

ECON4940 Understanding and Interpreting Chinese Economic Reform, Spring 2006

Olav Bjerkholt

Lecture note 10: The reform of state-owned enterprises

1.1 Introduction

The reform of state-owned enterprises is a key issue in the overall Chinese economic reform and for obvious reasons. Although some new kinds of enterprises of industrial production appeared soon after the beginning of the reform the bulk of China's industrial capital, labour force and production capacity was incorporated in the state-owned enterprises (SOE). This topic is on the reading list covered by Wu (2005), Chapter 4.

For the development of China's enormous industrial production capacity today, the reform of the SOEs has doubtlessly been of considerable importance, not only because of the production capacity the SOE's production factors represented but also because the successful reform of the SOEs from the kind of production units they were under the planning system to the modern corporations many of them have become today.

We can interpret our overall study topic – the Chinese economic reform – in somewhat different ways. One interpretation is that we should above all learn about China's economy today with a view towards the history to understand how China achieved its current system and economic capability. Another interpretation looks at the history differently, not from the vantage point of today, knowing the end result so to say, but to understand the choices made in the historical context. The difference is very important with regard to the Chinese economic reform because the ideas of the target or the end result differed very much among those who took part in the decision process.

The Chinese economic system is difficult to characterize. Obviously, market signals plays a considerable role for an economy which has become so able to compete on the world market. On the other hand it differs in a number of ways from the textbook picture of a modern competitive economy. My interest is much more on the process of how the reform come about through decisions, compromises, experimenting, luck, etc. in historic time, rather than the retrospective view of how the modern Chinese economic system came out of China's planned economy through a series of steps. In my view Wu Jinglian tells us both kind of stories. As he was an active participant in the economic discussion of reform measures throughout the reform period and even long before that, he has a very good background for giving us a picture of the economic discussion at various stages, as is apparent from the book. On some topics I think he is leaning too much towards the retrospective view in his presentation of the history.

1.2 Reform or transformation of the SOEs?

Were the SOEs reformed from the role they played in China's planned economy into the state-owned or state-dominated corporations in China today or is the change over time in these units more adequately described as a transformation, as Wu Jinglian says? There is hardly much doubt that "transformation" is a more appropriate term. The transformation is not only a transformation of the individual enterprises and how they function internally, it is

equally important that the corporate sector as a whole was transformed, and the environment in which these enterprises operated.

The production system based on SOEs of production within an overall centrally planned economy was based on the Soviet model with some adaptations to Chinese realities. All urban workers were employed by SOEs, which we may consider from one point of view as different enterprises, but perhaps more correctly as parts of an overall state enterprise.

The SOE had a management, but was dictated from the appropriate government department what to produce, how much to produce, where to get raw materials and intermediate inputs and to whom the products would be delivered. The role of the management was to carry out these decisions. The management also was subordinate in certain areas to the party cell of the SOE. Thus Wu (2005) calls the SOE merely a “grassroots production unit for cost accounting.”

Besides the production the SOEs also had other important functions in the Chinese society as it “integrated the functions of employment, social security and social relief, providing a full spectrum of social services from cradle to grave.” Multiple roles and multiple objectives naturally attracted attention away from production efficiency. The subordination to government was very complex as several different parts of governments were involved and the running of SOEs was also shared between central and local government. A general feature of the system was that there was no coordination of power and responsibility.

We see from this that the SOEs were very different from almost all conceptions we may have of a corporation producing for a market. The SOE did not have to concern itself with the supply and demand of the market and it did not have to worry about competition. The budget constraint of the SOE was to very “soft budget constraint.”

Wu (2005) Chapter 4 states three alternative ways of transforming the corporate sector in China:

- (1) develop private enterprises;
- (2) withdraw state-owned capital from ordinary competitive industries; and
- (3) transform traditional SOEs into modern enterprises compatible with a market economy.

We can see these both as alternatives and complements in trying to transform a planned economy into a market economy. But the Chinese were not prepared to give up state ownership and planning, far from it, but at the same time it was a need for achieving a bigger social surplus and that could not be achieved without more efficient industry. Clearly, the efficiency achieved in the leading industrial nations attracted interest, but the Chinese economist most likely paid much more attention to the various attempts at reforming the planning system in Eastern Europe. Yugoslavia, outside the Soviet bloc, had special interest as it had pioneered the concept of a socialist market economy, a denotation very close to what China would adopt.

