# *STATE OWNED ENTERPRISES IN CHINA: THE CHALLENGES OF REFORM*

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*Abstract: The reform of state owned enterprises in China has become a major issue of China's economic policy. This paper shows the importance of the public sector in China's economy and emphasizes, from an Austrian economics perspective, the challenges that any attempt to reform public companies has to meet. In particular, it assesses the case for reform in light of the incentives and economic calculation problem of public decision-makers.*

*Keywords: China, state owned enterprises, Austrian economics, economic reform, bureaucracy*

## How important are state enterprises in China?

Although the private sector has increased progressively, state enterprises are still significant in China's economy. State firms' share in GDP is debated but has been assessed at between 30% and 50%. According to independent sources[1], the public sector holds around 150,000 enterprises, which employ 17% of the urban labor force, and create 22% of all the revenues generated in industry. The assets of these companies are estimated at 16 trillion dollars, representing 38% of all the industrial assets. The public sector of China is a heavier borrower and a major customer of the banking system: the enormous amount of commercial loans, most of which is dedicated to these public companies, is now close to 170% of GDP, a huge increase relative to the level recorded in 2008, when it was less than 100% of GDP.

In strategic industries, various authors estimate that the government controls more than 90% of assets. The government is especially involved in strategic industries, controlling more than 90% of all domestically funded fixed investments in IT and transportation, and more than 80% in the production of electricity, gas and water.[2] Oil and chemicals and automobile construction are also heavily controlled by the state.[3] However, the exact share and influence of state companies cannot be accurately established, given that the government does not provide comprehensive statistics. According to official information, the number of state companies in China is 9105, and the number of government-controlled firms is 11405, but this seems to severely understate the

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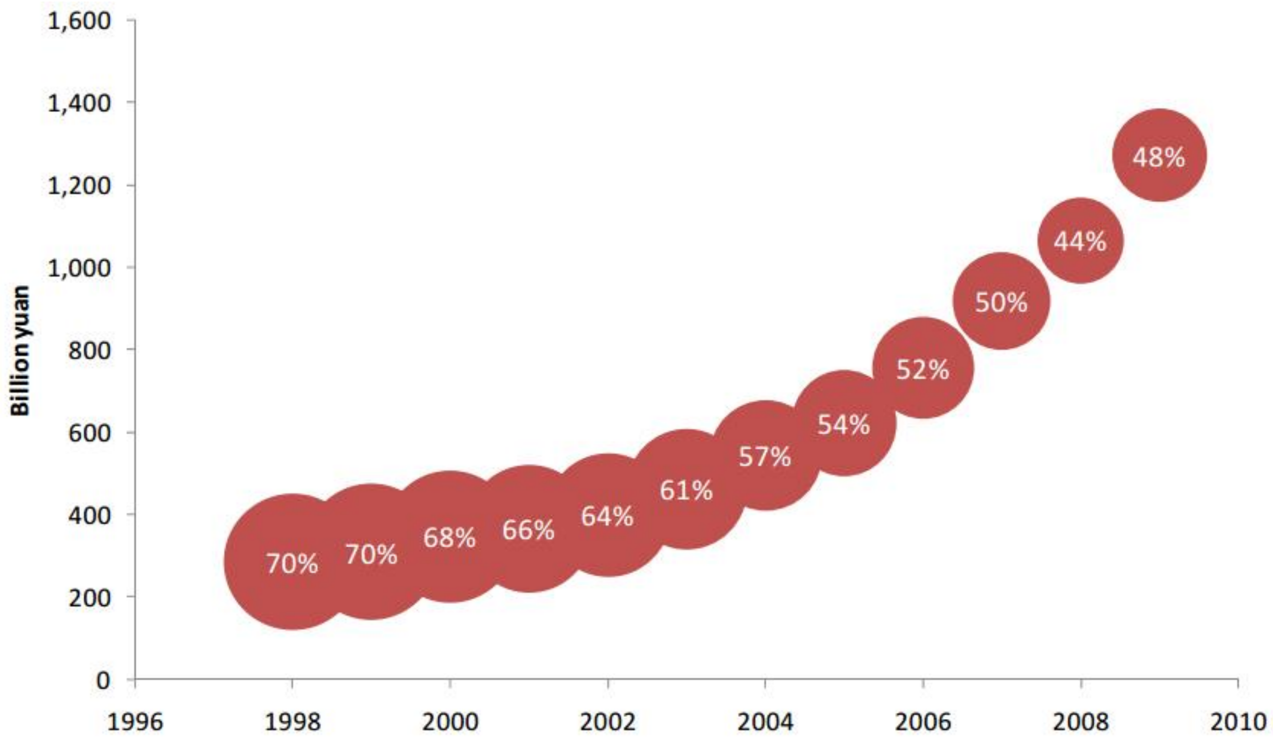
[1] Curran, Enda, 2015.
[2] Szamosszegi and Kyle, 2011, p. 16
[3] McgGregor, James, 2012, p.19.

