Enterprise Reform in China

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Social welfare functions of the Chinese Communist regime are largely relegated to state owned industrial enterprises. In addition to productive assets, the SOE also comprises employee housing, health care, pension plans, schools, hospitals, recreation facilities, and even infrastructure. Depending on the type of industry, a quarter to a half of SOE assets may be tied up in these non-production assets.

SOE managers are bureaucrats whose job is to follow procedure and carry out orders. Their orders include production targets, wages, pricing of all inputs and outputs, and social welfare of the employees who are the “workers”. Communism in theory is a social organization whose primary objective is to ensure the welfare of workers. Lifetime employment is guaranteed.

SOE managers use a Soviet style socialist fund accounting to report their revenues and costs, and compute fund excess to be returned to the State or funding needs to be received from the State. Outmoded technology, overstaffing, and gross inefficiency characterize the productive portion of these enterprises. The managerial line of command does not contain a point of responsibility for efficiency or quality. The additional funding needs of money-losing SOEs emerged as a significant financial burden for the government.

In the reform era the State has decided to offload its SOE funding obligations to the state owned banks and at the same time embarked on a program to improve SOE efficiency. In what may be described as a “carrot and stick” approach, the managers are given authority to make production, pricing, and marketing decisions and they are held to efficiency targets. A business accounting system is used to compute efficiency measures. Managers who exceed efficiency targets are rewarded in a profit sharing scheme. They are expected to operate as business managers who make commercial decisions rather than as bureaucrats who carry out orders. The State, as the owner of the assets under their care, charges them with “conserving or increasing the value” of its assets under their management.

This enterprise governance scheme, called the “contract responsibility system”, was tried and fine-tuned but it failed to achieve the efficiency gains the State wanted partly because measures of managers’ ability to manage the productive assets are confounded by the non-production social welfare obligations that are bundled in with the productive function. Besides, enterprise governance in the contract responsibility system provides no substitute for direct state control to monitor and discipline managers.

Accordingly, the contract responsibility system was discontinued in favor of a system patterned after corporate governance in mature market economies. The prototype for this new format was a state owned retailer in Beijing. The productive assets of the SOE were disgorged and a share holding corporation was formed to receive them. The original SOE was left with only the schools and hospitals and other non-productive assets and it received about 30% of the shares in the new corporation. Approximately 10% of the shares went to employees of the two firms. The other 60% of the shares authorized were sold in a direct subscription IPO. Half of these shares was sold to the public and the other half was reserved for “legal persons”, mostly state-owned or state-controlled institutions. IPO proceeds were apparently used to pay down debt and to invest in profitable projects. The corporate structure was superficially familiar with bylaws, a board of directors, shareholder meetings, and new accounting standards but the corporate governance was incomplete.

The incorporation of the shareholding firm was a turning point in Chinese reforms because it introduced recognizably capitalist elements into the Chinese socialist economy. The CPC leadership packaged the radical changes into socialist language for general and consumption and also promulgated rules and procedures to ensure the primacy of and control by the CPC.

To make sure that the ownership mix that the government had put into place does not change, trading of shares was strictly prohibited. Perhaps the State was fearful of foreign ownership or of financial warfare by the Taiwanese; or they may have wanted to avoid the rapid concentration of shareholdings that occurred in some of the CEEFSU countries during transition. In any case these measures did not succeed. The demand for liquidity and the power of market forces took over and curb markets formed spontaneously.

China's reform program is based not on relinquishing state ownership of economic enterprise but on improving its efficiency. It is motivated by the State's inability to continue funding SOE losses from state revenues. The extent to which reforms have in fact reduced the State's role in the economy and engendered the private sector is likely an unintended consequence of policy changes whose real purpose was enterprise reform.

The dynamics of this process is best understood in terms of what happens to household savings taking into consideration that centrally planned economies are most advanced in heavy industries and least advanced in the financial sector.

Banking and the NPL Problem

During the 1950s the CPC nationalized all banks and merged them into the People's Bank of China (PBC). It remained the only bank in China for decades and also served as China's central bank and its regulatory authority for the financial sector. It was the nation's financial monolith. Its power will ensure that the financial sector will the most inflexible to reform measures.

During the reform era, decentralization and the movement towards a market economy have progressed rapidly in all sectors except for banking. The PBC is still a formidable monolith and an oddity in progressive transition economy. The PBC can assert its power at will because the reform era organizational chart is fuzzy and lines of authority are not clearly drawn. Four large state-owned banks dominate banking in China. They are controlled by the PBC. Banking is still centrally planned. Lending policies are influenced by powerful insiders and dictated by a political agenda perhaps with some consideration for social engineering. Market forces are now allowed. The allocation function of capital markets is subverted.

As in other transition economies the extent of the bad debt problem in China presents thorny measurement problems. The data on non-performing loans are supplied by the state owned banks themselves and there is not an independent assessment of their validity. The variation in accounting methods compounds this problem. Standards for the classification of loans, treatment of overdue interest, and provisioning for loan losses differ considerably from those articulated by the Bank for International Settlements (BIS) and from other Western norms. It is impossible to make a comparative analysis without taking these differences into consideration.

Competition

Self-sufficiency and isolationism were important elements of Chinese socialism. Trading was a sign of weakness. Comparative advantage was not permitted. Prior to reform China remained closed to the outside world behind the so-called "bamboo curtain". When Mao and Deng successively decentralized the economy, provinces, municipalities, and even counties were directed to be self-sufficient. Labor mobility was restricted. Capital was allocated. Even regional trade within China was retarded. The central planners set prices and dictated production and consumption quotas. Producers were told what to produce and in what quantity with all inputs and

outputs priced by the authorities. Citizens carried “ration cards” that contained instructions on what they would consume, how much, and at what price. There was little scope for competition.

This economy became characterized by gross inefficiency. The government determined that a cause of inefficiency in production was that the bureaucratic chain of command did not contain responsibilities or incentives. In the reform era the State has sought to improve the efficiency of these enterprises by liberalizing price controls and production quotas. Managers are given greater autonomy and allowed to make commercial decisions. In the so-called “contract responsibility system” or CRS, each firm is evaluated and rewarded based on performance. For example, a revenue sharing scheme may be applied to a certain level of profit and beyond that the firm may be able to retain all earnings. These schemes are not immune to subversion or perverse incentives. Since the inception of this program various performance formulas have been tried and the CRS has been successively refined. The objective is that the firm should operate less as an agency of the State and more as a business enterprise while still remaining in State hands.

The most radical feature of this system is that the State’s firms are pitted against each other in nationwide competition. Theoretically, market forces and not central planning determine prices and production levels. The market also determines which of the multiplicity of firms will survive because it enforces a process of attrition that is expected to weed out excess capacity and inefficiency. Mergers, acquisitions, bankruptcies, and unemployment are expected in the restructuring process. It is an experiment in economics to determine whether central control is separable from central planning and whether the benefits of a market economy may be attained without ceding state ownership. The stated objective of these reforms is a “socialist market economy”.

The success of this strategy requires that competition in itself can be a substitute for privatization. Researchers have argued otherwise because of fundamental differences in corporate governance and the transaction cost mechanism. What would be an optimal systemic transaction cost of price competition in the private sector is a real cost to the monolithic state. As the owner of all competing firms in the same industry the State has both the incentive and the opportunity to manipulate prices and undermine real competition. State-owned enterprises in China are engaged in a form of centrally planned competition. For example, airlines are allowed to engage in price competition only within very narrow guidelines and banks are completely forbidden to set interest rates on either side of the balance sheet.