both the interest of investors and the overall safety of China's securities markets. For example, as did the USA and Europe, China's market must have a centralized and uniform securities settlement and clear centre, to improve efficiency and lower costs.[49] Softwares such as futures (of shares composition), swaps, forwards, and other risk-mitigation instruments also must be introduced as soon as possible. To prevent the market from the negative effects of foreign financial crises or of international speculation, some sound legal mechanisms have to be designed. For example, qualification standards must set conditions for entry of foreign capital and only 'Qualified Foreign Institutional Investors' (QFII) can be allowed to enter the securities market; others must be screened out.[50] Other methods are also deserve consideration, for example, rules may provide that the total amount of foreign capital be limited under a ceratin cap, say, 10% or 20% of the total market value. The rules also can limit a foreign investing fund to a certain rate of A shares of a single company.

The further development of China's securities markets also depends on the legal changes in other sectors. For example, the market urgently needs the participation of banks,

[49] USA has the DTCC. Europe has EUROCLEAR (created by France. Belgium and Holland) and CLEARSTREAM (German. and Luxemburg). China presently does not have such a uniformed system. See "Zhou Xiao Chuang: China will Unify the Securities' Registration and Settle System". *Xinhua Net* (1 April. 2001). online: <http://finance.sina.com.cn/y/48326.html> (date accessed: 15 April. 2001)

[50] For example. only "qualified foreign institutional investors" (QFII) have the right to invest in the securities market in Taiwan and India and an up limit. say. 2 billion USD. is set for them. *Ibid.*

but existing banking laws prohibit China's commercial banks from investing in the securities market. The same restriction is also imposed on insurance companies. Another obstacle to foreign capital investing in China's securities market is the unconvertibility of the China Dollar under the capital items. Details of this have been discussed in the previous chapter. In a word, only if all these obstacles are removed by new laws and rules, can China's securities market develop further and contribute more to China's economy privatization.

Chapter Five: Facilitating Laws in China

An example may illustrate well how important the legal environment is for China. An important component in China's private sector, China's private capital has accumulated tremendously. According to statistics, by the end of 2000, residents' banking deposits alone had reached 6430 billion China Dollar.[1] The government has tried in numerous way to promote the outflow of this money to stimulate economic growth but with little success. Really, it is demands for further investing, rather than demands for consumption, which can attract the money out of the pool. However, to stimulate the demands for further investing requires an investing environment favourable to private investors. Such an environment must be supported by a series of laws, including constitutional provision of the rule of law and of equal treatment to private ownership, business laws including company law and FDI law, labour law and laws which set in place a social safety net. Consequently, all the legal changes for privatization should be designed with just these goals in mind.

5.1 Constitutional Law

China's current Constitutional Law was promulgated in December 1982 and was amened three times, first in 1988, again in 1993, and recently in 1999.[2] The specific features of this constitutional law of the largest communist country - and indeed one of the few

[1] *Statistics Report for China's National Economy and Social Development in 2000,* online: stats.gov.cn Hompage< http//www.stats.gov.cn/tigb/200103090128.htm> (date accessed: 15 June. 2001).

[2] The 1988 amendment allows, for the first time, for the existence and development of private business, and the 1993 amendment establishes the so-called "socialist market economy" in China. The 1999 amendments strengthen the role of the private economy by regarding it as "an important element of socialist economy." See details which follow.

remaining - may be summarized as follows:

(1). As a consequence of autocratic party rule, the rule of law remains beyond the reach of the Chinese people. The Constitutional Law declares that "all the powers belongs to the people" and it establishes the People's Congress as the legislator at all levels to exercise state power. In practice, the election system is a farce. The People's Representatives are chosen from the communist party, and are required to follow the uniform directions or orders of their upper level communist organization. Indeed, the People's Congress at each level is merely a 'voting machine', which votes for any laws or regulations suggested by the Party. According to the Law, China's National People's Congress should be the highest legislative organ with the power to enact laws, select the state's leaders including the Chairman himself, the State's Chairman, and the Prime Minister, and decide on every important issue when necessary. But in fact the Political Bureau of the Party is the real decision-maker. The Bureau, headed by the General Secretary of the Party, now has seven members and decides almost every important issue. To make matters worse, there exist no efficient mechanisms to supervise the exercise of the the Party's power: the Law doesn't provide any practical constraints on the power of the ruling party, the Communist Party of China. All the media are owned by the state and controlled by the government, no laws allow protest from the people, no opposition party exists or is permitted to develop to challenge the ruling position of China's Communist Party. All the officials, judges and prosecutors are recommended and appointed by the "Communist organization", through the approval procedures of the "People's Congress", the ruling tool and ornament of the dictatorship. The current leadership of China illustrates this point well. The current Chairman of the National People's Congress, Mr. Li Peng, has stayed in this position for four years. Previously, he had been the prime minister for ten years. It is said that he will hold the position of the State's Chairman from next year! He has travelled from one position to another and occupied the leadership of China for nearly 15 years. Remarkably, the Law states that the Chairman of the National People's Congress, the Chairman of the State, and the Prime Minister shall not hold position continuously for two sessions (each session is for five years).[3] But the Law does not preclude a man from holding the three positions consecutively. Not surprisingly, in China, people now use "generation" to refer to the state's leadership. Chairman Mao is the first generation leader, Deng Xiaoping the second generation, and now Jiang Ze'min and Li Peng the third generation. In other words, if a man catches hold of power, he will hold it for a generation! at least 15 years! "A power without constraint only leads to corruption"- the grief of China's law is that it fails to lay down the framework to constrain the ruler's power and establish and promote real democracy.

In China's judicial tradition, the executive power is ascendent to the legislative power, which is always subject to interference by some administrative organ, and the courts are always subordinate to government. There exists no clear division of power between the executive, the courts and the legislatures. This makes it hard to maintain an independent appeal and dispute settlement procedure. In fact, transaction between power and wealth is prevalent in present China and the laws are mere decorations. In a word, the constitutional law of a rule-by-man government cannot provide the necessary legal framework for successful privatization. It must be repealed or amended radically.

(2). Despite the political dictatorship, the Law states that China must institute "market

[3] China Constitutional Law. Articles 66, 79 &87.

economy".[4] The market economy is an economy ruled by law. In such an economy, equal treatment is accorded to all parties, whether they are private or public in nature. Monopoly is broken down, and fair competition is guaranteed. However, the Law tries to protect the dominant position of public ownership and fails to accord equality to the private sector.

Like the previous four constitutional laws[5], the Constitutional Law still seeks to protect and promote the so-called "socialist public ownership". The articles governing ownership prescribe as follows:

Article 6:	The foundation of China's socialist economic regime is the socialist public ownership of the means of production, the All-the-people public ownership and the collective ownership.
Article 7:	The state-owned economy, i.e. the economy of socialist All-the-people public ownership, is the dominant force in the national economy. The state protects the establishment and development of the state-owned economy.
Article 8:	In rural areas, peasants may use means such as contracts to engage in production, supply and selling, credit and consumption, which is a collective ownership.
Article 9:	All natural resources including mines, rivers, forests, mountains, grassland etc are owned by the state, with an exception which has been provided for by other specific laws.
Article 10:	All the lands within the cities are owned by the state. Land in rural areas and suburbs are owned collectively.
Article 11:	The individual economy prescribed by laws is a complement to the socialist economy of public ownership. The state protects the legitimate rights and interests of individual economy. ... The State allows the existence and development of private economy within the limits of rules and laws. Private economy is the complement to the socialist economy of public ownership. The state protects the legitimate rights and interests of private economy...
Article 15:	The state carries out the socialist market economy.
Article 16:	The state-owned economy has rights within the limits of rules and law to make decisions on business operation.

Compared to its predecessors, this constitutional law introduced three main developments, which find expression in its amendments in 1988 and 1993 respectively, namely: it has granted legitimacy to the existence and development of private economy; it has

[4] China Constitutional Law, Article 15.

[5] China has passed four constitutional laws, in 1954, 1976, 1978 and 1982.

changed an expression from state-run enterprises to state-owned enterprises; and it has established the socialist market economy.

Despite changes to some concepts such as the socialist market economy and state-owned enterprise, it can be seen from the above listed articles that this law still cannot provide enough space to initiate the necessary privatization programs, because the law provides for the "Socialist All-the-people Public Ownership" and "State-owned Economy"[6], which means that the private sector and the public sector cannot play on a fair basis. Thus, it is not surprising that special privileges such as subsidies are given to some loss-making SOEs and for some businesses which the private investor is prohibiting from entering. As a result, all prospective privatization programs will be contradictory to these rules.

There is, however, a contradiction between the article concerning the socialist market economy[7] and other relevant articles. Market economy, whether capitalist market economy or so-called "socialist market economy" or whatever other market economy, requires the free flow of the means of production including land and other resources from one investor to another, determined only by who can create more value and greater efficiency. On one hand, this law calls for the establishment of market economy. On the other hand, it imposes many restrictions on the control and transfer of means of production such as land and natural resources[8]. Privatization is more than a mere political policy: it is also a demand for market

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[6] China Consitutional Law. Article 6 &7.

[7] China Constitutional Law. Article 15.

[8] Individuals or private investors may not have the ownership right of land. What they can acquire is the "usage right" transferred by the State. The period of the usage rights varies. but generally do not exceed 70 years. even in the case of purchasing of a house or other realty.

rules and a key component of market economy.

The All-the-people Public Ownership has a number of significant implications. First of all, there exists no actual legal representative to carry out the ownership. All-the-people ownership thus become "no-ownership", and in consequence, nobody cares for the protection and value increase of the state-owned assets, including state-owned enterprises. This lack of actual ownership to represent and care for the state-owned assets also gives rise to the disabled management of state-owned enterprises and subsequently to low efficiency and all kinds of corruption. When liability for a SOE's wrongdoings is unavoidable, the final victim is the State, because the State is the investor and all the assets are owned by the State. The Board of Directors and the top managers pay little attention to their duty of care, and in some cases they even take measures to transfer the public assets to their own control and make the public assets their individual private property.[9] It is not surprising then that when a SOE declares insolvency and goes bankrupt, the top managers of the enterprise are often found to have made great fortunes.

It should be noted that China has taken some measures to partially privatize some of its SOEs, but all the past reforms were taken in the context of "sticking to socialist public ownership". Some small enterprises were contracted to private individuals for management and operation; but for medium or big enterprises, contracting or leasing is not practical. In fact, due to a lack of supervision from the actual owner, those private individuals who win the chance to be awarded the contract take every chance to embezzle the public assets. These

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[9]One way of doing this is for the manager to set up a private company which will then transact in unreasonable conditions with the SOE in which the manager subsequently takes a large position.

individuals, who often became millionaires overnight, are always connected with government, because the contract awards are processed and decided by government. Moreover, there exists no uniform law to govern the contracting of SOEs.

All such reforms end in failure due to the problem of ownership. Therefore, to launch a privatization movement and achieve ideal results, the current constitutional law has to undergo radical amendment. Amending constitutional law is not a easy thing, always takes time and is often preconditioned by a simultaneous (synchronized) political reform. However, in the current political situation, it seems totally impossible for the Communist Party to lay down the flag of ownership which it has held for more than fifty years.

Abolition of the "all-the-people public ownership" is the fundamental objective, though the steps must be taken gradually and may include some temporary options to bypass the restrictions of ownership, for example, transferring some SOEs to private control though leasing, concession etc. But none of these options can ultimately resolve the problem.

5. 2 Company Law

Promulgated in 1993, China's Company Law took effect in July, 1994. In December 1999, it was amended. The new company law provides rules for the establishment and operation of limited liability companies and stock holding companies. In the section "the limited liability company", "Wholly State-owned Company" is listed individually and defined as a company established and invested exclusively by an investing agency or a government authorized by the State.[10]

Pursuant to this law, all the SOEs set up before the effective date may be transformed

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[10] China Company Law, R.S 1999, Chapter 2, Section 3, Article 64.

into limited liability companies or stock holding companies. If an enterprise has multiple investing agencies, it may be transformed into a "standard" limited liability company. If it has only one investor, it should be transformed into the "wholly state-owned company",[11] in which case no shareholders meeting is held and all important management issues are decided by the Board of Directors appointed by the investing agency or the government.

Existing company law continues to lag behind the development of modern companies, and it lacks practicability and fails to provide the necessary procedure for litigation.

Accountability Mechanisms .

As discussed previously, the property right of SOEs vests in the State, and the enterprise itself only has the right to operate the assets on the State's behalf. In consequence, nobody has a close and direct interest in the property right of the SOEs. In other words, national ownership lacks a mechanism to establish a direct relationship between the interest of the enterprise and that of its employees and other stakeholders. This problem also finds expression in the company law. Company law dose not provide a scheme to link the company's performance with the managers or employees' accountability. Since public ownership sometimes means no ownership or a legal fiction, when a SOE is held liable for wrongdoing, the final victim is the State, because the State is the investor and all the assets are owned by the State. Consequently, the Board of Directors and the top managers pay little attention to their duty of care.

Excessive Regulation of SOEs

Many countries are burdened by a multitude of rules and institutions governing the

[11]China Company Law, R.S 1999, Article 21.

exercise of economic activities. Attracting investors requires streamlining these regulations and procedures for obtaining licenses and other official permits required to conduct business. For example, a rule that requires the use of products of domestic origin might prohibit an investor from using traditional suppliers; the investor might therefore lose interest in participating in the privatisation program.[12]

China's SOEs are regulated excessively by the government. For example, according to Company Law, an enterprise has the autonomy to make decisions on its business management, but because of other regulations and policies as discussed below, this autonomy is limited as a matter of fact. In consequence, enterprises lack mechanisms to keep pace with market changes. For a real market economy, legislation is needed to protect the interests of market players and to maintain the market order, but this kind of legislation should not become an obstacle to an enterprise conducting its business in a more flexible way.

