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State Enterprises in China: Dealing with Loss-makers

Beijing's municipal government has closed another 188 state factories in recent weeks, for a total of at least 2,000 state enterprises closed nationwide in the past year. In addition, many of the loss-makers were merged with profitable enterprises, as the Chinese government renewed efforts to deal with the persistent low efficiency of its state enterprises.

Between 1979 and 1989, urban and rural *collective* industry's gross output value increased 19 percent annually while that of the *state* industry increased by only 8.1 percent. As a result, the share of the state sector's contribution to the gross value of industrial output has declined from 77.6 percent (1978) to 54.6 percent (1990). While its relative importance was diminishing, the health of the state sector worsened in recent years as well, as more and more enterprises went into the red, under the burden of large bank loans and subsidies. State enterprises' total losses tripled over two years and by late 1991 had risen to 20 billion yuan (US$3.3 billion). The loss-making enterprises have also created a chain of inter-enterprise debt amounting to about 200 billion yuan. To help settle that longstanding debt, the government has injected 35 billion yuan into the state sector. The stock of unsold products has increased rapidly, and the central government has had to restrict the output of certain products such as textile goods and tobacco.

In addition to providing loans and subsidies, the central government has also initiated preferential tax policies for large- and medium-sized state enterprises, which once were considered the backbone of the socialist economy. The price of protection has been high, however. In 1989 and 1990, about 20 percent of budgetary income went to subsidize such enterprises. Furthermore, inefficient state enterprises adversely affected the productivity of local economies. Across the various provinces of China, the extent of state-sector activities (as measured by the state sector's share of gross industrial output value) correlated negatively with the total factor productivity of the provincial economies (see figure).

At least three factors have influenced the profit margin in the state sector during recent years: the stabilization

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program, competition from the non-state sector, and the decapitalization process.

- The stabilization program of 1989 and 1990, with its monetary restrictions, should have hit the deeply indebted large- and medium-sized state enterprises harder than it did the sounder non-state sector. But because of the government's swift relief actions — pouring money into the state sector — the decline in output growth during the past two years was roughly even between the two sectors. The respective growth rates of gross industrial output value fell to about one-third of the rates in 1988 (in the state industry the rate was 12.61 percent in 1988, 3.86 percent in 1989, and 2.96 percent in 1990; in the urban and rural collective industry, 28.16 percent in 1988, 10.48 percent in 1989, and 9.02 percent in 1990).
- Increasing competition from non-state enterprises has been responsible for loss of profit in the state sector. The monopolistic state industry was highly profitable before and during the early stage of reform — significant entry of competing non-state enterprises began only in the mid-1980s. But town-, village- and private enterprises enjoy more managerial flexibility in setting prices, hiring workers, and so forth. They also have more leeway in retaining profits and paying taxes to the government, and they take less responsibility for employees' welfare (pensions, housing, medical care). Hence, state enterprises are deprived of part of their monopoly profit through competition. The managers in the state enterprises tend to blame the "unfavorable external environment" and want the government to provide "fair" external conditions.

It should be pointed out that non-state enterprises operate largely in competitive markets; therefore, any excess profit they accrue probably does not last long. On the other hand, state enterprises, especially the large ones, hold a monopoly on key industrial capital, materials, and credits. The controlled low prices for products sold by the state enterprises are largely matched by the low prices of the rationed input materials. Hence, state enterprises actually enjoy better external conditions, especially considering their monopoly position. The continuous expansion of the non-state sector suggests that the root of persistent inefficiency and loss-making in the state enterprises is the lack of an appropriate internal incentive structure in this sector.

True, with the implementation of the "management contract responsibility" system over the past 10 years, the managerial autonomy of state enterprises has increased. Managers — who have "residual control" over enterprises — may undertake virtually any activity not specifically restricted by government. This has meant expanding market-oriented activities and allowing decisionmaking, not only in areas of production, sales, supply, employment, wages, and bonuses, but also in non-industrial activities, such as workers' housing and fringe benefits. But government regulation of state enterprises, such as through tight controls on total wages and the application of prohibitive bonus taxes, limits this autonomy. Detailed rules also restrict state enterprises in their purchase of durable consumer goods.

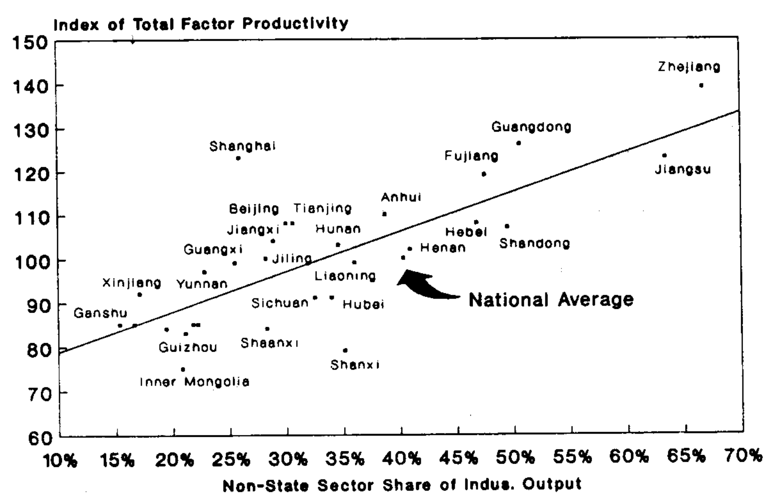
- Having given up managerial control and redefined profit distribution, the state still retains ownership of capital stock. Rents from key industrial capital, state-controlled basic materials, and state-allocated loans and credits are still large and attractive. Part of these rents has been captured by managers and workers in the state enterprises through expansion of in-kind fringe benefits. Non-industrial capital-per-labor, which is a measure of in-kind fringe benefits (such as housing), is highly correlated with industrial capital-per-labor for state enterprises. Hence, the more the government invests, the more the managers and workers are able to de-capitalize industrial resources by expanding non-industrial construction.

