

Prosperity of Non State Sectors And Recession of SOEs in China: A Proper View of Them

Jun Wang Zhen Fang

Fudan University,
Shanghai 200433, P. R. China

Abstract

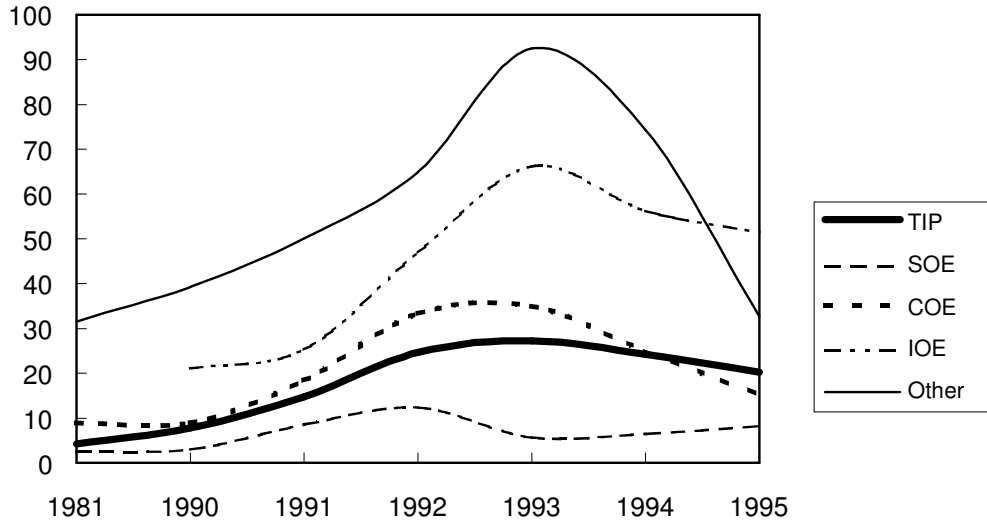
The rapid economic growth of China features boom of the non-state sector and relative stagnancy of the state-owned enterprises (SOEs). These macro statistics themselves do not justify the popular belief that non SOEs will definitely continue to outperform SOEs and that accordingly SOEs should be transferred to other types of ownership as soon as possible. The performances of both economic sectors have to be looked at in their proper perspective and factors behind their prosperity and stagnancy have to be analyzed before any conclusion about their future can be made. In this paper we try to investigate some of these factors. With further reforms and establishment of a mature market system the current situation may turn around.

Foreword

Data for the first half of 1997 show that China's economy continues to grow rapidly, despite the continuation of the 'tight' monetary policy initiated in mid-1993. Real GDP growth, at 9.5%, was not much below the 9.8% recorded in the first half of 1996. Industry booms. Inflation is curbed. Exports soar. China's success draws attention of the world. It is, however, a success of paradox.

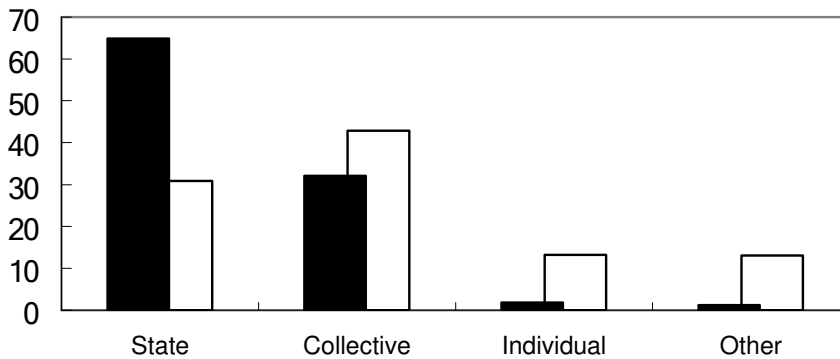
A scrutiny of the statistics reveals that it is not state-owned enterprises (SOEs), but enterprises in the non-state-owned sector, such as township and village enterprises, privately managed high tech enterprises, and foreign and private enterprises, that drive the Chinese economy. The decline in profits and taxes from the SOE sector is more than offset by the rise in revenue contribution from the non-SOE sector. The situation has been continuing for more than ten years. The prosperity of non-SOEs is a stark contrast to the recession of SOEs, which are incapable of preventing their declining importance to the national economy. In 1994, the growth rate of the SOEs stayed at 6.5%, much lower than the total industrial production growth rate of 26.1% (*figure 1*). By 1995, state-owned enterprises had fallen to only 30.9% of GDP whereas in 1985 they accounted for 64.9% of GDP (*figure 2*). In the first half of 1997 (Jan-Jun) industrial value added from SOEs grew at an insignificant rate of 5.5% while output by collective enterprises 1) rose by 12.5% and that of those in the 'others' category 2), including private and foreign-invested enterprises, was up by 15.1%. This leads a number of people to conclude that the best solution, economic and political, is to transfer as quickly as possible, and as many as possible state enterprises to other types of ownership. We have to inspect the factors behind the success of non state owned sector as well as that of the operational predicament of the state owned sector before any conclusion could be made.