Top Managers Appointment System

Rather than being elected at a Shareholders Meeting and appointed by Board of Directors, the directors and top managers of most SOEs are appointed by the government, through a process of appraisal and approval by the relevant department of the Communist Party Committee. As a result of the approval criteria, some directors and managers are actually politicians rather than business managers. Until recently, the managers of enterprises

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[12] Many countries have simplified the procedures in this respect. For example, since 1991, India has abolished many industrial licensing requirements in pursuit of its liberalization program. Similarly, as part of a broader economic reform program that includes privatisation of most of the country's SOEs, President Menem of Argentina signed a decree in October 1991 abolishing dozens of government agencies, including some of the 36 or so agencies involved in regulating foreign trade, and eliminating the often petty controls that beset private business activity. See P. Guislain, *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience* (Washington: World Bank, 1997)at 56.

were still ranked and treated as governments officials, with their positions being linked with different levels of government officials.[13] For example, the position of some presidents may be equivalent to a ministerial position, especially those presidents of the national companies, who are always retired ministers from relevant departments. Though these top managers have changed their career from government to enterprise, the political treatment they receive remains the same, for example, they can hold diplomatic passports when they are on a business trip outside of China. On the other hand, some top managers of SOEs take positions in an enterprise only in order to pursue a higher or equivalent position in government: they don't care about the operation of the business, but are taking advantage of the assets and privileges of the enterprise to pave the way for promotion. As a matter of fact, some directors or managers have no experience of business management, they know nothing about the market and production rules.

Internal Decision-making System: Communist Party Committee's Role (CPC)

Since an SOE may be actually owned by a governmental department, material issues such as acquisition, merger or separation of SOEs takes place almost in all cases as a result of an order from the government. Administrative power is always used to influence the operation of companies, and there is no real separation, which should be provided by the Company Law, between government and enterprise in the case of SOEs. [14] In some cases,

[13]A relevant regulation was promulgated recently to require the abolition of the links between the ranks of the top managers of SOEs and governments officials, but with little result. See "The Basic Rules to Establish Morden Enterprises System in SOEs and to Strengthen the Management". Online: SETC Homepage <http://www.setc.gov.cn>. (date accessed: 27 October, 2001).

[14]Despite the fact that the government of China really has initiated a restructuring program to reduce the number of administrative departments and change some of them into national companies while shifting their original administrative powers to the hand of the State Economic and Trade Commission, actual separation

civil servants even hold concurrently the position of director or top management of SOEs.

Governmental interference is most reflected in the role CPC plays in corporate governance.[15] This is not required by the company law; however, it is invariably the reality of the situation. First of all, shareholder meetings function poorly in China's SOE, because the fundamental shareholder is the State or government, even though the shares may be held by different representatives. As mentioned above, in most cases, members of board of directors are appointed by government. Even when they are not, most of them must be communists, who have to obey the order or policy of the communist committee. In fact, such cases are not uncommon especially for some national companies where the Chairmanship of BOD of an SOE is an honorary position, with the Chairman being a retired minister in his or her 70's. In such cases, the chairman usually will not have the power provided by the Company Law and the president (CEO) will be legal representative. Indeed, whether a director has more authority than other directors depends on whether he is the head of the CPC within that SOE, because he can then put any disagreements arising at director meetings before a meeting of CPC, where the Party rules on a centralized decision-making system basis. Under such a rule, a decision is made collectively and responsibility will be assumed collectively too. In the result, nobody will hold actual liability if any wrongdoing is committed.

<u>Investment Restriction</u>

The Company Law stipulates that the registered capital of a stock-holding company

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between government and SOEs has not yet been achieved.

[15]Each SOE has a Communist Party Committee within its organization. The case is the same in all local governmental units. Actually China is ruled by two administrative systems: one is the usual government, the other is the CPC system. There is no separation between the party and the government.

must be the total amount of received capital registered with the registrar.[16] Compared with the 'authorized capital' rule in most common law countries, this rule lacks elasticity. Especially when a privatized company wants to list in an overseas stock market, the rule will pose some serious problems. In most cases, the laws of the listing country require that legitimate and valid authorization on the planned share issue by the company should be included in its business license or the Articles of Incorporation, but in China those shares which have not been placed cannot be registered and included in the Articles of Incorporation. Thus, the legitimacy of listing of Chinese companies in overseas stock markets is always doubted. This problem may mean nothing to a small company, but for large scale ones, especially those who want to pursue international development, it is a serious obstacle.

The Company Law stipulates that, an investing company and holding company authorised by the state council excepted, a company shall not invest more than 50% of its net assets in other companies.[17] In privatization, this rule precludes a company from purchasing other businesses, and acquisition and merger through the stock market becomes totally impossible.

Public placement for funds is one of the two ways provided by the Company Law to incorporate a new stock-holding company.[18] But, according to the Securities Law, all public placement is subject to a certain limit and prior approval. In this matter, the rules of the Company Law are subordinate to the rules of Securities Law. Yet, according to the laws of

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[16] China Company Law. R.S.1999. Article 78.

[17] China Company Law. R.S.1999. Article 12.

[18] The other way. private placement. is not provided by China's Company Law.

other countries, not all shares issues must be registered or approved. Those shares issued under a legitimate limit, especially those that do not intend to list on the stock exchange, should be exempted from approval procedures. This kind of exemption for small capital placement should be added to the Company Law. This matter has great significance to the privatization of small sized SOE: when an investor is to buy a SOE, it can use this mechanism to raise the necessary funds in an easy way.

Other restrictions, such as the limit on 'one person' companies,[19] will also be a potential impediment to the establishment of more private companies and acquisition of and mergers with other companies, which are the popular methods in privatization programs.

Lack of Protection of Minority Shareholders

Since in the past, all a SOE's shareholders were, in fact, different representatives of the State, all SOEs had just one shareholder, the state. Consequently, the Company Law did not provide appropriate rules to protect the interests of minority shareholders. When privatization is implemented, atomorization of shares will increase the number of minority shareholders, most of which are private sector. In this fashion, the protection of the interests of minority shareholders becomes a very important issue.

Company Law suffers from numerous defects in this respect. For example, the law does not require that the Board of Directors have representatives from minority shareholders. The law does not even require a quorum of shareholders at a shareholder's general meeting. Thus, in practice, particularly in SOEs, the shareholder's general meeting is always controlled

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[19] Article 20 of the Company Law stipulates that to incorporate a limited liability company, there must be more than two and less than 50 shareholders (with so-called "wholly owned company" and Foreigner's Sole Venture excepted). This prohibits the 'one-person' company.

by the majority shareholder (always the State). In this regard, the Company law should provide more rules, such as 'accumulative voting' or 'agent voting', to restrict the behaviour of the majority shareholder. Independent directors are also needed to look after the interests of minority shareholders.

In common law countries, company law has a rule in place called 'pierce the corporate veil'. This rule is designed to protect the interests of other shareholders, especially minority shareholders, creditors and other stakeholder when one of the shareholders, usually the majority shareholder, takes advantage of its special position by disregarding the separate corporate existence. This rule works mainly in two cases: fraud, in other words, using the corporation to effect a purpose or commit an act that the shareholder could not effect or commit on her own (for example, fraudulent representation); and agency, namely, a corporation merely acting as the agent of someone else.[20] In practice, fraud and agency are very common in China, and it is therefore urgent that the Company law include this rule.

Lack of Rules About Duties of Directors and Officers and Oppression Remedy

Protection of the interests of all shareholders and other stakeholders requires restriction of the behaviour of directors and officers through clear definition of their respective duties. For example, under the *Canada Business Corporations Act*, managers may be liable if they act in a manner that is "oppressive to or is unfairly prejudicial or that unfairly disregards the interests of any security holder, creditor, director or officer".[21] In contrast, in China, the

[20] J.A.Vanduzer, *The Law of Partnerships and Corporations* (Toronto: Irwin Law, 1997) at 95 - 102.

[21] *Canada Business Corporations Act*, R.S.C. C.1985, c.C-44, s.241(2).

Company Law not only provides few detailed rules of fiduciary duties to prohibit officers and directors from transacting with the corporation and from taking advantage of insider knowledge, but also sets few requirements about their duties of care. Besides these restrictive rules, the law also requires some stimulation mechanisms to encourage management to look after the shareholder's interests.

Remedy mechanisms must be also put in place to deal with cases of directors and officers breaching their duties. Besides traditional remedies such as the shareholder's derivative action for injuries to the corporation, the *Canada Business Corporation Act* provides four kinds of "oppression remedies": share purchase, liquidation and dissolution, remedies against shareholders, and compliance. The oppression remedy plays an important role in protecting all the investor's interest, and will, if introduced to China's Company Law, attract more investment from the private sector. For this purpose, rules should be set to provide procedures to enable shareholders to submit proposals or to select representative to sue the directors or supervisors who have committed harm to the interest of the company.

5. 3 FDI Law

5.3.1: A General Introduction to China's Foreign Investment Laws and Policy

In 1978, China opened its door to the world for the first time in almost 100 years. Since then, China has begun efforts to attract foreign investment. Four designated areas, so-called Special Economic Zone (SEZ), were mapped out and more than ten costal cities were designated as "Open City" where foreign investors could establish factories and engage in commerce. In the SEZs and open cities, favourable conditions were offered to foreign businesses which domestic businesses in other areas have no title to enjoy.

In this environment, since 1979, a series of laws and regulations have been enacted to enable the inflow of foreign investment and provide it with basic protection, as will be reviewed in detail below. Although these laws are not perfect, they mark a good starting point for this historic change. They are by name the following:[22]

A. *The Law of Chinese-Foreign Equity Joint Ventures* (hereinafter: Equity Law), enacted in 1979 and amended in 1990, supported by its *Implementation Rules* (hereinafter: Rules) promulgated in 1983;

B. *The Law of Chinese-Foreign Contractual Joint Ventures* (hereinafter: Contractual Law), enacted in 1988, supported by its *Implementation Rules* (hereinafter: Rules) promulgated in 1995;

C. *The Law of Foreign Capital Enterprises* (hereinafter: Foreign Capital Law), enacted in 1986, supported by its *Implementation Rules* (hereinafter: Rules) promulgated in 1990.

The Ministry of Foreign Trade and Economic (MOFTEC) was established to administrate and promote foreign investment. Pursuant to the above three laws and their implementation rules, MOFTEC promulgated a number of regulations to regulate and promote foreign investment.[23] The four SEZs and the Open Cities also promulgated their own local

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[22] Online: Chinalaw114 <http://www.chinalaw114.com/chinafa/category.asp?cate=167>. (date accessed: 22 July 2001).

[23]The important ones include:
a .Provisions on the Contribution of Capital by parties to Chinese-Foreign Equity Joint Ventures. 1988
b. Interim Provisions for the Duration of Chinese-Foreign Equity Joint Ventures. 1990
c. Provisional Regulations on the Establishment of Foreign-Funded Joint Stock Companies Limited. 1995
d. Provisional Regulations on Investment Companies Established by Foreign Investors. 1995
e. Provincial Measures on the Establishment of Sino-Foreign Joint Venture Trading Companies on a Pilot Basis. 1996

regulations pursuant to the three foreign investment laws and the regulations enacted by MOFTEC.

Together these rules provide basic protection or promotion for FDI and have contributed much to China's booming economy of recent years. However, in the more than 20 years since the promulgation of the first FDI-related law, no significant revisions have taken place.[24] Today, as the economy becomes more and more global, the following restrictions continue and frustrate the growing need for FDI.

5.3.2: The Weakness of China's Foreign Investment Laws

(1) Area Restrictions.

First of all, only limited geographical areas, the SEZs, actively promote FDI. Unbalanced inflow of FDI in different areas has given rise to uneven distribution of material and wealth and uneven development across the country. In consequence, the gap between the east and the west of China has grown with attendant social problems, such as the deterioration of the eastern environment, the excessive demand for infrastructure due to the expansion of costal cities, and even problems associated with national defence.

(2) Industry Entry Restrictions.

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f. Interim Provisions Guiding the Direction of Foreign Investment
g. A set of examination and approval policies regarding foreign investment in the transportation on water sector. the civil aviation sector, the construction sector, and the advertising sector etc and a set of principles and procedures.

[24] A recent news release announced that amendments to the Contractual Joint Venture and the Foreign Capital Enterprises Law were passed on October 31, 2000. It is said that some performance requirements restrictions are moved but without detailed information provided. See "Amendments to the Contractual Joint Venture Law", online: <http://finance.sina.com.cn/g/20001103/90851.html> (date accessed: 3 November, 2000)

The Equity Law provides a list of the fields in which establishment of equity joint ventures are permitted, most of which are manufacturing-related, agriculture-related, and tourism-related. Many others, such as financing and telecommunication etc., are precluded from the list.[25] The Contractual Law regulates the scope of business which must be approved by the authorities, including a provision that requires that imports and exports must be connected to the scope of business.[26] The Foreign Capital Law provides more detailed and stringent restrictions on the choice of fields for the foreign investors. In its implementation rules, that law establishes three categories, namely, "Prohibited field", "Restrictive field", and "Non-restrictive field". Notably, media such as news press, publishing, TV, film and broadcasting, domestic commerce, foreign trade, insurance, and post and telecommunications are prohibited from foreign investment; and many fields, including public utility, transportation, real estate, trust and investment, and leasing, are restrictive fields for foreign investors.[27]

(3) Investment Life Term Restriction.

