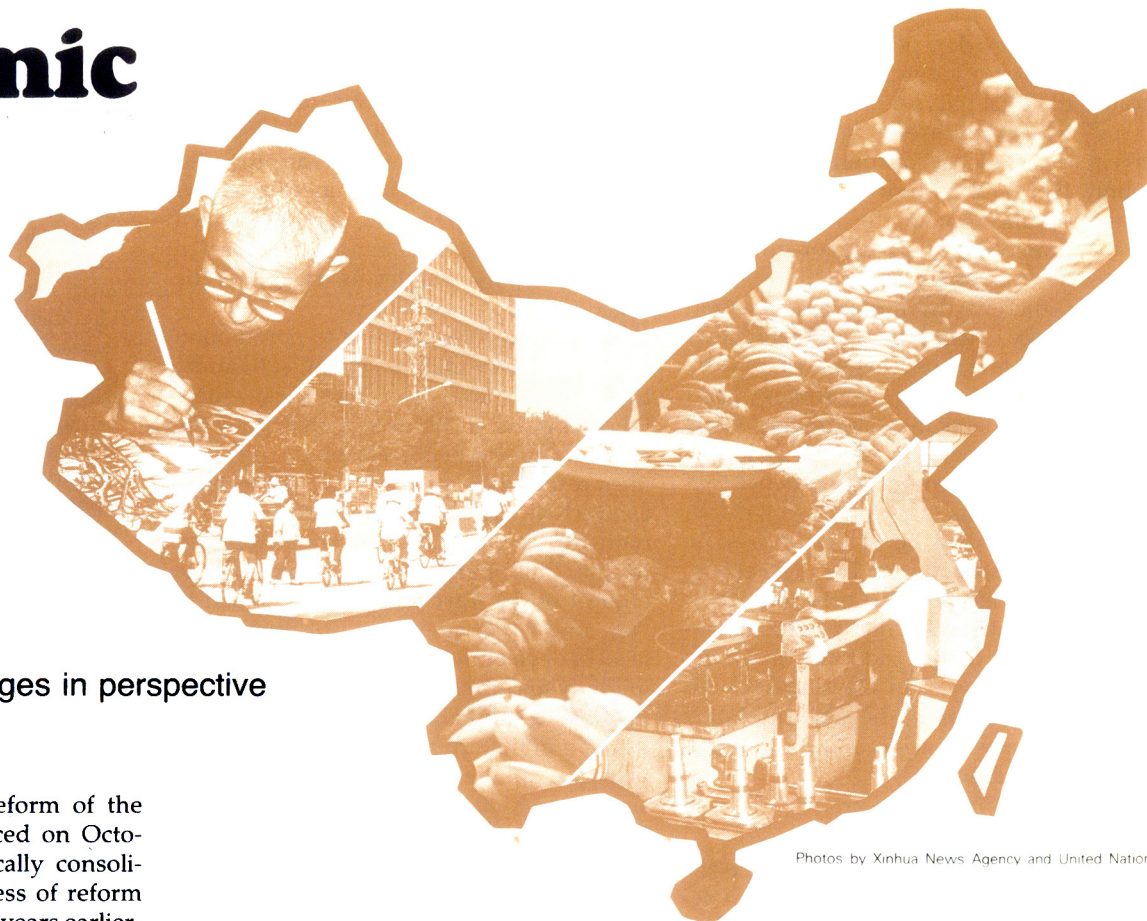


# Economic reform in China



Photos by Xinhua News Agency and United Nations

## The recent policy changes in perspective

**Luc De Wulf**

With the Decision on the Reform of the Economic Structure, announced on October 20, 1984, China dramatically consolidated and accelerated a process of reform that had begun more than five years earlier.

In the late 1970s, in the years after the "Cultural Revolution" and in the midst of growing official concern with slow improvement in living standards, the Chinese leadership first expressed interest in new approaches to the country's economic development. While overall growth since the 1949 Revolution had been remarkable, it was achieved largely through the application of greater amounts of physical capital and manpower rather than through more efficient use of resources. There was concern that the sacrifices required were becoming disproportionate to the gains achieved. Past economic development, with its emphasis on large-scale investment, growth of heavy industry, mass participation, and egalitarianism, had left workers and peasants with only moderate increases in incomes and inadequate supplies of consumer goods. Citing excessive levels of investment, rigid administrative control over resource allocation, insufficient individual incentives, and undue emphasis on local, regional, and national self-sufficiency, the authorities laid the groundwork for economic reform.