Figure 1. China's Industrial Production Growth Ratio by Sectors (percentage)



Note: TIP: Total Industrial Production SOE: State-owned Enterprises
 COE: Collective-owned Enterprises IOE: Individual-owned Enterprises
 Source: China Statistics Yearbook, 1982-1996

Figure 2. Gross Output Value According To Ownership (percentage)



Source: China Statistics Yearbook, 1986 and 1996

1. Growth in Non State Owned Sector

The past ten years witnessed a significant growth in non-state owned sector of Chinese economy. Here we attempt to investigate some factors behind the success that should be kept in

mind in evaluation of the non state-owned enterprises.

(1) Backup from Local Governments

In an underdeveloped economy, which is usually accompanied by ambiguous ownership and dysfunctional legal system, enterprises must rely on the government to obtain raw materials and capital. With the discretion and consideration from the governments, township and village enterprises often enjoy a lot of preferential policies in taxation or other areas. And the local governments, in turn, collect considerable revenue from these enterprises. After all the governments have to resolve most of their finance income by themselves under the new finance responsibility system. This kind of backup function from local governments is particularly important for enterprises in an underdeveloped economy and an unregulated legal system, as are just the cases in China. The local governments include these enterprises under their protective umbrellas and provide security and facility to them so that they can decrease the enterprises' operational cost and help to obtain scarce resource. Some private or self-employed enterprises also maintain very close connection with individual bureaucrats in governments. These government officials are often the decision-makers in various local policies and projects. For obvious reasons such private or self-employed enterprises form kind of special mutual-beneficial relationship with the government officials.

Company X, with a coalmine in southwestern Shandong Province, is run by the local government. Nearby is a state-owned mining company, Y, with better technicians, more advanced equipment and technology and adequate medical facilities for workers. When a dispute arose in spring 1995 about the mining field allocation, the local government decided in favor of company X despite opposition from many mining experts. Company Y suffered a deficit due to unfavorable mineral resources and transportation, which is also at the discretion of administrative offices.

A fair production and market environment is vital for fostering of true entrepreneurship. Without such a fair environment, low efficiency and primitive management are protected at the cost of better enterprises. The economy booms with much bad long-term effects such as unduly resource exploitation and environment pollution.

(2) Development of the Privately Managed High Tech Enterprises

Another factor for the success of non state enterprises is that high tech enterprises have been growing rapidly in the past years . There are not authoritative statistics of this particular category of enterprises. But it is generally accepted that high tech enterprises in some major cities in China have been enjoying a real prosperity. Unlike the township and village enterprises that are usually labor-intensive, the high tech enterprises are technology-intensive and capital-intensive. Both types of enterprises, however, utilize the advantage in their ownership structure.

More than 80% of the high tech enterprises are invested with external system money by state-owned enterprises and state-owned institutions, including universities, research centers and even government offices. The high tech enterprises are not owned by the state. And they are not collective (township and village) enterprises, nor are they private business, joint ventures or shareholding enterprises. This unique, ambiguous ownership accounts, to a large extent, for their significant growth. Also, the managers and technicians in these high tech enterprises keep their positions in the parent companies or institutions. The managers and technicians have a very close relationship with their parent firms.

Scrutinizing the good performance of the high tech enterprises, we may find two important reasons that may not justify a long-term success for them.

First, in an economy that lacks capital the parent firms provide external system capital to the high tech industries, either by letting them retain surplus profit within the enterprises or by filling in timely capital. Accordingly the high tech enterprises often do not have to turn to commercial bank loans for capital. This is an advantage that other types of enterprises do not enjoy. Considering profit distribution and management style, parent firms seldom make contracts with their invested high tech enterprises. Thus parent firms casually put money in these enterprises when the business lacks capital. Whereas after the enterprises grow and their assets expand, the increased value hardly goes to the parent firms. The investors' rights and the relationship between investors and the enterprises are far from regulated.