Considering this reform problem also evokes the old Lange-von Mises discussion of capitalism versus socialism in the 1930s

1.3 The steps of reform

The time phases of reform of the SOEs may be divided in three,

- (1) the early reform period 1979-1983,
- (2) the Zhao Ziyang reforms of 1984-88, and

(3) the corporatization reforms of the 1990s.

There is a continuity here, in the sense that ideas were launched, some of them were adopted as reform measures, tested out in practice and the experiences led to more thinking and better reforms. We can note also between phase 2 and 3 happened yet another of the political event of great dimensions, the Tiananmen demonstration and its brutal repression. It led to the fall of Zhao Ziyang as premier and a change in the political atmosphere of China. It also led to a resurgence of conservative political forces and a delay in further reforms which did not really come on track until 1992-93. It is not obvious that this was much of a disadvantage.

1979-83 MORE

1.4 The 1984-88 reforms under the direction of Zhao Ziyang

These reforms are discussed at some length in Wu (2005) as the “power-delegating” and “profit-sharing” reforms. Wu (2005) also dismisses these reforms as unsatisfactory. Perhaps this is little unfair, we should not dismiss the importance of these intermediate steps, not least for the political support Zhao Ziyang managed to mobilize for his reform proposals until his downfall.

The attempts at reform in the first phase had failed, the attempts at rationalizing reforms of the financial and price systems had failed, but reform itself was a success, thanks to vigorous growth in agriculture and non-state enterprises. This success bred optimism, especially that food supply no longer seemed to be a bottle neck. Also the energy supply situation improved in the first phase, another reason for optimism.

Zhao Ziyang advocated to begin with three initiatives: 1) a comprehensive reform program, 2) an altered role for the planning system, and 3) a financial rationalization called “tax for profit.”

Everybody agreed on reform, but what kind of reform? We can distinguish in this period two camps in the economic discussion. The conservative camp argued in favour of a dominating role for planning of the key sectors in the economy, combined with an increase role for market forces for less important sectors and smaller enterprises. The opposite camp of reformists, inspired European rationalizing reforms, rejected the division of the economy into different sectors with different operating mechanisms. Instead, the reformists wanted the state control over the economy exerted through economic levers, such as prices, taxes and interest rates. This implied that mandatory planning had to go, but the reformists were not too clear about the precise role of government.

Both camps were in fact somewhat weakened by developments. The conservative approach in favour of mandatory planning were less convincing in an economic situation of macroeconomic slack, goods were not scarce and consequently little need for rationing and compulsory allocation. The success in agriculture was due to institutional reform and market forces, the planning system, go no credit.

The reformists were weakened by the failure of achieving anything in the first phase. China differed from all other planned economies in not charging enterprises for state-supplied investment in fixed capital. Price realignments had not taken place. How could the economy be steered through economic levers when the efforts to correct the most distorted prices had failed? The reformists would gradually shift their arguments towards advocating market determined prices.

Facing these two different camps represented all the way up to the highest level within the CPC, Zhao Ziyang succeeded in proposing a reform program that got full support in October

1984. The central idea was that enterprise reform would be followed by comprehensive reforms. Enterprises should become self-managing entities responsible for their own profits and losses, with the authority to determine their own labour force, organizational, and reward systems and the authority to set their own prices – within the scope of the state plan. Coordinated reform of all the systems – planning prices, state administration, labour and wages should follow and be completed within five years. Within this package the reform of the price system would be the measure of success or failure. The role of market prices is quite suppressed in the policy document, only a slight hint of a greater role for market price may be read into it.

But the actual development should turn out to differ substantially from the agreement expressed in the October 1984 decision. What followed was increasing what we have looked briefly at before, increasing reliance on market prices and growing out of the plan.

It may be counted as Zhao Ziyang's achievement that he managed to get endorsed a reform program of state-guided semi-market economy and then followed it up with policymaking that was much more eclectic and more shaped by economic reality.

The second initiative of Zhao Ziyang was an altered role for the planning system. The planning system at this time was not too different from the conservative camp's view. It dominated a number of key sectors, and played a smaller role for other sectors, and quite unimportant for minor sectors. The political compromise worked out was the freezing of the planning system. A number of allocations were determined in absolute numbers. The dual-track had by this time been working in practice but it had not been clearly established the right of enterprises to buy and sell outside-plan products at market prices. Before this decision in early 1985 the SOEs had not been authorized to set market prices on their outside-plan transactions.

The planning system now became a set of contracts between government and SOEs, contracts that had to be fulfilled, whether profitable or not. The compromise satisfied the conservative camp as it seemed that it safeguarded priority investments which were seen as prerequisite for growth.

The third initiative in Zhao Ziyang's reform plan was the "tax for profit."