The Four Modernizations Program, launched by the Central Committee of the Communist Party in December 1978, sought to put China on the path of sustained, balanced, and rapid development. It represented a break with past economic policies and announced the process of wide-

spread economic reforms. Although it did not present a blueprint for the new economic system, it did indicate a commitment to trying different methods of resource allocation and distribution. Under this program, experiments were evaluated, modified, and implemented on a national scale when judged beneficial, and changed or eliminated when found inappropriate. From the very beginning, China's economic reforms have been part of a pragmatic and dynamic process, one that combined both bold steps forward and strategic retreats.

The 1984 Decision has distilled the essence of these various earlier reforms and has sketched the direction in which the authorities intend to steer the economy. As such, and for the first time, the reforms have been presented as a comprehensive, continuous undertaking, backed by the full authority of the Central Committee. This is expected to muster the support of those Party members who had been opposed to the reform movement on ideological grounds and of those who had been reluctant to implement what they viewed as a passing phenomenon. Although no precise timetable has been presented for the introduction of the reforms, most of them are to be in place within five years. Price, banking, and monetary reforms, however, are expected to require additional time.

This article surveys the nature and intent of these reforms; its coverage is selective

and deals primarily with agricultural and industrial reforms. Reforms in the public finance and banking sectors are mentioned only briefly and, for lack of space, China's efforts to attract foreign direct investment and increase international trade are not examined. (A subsequent article will deal with these and other aspects of the reform—the Editor.)

### Agriculture

China replaced its agricultural cooperatives with communes in 1958 but the reorganization, followed by two years of disastrous weather, so disrupted agricultural production that it took more than five years for it to regain the 1957–58 level of output. Commune production subsequently realized moderate growth, but often at high costs. More rapid increases in production were hampered by an incentive structure that did not link remuneration to effort, by detailed high-level planning that often neglected to take local circumstances into account, and by political interference in production decisions.

To remedy this, a production responsibility system was introduced on an experimental basis in two provinces as early as 1978. Success there in increasing productivity gradually led to the introduction of the system in most rural areas, including some state farms. Production responsibility systems differ slightly from one another,

but all are based on a contractual relationship between the commune and a group of farmers, a household, or an individual. These contracts specify the amount of land to be cultivated, the amount and type of produce the contractor is to deliver to the state, and the required tax payments and contributions to the welfare and investment funds. The contracts, as they refer to access to land, were originally valid for 5 years, and have, since January 1983, been extended to 15 years (50 years for orchards); amounts of produce, and other aspects of the contract, are adjusted more frequently. Contracts can be passed on to children or other beneficiaries, and can be sold with the permission of the commune; compensation for improvements, such as irrigation or application of fertilizer, may be negotiated. The contractor is free to dispose of excess produce in free markets. These free markets, which had all but disappeared during the "Cultural Revolution," have been revived, and their operation has been facilitated by state authorization permitting long distance transportation and marketing for all agricultural produce—even grain, a commodity whose trade had been a state monopoly since 1949. Simultaneously, the commune's production and economic responsibilities have been divorced from its administrative functions, which now reside with the newly revived townships.

The response to these changes has been impressive and is credited with a large share of the 9 percent average annual growth in agricultural production realized in 1981–83. Admittedly, increased procurement prices, which rose 20 to 25 percent in 1979, favorable weather conditions, and the shift back toward greater regional specialization contributed to this performance. Yet both personal observation and reports from experts indicate that the system has infused the rural areas with a new enthusiasm and has been much better able to draw on the resourcefulness of the peasants.