Second, as has been mentioned, the managers of the privately managed high tech enterprises keep their positions in the parent firms. But to the individual managers the two levels of firms do not mean the same. After 10-30% of the profits are paid to their parent firms as dividends the remaining 70-90% are kept inside the enterprises. These parts of profits are distributed to high tech enterprise managers and employees as bonuses, housing savings and pensions. On the one hand, this flexible money motivates the managers and employees to increase enterprise profits and helps to cultivate entrepreneurial spirit. Exempt from direct government interference the managers implement effective management within the enterprises, exploit markets with enthusiasm and creativity, invest in research and development and expand to brand new high tech areas. On the other, not surprisingly, the parent firms exert protective functions similar to those of local governments upon local business. Facilities and opportunities are first granted to the high tech enterprises. The parent firms take more than financial responsibility of the investment. They also take part of social responsibilities for the enterprises they invest in, like housing and pension.

Profits gained through the above advantages in high tech enterprises are entirely registered to the enterprises themselves. The parent firms collect very little credit. This aspect of consideration may discount the success a little from the greatly applauded high tech enterprises.

2. Relative Stagnancy of the State-Owned Enterprises

Between 1988 and 1995 the percentage of losing enterprises rose from 10.8% to 47.4%. Officials from the central government of China made it clear that things might not ease up in the near future. Many questions have been raised as to whether the reform of state enterprises would succeed at all. But are the SOEs a heavy burden that should be abandoned promptly? A detailed analysis is needed in addition to the discouraging macro statistics.

(1) Historical Reasons

Contrary to current opinion, state investments in state enterprises are seriously inadequate. Since the reform of the investment system in the 1980s the enterprises depend mostly on bank loans for their development. The equipment of most state enterprises is rather outdated and the depreciation rate is too low, whereas these enterprises have already, along the years, repaid state investment several times over. The self-accumulation capability of SOEs is quite low. Before the reforms all profits were turned to the State, and today the enterprises still hand in over 70 percent. Why is it that they are now told to find for themselves funds for new equipment? Debts began in 1984 when Treasury allocations were replaced by bank loans and enterprises were badly in need of circulating assets. In other words, the high debts of state enterprises come as no surprise. They

are the consequence of the historical policies of the planned economy. And restrictions on the issuing of stocks and bonds impede the method of increasing their capital continuously by means of 'direct finance' in which the end lender purchases stocks issued by the end borrowers.

(2) Social Responsibilities Carried by SOEs

On average one out of four workers in SOEs is redundant, while retirees represent another fourth (up to one third or even one half in old enterprises). The huge amounts of potential underemployment in SOEs are the results of the old ideology that the state must guarantee full employment even at the cost of the enterprises. And an enterprise does not have the full right to fire surplus laborers. SOEs provide a lot of social services that should be undertaken by the society, including pension, medical care, children care and construction donations. In China it is well accepted that the image of state-owned enterprises is not efficiency but rather non-economic factors such as employment and social welfare.

Since February 1994 the Policy of Bankruptcy and Merging is implemented in China to get rid of the hopeless state enterprises. But an enterprise cannot declare bankrupt until there is an enterprise that would buy its assets, bolt and barrel, and resettle its workers, including those retired. The resettlement of redundant workers is a crucial issue. It is another liability that the well-performing enterprise has to take.

(3) Industrial Structure

Another main reason for the deteriorating performance of the state-owned enterprises is the repetitive investment by local governments. Investments in the same industry are conducted in local areas; thus small size factories with low technology are built everywhere. The increase in real production volume of China's mining and industry is significant. China has the highest production volume of steel and iron, coal, cloth, cement, glass sheet, lathering machines, washing machines, electric fans, refrigerators and TV sets. However, this large output does not guarantee a good market. According to an investigation of 609 types of consumer goods, only 38 of them (6.2%) sold well. And most of these popular goods are agricultural products.

A most typical example is the automobile industry. The automobile industry is a promising market. Many small factories are established in local areas because many believe that making money is as easy as installing four tires. Of the 116 automobile companies, 7 are idle, 10 are producing less than 40 units annually, 18 are producing less than 1 units daily and 21 are producing below 5 units daily.

This situation is the result of a bad industrial structure. 22 provinces listed the automobile industry as their pillar industry in their Ninth Five-year Plan. 24 provinces identified electronic industry as their pillar industry. Machinery (16 provinces), chemical industry (16 provinces) and metallurgical industry (14 provinces) are the next most chosen pillar industries. As the best supported industries, pillar industries are supposed to play an important role in creating high value added industries and leading regional economic growth. In order to achieve that the industries should be characterized with a huge domestic market, high growth rate and the capability of becoming an export industry. Unfortunately most of the local governments are choosing electronics and the automobile industry as their pillar industry. From the day they are blueprinted, these SOEs have been predestined to lose.