The Equity Law prescribes a time limit of between 10 to 30 years for the term of joint ventures with an exception for special projects allowed to exceed that limit.[28] The Law requires that, for investment in some fields, the term of the ventures should be determined ahead of time and that the ventures must apply for approval with the authorities six months

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[25] Rules for Equity Law, Article 3.

[26] Contractual Law, Article 1.

[27] Rules of Foreign Capital Law, Article 4&5.

[28] Rules for Equity Law, Article 100.

ahead of the termination of the contract term.[29]

(4) Establishment Procedures Restrictions.

All establishments of FIEs are subject to government approval. Most of the time, the establishment of a FIE is subject to a very complicated review and approval procedure. The multiple-approval system involves several approving authorities, and requires application to obtain licenses before the start of the FIEs. As a result, approval of FIEs is a lengthy and costly process, and sometimes the best investment chances are missed. Another negative effect is that the complicated approval process may lead to corruption, abuse of power, and inefficiency.[30]

(5) Restrictions on Approving Criterion.

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[29] Equity Law. Article 12.

[30] For example. to start a Equity Joint Venture. the incorporators have to draft the Project Proposal and Preliminary Feasibility Report and submit them for review and approval by several authorities. Only after these documents get approved do the parities sit down to negotiate on the agreements or contracts and work out the articles of incorporation. The contracting parties will still have to obtain comments from both the administrative departments of the China party and the provincial government where the FIEs will be located. Then these documents must be submitted to the Approving Authority and then registered with the Registrar.(Rules for Equity Law. Article 9&10&11; Rules for Contractual Law. Article 7&8) For the establishment of Contractual Joint Ventures. other documents such as business licenses and financing certificates. are required (Rules for Contractual Law. Article 7).Foreign Capital Enterprises have to go through more procedures and provide more documents. For example. if the products of a Foreign Capital Enterprise involve export licence. export quota or import licence. it must get approval of the authorities of foreign economic and trade beforehand. And before the submission of the application for the establishment of the company. the foreign investor must submit to the local government a detailed report covering the following contents: the purpose of the establishment. scope of business. scale of the business. products. technology and equipments used. the proportion of the sale of the products in domestic market. land use. and requirements for water. power. fuel and public facilities. The company must also submit a list of imports intent with all other documents to the Approving Authority.(Rules for Foreign Capital Law. Article 9&10&11).
The laws also require that if an Equity Joint Venture wants to set up a branch or a sale agency. it must get the approval from the MOFTEC.(Rules for Equity Law. Article 42). A party must get the approval from the authority if it wants to transfer to a third party in whole or in part of its contribution (Rules for Equity Law. Article 23). A party of a Contractual Joint Venture that wants to transfer its right or obligation to the other party must also get approval from the Approving Authority (Contractual Law. Article 10). If a Foreign Capital Enterprise wants to separate itself or merge with others. it must obtain the approval too. (Foreign Capital Law. Article 10).

With respect to the establishment , the worse thing is the unclear definition of the criterion for approval. The criterion is defined to "be instrumental to the development of national economy" or "in conformity with the national economic policy". If the establishment of the FIE is "not in conformity of the needs of the national economic development "or " against the national industry's policy", it cannot be approved at all.[31] The ambiguity of this standard not only leaves government with unlimited discretion to prohibit or regulate outward investment flows, but also makes the prospective foreign investor confused whether its investment will be approved or not.

(6) Performance Requirements Restrictions .

Firstly, as a condition of approval, a Foreign Capital Enterprise must sell over 50% of its products to foreign markets.[32] If a Foreign Capital Enterprise is to sell its products within domestic markets, a limited proportion must be granted first and additional approval has to be obtained if the limit is exceeded.[33]

Secondly, the laws set restrictions for the purchase of materials. These materials, including equipment, fuel, transportation vehicles etc, have to purchased, as the first choice, from domestic markets. Otherwise, the company has to arrange by itself the foreign currency to purchase them directly from the international markets.[34] Foreign Capital Enterprises may purchase the materials from either domestic markets or international markets, but should take

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[31]Rules for Equity Law, Section3. Article 5; Rules for Contractual Law. Article 9.

[32]Foreign Capital Law. Article 3; Rules for Foreign Capital Law. Article 3.

[33] Rules for Foreign Capital Law. Article 45.

[34] Equity Law. Article 9.

the domestic as the first choice given the likely contracting conditions.[35]

Thirdly, the laws provide that part of the contribution equipment or material provided by the foreign investors must be those which are not able to be produced in China and the price must be assessed reasonably. The laws also require that industrial property or know-how must be "advanced and applicable" enough to improve productivity.[36] The contribution of both equipment and industrial property must be reviewed and approved by the authorities.[37] Technology transferring contracts are also subject to prior approval.[38]

Finally, both Equity Joint Venture and Foreign Capital Enterprises must insure their property with a Chinese insurance company,[39] and only Chinese citizens are permitted to act as chairs of the Board of Directors.[40]

(7) Financial Regulation Restrictions.

These restrictions include the responsibility of the FIE for balancing its foreign currency account[41] and maintaining a mandatory minimum shares input[42], as well as the

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[35] Foreign Capital Law, Article 15.

[36] Rules for Equity Law, Article 44.

[37] Rules for Foreign Capital Law Article 27,28&30; Article 27&28.

[38] Rules for Equity Law, Article 46.

[39] Rules for Foreign Capital Law, Article 83; Equity Law, Article 8.

[40] Equity Law, Article 34.

[41] See Rules for Equity Law, Article 75; Contractual Law, Article 20; Foreign Capital Law, Article 18; Rules for Foreign Capital Law, Article 56.

[42]The Equity Law stipulates that the foreign parties shall hold a minimum of 25% in the registered capital (Equity Law, Article 4). The Contractual Law provides that in the case of the enterprise taking the form of limited liability corporation, the foreign investor also shall inject at least 25% of the registered capital. (Rules for Contractual Law, Article 18).

prohibition against reducing its registered capital during the term of operation,[43] and so on.[44]

(8) Other Operation Rights Restrictions.

Firstly, the FIEs do not have the freedom to set the price for their products in some cases.[45] Other rights such as separation and amalgamation of FIEs and transferring shares and mortgaging assets are also restricted and subject to approval.

Secondly, companies have to apply every year for import licenses and export licences for materials needed and their products.[46]

Thirdly, the laws prohibit Equity Joint Ventures from transferring their usage right of land and restrict Foreign Capital Enterprises from transferring the usage right within operation term without permission.[47] A permission is also mandatory for a Foreign Capital Enterprise to mortgage its assets.[48]

(9) Provision of Tax Incentives.

Tax incentives are not restrictions. However, these provisions lead both to the reduction of national revenue and taxation income and to uncertainty among foreign investors

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[43] Rules for Equity Law. Article 22; Rules for Contractual Law. Article 16; Rules for Foreign Capital Law. Article 22.

[44] If an Equity Joint Venture wants to buy gold. silver. platinum. oil. and coal from domestic market for the purpose of production. these goods must subject to international prices. As well. the Equity Joint Venture must pay foreign currency if it purchases from China's trade companies. In addition. the products which are to be sold in domestic market are subject to the price level set by the government: only those for export can have the price decided by the company on its own.(Rules for Equity Law. Article 65&66).

[45] If the products of FIEs will be sold to domestic market. the price must be within the level limit set by government. FIEs only have the right to set their price when these products are sold to international markets.

[46] Rules for Equity Law. Article 63; Rules for Foreign Capital Law. Article 47.

[47] Rules for Foreign Capital Law, Article 36.

[48] Rules for Foreign Capital Law. Article 24.

who may be concerned that these incentives will not last long and may therefore become discouraged on investing. In fact, according to one survey, under certain legal frameworks, market scale, labor cost and productivity and not financial incentives, are the decisive factors for foreign investors in making their final investment decision.[49]

This is but an overview of the restrictions which China's laws place on FDI. More restrictions may be found in the by-laws or regulations promulgated by MOFTEC and other authorities such as SAFE and the State's Administration of Industry and Commerce (SAIC).

(10) Other Policies Detrimental to FDI's Further Development in China

Strict price regulation impedes further development of FDIs in China. The government rather than the market plays the decisive role in setting prices, and this regulation of price has become one of the biggest impediments to the inflow of FDI. China's governments still control the price setting of most products, including agriculture, food, electricity, oil and even some services such as telecommunication, civil flights, and train transportation. For example, FDI has been allowed to enter the power sector, but the price of electricity and the price of power is decided by government. These price regulations, in some cases, not only reduce the price differences between the inputs and outputs and result in a decrease of profitability, they also increase the risk factors due to their universality and uncertainty.

Another important impediment arises from the strong State-owned Enterprises themselves. The protection and support the SOEs receive in all aspects puts them in a more advantageous position over FIEs, which are under the category of "Private Enterprises". Therefore, some foreign investors may find themselves reluctant to enter a ceratin field to

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[49] IMF. *Lessons and Experiences: Foreign Direct Investment* (Washington: World Bank, 1997) at 85.

compete against the SOEs which may receive subsidies or other preferential treatment.

Conclusion:

Compared with the requirements for protection and promotion provided by WTO, NAFTA, and other international organizations, China FDI laws fail to provide for national treatment and MFN treatment to FDI. The protection provided by law is not sufficient to attract FDI, nor do the laws follow the investment neutrality principle. Investment screening, performance requirements, and local participation requirements are prescribed, and complicated approval procedures and requirements are still mandatory.

5.3.3: Strengthening of China FDI-related Laws to Facilitate Privatization

Privatization with the participation of foreign investment will tie China closer to the rest of the world; China's integration into the global economy through the foreign capital ties will, in turn, increase the possibility of a successful privatization. Now that China is a member of the WTO, it should undertake to improve its legal framework especially as it concerns foreign trade and investment.

Suggestion:

To promote foreign investment in China for privatization, the following principles should be considered and changes made accordingly:

1. Formulate a Privatization Law, which would identify the businesses for sale to foreign investors and outline the process; a special body or agency might be created to coordinate the detailed process, or the decision-making power might be entrusted to the State Economic and Trade Commission.[50]

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[50] See details in Chapter Six *infra*.

2. To satisfy the requirements of WTO, adopt a more liberal economic policy and amend foreign investment laws to improve the protection of FDI by providing National Treatment and Most-Favoured-Nation treatment to FIEs. Investment neutrality should be strengthened, established approving procedures simplified, and all restrictions such as investment screening, local participation and performance requirements lifted.

3. Especially the tax incentives provided by legislation to FDI should be removed. As an alterative, a low-level while neutral taxation system which suits all kinds of investments should be established.

4. Technically, rescind the three foreign investment laws and amend the existing Company Law, and in their place put a "Foreign Investment Protection and Promotion Law" and a general Company Law. The "Foreign Investment Protection and Promotion Law" will provide National Treatment, Most-Favoured-Nation treatment, and other promotion measures to FIEs. The approval procedures for establishment of FIEs will be defined by the new Company Law.

5. Improve Securities Law and make the market more regulated and standardized by increasing transparency and providing a set of mature rules to promote capital raising and to protect the rights of investors. [51]

7. New laws with respect to designing and introducing efficient financing mechanisms such as BOT and Project Financing should be introduced and named as "China Foreign Financing Law".

5. 4 Securities Law

[51] See details in *infra* section below.

Securities markets play a very important role in privatization. If a country has a well-developed and well-regulated securities market, it will have more options to transfer the ownership of enterprises. China's securities market is ten years old, but the Securities Law was enacted as recently as 1999. Suffering a series of problems, the market, in essence, is far from developed. A developed securities market requires two things: a developed market structure and system and strong regulation. The former has been discussed in Chapter Four. The following part will mainly focus on the regulation of the market.

Strengthening regulation requires first of all separation between government and business enterprises in the securities business. However, driven by the State's policy instead of market rules, China's securities market is always subject to governmental interference which has turned the market into a 'planned market'. Until quite recently, approval had to be obtained from government to issue shares on the securities market. Although independent and professional non-government organizations have taken on the role of recommending enterprises for listing, the market still has features of a planned economy: governmental influence can still be found in decisions affecting the qualification of an issuer, the amount of shares to be issued, the price and the time to be listed, and so on. Strengthening the regulations also requires the regulator itself, China's Securities Regulation Committee, to limit its role to making judgments concerning conformity with the rules. It must cease acting as an administrator which decides all of the operations of the securities market.

Since privatization needs participation of private capital, strengthening the regulations must also include protection of the interests of the investors, especially private investors. However, in China, lack of adequate protection for the investor's interest leads some private investors to prefer depositing their money in banks rather than investing in the securities markets. At present, unlawful operations have become so serious that infringements have become common practice with many listed companies. Among the infringements, illegal release of information, insider trading and associated transaction (self-transaction) are the most serious phenomena. Sometimes, these are connected to government corruption. Mechanisms should be established to guarantee a strict implementation of rules concerning the behaviour of the listed companies, stock exchange markets, and intermediaries such as accounting and law firms.