Tax for profit: 利改税 lì gǎi shuì

This was designed to be a centrepiece of enterprise reforms, creating an entirely new financial system that would serve as the basis of the commercialization of all enterprises. Some experiments in this direction had been undertaken in the first phase.

The principle of tax-for-profit was reclassification of profits into a set of functionally differentiated revenue streams, most of which were designated as taxes. The most important such revenue streams would be capital charges, resource taxes, sales taxes and income tax. The enterprise would then become the residual claimant of after-tax profits. Tax-for-profit was a key element on these reformers' conception of enterprise reform. But its implementation was closely related to that of price alignments. Without price adjustments it would in practice be impossible to set tax rates at approximately uniform rates.

Tax-for-profit was also conceived as a key element in overall financial reform. It would not only put the relationship between enterprises and the government budget on a much sounder basis, it would also serve as a basis for dividing revenues between central and local governments.

A successful tax-for-profit reform would then allow for enterprise competition under more equal conditions and thus be the basis for enterprise autonomy.

Although the idea seemed simple enough, to implement it turned out to be exceedingly difficult as a negotiation process between several stakeholders. In general industrial interests argued for low taxes, while the Ministry of Finance was concerned with protecting the government revenues and pushed for high rates. The outcome a seriously flawed program as price alignments were not included in the reform, neither was charges for fixed assets. Priced reform failed because there were even more stakeholders to negotiate with and price reform met with opposition for its possible effect on inflation, for its possible negative effect upon revenues, and of course for industries which benefited from low input prices.

Capital charges were dropped as a compromise. There were technical difficulties, well known from other countries of setting charges for old capital, but a more important difficulty was the huge divergence of profit rates among factories. Raw materials and mining products had very low profit rates. The regional dispersion of profit rates was also considerable, the advanced coastal regions had much higher rates of profit for the same products. Another argument was that the capital had been allocated by the government, not as a result of enterprise decisions. And the value of capital was difficult to set based on distorted past asset prices.

NB: MILITARY INDUSTRY IN CONVERSION.

Thus the tax-for-profit reform became incomplete and left great dispersion in after-tax profit, corrected by the introduction of “adjustment tax” for highly profitable enterprises. In the design of the system the retained profit was intended to be around 15 %.

The tax-for-profit lasted only until 1987 and became another example of failure in the design of reform.

A new discussion about economic reforms started up in 1985 and this time the two competing camps were denoted as adherents of price reform vs. adherents of enterprise reform. The “price reformers” argued for comprehensive reforms of prices and taxes in a preliminary stage and then quickly followed by a shift to market prices. The “price reformers” wanted alignment of prices but also adjustment of other parameters of great importance for enterprise behaviour, such as the tax system and the finance of enterprise capital. They emphasized that in a true market system the enterprises should all be impartially guided by the same set of prices and parameters, exogenous to the enterprise. They opposed special bargains for individual enterprises.

The “enterprise reformers” was opposed to price reform, not because it was not needed but because they considered it as unachievable to negotiate anything like reasonable realigned prices. There were too many stakeholders and too much information asymmetry. The “enterprise reformers” preferred the two-tier price system of plan prices and market prices and then would let the market prices play a more and more dominant role. They were concerned about how to make managers become true profit maximizers and to learn the entrepreneurial skills needed and become sufficiently market oriented. This argument required a close link between enterprise performance and management rewards. “Incentives” was the key word. Fostering entrepreneurial skills was in their view a necessary precondition for effective price reforms, because only when entrepreneurial attitudes were in place would managers effectively adjust to the changing signals about resource scarcities that price reform was supposed to provide. The enterprise reformers went further by arguing that reform needed to be supported by creating a strong reform constituency, hence they argued for creating a class of managers, and also a greater role to play for entrepreneurial managers. They could have multi-year contracts and they could lease an enterprise from the government.

“Price reformers” and “enterprise reformers” needed different macroeconomic environments. Price reform could only be conducted under macroeconomic slack, while the “enterprise reformers” argued that China was prepared for rapid growth and would use that momentum for undertaking the required enterprise reform. The two camps also reached opposite conclusions about the desirability of longer-term management contracts.

Zhao Ziyang attempted at the end of 1986 to draw up a new reform program to gather support from both camps. After much effort it failed. The policy pursued by Zhao Ziyang after that was close to that of the enterprise reformers. Then again Zhao Ziyang and Deng Xiaoping in 1988 pushed once again the price reform but also this time it failed partly for macroeconomic difficulties and partly because Zhao Ziyang's demise in 1989.