(4) Government Interference

The state-owned assets belong to the state. The fact is that many central and local governments are exercising their part of the ownership of the state-owned assets. Direct participation of the administrations to the enterprise management can be seen here and there. The problem is that under this circumstance, no government departments want to take the responsibility of holding or increasing value of state-owned assets. When the administrative department, who should be a unit in charge of society management, makes decisions on major affairs of certain enterprise, confusion and inefficiency in the decision making will occur, resulting in the enterprise cannot work effectively or timely to the market trend.

From the above-mentioned four reasons for the failure of SOEs, we say that the problem is not the ownership. SOEs are reformable. SOE reforms have been underway and several relevant laws and regulations were made, notably the Modern Enterprise System introduced in 1995.

For (1), according to the Outline of the Ninth Five-year Plan and the Long Term Targets Through the Year 2010 (the 'Outline'), which was approved by National People's Congress in March 1996, three initiatory measures will be taken. First, implement interest exemption and suspension and reschedule the principals repayment for a part of the merged enterprises. Secondly, transfer the debt which was caused by 'Bo Gai Dai' (transformation of fiscal allocations to bank loans) to the national capital. Thirdly, write off the debt that the bankrupt enterprises had. Other solutions include fund raising by stock issues, debt-equity swap for the SOEs to the public and debt reduction through the division of the enterprise.

At the end of 1995 reform of the social security system was finally started aiming at the establishment of a social system of old age pension, medical insurance and unemployment insurance. Related to the SOEs, separation of non-production assets including employees' dormitory, schools and kindergartens for employees' children, hospitals and other welfare services is tried.

As for the clash between the local governments' choices for pillar industries and the central government's industrial policy, pressure from the central government can reduce some provinces' pillar industry types. For example, Chongqing reduced the number of its pillar industries from 6 to 3, and Guangdong eliminated the automobile industry from its list of pillar industries. A promising solution to repetitive investment and declining market share seems to be enterprises merger, either in the form of shareholding company or enterprise groups.

In Shanghai, the biggest industrial city that accounts for one-sixth revenue of the central government of China, a number of enterprise groups and shareholding companies came into being. These core groups testify to the reformability of SOEs. Typical examples include Shanghai Yibai, Shanghai Hualian, Shanghai Youyi, Three-gun Group, Shanghai Pen Manufacturing Company, Shanghai Textile Machinery and Machinery And Electricity Holding Company. They make hit products, expand market and turn many deficit enterprises to profit.

China is making genuine efforts to separate administrative function with management function within SOEs. The Modern Enterprise System is the core of SOE reform. It features clearly defined property rights, clear-cut responsibility and authority, separation of the function of the government with enterprises, and scientific management. In Shanghai, the pilot city in the state enterprises reform, The First Commercial Bureau, The Second Commercial Bureau, the Electricity Bureau and the Metallurgical Industrial Bureau have been abolished as administrative institutions.

Given these developments and proposed solutions, the performance of SOEs can be expected to improve. Indeed, one can be confident that SOEs in China have gone past the 'reddest' days in profits and loss accounts. Recently there have been signs that the SOE sector in China is turning around. With the state enterprise reform in high gear in 1997 and 1998, further advances of SOEs are on the way.

Conclusion

Recent years witnessed a significant growth of China's economy. This growth features boom of the non-state sector and relative stagnancy of the SOEs. At the first look, the economic indices of the non-SOEs are rather good and those of the SOEs discouraging. A detailed and complete analysis, however, reveals that the success of the non-SOEs should be discounted. With enforcement of relevant rules and establishment of a mature market, non-SOEs may lose many of the advantages they are now enjoying. And with the implementation of Modern Enterprise System, SOEs are expected to have better performance. As is indicated by figure 1, in 1995 the growth ratio of SOEs increased while those of non-SOEs suffered a considerable decline. In a word, the SOEs will forge ahead with a paradoxical success, just as the non state-owned enterprises are now exhibiting.

Note:

- 1) 'Collective enterprises' located in cities normally are owned by members of the enterprises. However, most of these enterprises do not have a definition or regulations on collective ownership. Therefore, actually the local governments are the representatives of the owners to manage and supervise the enterprises.
- 2) In China, 'other sectors' (Figure 1) excluded from state-owned sector are called non-state sector rather than private sector. This is because these sectors excluded from the state-owned sector are not pure private sector and because private ownership in China is considered somewhat taboo. This article also uses this definition. Private sector is used only when referring to private and self-employed enterprises in non-state owned sector.