Associated Transaction

Under market conditions, transactions are always done on equal terms. However, in China's securities market, unequal-value transactions are not uncommon, associated transactions or self-transactions included.[52] Associated transactions occurs when a company transacts with its own shareholders, member companies, or other subsidiaries. Often used to transfer assets illegally, this kind of transaction can easily lead to unequal-value transactions and most associated transactions are finished outside of the securities market in an opaque way, which always harms the interest of minority shareholders and creditors. For just this reason, transactions of this sort are prohibited or restricted by securities laws in most countries. However, China's Securities Law provides little restriction of associated transactions nor does it provide any rules on transactions outside of the securities market. In China, associated transactions between listed companies and their parent companies or

[52] "Six Major Problems in the Restructuring of Listed Companies". *China Economy Review* (26 February. 2001). online: <http://cndaily.sina.com/headline/fnHeadline/2001/0227/2851249.html> (date accessed: 26 February. 2001).

subsidiaries always take the form of assets purchasing, shares transfer, lease of assets, borrowing, or mortgage pledge. Few of these transactions are declared and submitted to shareholder meetings for discussion, and indeed some companies fail even to keep financial records of the transactions. For example, some companies engaging in associated transactions to make the financial sheets look more profitable for the purpose of fraud. In the case of balance sheet restructuring, the controlling shareholder(s) may purchase or lease the inventory or assets at a very high price or borrow money at a very high interest from the listed company. No transaction really happened and no cash has been paid, yet the transaction will be recorded as receivable on the balance sheet which makes the company look more profitable. All of these infringe upon the interest of the investors at large and harms the interests of minorities shareholders and creditors particularly. Legal changes must be made to restrict associated transactions. For example, when the associated transaction values over 5% of net value of the company, information release must be made, the transaction must be submitted for approval of minority shareholders in the absence of the majority shareholders, and independent advisor's judgement must generally be sought.

Other forms of fraudulent transaction are made between two different companies without any legal links, yet are similar to associated transaction in some ways. [53] They also involve un-equal value transaction where some companies exchange their high quality assets or huge cash for the low quality assets in listed companies. The objective of the transaction is to acquire the 'shell' or the legal status of the listed company, a kind of resource, to obtain low-cost and low-risk capital from the market. The transactions, sometimes even pushed by

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[53] *Ibid.*

government with a promise to compensate the former for the loss, turn out to be fraud in most cases, where the raised capital is always transferred away illegally.

Information Release and Insider Trading.

China securities law does provide rules to regulate information release and to prohibit insider trading, but in practice, violation of these rules is not uncommon.

According to the law, the information released must be truthful, accurate, complete, fair and timely; however, delayed release and misstatement always take place. Recent cases reveal that some listed companies have learned to release the information to some selective persons such as the brokers. To prevent this kind of violation, China must introduce the experiences from USA securities law. According to the American "fair transaction rules, if a company releases the information to some persons, it must release it to the public at the same time. Even if the release is not intentional, the same and complete release must be made within 24 hours".[54] China's securities regulator should strengthen the enforcement of the laws. To this end, information release must be supervised in an active way and on a continuous basis. And the law must define the term of 'materiality' in a clearer way to avoid any loopholes that the listed companies may take advantage of.

Connected with the information release, insider trading is also common in China's securities market. China lacks a complete set of rules to prevent such violations. Liability, both civil and criminal, should be set for insider traders. Rules must be put in place to restrict the behaviour of brokers and their dealers, and they must be subject to joint liability where

[54] "Selective Information Release Is the Variation of Insider Trading". *Financial Times* (13 April. 2001).online: <http://finance.sina.com.cn/y/52332.html> (date accessed: 15 April. 2001)

circumstances warrant.

Requirements Before Listing

Before a company is approved to be listed, prior restructuring must be undertaken to meet the qualifications set by the regulator or the stock exchange. In China, the threshold for companies to list is still rather low in terms of management level. Generally speaking, the qualifications in terms of management level should at least include the following: the company must operate and assume the responsibilities and risks independently; it must have established sound corporate governance; and it must be committed to avoiding 'unfair competition in the same sector' and to reducing associated transaction. Hence, restructuring must aim to improve the corporate governance of these would-be listed companies and transform them into standard joint stock companies, as well as to oblige them to conform to international practices with respect to financial rules and management of assets and human resources.

It is especially important for China to improve the governance structure of the listed companies, the quality of which is the foundation for a healthy development of the securities market. For this purpose, basic rules and standards for the governance structure of China's Listed Companies should be enacted to strengthen the working procedures of the board of directors and to improve the supervision by the board of directors or the management team. OECD requirements are a good example, for instance, the management of listed company must be recruited from the market and should not be civil servants or have any close connection with civil servants. A new salary stimulation system will also help to improve the governance structure of China's listed companies.

However, at present, the dominance by the State share in the listed companies will prevent the establishment of an effective governance structure and will harm the protection of the interests of private shareholders. This problem can be solved only by the enactment of new laws to enable the State share to be traded and transferred to private investors.

Lack of Protection of the Interest of Minority Shareholders and Creditors

China's securities law fails to provide adequate protection for the interest of minority shareholders. This can be attributed to several drawbacks of the law. First, the law fails to restrict associated transactions and insider trading, as has been discussed above. Second, the law protects the State's control of the listed companies by restricting the State share, which accounts for two-thirds of a listed company, from being traded. In consequence, all issues are decided by the controlling shareholders or the State representatives, while the minority shareholders, alway being private investors, have no say at all. To make matters worse, the laws do not provide a set of rules on the collection of votes made by scattered minority shareholders, most of them individual investors who can only vote 'with foot'.

The securities law also fails to provide adequate protection of the rights of creditors. For example, in all kinds of restructuring designed for listing, a great quantity of low quality assets and debts are stripped away from the company and transferred to the controlling parent company, which, however, does not have enough assets or profitable business to guarantee the repayment of the debt. In such case, it is very difficult for creditors to obtain satisfactory remedies from the existing laws.

China's securities laws also lack provisions to enable investors to be compensated if they suffer loss due to the fraud such as insider trading, market manipulation, and misleading information. The regulator should support the claims lodged by investors by hearing the case; however, according to the exiting laws, the regulator can only impose administrative sanction on the wrongdoers by confiscating the illegal income to the state's treasure. To better protect the interests of the investors, civil procedures should be applied to these cases. The relevant amendment should be added to the existing securities law. In addition, for better exercise of the authority and functions of the regulator, the securities regulator should be seized of more powers to investigate, as is the case in Hong Kong. For example, the regulator should have the power to get a 'document of search' from the court or check bank accounts of the suspects.

Conclusion:

A sound and well-structured securities law system has not formed in China. The existing laws, which compromise the interests of all kinds of parties, need amendment in many respects. Also, entirely new legislation needs to be enacted. For instance, rules about acquisition and merger should be designed to standardize all kinds of restructuring; an Investing Funds Act needs to be enacted to meet the principles and requirements of the WTO; uniform contracts must be designed for market players such as the stock exchange, brokers, stock investors, and settlement bodies; rules must be put in place to standardize the services of such intermediaries as accountants and lawyers. All of these amendments or improvements must be subject to the primary objective of strengthening the regulation of the market, because only a well-operated securities market which provides adequate protection to investor interests can facilitate the privatization of the economy.

5. 5 Banking and Financing Laws

Privatization, especially enterprise-level privatisation, is actually a kind of transaction of assets, which inevitably needs the participation of banks. All financial settlement must be done with banks; banks also can provide debt financing and other products and services for the investors; moreover, banks themselves sometimes are the investors or buyers in the privatisation. A developed credit and bond market based on the banking system will no doubt facilitate the process of privatization.

Global experiences indicate that an open banking sector will contribute much to the success of privatization. In all countries which have successfully implemented privatization, the banking sector is open to private investors including foreign banks. Indeed, opening the banking business to the private sector is an integral part of economy privatization.

Comparatively, China's banking sector is still a closed one dominated by State-owned banks, where the interest is controlled by the government rather than by the market and China currency is not convertible under capital items. Particularly, the inconvertibility of China currency under capital items seriously hinders the further development of the capital market, and this discourages foreign investors from investing in China's market. To open the banking sector, legislation must be enacted to enable private capital to enter. Presently, no private banks are permitted in China and even the number of join-stock banks is very small. Moreover, foreign banks based in China are precluded from such business as lending and receiving deposits.

In a number of western countries, banks have participated in privatization as buyers, which has proved to be a successful practice. But, in China, the prohibition of banks and insurance companies from investing in securities market precludes this possibility.[55] Rules prohibiting banks from investing in the securities markets originated from 1933 USA Banking Law which attempted to reduce 'foams' taking on the stock market and thus to prevent financial crisis. But later it was proved that the financial crisis had few links with the involvement of banks in the securities business. Indeed, in November 1999, USA promulgated *The Financial Service Modernization Act* which repealed these rules.[56] If only for the purpose of privatization, China must amend the associated provisions in the existing banking laws and securities laws as soon as possible, lest China face challenges from foreign financial institutions, which, always investing in all kinds of financial business, will gush into China now that China has been admitted to the WTO.

5. 6 Labour Law

Privatization is not just the transfer of assets or property from public to private sector, it is also a transformation of employment relationships. In China, staffs formally hired by SOE have different political and economic status from others working in private sector. SOE employees are recruited, from the labour law point of view, by the state, rather than only by the SOE itself. An SOE's staff can enjoy many special privileges, such as life-time guaranteed job, medical insurance, housing and so on, which others working in the private sector and China's 0.9 billion peasants do not enjoy.

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[55] Article 43 of "China's Commercial Banks Law" provides that "within China's jurisdiction, the commercial banks shall neither invest in trust and securities business nor invest in non-self-use real estate", and "commercial banks shall not invest in non-banks financial institution and other enterprises".

[56] X.Shen.Qiao. "Securities Law Needs Amendments Urgently". *China Youth Daily*. (2 Feburary. 2001. A1). Also see F. Guo. *Regulation and Legislation of China's Securities* (Beijing: Law Press. 1999)at 136.

When privatization happens, the employees of the privatized enterprises will also face the problem of losing the status of 'state employee'. Job guarantee will no longer be available, and the employees will find that they have been pushed to the labour market. As a rule, the labour market should be directed by market rules, and laws and new rules are urgently required to regulate the operation of the market.

First of all, new rules must be in place to adjust the transitioning employment relationship. For this purpose, a labour contract system must be established and applied to all kinds of enterprises. The management of labour contracts must be improved to standardize the establishment, change, and termination of labour contracts, and the essence of the labour contract, freedom and equality for both sides, must be guaranteed. This is the first step in protecting the interests of the employee under transition conditions. In some cases, collective contracts may be a consideration. Collective contracts are reached after a fair discussion between the employer and the representatives from the employees at large. Hence, this kind of contract should apply not only to the individual employee, but to those employees who have common characteristics. In this way, democracy is promoted among the management of the enterprises. To bring more fairness to the establishment of labour contracts, a three-party coordination system must be set up on basis of coordination meetings held among representatives from governmental departments in charge of labour relationship and worker and employer unions. This system may exist at multiple levels, from national level to grass-roots level. Moreover, to deal with possible disputes arising out of the labour contracts, a meditation and arbitration system with multiple level and multiple forms must be strengthened, institutional bodies must be set, and arbitration teams must become more professional.

Secondly, new rules are needed to change the old salary allocation system which is cursed with numerous problems, including the following: salary is not linked with performance; salary level in monopolized sectors is unreasonably high; the decision mechanism to set salary is still crude; and so on. The new labour law should recognize the legitimacy of income derived from investments including capital and technology and other productive elements rather than just labour input. The law must also provide some stimulation mechanisms. These may include linking the annual salary of an enterprise's top management to performance, which is the risk they hold and the responsibility they assume in business management and operation. For top management and key technological staff, share option is also a good sweetener.

The decision-making mechanism for setting salaries also needs change. In the past, the salary level was unilaterally decided by the state disregarding the specific productivity and performance conditions of different enterprises. The new rules should recognize the right of an enterprise to decide the salary level for its employees on its own. The new mechanism will take into account the market price of a certain labour and the economic efficiency of the enterprise itself. A supervisory and monitoring system for salary allocation needs to be put in place to guarantee the establishment of the lowest allowable salary line and enforcement of the rule, to improve the transparency in the income allocation by disposing of unreasonable or illegal income, and to adjust excessive income through income tax.

Finally, the new laws should eliminate all the obstacles which prevent the establishment of a unified, open, competitive, and regulated national labour market.

Presently, in China, people have no freedom to move their residence from one place to another, and in most cases, people are only allowed to work in the area where their residence is registered, In consequence, freedom to choose one's job is handicapped. The residence registration system should be abolished, and the personal files system should also be modified. All these legal changes are necessary to create a market where the labour force can move freely from one area to another and from public to private sector.

5. 7 National Safety Net

China has not established a complete and sound social insurance and protection system. Without the support of such a social safety net, it is very dangerous to launch a large scale privatization program. The restructuring of an overstaffed SOE will inevitably lead to down-sizing of the numbers of employees. Indeed, so far, about 21 million persons have been laid off from the SOEs.[57] Some of those laid-off find themselves in trouble because they can receive little support from the government if they cannot find new job opportunities. Unemployment without support from social insurance and protection will threaten social stability.