The rural reform, however, has not come without problems. The more efficient utilization of the rural work force has made about one third of the agricultural workers redundant and created the need for alternative forms of employment. In order to avoid the social and economic problems of large-scale rural-urban migration, the authorities continue to control such migration strictly. Therefore, new employment possibilities have had to be created in the rural areas themselves. To meet this need, industrial production in the rural areas and nonagricultural activities, such as livestock breeding, water resource management, commerce, handicrafts, catering, construction, and transportation, have been stimulated and are currently, in fact, the fastest

growing sectors in the economy. About 10 percent of the rural work force is now employed in the industrial sector, while between 10 and 15 percent is engaged in various specialized nonagricultural occupations. In more advanced regions, such as Jiangsu, the share of industrial employment is much higher, but further progress will be needed to meet this challenge.

Another problem that followed the success of the production responsibility system has been the emergence of acute shortages of consumer goods, agricultural inputs, and construction materials. The rural population now possesses greater purchasing power, but the supply of goods has not kept pace with demand. Authorities have been making more industrial production available to the countryside, and moderate progress has been made.

### Industry

The Four Modernizations Program, which initiated the reforms, gave equal emphasis to urban and rural areas. Yet reforms in the rural areas have proceeded more speedily and are now virtually completed. In the urban areas, where economic relations are much more complex, reforms have been implemented more slowly, with more time devoted to experimenting. On the basis of this experimentation and heartened by the success of the production responsibility system in the rural areas, authorities have indicated in the 1984 Decision a willingness to accelerate urban reforms.

These reforms principally seek to redress inefficiency in the state-owned industrial sector, which the authorities have laid to several interrelated factors. First, mandatory central planning, which was inspired by the Soviet model in the 1950s and may have been proper for the simple economy of that period and in the context of forced growth based on the development of heavy industry, is now seen as insufficiently flexible to deal with the greater complexity of an expanding industrial base. Second, enterprises were constrained in their pursuit of efficiency. Treated as departments of government agencies and managed as such, they were, until recently, required to hand over all their profits to the budget, which in turn covered their losses and provided their investment funds in the form of a grant from the budget. Supply and distribution channels were rigid and unresponsive to shifts in demand; wages were set to give more weight to seniority than job performance or enterprise profitability; bonuses were prohibited; and recruitment and dismissal of workers were outside the purview of the manager. Third, the price structure was greatly distorted. This complicated the assessment of enterprise per-

formance, hampered the introduction of technological innovation and the rationalization of the production mix, distorted consumption patterns, and caused both shortages of goods with low profit margins and excess production of goods with artificially high margins. Because consumer prices for many goods were less than procurement prices, the budget incurred large subsidy expenditures. Fourth, the pre-eminent role of state-owned and collective enterprises, combined with a disregard for the contributions that could be made by the private sector, deprived the economy of a source of creativity and left whole areas of consumer demand unsatisfied. (The private sector refers to small enterprises run by individuals or groups of individuals.)

The purpose of the industrial reforms, therefore, was to modify the economic environment within which enterprises operated so that they would become independent economic entities, responsible for their own profits and losses, and endowed with both the incentives and the authority to improve their efficiency and profitability. The essence of these reforms can best be captured by looking at their impact on planning, enterprise management, prices, and the role of the private sector.

**Planning.** In the course of the next few years, the scope of mandatory planning in China will be narrowed, while that of guidance planning expanded. Planning will concentrate on outlining the direction the economy should take, while increasing use will be made of macroeconomic policy instruments, such as correct price signals, taxation, credit and interest rates, profits, and wage differentials. The 1984 Directive indicated that in the future mandatory planning will be restricted to major products that have a direct bearing on the national economy and on the standard of living. The central plan will include output targets for energy, rolled steel, cement, basic raw materials for the chemical industry, and synthetic fiber. In agriculture, targets will be used for cereals, cotton, edible oil, tobacco, jute, pigs, and fish products. All in all, mandatory planning will eventually pertain to only 60 industrial and 10 agricultural commodities, down from 120 and 29 at present. Other products will be more broadly regulated through a guidance plan, with state and collective enterprises and the private sector allowed to compete among themselves. Although no statistics are yet available to gauge the importance of the commodities under the mandatory plan, it appears, for the near future at least, that they will continue to constitute the bulk of total production but they will comprise a much smaller share of the number of commodities.