The in-kind fringe benefits in Chinese state enterprises are not counted as value added and are not taxed when they enter cost accounting. Therefore, managers tend to underestimate the figures for industrial profit and productivity. But mainly rich state enterprises with a high level of capital investment (and with large subsidized loans and credits) are interested in the expansion of in-kind fringe benefits.

In a sample of 900 large and medium-sized state-owned manufacturing enterprises during the period 1980-85, average non-industrial capital expanded by 65.5 percent (890 yuan to 1,473 yuan per worker) while industrial capital increased only by 33.5 percent (from 5,496 yuan to 7,338 yuan per worker). Statistical analysis also shows that in these enterprises, a 1 percent increase of industrial capital was accompanied by a 0.5 percent raise in fringe benefit funds. Low industrial productivity and profits were the result. The estimated loss of industrial profit due to decapitalization could explain almost half the productivity gap between state and collective enterprises.

The central government of China does not have the financial capability to support its inefficient state enterprises. Many Western and Chinese

The Productivity–Ownership Link 1985-87 — Chinese Provinces



Source: G. Xiao, China Economic Review, *1991* economists suggest closing them altogether. In December 1986, the People's Congress enacted the Law on Bankruptcy, parallel with the State Enterprise Law. However, implementation of the bankruptcy law has not been easy. Urban workers in the state sector spend more than half their wages on food and obtain housing and many other fringe benefits from their enterprises. If the enterprises stop production, the government has to continue to pay basic wages to the workers — it would be impossible to take away in-kind fringe benefits, such as housing, from suddenly unemployed workers. Although production facilities could be transferred to other profitable enterprises, it would be difficult to find jobs for all the workers. The Chinese leadership has to overcome the dilemma of how to reconcile economic rationality with the wide range of job security and fringe benefits that Chinese socialism has traditionally offered. And to some degree, subsidies to profit-losing state enterprises are the price for political stability. For example, during the ill-fated 1989 student uprising, the government paid workers "stability bonuses" for staying out of the streets.

Even if the state manages to close many of its loss-making enterprises and then invests heavily in money makers, succes is not guranteed. Investments, soft loans, and subsidies to the sound state firms might provoke their metamorphosis into loss-makers. Their current profitability will be lost to more competitive non-state enterprises and to rent seeking, as managers and workers pursue their fringe benefits and act in their own interest. The root of inefficiency is still the state monopoly of capital and investments.

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The article is based on the author's recent findings from the ongoing research project Industrial Reform and Productivity in Chinese Enterprises.

Possibilities or Traps in Central Europe — Catching Up with the West

There is much good news about the process of transition in Central and Eastern Europe (CEE). In Poland, hyperinflation has been checked, and shelves in the department stores are filled once more with goods. In Hungary, 50,000 new private enterprises were set up in the last three years, and foreign investments have multiplied. New legislation and a comprehensive privatization plan have spurred a major transformation in Czechoslovakia, and price liberalization has advanced rapidly all over the region. Most of the CEE countries are succeeding in replacing the collapsed Soviet and Comecon market and restructuring their exports toward the world market — and in a much more flexible way than anyone believed possible.

Good news often serves as a basis for over-optimistic forecasts, however. For example, there are claims that if all the barriers are swept away, multiparty democracy and free markets will unleash the creative forces of capitalism, and clear the way for catching up to and, in due time, integrating into Europe.

Under favorable circumstances, this might indeed happen in some countries of the region. To be realistic, however, we also have to consider the negative trends, which are partly reflected in some bad news emanating from the region. I do not mean the unavoidable and transitory negative developments — the side effects of transition — because macroeconomic stabilization has its price and pains. Inescapably, major economic and export restructuring brings factory shutdowns and unemployment. Income, both national and personal (for the majority of the population), must decline in the initial stage of this unique and unprecedented metamorphosis. It is also normal for the tremendous changes that touch every sphere of society to have a shock effect, even in countries that did not apply the so-called economic shock therapy — that is, eliminating subsidies and/or introducing market prices from one day to the next. It has become clear that transition is a gradual process, with or without shock therapy, and it is not enough to swallow its bitter pill just once to end the pain. Privatization, or for that matter, developing a new social policy, with all the costs involved, takes many years.

The roots of the CEE problems go far beneath the layer of a rigid, ideological, and mismanaged economic system of state socialism. The CEE crisis has striking similarities to the Latin American economic crisis (which began in the mid-1970s and led to hyperinflation and long-lasting stagnation, as well as the collapse of various dictatorial regimes), clearly reflecting the close correlation between the structural crisis of the 1970s-80s and the peripheral status of some countries and regions in the world economy.

The post–World War II trap into which the less industrialized peripheral countries fell was the result of *import-substituting industrialization*. Since the late eighteenth century, as recommended by Alexander Hamilton and, later, Friedrich List, through the Soviet modernization model and well into the twentieth century, this system seemed the most promising way for latecomers to cope with their backwardness. Revolutionary post-War developments in technology and science — unparalleled for their rapidity and the harshness of the structural shifts they generated — wrecked previously leading sectors of some economies. Import-substitution became a dead end. The non-competitive, non-export-oriented economies