A basic standard of living system was set up by the government from the early 1990s. Under this system, some SOEs, particularly small ones, pay the laid-offs a severance fee which terminates entirely the employment relationship. Others may establish a 're-employment centre' to provide further training and help those laid-off find other jobs. The re-employment program is limited to a certain period, say, half a year or longer. Those who

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[57] See "the Tenth five-year Outline for the Development of Labour and Social Safety Protection". on line: MOLSS homepage. < Http//www:molss.gov.cn/news/2001/05141.htm.> (date accessed: 5 August. 2001).

are put under the program may receive some basic financial aid until the period expires, at which time they will be pushed out of the centre and have to solve all their problems by themselves.

Neither the severance pay nor the re-employment program is able to solve the problems of the laid-offs. When the laid-off find themselves in trouble again and have no means to live, they may turn to crime which also seriously threatens social stability. China needs a national and uniform safety net, which consists of at least three components: unemployment insurance, retirement pension, and medical insurance. Under this net, the SOEs are freed from the burden of assuming responsibility for their laid-offs, and the laid-off can receive protection from this umbrella as soon as they lose their jobs. This net must be independent from all enterprises and institutions, with funds coming from multiple sources and managed by professionals.

First of all, since privatization, especially a mass privatization program, will influence all kinds of citizens, the net must cover all enterprises, both public and private. It must also apply to every citizen, including peasants who comprise the majority of China's population. For decades, China's 0.9 billion peasants have received no social insurance at all from the government, including medical insurance and unemployment insurance. They are not even included in the samples government uses to calculate the unemployment rate. In the movement towards industrialisation and urbanization, many of the peasants have actually lost their links with and support from the piece of land allocated to them in 1980s.[58]

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[58]In the late of 1970s and the early of 1980s, according to Deng's reform, each peasant across China was allocated a piece of the land for personal use. However, when a peasant becomes a State employee, he or she loses the right.

Secondly, the net must be funded from multiple sources. A lack of capital is the major obstacle. Besides the money allocated from government's budget and collected from both enterprises and individuals, it is suggested that government use the revenues from the sale or flotation of SOEs to complement the net account. In June 2001, the State's Council promulgated "The Interim Methods to Sell State's Shares in SOEs to Collect Funds for Social Insurance ", under which state shares equivalent to 10% of funds to be raised must be sold to the public and the revenues hence generated transferred to the control of National Social Insurance Fund, an institution specially organized to manage the fund.[59]

Thirdly, the funds must be entrusted to professionals for operation under market rules. The funds may take all kinds of measure to achieve value-adding, for example, listing on stock exchange, purchase of other SOEs, investing in other projects, and so on.

Finally, such activities as the payment of insurance may contracted out to banks and hospitals, and others such as the registration of unemployment and the retirement, may be stripped from enterprises or institutions and handed to community services.

To establish this net, a series of laws and rules are needed. Up to now, the State Council has promulgated some rules, including "the rules of unemployment insurance", "Interim rules regarding collection of social insurance fee ", "Decision on the establishment of uniformed pension for staff in city and urban "and so on.[60] These measures are not sufficient to provide the protection and support required. New laws are urgently called for

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[59] N.Wang. "Rules published to Sell State's Shares". *People's Daily* (13 June. 2001) A3. See more details in Chapter Five regarding the institutional setup for China's privatization.

[60] See "the Tenth five-year Outline for the Development of Labour and Social Safety Protection". on line: MOLSS homepage. < Http//www:molss.gov.cn/news/2001/05141.htm.> (date accessed: 5 August. 2001).

to make the net system more reliable and sustainable and to bring more people under its umbrella. To this end, the government should enact "Social Insurance Law" and associated laws such as "rules on pension", "rules on compensation for injury on duty", and so on.

In addition, other matters such as the supervision of the fund require detailed regulations. The new law must provide rules needed to establish a supervisory system for the budgeting, fee collection, insurance payment, funds management and operation, and all other aspects of the process involved. Institutions, including auditors and representatives from enterprises , workers union, and government, must be set up to guarantee the transparency and efficiency of the whole process of the funds operation; investigation, prosecution and penalties must be provided to prevent all kinds of risks possibly arising.

In some cases, professional training should also be considered to be an important element of the social safety net, especially when large scale privatization is implemented. Similarly, the training should not be provided by the individual SOE to be privatized, but by a unified training organization established for the sole purpose of training for privatization. A privatization law may include this in its issues to be addressed.

5. 8 Dispute Settlement

An efficient, transparent, and impartial dispute settlement system will inevitably increase the attractiveness of the investment environment. However, the improvement of the system will involve the reform of the whole judicial system in China. A detailed discussion of this aspect exceeds the intention of this thesis, but it is critical to stress the importance of judicial independence to dispute settlement arising in the process of privatization. China still has a long way to go to achieve the rule of law,[61] where administrative power is restricted and the privileges of the court are widely respected. One principle of the rule of law is that the courts must be independent and the primary adjudication centre. In China, courts are situated in police stations and procuratorate and judicial power yields to administrative power. Also, judicial acts always serve the political interest. In the absence of independence, judicial corruption is not uncommon, and neither transparency nor justice can be guaranteed in dispute settlement. To improve this situation, radical judicial reform has to be undertaken. For example, to achieve transparency, all 'hidden rules' must be abandoned, and rules or laws must be publicized before they are enforced. Moreover, as a part of the reform, privatization of the judicial sector may help to increase the impartiality of dispute settlement in a short term.

[61] Ironically, President Jiang ZeMin recently advocates using "morality" to administer China. See the Editorial tilted "Use Morality to administer China" *People's Daily* (1 February, 2001) A1.

Chapter Six: Enabling Laws - Sale of the State Shares

Along with the promotion of the private economy to dilute the role of the public economy in China's whole economy, laws should also be placed to provide exit channels for some SOEs, a process often termed enterprise-level privatization. Compared with the first approach, enterprise-level privatization is a subordinate consideration for China. A number of techniques have been used around the world to privatize SOEs, and most of them can be applied in China on the condition that associated legal changes are brought in beforehand or at least at the same time as the implementation. Whatever the case may be, the key point is that laws need to be in place to complete a safe, fair, and efficient ownership transfer from public to private sector through market measures and to prevent the illegal transfer of the State's assets.

6. 1 China's SOEs

Before this thesis goes on to explore the specific enabling laws needed to privatize the individual SOE in China, a brief review of China's SOEs is in order.

Both in theory and in reality, the SOEs are the major players in China's economic arena. Important sectors such as manufacturing, public facilities including the operation of power and oil production, and financial services are controlled by public ownership, and most of the companies in these fields are SOEs exclusively. Indeed, with the exception of some tertiary services, the agriculture industry, and perhaps some light industries and some information network companies booming in recent years, which have investment from private capital, the SOEs still position dominantly in national economy.

From the early of 1990s, the SOEs undertook a series of restructuring moves. Firstly, some of the state-owned enterprises were restructured to become standard companies pursuant to the Company Law, and some of these became limited liability companies and others stock-holding companies. Superficially, Shareholder Meetings are formed and Boards of Directors are created. Securities law was enacted in 1999 to enable the stock-holding companies to pool money through the stock exchange. Around 1997, a further restructuring campaign was commenced in an attempt to make the SOEs 'sharized', a legal action to divide the whole ownership of an enterprise into different shares and then to allocate them to different owners. The result of the 'sharization movement' was that most of the SOEs later found themselves becoming owned or controlled by multiple shareholders, but all these shareholders were just different representatives of the State, which merely serve as the investing agencies of the State. As a result, these companies are still typically owned and controlled by the State.

As in most other countries, China's SOEs now face a number of problems including low productivity as a result of low level management, overstaffing, high debt ratio and lack of capital, and so on. The SOEs occupy the most valuable part of China's resources, but fail to use them efficiently. Consequently, China's economy is suffering slower development, and is even threatened by a complete halt in a near future. Therefore, to develop the economy further, remedying the problem of the SOEs is the first priority. Privatization may be the last resort and the only workable solution to these problems.

In China's move towards capitalism, trials have been undertaken to transfer the ownership of SOEs to private operators for a temporary period. Contracting (to individuals), one of the techniques used, was once very popular. Contracting does not transfer the ownership permanently, and in practice, the contracting terms were always set for a short period, say, one or two years. Contracting was only suitable for very small enterprises, because it was very dangerous to entrust a big enterprise to an individual, who probably did not have any business management experience and probably won the contract because of personal connections to one of the governments. Indeed, no rules or laws were in place to guarantee a proper choice of contractor, and no mechanisms existed to ensure that the contractor acted in the best interests of the enterprise. In consequence, most often, the contracted enterprises ended in bankruptcy while the contractor became rich.

The real-sense privatization experiments took place since 1991, when in some areas, some SOEs explored selling some proportion of shares to their employees, thereby permitting the employees to become minority shareholders. This technique too soon got criticised and failed to spread across the country. Nor was this without reason: allocating shares to employees in a simple way raises the problem of social unfairness since some enterprises are well-off while others are not.

New techniques of privatization have been introduced. In 1994, Zhuhai Hengtong Group purchased part of the State shares held by Shanghai Building Materials Group, in the first example of trade sale. And on June 6, a SOE called Dongbai sold all State shares it held through bidding process to private investors. [1] A rule titled "Sell the State's share to raise money for the National Social Insurance", was promulgated by the State Council on June 12,

[1] This the first bidding case to transfer the State shares. The tender asked for 165 million China Dollar, the winning bid was 192 million China dollar. See J.Xu, "Bidding for the State Shares in Dongbai Group", *Shanghai Securities Daily* (8 June, 2001) online: <http://finance.sina.com.cn/s/69266.html> (date accessed: 14 June, 2001).

2001.

6. 2 Restructuring Before Privatization.

Privatization of an enterprise consists of more than the selling of shares through certain ways. To ensure a maximum privatization effect, some prior restructuring measures must be adopted, especially in the case of privatization of larger public infrastructure enterprises. Prior restructuring is always carried out to improve corporate governance by transforming the form of the enterprise to those governed by private law (the company law). The legal status of an SOE determines in part the measures required before privatization. If an SOE is still governed by public law, corporatization beforehand will be a better start for further privatization. If an SOE is already governed by private law, prior restructuring will likely address management, staffing and finances, as well as certain issues regarding contracts or obligations. In both cases, however, the old SOE may have to be broken up to some degree and some of its activities or assets separated or spun off from its main activity. These various restructuring measures may require amendment or repeal of existing legal provisions or even the enactment of new legislation.[2]

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[2] The U.K electricity law of 1989 illustrates this well. This first part of the law establishes the new sector framework, including sector structure, competition, and regulation. The second part deals with the re-organization of the power industry. It addresses the creation of new companies organized under company law, whose shares are initially held by the government; transfer of the assets of the former public enterprises to the new companies; winding up of the old entities and treatment of their debts and other obligations; management of the new companies before they are privatized; and other transitory provisions. It also includes provisions on the floatation of the power companies. The third part contains miscellaneous provisions concerning, for example, nuclear liabilities and pensions scheme. In Germany, the partial privatization of Deutsche Telekom in 1996 also required radical restructuring of Deutsche Bundespost. It had to be split into three new companies responsible for telecommunications, postal services, and financial services; many other issues were settled, too, such as the responsibility of the new companies for employee retirement. In summary, many issues are bound to arise, and have, as infrastructure enterprises are readied for privatization. These include not only the general enterprise-level pre-privatization measures including financial, corporate, management, and labor restructuring, but also the enterprise restructuring measures needed to make the sector more competitive including breakup of monopolistic enterprises and establishment of successor companies. See P. Guislain, *The*

Although without prior restructuring, a privatization program may go more speedily, as was the case in Pakistan,[3] and the buyer will probably have better capability to complete the restructuring, it is necessary for China's case, since under current political and legal conditions, there is neither need nor likelihood for China to complete the entire privatization program within a very short time. Prior restructuring is particularly important for China's SOEs. Firstly, corporatisation is a necessary step for some of China's SOE. Although China's Company Law took effect in 1994, not all the SOEs have been transformed into companies as stipulated by the law. Some of the SOEs are still governed by "China's State-owned Enterprise Law" under which the enterprises do not take the form of companies in terms of institutional or governance structure. Before privatization, these SOEs should be transformed into companies organized under company law, especially where privatization of a public-law enterprise is to be done by way of public flotation. The main objective of the transformation is to improve the enterprise's corporate governance and to render it a legal person that engages in business independently. As mentioned previously, certain conditions of China's SOEs are different from the situation of SOEs in western countries. For example, China does not have an independent workers union in the SOEs; there exists no power division between the management and boards of directors; in some enterprises, there are no shareholders or boards of directors at all; the communist party committee (besides the governments) always involves itself in the enterprises business; and so on. All these conditions must be changed

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Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience (Washington: World Bank. 1997) at 95 - 107. [hereinafter *Privatization Challenge*].

[3] See S. Aziz. *Privatization in Pakistan* (Paris: OECD. 1996) at 1- 9.

before privatization. Germany provides a good example in this respect. In Germany, nearly all public enterprises were converted to private-law companies as of July 1, 1990.[4] Besides the improvement to corporate governance, corporatization will also increase the accountability of SOEs, allow better measurement of their performance and comparison to the performance of private firms, force significant improvement in productivity, and prepare and further the cause of privatization.