The reform effort has squarely faced the possibility that some enterprises outside the sphere of mandatory planning may not be able to withstand competition. Already a number of enterprises that were unable to meet the required quality or cost standards have been merged with other enterprises, forced to change their line of business, or simply closed down. These consolidations differ, however, from bankruptcy in market economies, since the state attempts to minimize both the loss of productive capacity and the transitional problems for the workers affected.

**Enterprise management.** The new reforms recognize that in order for enterprises to be run as independent economic entities and assume responsibility for their own results, they must be given greater authority and greater incentives to work efficiently. This has led to the introduction of a whole series of interconnected reforms.

Enterprise management is to be gradually separated from the government agencies that, until now, have taken most managerial decisions. These agencies will now set broad policies, coordinate production, and assist enterprises in the achievement of their own objectives. With this newly acquired independence, enterprises are being made increasingly responsible for their own profits and losses, and a system to determine which share of the profits will be retained by the enterprises is being put into place.

After experimenting with several profit-sharing and income tax schemes, an income tax for state-owned enterprises was introduced in mid-1983 and was fully implemented by the end of 1984. The rate of this income tax has been set at 55 percent. But as price distortions affect enterprise profitability often more than does managerial efficiency, an adjustment tax has been applied to the after-tax profits, to bring profits more or less in line with those retained before the introduction of the income tax. The new system also has allowed enterprises that improve their profitability to retain the larger part of increased profits. Although the new tax system is intended to provide a legal basis for the disposal of profits, and therefore streamline the relations between the supervisory agencies and the enterprises, it will not yield its full potential until the price structure has been rationalized.

Directors of enterprises are now to be appointed by supervisory departments, and their authority has been broadened under the new reforms. Workers' Congresses continue to exist, but their role in managerial decision making has been circumscribed. The managers have now been allowed greater discretion in the recruitment and

dismissal of workers and do not have to absorb workers assigned by the employment department, as was the practice in the past. They now have the authority to organize job-specific examinations and recruit accordingly. As a corollary, workers have been granted somewhat greater mobility, and school graduates have been encouraged to submit job applications to various employers. Managers have also been given greater discretion to promote better and more qualified workers and to dismiss those that do not perform well.

The wage policy has also undergone rapid change. In 1979 enterprises began to give bonuses to more efficient workers. These bonuses initially could not exceed 2.5 months of basic salary, a restriction abolished in 1984. Now enterprises can grant the bonuses they choose, but a progressive tax has been levied on enterprises that grant bonuses in excess of 2.5 months of basic wages. The regulations specifying that only enterprises that achieve profits and improve their performance can grant bonuses have also been strengthened. A common problem, however, with the bonus system has been that managers often distribute them in an egalitarian fashion, thus undermining their very purpose.

The October 1984 Decision endorsed the policy of bonuses but went one step further and recommended that the wage system itself be reformed, widening the wage differentials between various trades and jobs, and increasing the remuneration for mental work. These deviations from the strict egalitarianism that long had been the hallmark of much of China's development model are deemed necessary as the previous system was felt to have undermined workers' commitment to tasks and bred mediocrity. The authorities, however, do not feel that gearing remuneration of workers to their contribution absolves society from its responsibility of taking care of the less fortunate.

**Prices.** The present distortions in China's price structure are largely the result of adherence to a system of fixed prices that gradually became divorced from productivity developments and unrelated to international prices. This allowed wages to remain stable for very long periods, but the budget eventually had to absorb the increases in procurement costs for basic necessities. As a result, in 1983, subsidies for basic necessities constituted nearly one fourth of budgetary expenditures.

These shortcomings in the price system were first recognized in 1979 but adjustment was not believed possible within the context of the Sixth Five-Year Plan (1981–85). A consensus, however, appeared to develop that price reform would be undertaken in earnest in the Seventh Five-Year

Plan (1986–90). Partial measures were taken in the meantime, and some prices were changed. Foremost among these was an increase in agricultural procurement prices in 1979. Since consumer prices were only partially increased, however, budgetary subsidies rose sharply. Selective price increases have also been granted for commodities that were in short supply or whose production costs had increased substantially, while prices for certain other goods were reduced, often to help producers unload overstocks or to keep down increases in the cost of living. In addition to these changes, some producers were authorized to let prices for some of their output fluctuate within a fixed margin around the state-fixed prices or to negotiate the price of a share of their production. These more flexible price practices were largely restricted to overstocked commodities and to production in excess of the state-fixed production quota. But prices of commodities of lesser importance were increasingly freed from state control and were allowed to be determined by market forces. Similarly, the prices agreed upon between buyers and sellers on free markets were totally freed, although in principle the state retained the authority to intervene whenever prices would otherwise increase too fast.