importance of public sector. A former leader of State-owned Assets Supervision and Administration Commission of the State Council (SASAC) presents a completely different figure: 114500 state enterprises.[4]

Figure 1. Value added of state enterprises share of value added
(after Szamosszegi and Kyle, 2011, p. 14)




The Xi Jinping administration considers the reform of state-owned enterprises as a fundamental pillar of the much needed economic restructuration, a reform intended to improve the competitiveness of Chinese economy. In 2015, policymakers issued a plan for reforming public companies, so as to improve their performance and reduce corruption.

The goal of this paper is to show that the ambition of Chinese decision-makers to reform public enterprises is groundless. The problem these companies are facing is deeper than most decision-makers want to admit, and it is related to the property regime which shapes their behavior.

**State owned enterprises as a legacy of socialism**

The most important economic pillar of the Chinese economy refers to the state-owned enterprises. Their mission is, on the one hand, to fuel economic growth and, on the other hand, to enhance the geopolitical influence of Chinese government. The selection and evaluation of its

[4] Idem, p. 18-19.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managers belongs to the Central Department of Organization, of the Chinese Communist Party: "The department is accurately, if blandly, described as the human resources arm of the Party, but this does not do justice to its extraordinary brief and the way it is empowered to penetrate every state body, and even some nominally private ones, throughout the country. The best way to get a sense of the dimensions of the department's job is to conjure up an imaginary parallel body in Washington. A similar department in the US would oversee the appointment of the entire US Cabinet, state governors and their deputies, the mayors of the major cities, the heads of all federal regulatory agencies, the chief executives of GE, ExxonMobil, Wal-Mart, and about fifty of the remaining largest US companies, the justices of the Supreme Court, the editors of the *New York Times* and the *Washington Post*, the bosses of the TV networks and cable stations, the presidents of Yale, Harvard, and other big universities, and the heads of think tanks like the Brookings Institution and the Heritage Foundation."[5]

We could say that the rotation of directors in state companies defies the quotas[6] proposed by Oskar Lange: the directors have the rank of a minister and generally are members of the Chinese Central Committee,[7] while the regime still relies on the pseudo-solution of managerial know-how

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[5]McGregor, Richard, *The Party*, p. 72.

[6] Refering to Lange's model, Yasheng Huang argues that although it has been assimilated by the chinese system, it is no longer important in contemporary China: „Lange (1938) also envisaged that the government in his socialist market economy would have a major influence on the level of aggregate investment and that investment would be allocated by an investment board. Lange's model assumed the state ownership of the means of production. Such ownership is becoming less and less important in China. Nevertheless, the Chinese Government has a major influence both on the amount and nature of investment in China, particularly in infrastructure and in the selection of key sectors for development, as well as in human capital formation and in the direction of scientific and technological research. It could therefore be argued that this aspect of Lange's socialist model has, to some extent, been adopted. The Chinese economy has become a mixed economy in which the CCP plays a central role by providing a general framework or blueprint for China's development. Nevertheless, whereas Lange's model assumed state ownership of all capital, this pattern is no longer followed in China. We can conclude that the Chinese model does not conform with Lange's model of competitive market socialism." Huang, Yasheng, p. 286. Also, the economist Janos Kornai considers that chinese market socialism is not an implementation of Lange's model, which was based on public property, because: "In the real world of China and Vietnam, the market has become the chief coordinator. That may be a welcome change, but the profound changes in the ownership structure mean the present state of affairs has nothing to do with that earlier intellectual vision of "market socialism." See Kornai, Janos, *From socialism to capitalism: eight essays*, *Central European University Press*, Budapest, Hungary, 2008, p. 58.

[7]See Ming Du, *China's State Capitalism And World Trade Law*, International and Comparative Law Quarterly, vol. 63, no.2, April 2014, p. 418. See also Duanjie Chen: "among the past five CEOs of CNOOC, the first was the deputy minister of the Ministry of Petroleum Industry before heading CNOOC, the third became a provincial governor in 2003 and the fifth became the CEO and party secretary of Sinopec in 2011, while the current CNOOC chairman of the board and party secretary was from CNPC, and was promoted to be one of the 205 members of the Central Committee of the Communist Party in 2012. Similarly, among the other nine top executives of the top 10 SOEs, there is a former deputy provincial governor (CNPC),a former CEO of CNOOC (Sinopec), a former deputy minister of the central government (China Mobile), a former Chinese economic and commercial counsel in Spain (China Minmetals), and a former CEO of another major central SOE (Sinochem). The other four top executives were promoted internally. And all these top executives are the party secretaries in the company." Duanjie Chen, *China's State-Owned Enterprises: How Much Do We Know? From Cnooc To Its Siblings*, p. 19.