Secondly, breakup and liquidation of public enterprises is also needed for China's SOE, particularly for the national enterprise groups which were converted from the former ministries. These enterprises usually possess the majority of the assets in a sector, and have millions of employees. It is an impossible, or at least, very difficult, task to privatize such giants by way of trade sale or floatation before splitting them. In the fragmentation of the enterprise, the national enterprises group can be dismissed, and its subsidiaries should be incorporated as separate and smaller companies. The breakup of an SOE can help to eliminate the monopolistic or dominant position of the SOE, to make the enterprise more attractive to investors, or to maximize sales revenue by separately selling nonoperational assets, such as excess land, buildings, or machinery. In this kind of restructuring, liquidation may be used to dispose of the assets or liabilities of the old enterprises, and winding up of an SOE should be facilitated when necessary.

Financial restructuring is also needed before privatization since China's SOEs are often technically insolvent or in a state of bankruptcy. Triangular debt is popular among China's SOEs, and most of the debts are owed to the state-owned commercial banks .

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[4] See *Privatization Challenge*, *supra* note 2 at 101-102.

Financial restructuring, then, needs to address these debts and the treatment of state-guaranteed obligations particularly. In some cases, these debts to the government may be reduced or written off, while subsidies may be granted or capital increased to make these SOEs as attractive as possible to prospective private investors. About a one and a half year ago, China adopted debt-equity swap in some SOEs with a view to resolving the bad debt problem faced by the State's banks. This measure was actually designed to relieve the SOEs of the burden of debt repayment. When the banks change their roles from creditors to shareholders of the enterprise, they lose their right to claim the debt and only have the right to allocate profits. Usually the status of outstanding debt will not change; however, whether the banks can get the profits depends on the enterprise's operation conditions. Financial restructuring should also aim to set up financial systems and prepare new financial statements in accordance with generally accepted accounting principles. Although the most recently-amended Accounting Law was effective in July 2000, some SOEs have not finished the conversion to that financial system. China is not the only country that has had to undertake financial restructuring. A similar situation can be found in Germany, where nearly all public enterprises were converted to private-law companies as of July 1, 1990, and the new companies were required to draw up their opening balance sheets in Deutsche mark.[5]

In view of the complexity of privatization operations and their lengthy implementation time, interim measures may have to be taken for the management of public enterprises and assets pending privatization. These measures may include, for example, the replacement of the management team, possibly by a new manager or administrator with special powers; a

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[5] *Ibid* at 97 - 98.

transitional system to phase out special SOE privileges and obligations; limitations on SOE managers' powers of alienation during the preprivatization period; liquidation of what remains of the SOE after its corporatization or its privatization through the sale of its assets; fulfillment of obligations for which the government continues to be responsible; and allocation of revenues and liabilities of the SOE that accrue during the transition period or between the signing of the privatization contract and the effective transfer of the enterprise to its new owners.

In addition, China's SOE always suffer from overstaffing. This problem is especially serious in China's case, not only because China has the biggest population in the world, but also because China used to promote full employment to prevent social disorder. In fact, some economists even suggest some of the SOEs should be maintained only for the purpose of employment instead of profits.[6] In China, SOE overstaffing also contributes to the way enterprises operate. An SOE, especially a large scale SOE, is usually run as a small community. It not only includes the core enterprise, but also enterprises such as schools and restaurants under its management. The staffs that work in these units are also included in the total employees and participate in the same salary and benefit scheme. Before privatization, non-core business must be contracted out, some assets must be spun off, and further layoffs must be considered. From this perspective, prior restructuring itself is actually a sort of privatization.

Finally, how to deal with contractual obligations is a very important issue in prior restructuring. For example, an SOE may be bound by an agreement to purchase materials at

[6] Q.T.Chen., *The Road for SOE' Development* (Beijing: China Development Press. 1999) at 106.

a higher price from a protected industry. In some instances, the new company is the legal successor of the old SOE and it will in principle succeed to all the latter's rights and obligations. This succession may jeopardize the success of some privatization operations when certain obligations of the former SOE are contingent, uncertain, or undisclosed. This problem can be circumvented, however, at the corporatization or privatization stage by limiting the new company's obligations to those expressly listed in the agreements setting it up. The state would remain responsible for residual obligations.

6. 3 Techniques Applicable

6.3.1. Techniques Available

Before techniques are designed to privatize a single SOE in China, such factors as the size, operation and financial condition, and the sector it belongs to, must be taken into considerations.

For small SOEs with no economic promise, the easiest solution is to let them die on their own according to the law. To this end, liquidation and bankruptcy should be allowed and promoted. Comparatively, liquidation or bankruptcy involves simpler legal procedures and is often used to privatize poor performance small-sized SOEs. *China's Bankruptcy Law* was enacted in 1986, but according to this law, public entities and "strategic enterprises" are protected against bankruptcy by receiving special support from the government. Under this protection, in practice, few declare bankruptcy. What China's government should do now is to remove this protection and enable liquidation and bankruptcy as much as possible.

For other SOEs, direct sale of the State's assets or shares to the private sector is a better strategy. Trade sale always takes place outside the securities market, and this technique may take various forms. For example, state assets or shares may be sold to the company itself, to the company's shareholders[7], to its employees, or to a third party, a strategic investor. Trade sale, by way of direct sale or bidding sale, is specially suitable to privatize smaller sized SOEs or a big SOE partially, that does not require too much cash. Trade sale is also more suitable for the SOEs which have net worth and cannot meet the financial requirements to issue stocks on the market.

For bigger SOEs with better financial conditions, floatation should be the first option for privatization. There is much space for SOEs to list on the stock exchange to spread the ownership, since less than 1200 among about 20000 SOEs in China have been listed up to now.[8] In the case of floatation, practices such as golden share may be adopted. However, SOEs which will list in the future must be allowed to trade the State shares to public investors. Beginning immediately, for those already listed SOEs, the securities market will provide more possible options to transfer the existing State shares to the private sector.

Other techniques may also effect privatization of the State shares. Conversion of the State shares to preferred shares or debt is a case in point. Preferred shares just ask for a return of fixed-rate, and the shareholders do not participate in the company's management and the allocation of profits. Conversion of State shares to preferred shares is specially suitable for those SOEs with a high debt ratio since preferred shares also rank behind debt when claiming

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[7] In 1994, Dazhong Taxi sold the State shares it held to its B share's holder. X.W.Xia, "The Eleven Methods to Reduce State Shares Suggested by Some Experts", *QuanJing Securities Daily* (1 December, 2000), online: <http://finance.sina.com.cn/2000-12-01/25772.html> (date accessed: 14 June, 2001).

[8] X.Q.He, "Comments on Wu'Ling'ye's method to reduce its State Shares", *China Economy Review* (22 February, 2001).

for compensation in liquidation or bankruptcy. The State shares can also be converted to debt, either in the form of State bond or corporate bond. A State bond may have a longer maturity and lower interest. Equity-Debt swap can improve share mixture and financial structure; it also can help to avoid taxation in a legal way. But because debt financing is the lowest cost only as regards larger risks, only those SOEs with lower debt ratio and good performance can apply this technique.

Different techniques may involve different payment methods. The rule in privatization should be that buyers pay for their acquisition of shares or assets of enterprises in cash. However, China may be flexible in this regard by considering other options such as deferred payment (seller financing) and credit (bank financing). Debt-equity swap is another instrument which can be accepted in payment for privatization.[9] Special state obligations, which can be either redeemed at the end of their term or used as payment for shares in enterprises privatized through public offerings, can be one of the options of payment.[10]

As illustrated by international experiences discussed in previous chapters, the above techniques can be combined together when used for a specific enterprise. For example, the SOE may first sell part of its shares to its existing shareholders and its employees and part of its shares to a third institutional investor, then it may list on the stock exchange and sell the rest shares to the public. Since most of China's SOEs are medium or small sized, it is impossible to list all, or even most of them, on the stock exchange. In this case, a sectoral

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[9] For example, in France, the privatization law stipulated that shares could be paid for by state debt securities and investment certificates previously issued by the SOEs, the swap value of which would be set by ministerial order. See *Privatization Challenge*, *supra* note 2 at 138.

[10] Such state obligation have been issued by France and Morocco. *Ibid.* at 139.

assets restructure which involves application of most the techniques may deserve consideration. The restructure process may be managed by the investing corporations[11] that work as privatization funds in western countries, that is, the investing companies take over all the State shares first, then sell or transfer them on the market through exit channels. Whether this mixed technique will succeed depends on there being a sound exit mechanism. Still, there are two final options: reorganize them into new companies and float or transfer to strategic investors including foreign investors before flotation.

6.3.2. Application of the Techniques

As mentioned above, there is no a single technique appropriate to all SOEs and the adoption of techniques must depend on the specific condition of an SOE. China's SOEs may be divided into four categories based on the different industry policies they are subject to and their different capital structures and performance conditions. Different practises may be taken to privatize the SOEs under each category.

(1) Emerging Industries

These industries include finance, agriculture, bio-medicine, electronic telecommunication, tourism, and real estate.[12] In this category, few companies are listed, but on the whole, they are good performers and are in good financial condition. For these sectors, floatation should be the first option. Those that are already listed may issue convertible bond

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[11] Since 1988, 67 large scale investing corporations have been established in China, which possess assets valued 50 million China Dollar. Their investing scale has reached as much as 1500 billion CD. See H.Zhang, "The State-owned Investing Companies Should Play the Key Role in Reducing the State Share", China News Agency (26 November, 2000), online: <http://finance.sina.com.cn/2000-11-26/24704.html> (date accessed: 14 June, 2001).

[12] See "A General Introduction to Listed SOEs", *Shanghai Securities Daily* (31, May, 2001), online: <http://finance.sina.com.cn/t/66076.html> (date accessed: 14 June, 2001).

or new tradable shares to dilute the State's ownership in the enterprise.

(2) Strategic Sectors

This category includes petrochemical, nonferrous, public entity, steel and metallurgy.[13] These industries are very important to the country's economy, and at present, the State may need to control this sector. Companies in this category are always large and some of them are good performers. Floatation is the best way to achieve privatization, with golden shares set to maintain some control of the companies. Those with strong cash inflow may convert the State shares into preferred shares or debts.

(3) Competitive Sectors

Including food and beverage, brewing, textile, trade, paper and printing, this category has been open to competition.[14] Companies are just at the average level in performance, so trade sale to a third private investor may be the best choice.

(4) Traditional sectors

This category includes mechanic manufacturing, building materials, motor manufacturing, chemical industry, electronic instruments and metres.[15] Many listed SOEs are from these sectors, but most of their performances are rather bad. Since these SOEs have weak cash flow, it impossible for them to use cash to repurchase the State shares. Liquidation and sale to private investor is, probably, the best way for them to achieve privatization.

6. 4 Strategy and Principles

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[13] *Ibid.*

[14] *Ibid.*

[15] *Ibid.*

6.4.1. Strategy:

Privatization will be a risky project under current conditions in China and especially in light of its weak legal system and undeveloped market economy. Privatization can only be implemented where legal protection exists and promotion is available. A Russian-style radical movement will threaten the stability of China's economic development. Therefore, China's privatization should be achieved by promoting private ownership rather than by transferring ownership within a short time. A sound strategy should open the market and promote private business as soon, fundamentally and completely as possible. For this purpose, a macro plan which includes a precise timetable should be drawn up to guarantee the success of the program. Under this timetable, the privatization may be implemented in phases. For example, according to a plan set by China's government, as the first step, it will reduce the State share from 62% to 51%. In other words, 300 billion State shares will be reduced within the next five years.[16] Some of this transfer must be done outside of the securities market because if all these state shares were to be sold in the second securities market, market chaos would result. The timetable, however, must set clearly the period or phases allowed to prevent any delays arising out of endless discussion or consultation on issues involved. To guarantee that the timetable is met, it should be legislated, perhaps in the Privatization Law.

A proper sequence of privatization is very important to China's privatization. A first step may be to privatize the tertiary sector which may then provide service to the privatization process. For example, intermediaries such as accounting firms and law firms must be

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[16] "What Kind of Changes Will Take Place To The 300 Billion State Shares?", HaiRong Investment Newsletter (8 December, 1999), online: <http://finance.sina.com.cn/stock/market.../14582.htm> (date accessed: 14 June, 2001).

privatized to improve their independence. Banking and other financial institutions must be privatized to act as privatization funds to buy the State shares. Privatization of the banking sector is also a prerequisite to opening the securities market which can then provide a platform for further privatization of China's economy. Next may be the infrastructure sector which plays the dominant role in China's economy. Other sectors, such as light industry and manufacturing, may be on a later list, because these sectors have the largest number of employees.

The strategy also should take privatization as an opportunity to establish and improve the corporate governance of all China's enterprises. If democratic decision-making cannot be achieved politically, at least it should be provided within business. In government, one party rule brings autocracy and corruption and damages the interests of people. Similarly, an enterprise which has but one State shareholder cannot serve the best interest of the business. The multiple shareholder system must be established in China's enterprises, and division of powers must be introduced to the business decision-making process. To achieve democracy within the business activities of a company, it is a precondition that the communist party should be removed completely from decision-making, as has been discussed in Chapter Three.

In addition, the strategy must ensure that the transfer of ownership from the public to private sector is not the final objective of the program. Rather, the final objective must be to achieve the separation of government interference from business activities, and to build a more liberalized economy. Every legal change in business law should be designed to promote a freer economy and protect the interests of all the players.

Finally, privatization should not be regarded as just an economic reform. It is also an ideological liberation for Chinese people. The spirit of freedom and democracy originating in business activities should be spread to other aspects of the society. Legal change is necessary to remove all the unequal and discriminatory rules, whether they were aimed at different ownerships, different jurisdictions, different sizes, and all other differences which attract distinctive treatment.