The 1984 Decision has given greater urgency to the implementation of price reform. Although no definite timetable has been announced, it was made clear that prices will change, and change soon, albeit gradually. In essence the Decision announced that the scope of state-controlled prices will be reduced, while that of prices agreed between buyers and sellers will be expanded. The logic of this reform, therefore, is to create a situation in which prices—whether state-controlled or not—will reflect their production cost and take into account the supply and demand forces in the economy. The Decision recognizes that this will lead to increased prices for some commodities and reductions for others, yet it makes clear that the reform will not be allowed to cause a generalized price increase. The message is that the price reform will be introduced gradually, and the various economic agents given time to adjust to the changes by altering their production or input mix, or by absorbing cost increases through productivity gains. To the extent that subsidies will be phased out and prices of previously subsidized goods increased, real incomes of consumers will be protected as wages and other income elements will be increased accordingly. The Decision also predicts that real wages will continue to increase, since the reforms will boost productivity gains. In these circumstances the



maintenance of price stability will greatly depend on the implementation of a monetary policy that prevents excessive liquidity growth in the economy.

The implementation of the price reform will be the most difficult element of the whole economic reform movement, since it will have an impact on all segments of economic activity. Financial flows will be affected, as will enterprise profitability, thus putting at risk the lines of production of some enterprises and the survival of others. Similarly, budgetary flows and sectoral credit requirements will be changed. The realization of this pervasive impact of the price reform on the economy explains the authorities' past reluctance to tackle this issue. There is an awareness now, however, that the benefits of the economic reforms will be jeopardized if the price structure is not altered, and this has prompted the authorities to accelerate the price reform.

#### *Diversification of the economic structure.*

The widely recognized failure of the state and collective production sectors to respond effectively to market demand, to take sufficient advantage of the creativity of the work force, and to absorb growing numbers of people looking for employment led authorities not only to permit private activity to take place but also to stimulate such activities and clarify their scope. In the early years of the reforms, private sector activities were regarded with suspicion by some local authorities, who took arbitrary measures to prevent them from flourishing, but their contributions in providing new employment and new services have been gradually recognized. The number of private establishments has risen sharply in recent years, with these enterprises often absorbing graduates unable to find employment in state or collective enterprises. By the end of 1983 private establishments formed a still small, but rapidly growing, share of the total work force (about 2.3 million workers now, nearly a threefold increase since 1980). They are principally engaged in small-scale commerce, handicraft, catering, transport, and construction. Since early 1983 the private sector has been invited to lease small state-owned enterprises or to run them on a contract basis. As such, the role of the private sector is now firmly established in China, and its contribution is recognized as an irreplaceable element in the continued improvement of China's living standards.

**Commerce.** As recently as 1978 state and collective sectors accounted for 90 percent of total retail trade, thereby effectively monopolizing distribution channels. Production was largely insulated from distribution, and unsold inventories of some

products and shortages of others were frequent. In addition, administrative barriers to trade between regions prevented the free flow of goods, and gave rise to costly local monopolies.

To alleviate these deficiencies, distribution channels were gradually diversified. Since 1979, private sector trade, virtually abolished during the "Cultural Revolution," has been revived and by 1983 it accounted for more than 18 percent of total retail sales and a much larger share of the trade in vegetables, eggs, handicrafts and small industrial commodities. Recent reforms streamlined regulations pertaining to private trade, spelling out registration requirements, tax obligations, and rights.