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transfer from semi-private sector.[8] Moreover, it is claimed that politically managed enterprises have social virtues: “State owned enterprises are not only productive enterprises. They perform important social functions, providing education and medical and child care to their employees. In the mid-1990s, they operated more than 18,000 schools with an enrollment of 6.1 million students and 600,000 teachers and other staff. Hospitals built and run by state owned enterprises account for one-third of all hospital beds in China (Lardy 1998: 51). State owned enterprises were mostly founded in the 1950s-70s when all of their profits were submitted to the government, including the implicit pension funds of employees. However, since the early 1980s state owned enterprises have been required to be responsible for their own profits and losses, and the pension funds of their retired employees have to be paid out of retained earnings.”[9]

**The elusive attempt to make state companies efficient**

Chinese policymakers have sought for decades to improve the efficiency of public companies. Everybody acknowledges that an essential feature of China’s state capitalism is the government strong intervention in the economy. As public property and state enterprises tend to fuel corruption and laziness, the government has tried to limit these adverse effects by regulating businesses and asking their directors to assume responsibility for the financial results. It offered fiscal and other advantages in an attempt to create “national champions” and to turn domestic firms into significant economic actors in the global economy.[10] How exactly did the government change in the behavior of public companies, which criteria did it used to measure and improve their productivity, how were established their economic targets? Well, relative to this issue, it is perhaps revealing the following idea: „In September, 2008, I asked a leading Chinese scholar what ‘market socialism with Chinese characteristics’ means. His reply was that it means whatever the CCP wants it to mean.”[11]

In our view, three major issues should be analyzed before going any further.

First, the concept of efficiency in economics is not autonomous; it needs a proper foundation. To talk meaningfully about efficiency, one needs first of all to assume the existence of private property. Also, following the principle of methodological individualism, given that only

[8]“On the other hand, the better performance of the collectively owned enterprises and shareholding cooperatives may suggest that the performance of state owned enterprises can be improved if some elements of employee or community ownership can be introduced into the organization structure of the state owned enterprises.” Minqi Li, *Three Essays on China’s State Owned Enterprises: Towards an Alternative to Privatization*, p. 79.
[9]Ming Du, *China's State Capitalism And World Trade Law*, p. 26.
[10] Ming Du, *China’s State Capitalism and World Trade Law*, International and Comparative Law Quarterly, (Cambridge), vol. 63, no. 02, April, 2014, p. 448.
[11] Huang, Yasheng, 2009, p. 287.


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individuals have goals and objectives, not the states or other organizations, we can deduce that these goals have a subjective nature. Only acting individuals are able to draw conclusions about the relation between their preferences, expectations, used resources and given results. An external observer cannot establish the degree of satisfaction of one person or another.

Moreover, although the acting individual can make ex post evaluations relative to the efficiency of his/her activities, one does not have any instrument for measuring this efficiency, since personal utility and opportunity costs are established on the ordinal scale of preference – that is, one does not deal with cardinal magnitudes.

Secondly, it is nonsensical to make interpersonal comparisons of utility, therefore one cannot discuss the impact of an activity in terms of efficiency or benefits, for the wellbeing of the whole society. This leads us to conclude that justifying public policies through the lenses of efficiency cannot have a solid scientific foundation.

Thirdly, human goals are different. As a consequence, they can be contradictory. We can argue that the policy of making state enterprises more efficient conflicts the goals of those who become victims of this policy.

It is perhaps time to get back to ethics as a foundation for the problem of efficiency. As Rothbard said:" But if not costs or efficiency, then what? The answer is that only ethical principles can serve as criteria for our decisions. Efficiency can never serve as the basis for ethics; on the contrary, ethics must be the guide and touchstone for any consideration of efficiency. Ethics is the primary. In the field of law and public policy, as Rizzo wittily indicates, the primary ethical consideration is the concept that "dare not speak its name" – the concept of justice."[12]

**The challenges of SOE's reform: insights from Austrian Economics**

Besides the arguments presented above, the industrial policy and economic interventionism are plagued by major issues. Following a long tradition in Austrian Economics[13], we can say that any attempt to improve the efficiency of state companies has to take into account the following theoretical arguments:

The incentive argument

In the absence of private property rights people do not have proper incentives to conserve or to increase the value of resources. Thus, any industrial policy is inevitably plagued by corruption and rent-seeking.