1.5 The corporatization of the Chinese economy

The Tiananmen events in 1989 caused the demise of Zhao Ziyang and his reform followers lost influence as well. There was a conservative resurgence which called for macroeconomic austerity and reinforcement of planning. The coastal strategy promoted under Zhao Ziyang was also something the power holders wanted reversed. They also called for more fiscal centralization. By and large the overall message was to roll back reforms and lead the economy to renewed central control. This period lasted however only about three years (1989-91).

This reversal may seem surprising in view of the fact that despite the strong position of Zhao Ziyang, China's uncontested leader both before and after Tiananmen was Deng Xiaoping. The signal effect can be very strong in China and Deng Xiaoping turned around once more during his South China tour in 1992, as he then chose to endorse the reform-created institutions and attacked the conservative faction. The new reform agenda was adopted in October 1992 and proclaimed that China would adopt a “socialist market economy.” The key word in the title is of course “market”, not “socialist”.)

A new tax and fiscal system was adopted from 1994. Enterprise reform was taken up again and resulted in more freedom for enterprises to hire and fire labour. The new labour policy was in stark opposition to the guaranteed employment policy which had been reaffirmed as late as 1990. The new policy meant that unemployment might emerge. Accompanying the change in employment policy was various other aspects, regarding bonuses, social security, differentiated wages etc., some of which had been tried out over some years.

Also accounting ownerships forms more appropriate to a market economy were adopted. Privatization of state assets had not figured in any of the reform programs. Over time there had become considerable changes in the relative composition of ownership through the growth of non-state producers: collective, private and foreign invested firms. But the transformation of SOEs had also been initiated. The SOEs became increasingly “commercialized”, converted into modern corporate forms of various types, including limited liability joint stock companies. The opening of the stock exchanges in Shanghai and Shenzhen in 1992 contributed to attract attention to the prospect of large-scale privatization.

Then came another reform package at the end of 1993 under the title of “Establishment of a Socialist Market Economic System.” this package comprises much more than just enterprise reform, in general it aimed at providing a sound fiscal, monetary, and legal system within which the market could operate. Hence, it launched new systems of taxation and fiscal management, banking, investment and foreign exchange. The banking reforms aimed at establishing an independent market system in banking. The dual foreign exchange rate was abandoned.

The opening up for new ownership forms were the most difficult to get accepted and effectuated. These are among the most difficult type of reforms to implement also in the past. The aim was to create new institutions that limit the discretionary power of individuals. Precisely because the new institutions are meant to be impartial there is little scope for bargaining and compromise. The difficulty with such reforms in China was (and is) that the legal foundations are still weak. The way the CPS traditionally exerts power clashes in various ways with a modern society ruled by law.

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Chinas New Property Law of 16 March 2007

China's top legislature, the [National People's Congress](#) (NPC), adopted a landmark property law here Friday morning, granting equal protection to public and private properties.

It only took less than a minute for the nearly 3,000 NPC lawmakers to pass the much-revised bill, which had gone through a lengthy legislation process of more than 13 years and a record seven readings, by an overwhelming majority as the NPC concluded its annual full session in the Great Hall of the People in downtown Beijing.

The lawmakers applauded warmly after NPC Standing Committee Chairman [Wu Bangguo](#) announced the voting results. A total of 2,799 lawmakers voted for the law and 52 against. Thirty-seven abstained and one didn't cast vote.

The 247-article law, which is due to come into effect as of Oct. 1, 2007, stipulates that "the property of the state, the collective, the individual and other obligees is protected by law, and no units or individuals may infringe upon it".

This is the first time that equal protection to state and private properties has been enshrined in a Chinese law, which analysts say marks a significant step in the country's efforts to further economic reforms and boost social harmony.

China's state and private properties once suffered from serious violations due to a lack of respect for and protection of property rights.

"The significance of the law's adoption lies in the fact that it helps complete China's property rights system," commented Jiang Ping, former president of the Chinese University of Politic Science and Law.

"Only when people's lawful property is well protected could they have the enthusiasm to create more wealth and could China maintain its economic development," said Jiang, a scholar involved in the early drafting of the law.

The concept of improving the protection of private property was first brought up at the 16th National Congress of the ruling Communist Party of China (CPC) held in November 2002. In March 2004, the NPC adopted a major amendment to the Chinese Constitution, stating that people's lawful private property is inviolable.

The draft of the property law was first submitted to the NPC Standing Committee in 2002 and had been reviewed for an unprecedented seven times before it finally reached this year's parliament session for final approval.

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