Efforts have been underway for several years to bring the productive sector more in line with the commercial sectors; these are intended to help producers gear their output more toward market demand. Commercial enterprises are being urged to purchase according to prior orders rather than stock all products that enterprises have to sell. Manufacturers have also been prompted to improve their market research and participate more actively in the work of the commercial sector in selling slow moving commodities. This may require discounts or the repurchase of defective products, both practices that have been extremely rare in the past.

Administrative barriers between jurisdictions and between urban and rural areas, erected when local self-sufficiency was at a premium, are gradually being abolished. These restrictions had given rise to a multi-tiered distribution system that prevented the rationalization of trade transactions, burdened administrative and transport facilities, contributed to the maintenance of excessive inventories, and promoted the existence of small high-cost, regional producers. At present, experiments are under way to merge several levels of wholesale trade and to create an integrated supply network based on central cities, thereby

unifying urban and rural markets. Progress has been slow, partly because of entrenched positions and interests but also because many jurisdictions want to protect their inefficient enterprises from the competition of outside producers.

#### **In conclusion . . .**

The process of economic reform now under way in China represents a very important development in China's history. It entails not only a realistic assessment of the development model of the past but also a commitment to safeguard the socialist nature of Chinese society while allowing resource allocation to be influenced increasingly by macroeconomic instruments, the forces of supply and demand, and material incentives. In the process, mandatory planning and administrative interference will be reduced.

This shift in gears initiated in 1978 has proceeded rapidly and produced good results in the rural areas; in the urban areas progress has been much slower, and the newest reforms focus attention on this sector. A "blueprint" of the type of economy Chinese authorities want to realize is now available. Its full implementation is still a long way off and a number of obstacles will have to be overcome. Some of these pertain to the manner in which enterprises will adapt to the changed economic environment. Although most of the problems have now been identified, practical solutions are still to be implemented. Other obstacles are more subtle, but may be more intractable. One will be to persuade an established bureaucracy, accustomed to taking nearly all production decisions, that it should relinquish some of its prerogatives, and allow decisions to be taken in a less structured manner and with a less predictable outcome. Another will be to adjust an economic philosophy that, for many years, has emphasized strict adherence to egalitarianism and job security rather than economic efficiency, without alienating the adherents of the previous approach. Furthermore, China recognizes that a successful implementation of the reforms will require further progress in giving greater responsibility to younger and better educated personnel and in accelerating managerial and financial training.

In the years ahead, Chinese leaders will have to steer the country over uncharted territory. While other countries have reformed their economy or are in the process of doing so, no other country has attempted economic reform on this scale affecting one billion people. Under its previous management system, China made considerable progress toward meeting the people's basic needs. Now it wants to do even better. **ED**



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# Adjustment and reform in the Chongqing Clock and Watch Company, Sichuan Province, China

Here is an example of how one company responded to reforms in the period 1978–82. The Chongqing Clock and Watch Company (CCWC) was one of five state-owned companies chosen by Sichuan Province to participate in experimental reforms under the Four Modernizations Program. This gave the company some prominence in China's reform of light industry.

CCWC is one of the 12 largest producers of watches in China—a country where over half the urban residents own watches, and whose production and purchase of clocks and watches are unusually high for its per capita income level. The company started producing clocks in 1958, and began full-scale production of watches in 1977. By 1978, it employed 2,600 workers.

In the late 1970s, its output rose rapidly as a result of large investments financed by state grants. But the company suffered from shortages of capital, land, and labor (hiring of new workers being a highly restricted and tedious process); it had little authority to make decisions, and little incentive to expand production or to improve efficiency.

• **The reforms.** These were introduced mainly in 1980, and included:

1. Organizational changes, permitting joint ventures and various forms of association with other enterprises, which gave the company access to more resources, including land for expansion, and increased its control over the production of parts and components.

2. CCWC was among the pioneers of a new incentive system replacing the remittance of profits to government with payments of income tax. From 1980 onward CCWC was allowed to retain 60 percent of its total net product, which it used for wages, bonuses, and various benefits to workers, and to invest in expansion.

3. Financing of fixed investment by bank loans and retained profits, rather than by grants from the budget. The terms of the loans were such that the enterprise bore very little of the financial risk of productive investment.