6.4.2. Principles

Russia's experience in privatization discloses to other governments that they must face and solve the problem of guaranteeing transparency and fairness in the process of transferring ownership. Indeed, this problem is more serious and difficult in China given the absence of the rule of law. There can be no doubt that privatization always gives birth to numerous over-night millionaires, even in countries with developed legal systems. It is a kind of cost. However, the establishment of some technical mechanisms may help in this regard and can lower this cost.

First of all, the selling price should be set under market conditions, where competition mechanisms are involved. This is especially important where the technique of trade sale is used. Since trade sale is alway a negotiation process between the seller and the buyer, it is easier to play such games as 'black-box operation'. A special privatization body should be established to take charge of the whole process of the sale, and the enterprise itself, especially its top management, should be excluded from the selling process. As to the special privatization body, rules should also be placed to make it sufficiently independent.

To guarantee fairness and transparency, government should minimize its role and activities in the privatization. Government should restrict itself to working out the strategy, enacting the laws and rules the privatization needs, and dealing with all kind of disputes arising therefrom. Price valuation should be done by independent accountants. China's intermediaries are notorious for their collusion with government, so it is necessary to privatize this sector beforehand. For this purpose, all the intermediaries, such as accounting firms, auditing firms, and law firms, should be separated from government and the market should also be open to foreigners, which may increase the market's credibility.

Information release should be carried out strictly to let the people know what the government is doing. All important information, such as techniques used for privatization, timetable, amounts of shares/assets to be transferred, and the selling price, must be released. A branch in charge of the information release may be set under the special privatization body. The information release should take as many forms as possible, gazettes, newsletters, newspapers, magazines, internet, and other media. Business confidentiality in privatization should be narrowly confined, and citizens and investors must have access to all information regarding each privatization program. To this end, freedom of speech and freedom of the press must be provided, because one voice can hide the truth behind the facts and can only lead to all kinds of corruption in the privatisation.

To guarantee fairness, some practices of privatization must *not* be adopted. For example, pre-emptive rights (discount of 5%, say) may not be suitable for China's privatization where it plans to sell the State share through the second tier market. The State shares of the listed SOEs are the wealth of the whole Chinese people, while those who can buy through stock markets are at most 50 million. It is unfair to offer the discount of the wealth of all Chinese to only small part of the population.[17] Another unacceptable practice is employee-ownership which has been tried in many of China's enterprises. It is well known that SOEs differ in terms of performance, size, assets, and employee salary level. Especially in those monopolized sectors, the differences are very large indeed. Therefore, if only the employees of the enterprise with good performance and larger assets are entitled to purchase shares of the enterprise, it will be unfair to employees working with other enterprises or institutions that may suffer from an inferior financial condition. Privatization of state-owned assets must offer all Chinese people the equal opportunity to receive his or her proportion regardless of age, sex, occupation, rank, and all other social and legal status.

Finally, the use of revenues also raises the issue of fairness and transparency. For example, the market value of listed SOEs on the two markets is about 5000 billion China Dollar, and together the state share and the enterprise share reach as much as 3000billion China Dollar.[18] Even if sold at net value, 250 billion state shares will bring in a revenue of 1000 billion China Dollar. If the revenue is allocated per capita, each person might receive 1000 China Dollar. Use of that money raises the issue of fairness. Ideally, all the revenue should be turned over to the National Social Insurance Fund which covers every citizen of China.[19] The revenue, in any case, must not remain with anyone else or with any other

[17] The case in mainland China is different from that of Hong Kong. HK is a small place, where logically all HK citizens can go to buy the shares and in fact all the profits of shares held by HK government come directly from the securities market. See Ch.Jing, "Principle of Fairness must be considered in the Reducing of the State's Shares", *Southern Weekly* (8 June, 2001), online:<http://finance.sina.com.cn/t/69168.html> (date accessed: 14 June, 2001).

[18] *Ibid.*

[19] There are some exceptions, however. Part of the revenue may be used for other items, but the allocation and collection must also be prescribed by laws and rules. See following parts of this chapter.

organization. Special accounts or funds should be established, and the law or implementing regulations must prescribe how they are to be set up and the procedures for their operations and supervision[20]. For example, the laws should provide that part of the money must transferred to the National Insurance Fund as soon as the transaction is closed.

Protection of national interests in another principle China must stick to in its privatization program. China is still a developing country and some of its sectors remain weak and immature. Until these sectors become competitive in the international market, they require special protection. Although, in most cases, restrictions on participation by foreigners will be detrimental to successful privatization operations,[21] China cannot rule out restricting foreign investors' entry into certain sectors or limiting their stakes to a given percentage. But these sectors must be limited to a minimum number. To this end, China may also use the 'golden share' to maintain state control, though this arrangement "is not exactly appreciated on financial markets and it may affect a firm's market value".[22] In addition, national interests can be protected under company law by providing for shares without voting rights or with plural voting rights or by limiting the maximum number of any one shareholder's votes. All these provisions can be incorporated into the articles of the privatized companies. In some

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[20] In most legal systems, privatization receipts are considered to be public receipts governed by public finance legislation, not receipts that the government can use without restriction. Expenditures financed out of these proceeds should thus be subject to public expenditure and accounting rules. See *Privatization Challenge*, *supra* note 2 at 140 - 142.

[21] This lesson has been learned by France and Brazil, among other countries: after introducing restrictions on foreign investors in privatization, they had to abolish them. See *Ibid.* at 127 - 128.

[22] D.Carreau, "Legal and Institutional Aspects of Privatization" in J.Schuijer, ed., *Privatization in Asia, Europe and Latin America* (Paris: OECD, 1996) at 130. [hereinafter *Privatization in Asia, Europe and Latin America*].

cases, shareholder pacts can be used to set up a "core of stable shareholders" for the privatization programs.[23] But again, the law must require that any techniques used be transparent and fair, so as to maintain the full credibility of the privatization process.

6. 5 China's Privatization Law

6.5.1. Introduction

In China, government used to interfere in virtually every aspect of economic activity. Things haven't changed radically. In the privatization process, all transactions should be completed under market rules; however, the role of the government in privatization must not be neglected. Privatization does not mean the retreat of government from all aspects of the economy; rather it means a redefinition of the state's role. Government should find its major role in legal infrastructure construction rather than in economic planning.

Trials are still under way to transfer partially the ownership of SOEs to the private sector. But they face a legal bottleneck: Is privatization legitimate? Can privatization get protection from the law? Who should execute the process? Answers to all these questions must come from new legislation, a privatization law. Although the concept has transited from the past 'state-operated' to current 'state-owned', and the so-called 'market economy with China's characteristics', which has found its way into the Constitutional Law, the term 'privatization' is still a dangerous word for the government. The central enactment of the new law is to provide legitimacy to the transfer of ownership from public to private sector by the way of legislation.

As discussed in Chapter Five, even in the latest amendment to China's Constitutional

[23] *Ibid.* at 131.

Law, the private sector does not enjoy a status completely equal to the public sector. Therefore, prior to the formal commencement of the planned privatization program, it is necessary to amend the existing Constitutional Law so as to abolish the discrimination against private economy in terms of legal status.

Another reason for the enactment of the new privatization law in China is that privatization, as a property ownership transfer from public to private sector, cannot be achieved by means of administrative allocation, which used to be the main way to allocate resources in China's 'Planned Economy'. Administrative measures cannot bring the optimum allocation of resources; instead, it always gives rise to corruption. The ownership transfer must be achieved through market behaviour ruled by law. Presently, the market economy is far from mature; a sound legal system to regulate the market behaviour remains absent; and fair transaction cannot be guaranteed. Under these conditions, a privatization law not only can provide strong political support, it can also safeguard the process of privatization by delegating appropriate authorization, establishing an implementation agency, and designing fair and transparent sale&buy procedures.

As to the form of the legislation, specific laws may be not appropriate in China's case where hundreds, or even thousands, of SOEs varying greatly in size are to be privatized, since such a procedure is extremely demanding and seems suitable only for large scale privatization that are limited in number. Instead, a general framework law is preferred.

6.5.2. Content

China is a centralized country. According to its legislative tradition, the National People's Congress is responsible for making law, and the provincial people's congresses for enacting bylaws according to the spirit of the law. The ministries also have power to enact rules on matters within their respective jurisdictions. Under this law system, privatization law should also exist at two levels: the national privatization law (the General Legislation), and the provincial laws (the rules or bylaws).

Like the privatization laws in all other countries, China's Privatization Law should also provide flexibility by setting a broad principle. The law must not try to include too many detailed rules, since in China, the situation of politics and the economy changes very quickly, even within a short time. Moreover, each area and each sector of China may have its own specific factors which have to be taken into account. A very strict and detailed privatization law can only bind the government's hands in the privatization process.

Generally speaking, the law may include the following key contents:

(1). *Authorization*: Authorization entails two points. The first point is to provide legitimacy to the ownership transfer from public to private sector, the authorization of the behaviour itself. It also means which body is delegated the power to organize the privatization process.

(2). *Institutional set-ups*: The law should establish an independent organization to implement the privatization process and decide what kind of power and responsibility the institution may have. The law should also set up a regulatory institution to promote competition and protect the interests of the general consumers after privatization.

(3). *Enterprises selected*: Rather than list the enterprises concerned, the law may specify the sectors in which privatization will take place, or alternatively state the privatization criteria (enterprises belonging to the competitive sector, for example). It may also distinguish major privatization operations from minor ones by setting quantitative criteria such as turnover, number of employees etc.

(4). *Privatization methods*: The law should only suggest what kind of methods may be used in certain situations. The decision as to choice of privatization methods must be left to the privatization commission, because the condition of financial markets as well as other factors are always changing. Methods involved may be direct sale, flotation, shares swapping etc, which have been discussed previously.

(5). *Procedures standards*: The procedures for privatization must be fair, open, and transparent. Auditing and monitoring systems must be put in place for all aspects from valuation to sale.

(6). *The usage of the revenue*: At least part of the revenues should be contributed to the accounts of the Social Insurance Fund.

(7). *Period of validity*: For policy reasons, a time limit can be fixed for the completion of the privatization process, thus emphasizing the government's determination to retreat SOEs from the economy. But for legal reasons, a permanent framework law is preferable. Not only can it avoid the need for a new law at the end of the time limit and allow for a temporary halt to privatization depending on the state of the markets or public opinion, but such a law also recognizes that privatization will be a long term reform in China.

In essence, the law is only a general legislation which authorizes the launch of privatization programs, sets basic organization structure for the implementation system, and provides minimal standards of fairness, openness and transparency for the whole process. Under the general legislation, each sector and even some big national enterprises may have specific bylaws or rules enacted to meet their specific needs. These rules or bylaws must conform to the principles set out in the Privatization Law.

In China, SOEs may be established by the State, the ministry, the province, or the lower administrative bodies (departments). Accordingly, SOEs are categorised by different administrative rankings, from ministry-level company to department-level company to division-level company. When implementing privatization, it is a good idea to take advantage of this ranking. For ministry-level companies, privatization rules may be set jointly by the National Privatization Commission and the associated ministry or department, then submitted to National People's Congress for approval. For lower ranking SOEs, privatization rules may be set jointly by provincial privatization commissions and the same-level departments of governments.

6.5.3. Institutional Set-ups

(1) Privatization Commission:

The Privatization Commission may be established as executive agency to implement the privatization program. Although a single institution may be efficient and may be in a better position to control the process, China would be wise to consider using a number of institutions. China must privatize not only a great many national level large enterprises, but also many more local or regional enterprises without a national reputation. Therefore, it is suggested that both a National Privatization Commission and provincial commissions be set up. The National Privatization Commission may be made up of representatives from different sectors/ministries, for example, from SETC, the Ministry of Finance, the Taxation Bureau. It should also include representatives from the private sector. The members should be nominated by China's highest legislator - the National People's Congress or its standing committee. The chairman of the commission may be ranked as a deputy prime minister. The National Privatization Commission should not be a large body. Ideally, the quorum, being an odd number, should not exceed 11 or 13 people. Under the Commission, special consulting committees should be established, consisting of experts like accountants, lawyers, and other specialists.

In each province, a provincial privatization commission may be established. Similarly, the members of the provincial commissions should be nominated by provincial legislators, but their work must be put under the direction of the National Privatization Commission.

As to the powers delegated to the privatization commissions, they should have the authority, among other matters, to determine what should be sold, at what price, and in which way. They are responsible for all the aspects of the privatization process, ranging from advertising the program, arranging valuation of the enterprises, inviting tenders and organizing bidding, negotiating with perspective buyers, to closing the transactions finally.

The above model is just one alternative. There may be other kinds of institutional set-ups. The point is that the set-up must be a multi-sectoral organization, which can take advantage of privatization experience gathering in different sectors and can be used for better coordination. Maintaining independence is another principle the commissions have to abide by in their work. In China, to maintain independence is a very hard work. First of all, the commissions must not have a communist committee, and the commissions should instead be responsible only to the legislators who appoint their members. The commissions cannot be delegated the power to use the revenues from privatization programs; instead, the revenues should be accrued to a special fund or turned over to state's treasurer or provincial treasurers.

The members of commissions may enjoy a higher salary, and like any other governmental departments, they must be subject to the supervision of auditors, as well as other channels such as media, etc. Information release must be accorded great importance. The commissions must release detailed information on every privatization through various means including the internet. The release must be truthful, complete, and timely. Finally, mechanisms which help prevent conflict of interest should also be in place to achieve fairness and transparency in the implementation of programs. For example, the members of privatization commissions and their families should be precluded from acting as buyers of enterprises or shares offered for sale. Restrictions should also be imposed to prohibit them from accepting employment with any of the bidders for a specified period following completion of the privatization operation. However, independence does not mean that none of the institutions concerned must ever be allowed to function as an isolated entity and to act, simply as it sees fit.

(2) Regulatory Institutions:

In China, SOEs in different sectors are regulated by different sectoral ministries or departments. In fact, each ministry is a combination of regulating bodies and enterprises. For example, almost all power stations were owned by the Ministry of Electric Power and regulated by the local branches of the ministry. In 1999, China underwent an institutional restructuring and some ministries were removed and replaced with national companies. The powers that once belonged to those ministries were handed to the State's Economic and Trade Commission (SETC), under which a sectoral department was established to take charge of regulation of each sector.[24] Thus, for each sector, a sectoral ministry or a sectoral department under SETC is placed to take charge of its operation. These ministries and departments work as both policy-makers and 'judges'. In the latter role, they are responsible for deciding if an enterprise is conforming to the rules set by themselves. The problem with this kind of regulatory system is that the policy-makers always set rules to discriminate against private players and to restrict their further entry. Furthermore, the private investors have no place to obtain the remedy needed to protect their interests. To solve this problem, further institutional restructuring is required to remove more ministries and to transfer their regulatory functions to the SETC. In this way, the SETC may become a uniform sectoral rule-maker. Outside of the SETC, a new institution, regulator, should be established separately to be responsible for the investigation, adjudication, and sanction of cases. The rule-making and regulation functions should be divided and mandated to two separate bodies,. Otherwise, as the experience of the Monopoly and Merger Commission in the UK indicates, a body having both functions will abuse its powers by extending them wider and wider. The new institution may be named "Anti-monopoly and Fair-trading Commission (or Bureau or whatever)". In China, there is a "Consumers' Right Protection Association", which is a non-governmental organization that can play the role of coordinator in disputes. There is another governmental body, called "Industrial and Commercial Administrative Bureau", that is responsible for enterprise registration and overseeing enterprises' compliance with registration rules and other business regulations. The "Anti-monopoly and Fair-trading Commission" may take over

[24] For example, the Ministry of Electric Power was replaced by the State's Electric Power Company, and some functions were moved to the SETC and restructured into the Department of Electric Power.

parts of functions of the above two bodies, and make itself responsible for the supervision of both the enterprise's conformity to the rules made by the privatization commissions as well as any other sectoral rules, and the performance of the ministries in their jurisdictions. Any disputes regarding privatization may first turn to this commission before finally turning to the courts. Or at least, when both of the parties to the dispute are enterprises or institutions, they should file with this commission first.

6.5.4. Procedures for Privatization

To guarantee transparency and fairness in the privatization process, China's privatization laws should provide adequate control of the procedures of the privatization process. After the decision to privatize is made, the following steps will be the valuation of the enterprise, the selection of buyers, the signing of the agreement, and financial payment. In all these aspects, safeguards to ensure transparency and fairness and to reduce some of the risks typically associated must be built into the legislation. Basic rules must be in place to provide for a number of principles to govern privatization operations: freedom of choice of consumers, abolition of monopolies, fair competition, and adequate publicity to ensure transparency. These rules may deal with different phases of the interim period, from enactment of the privatization law through corporatization all the way to effective transfer of control over the enterprise to its new owners.

Among the procedures, the valuation is especially important. The valuation must be performed through competitive, transparent, and open sale procedures with wide dissemination of information. A competitive procedure usually offers the government better guarantees than does an expert valuation performed before the sale. Competitive bidding by several potential buyers, each of which may perform its own valuation of the enterprise, should more accurately reveal the true value of the enterprise. This procedure is also speedier and cheaper. The valuation should be carried out by independent and qualified experts and in conformity with generally accepted valuation principles. When setting up the institutional organization to implement privatization, China may establish valuation commissions or other special bodies responsible for setting minimum prices. However, where a valuation is made, it should serve only as a guide to the selling agency. Legislation should not prevent this agency from concluding a sale at a price below the estimate if, following a competitive selection procedure, no acceptable bid has been received at or above the estimate.

Also, China's privatization laws should provide specific safeguards for transparency in selecting the buyers. Mechanisms must be put in place to guarantee the selection is based on objective commercial, economic, and financial criteria. In China, corruption often attends the awarding of contracts. The laws should set out broad principles for the selection of buyers, typically by mandating a competitive, non-discriminatory, and transparent process. This involves rules on advertising the sale, eligibility requirements, disclosure or information to investors, amount of time given investors to prepare bids, evaluation and selection, and so on. Delegation of these matters must be accompanied by procedures ensuring accountability of the agency and its officials, together with control and appeal procedures. Noncompliance with the rules established for the bidding process may provide grounds for annulment of the selection. Moreover, the law must limit the discretionary power of the privatization commissions to choose investors. All their decisions must be based on the valuation made by the valuation committee referred to above.[25]

6.5.5. Usage of Revenues:

The usage of revenues must also be part of China's privatization law. International experiences show that when a country's existing law does not otherwise addresses proceeds of sale, its privatization law takes over this task. The common practice, also a sound policy, is to use the revenue from privatization to finance the costs of the privatization program and to allocate net revenues to the reduction of public debt or possibly to other expenditures that may reduce the public deficit, such as the capitalization of social security funds.[26] Net privatization revenues should not, however, be used to finance current expenditures or the ordinary budget. In China's situation, since the social net for the large population needs substantial support, most of the privatization revenue should be used to provide social insurance to the population. If not all, at least part of the revenues from each case, say, 60%, should be transferred to the National Social Insurance Fund.

The usage of remaining revenues should be decided not by the privatization commissions, but by the Peoples's Congress at all levels. If the enterprise to be privatized is owned, in name, by the State, for example, a national company, the sales revenues, except the part which has been turned to the National Social Insurance Fund, should be accrued to the

[25] This lesson is drawn from the experience in France. The first French privatization in the period 1986 - 1988 was sharply criticized for giving the Minister for Economic Affairs discretionary power to choose investors. The new privatization law of 1993 set things right by limiting the Minister's say to the choices made objectively and independently by the national valuation committee. See D.Carreau, "Legal and Institutional Aspects of Privatization"in *Privatization in Asia, Europe and Latin America, supra* note 22 at 132.

[26] In France, the revenue from privatization was used either to reduce the State's debts or was paid into the capital account by reinvesting into the privatized companies. See *Privatization Challenge, supra* note 2 at 141.

state. The National People's Congress can then decide where to use them. If the enterprise is owned in name by local government, then the remaining revenues should be paid to the treasurer of local governments.The law and the rules should limit the usage of the revenues in certain ways, say, the money should be forbidden from buying cars for officer's use and from building houses.

6. Other Provisions:

The law may also set forth some exceptional means of payment if a transaction is settled other than by cash, for example, using state bonds and other investing certificates to swap stocks issued by the privatized companies. To promote the maximum spread of ownership, the law may also stipulate in principle that under certain conditions an individual investor is not allowed to purchase over a certain percentage (say, 5%) of an company. For some strategic companies, it is also possible to rule that foreign participation be limited to a maximum percentage of the total shares. But these kinds of restrictions should be limited to the least extent, as has been discussed previously.

Summary

The low efficiency and other problems of China's SOEs requires their privatization. A privatization law is thus needed to implement the program. A newly created institution, comprising representatives from different sectors, is preferred for China, and a multi-sectoral regulator needs to be set up to promote and maintain post-privatization competitive environment. During the privatization, the principle of fairness especially must be taken into account in the allocation of the state assets. A good strategy including a well-designed timetable and situation-tailored approaches will increase the likelihood of success.

In a country such as China, where corruption is rampant, a sound and adequate control of the privatization process is especially vital. Mechanisms must be put in place to guarantee the transparency of the process and the independence of the implementation agency. This requires not only certain legal designs, but also a well-built legal environment based on the rule of law.

Chapter Seven: Conclusion and Expectation

In the past decades, privatization has been one of the most striking policies in the economic reforms adopted by most countries around the world. Under this policy, ownership of enterprises is transferred to the private sector; public monopoly is broken up; and the entire economy becomes more liberalized and globalized.

Both an economic and a political movement affecting all aspects of a society, privatization not only involves individual transactional privatization of single enterprises, but also involves the privatization of entire sectors and the economy overall. For both levels of privatization, legislative support is required. Numerous amendments have been made to existing laws and new laws have been enacted to facilitate and enable the launch of a single program or of larger schemes of reform.

International experience indicates that laws concerning privatization fall into two categories: facilitating laws and enabling laws. Aiming to provide a market economy environment favourable to private economy, facilitating laws have more links with sector or economy-level privatization. The facilitating laws include, among others, a constitutional law prohibiting discrimination against private ownership and providing the rule of law; a company law providing a sound governance structure; a FDI law to promote foreign investment, a securities law to develop a capital market; other business laws with provisions in conformity with international practice and market rules; a well-built social safety net; as well as a fair and transparent judicial system; and so on. All existing laws, if they fail to meet the above requirements, must be repealed or amended.

An enabling law or a privatization law is more related to the privatization of an individual enterprise. Such a law is necessary in most cases, not only because it can provide the necessary political support, but also because it can help organize the process by creating certain institutional set-ups and designing appropriate procedures. A sound and well-designed privatization law always provides clear mandate to an independent implementation agency; a series of mechanisms guaranteeing transparency, fairness and effectiveness; a post-privatization regulatory system; recommendation of privatization approaches in some cases; and other provisions. Golden shares, employee buyouts, and price control using RPI-X formula are a few striking legal designs articulated in the privatization laws of many states.

International experiences also demonstrate that privatization of single enterprises must be integrated into a wider economic reform strategy. The most important point is that privatization itself should not be the end, but the tool to realize the objective of a more liberalized economy. Thus, in such a process, all legal changes must serve that target by introducing deregulation, preventing monopoly, and promoting free competition.

Privatization is still under way in a lot of countries. China is one of them. Since no blueprint fits all countries, China must factor its specific situations into its privatization program when it applies the international experiences.

Although China has been on the road toward capitalism since 1978, as a former command economy that established "the socialist market economy" as recently as a decade ago, China's legal system has not developed sufficiently to launch a large scale privatization program.

Any laws amended or enacted to facilitate or enable the prospective privatization programs must keep in mind, and proceed from, the following factors: *politically*, China is ruled by a one-party dictatorship in which corruption has become rampant due to the collapse of traditional morality without replacement by the rule of law; *socially*, China has the largest population in the world, the majority of whom are peasants; *economically*, China lacks a well-built capital market and the signals of command economy still exist in many sectors such as the foreign currency control.

First of all, China needs urgently to improve its investment environment. For this purpose, a series of laws must be changed. For example, the company law must be improved to provide more sound corporate governance and adequate protection to all investors, particularly the minority shareholders; the FDI laws must abolish the obstacles to foreign investment such as local content and performance requirements; the securities law must be strengthened to impose adequate regulation on listed companies and to protect the interests of vast investors; a national social safety net covering all citizens must be built in advance to provide the basic insurance for those who will be laid off during the privatization program.

China's specific situation also decides the privatization approaches which may properly be adopted. A shock remedy by way of mass privatization is obviously not suitable in China's case; rather, China should stick to the its established gradualist approach to dilute public ownership step by step. Such reform may be tailored to create a competitive environment by breaking monopoly and promoting private entry. To this end, China is encouraged to use policy tools to unbundle some sectors, particularly the infrastructure ones, and to develop its securities market in order to effect natural privatization.

While China should put more emphasis on the privatization of the whole economy, the privatization must be supported and accompanied by the individual transactional transfer of ownership. Since China is a traditional command economy, a privatization law is particularly needed to enable a privatization program for individual enterprises. Like all other privatization laws, China's privatization law must first of all put in place the mechanisms to guarantee the independence, transparency, and effectiveness of the implementation institutions and post-privatization regulatory system. All these can be borrowed from international experiences, adjusted to meet China's specific needs.

Global experiences have proved that a reform aimed only at economic restructuring will reach an impasse in a short time and that a sound privatization program must be a part of a larger reform to a complete market economy. In consequence, technical improvements on specific laws alone cannot guarantee the success of privatization. Both a single privatization program and the operation of market economy require the same basic condition: the rule of law. The rule of law does not reside in the mere enactment of more laws or rules; rather, its point is that all laws must be enforced strictly, fundamentally, completely, and correctly! To achieve this, a democratic system must be established. After all, privatization not only means respect of private ownership, but also requires the independence of private entities. Unfortunately, current one-party rule in China will by no means provide such a democracy.

China's recent admission to the WTO offers a splendid opportunity for China to review its entire legal framework as well as a motive to launch a political reform towards more democracy. If China still sticks to its attempts to bundle together market economy with autocracy (the so-called "socialist market economy"), the future will prove that any privatization programs will end in failure.

It is expected that privatization, if properly implemented, will generate significantly positive effects on China's legal system. In fact, the process to achieve the objective of privatization is also a process to improve China's legal system. For example, privatization will improve the corporate governance of China's companies; privatization will make the regulatory framework more transparent; privatization will introduce to China more international norms since privatization will have made China's economy an integral part of global economy. Most importantly, privatization will make the concept of private ownership widely recognized by Chinese people, will grant the individual more rights, more respect and more protection, and will lead to a more democratic system. All in all, a privatization movement will bring a totally new China to the world.

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