4. The end of guaranteed purchase by commercial units of all the company's output. Permission to market some of its output gave the company a strong reason to base its production decisions on forecasts of market demand. The company could not set its own output prices, however.

5. CCWC was authorized to plan its own production, investment, and investment financing, and could play a significant role in planning sales. It could contract directly with suppliers when its needs exceeded its input allocation quotas. Targets were still set by higher authorities for physical output of the company's main products, product quality, labor productivity, and profit. They were not rigidly enforced, however, and appear to have had little influence on the company's actual production.

6. Since 1978, the company has been allowed to pay bonuses for efficient work, but in other labor matters there was little change. Quotas largely unrelated to the production plan limited the number of workers the firm could hire, and redundant workers could not be dismissed. When several hundred were made redundant by the collapse of the clock market in 1982, the worst that happened was that groups of 300 workers at a time were placed on study leave, with temporary loss of bonuses.

These reforms and policy measures eliminated the most important constraints on CCWC's expansion of production. They also gave the company strong material incentives to increase production and profits. The company has allocated bonuses rather evenly among workers. However, a high proportion of its retained profits could be used to construct subsidized housing for its workers. Housing, which was in extremely short supply, was funded entirely by the company and allocated on the basis of seniority. This gave workers a strong incentive to raise the company's profits.

CCWC responded to the new opportunities with a highly ambitious expansion program supported by heavy borrowing. Gross output nearly tripled between 1979 and 1981. To a large extent, the company geared its decisions to the interests of workers and their dependents. Employment increased by 50 percent, while average annual wages per employee rose from 755 yuan to 950 yuan. The average value of nonproductive fixed assets per worker (mainly housing) more than tripled from 1979 to 1982.

• **Marketing problems emerge.** By the end of 1981 the clock market had become saturated. And there were signs that watch producers, too, had overextended their capacity. National planning authorities intervened, limiting CCWC's targets for watch production to about half those planned by the company, and a reduction in watch prices imposed in April 1982 cut the firm's profit margins. At the end of 1981 CCWC began to have difficulty controlling the quality of its first-grade watches. In 1982, its clock production fell by 50 percent; watch production increased by only 10 percent; gross output rose by only 3.9 percent (compared with 66 percent in both 1980 and 1981); and total profits and retained profits fell by nearly one third.

The government's limitations on watch production and prices forced the company to confront more abruptly a marketing problem that was bound to emerge eventually. Despite this problem—the bane of consumer durables producers worldwide—the company had been left with strong financial incentives. It reacted by changing its development strategy from expansion of existing products to the development of new products and improvements in quality.

• **A change in strategy.** The change was accomplished through: (1) Selective adherence to the rules restricting the company's actions and affecting incentives. It seems likely that in this regard the company received special consideration by virtue of its prominence in the reform program. (2) Vigorously promoting sales. The most extreme example occurred in 1983, when several hundred clock production workers were forced to go out and sell clocks to avoid losing their bonuses and part of their wage. (3) Developing new products and varieties (including a washing machine timer and a gold-plated watch). On the whole, the company has been more successful in diversifying watch production than in finding new products to replace clocks. (4) Price reductions. Where possible, CCWC cut prices directly. Cuts in watch prices were forbidden because, being highly profitable and highly taxed, watch sales helped to maintain government revenue. Here the company disguised price reductions by changing the product mix and improving the quality of each grade of watch.

• **Conclusions.** CCWC's development in the past few years exemplifies how an enterprise can make the transition from extensive growth (by expanding the volume of output) to intensive growth (largely by widening the variety of its products and improving their quality). Promoting this transition is the underlying goal of China's economic reforms. In CCWC's case, the transition was accomplished in response to a mixture of reform in incentives, changes in market conditions, and direct government intervention that hastened the action of underlying market forces.

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*Based on a paper of the same title by William Byrd and Gene Tidrick in Recent Chinese Economic Reforms: Studies of Two Industrial Enterprises, World Bank Staff Working Paper No 652, price \$8, obtainable from World Bank Publications, P.O. Box 37525, Washington, DC 20013, USA. The paper is one of the first products of a collaborative research project between the Institute of Economics of the Chinese Academy of Social Sciences and the World Bank on enterprise guidance in China.*