[12] Ibidem, p. 187.
[13] See Glăvan, 2008.


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The interests of bureaucrats and small businessmen who become political entrepreneurs are a very good illustration of the weaknesses of the Chinese industrial policy, and of any economic models which overlook the fact that individuals respond to incentives, that they are not immune to their own self-interest. Even the most optimistic Chinese experts maintain, more or less explicitly, that the chances for the development of a genuine entrepreneurial class are quite small. As Walter and Howie show, the most important goal of Chinese industrial policy is to maintain the stability of the system created by nomenklaturists with the intention to promote their own interests: "What moves this structure is not a market economy and its laws of supply and demand, but a carefully balanced social mechanism built around the particular interests of the revolutionary families who constitute the political elite. China is a family-run business. When ruling groups change, there will be an inevitable change in the balance of interests; but these families have one shared interest above all others: the stability of the system. Social stability allows their pursuit of special interests. This is what is meant by calls for a "Harmonious Society".[14]

We are talking about a politicians' dream come true, that is about a group of persons who are simultaneously managers of public assistance, beneficiaries of this assistance and arbiters; a group owning all the means necessary for perpetuating this illusion. Everything that is considered state economy in China is basically a big family business: "The state-owned economy, nominally "owned by the whole people", is being carved up by China's rulers, their families, relations and retainers, who are all in business for themselves and only themselves. From the very start of political relaxation in 1978, economic forces were set in motion that have led to the creation of two distinct economies in China—the domestic-oriented state-owned economy and the export-oriented private economy. The first, which many confuse with China, is the state-owned economy operating inside the system. Sponsored and supported by the full patronage of the state, this economy was, and has always been, the beneficiary of all the largesse that the political elite can provide. It is the foundation of China's post-1979 political structure and the wall behind which the Party seeks to protect itself and sustain its rule."[15]

In the last decades China's public sector has implemented numerous changes and transformations. But most of them are only tools to obscure the true nature of state companies. For instance, state-controlled firms now use the stock exchange market, have contracts with financial intermediaries and borrow in a "transparent" fashion applying modern financial

[14] Carl E. Walter and Fraser J.T. Howie, *Red Capitalism*: *The Fragile Financial Foundation of China's Extraordinary Rise*. See the section*China is a family business* of the first chapter.
[15] Idem.


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techniques. Apparently public companies use economic and innovative means to win an economic competition. In fact, this modern interface is just a mask for the old habits of a system basically controlled by the *nomenklatura*. Neither the profits nor the critical decisions of these companies come from the realm of private property, but belong to the political system and are dependent on the relations between various political groups of interests.[16]

From a different study[17] we can understand better the exact dimensions of the relation between political elite and Chinese business environment, which shapes the kind of capitalism functioning in China. For example, China Satellite Communications Corp., the country's monopoly satellite operator is managed by Wen Yunsong, the son of former prime minister Wen Jiabao. Zhu Yunlai, the son of another former prime minister, Zhu Rongji, is CEO of China International Capital Corp., one of the most important investment banks.

The calculation argument

Starting with Mises (1990), Austrian economists have acknowledged that without private property, economic calculation is impossible because money prices cannot develop. The market process transforms the ordinal preferences of market participants into quantitative information, i.e. market prices. These cardinal values are essential in order to calculate the profitability of various production processes, and to guide entrepreneurs into making the optimal investments.

With no private property (as in socialism), the decision-maker lacks a rational possibility to make decisions among various investments. Interventionism is arbitrary because it cannot be assessed in terms of profit and loss test, as private activities are. As Rothbard (1962, p. 825) added, any particular decision to replace private property with public action creates an island of calculational chaos.

Now, in light of this approach it is of course an error to maintain that in state enterprises – where we have islands of calculational chaos – it is possible to calculate the level of productivity. And as far as the social role of public enterprises is concerned, we should not forget the political origin of these firms, and the moral hazard associated with them. And if we know a priori that

[16] Idem. Newspaper articles discussing the family businesses of chinese politicians are quite few. See, for example, *Mapping China's Red Nobility*, Bloomberg News, December 26, 2012: http://go.bloomberg.com/multimedia/mapping-chinas-red-nobility/ and Barboza, David, *Billions in Hidden Riches for Family of Chinese Leader*, The New York Times, October 25, 2012, available at: http://www.nytimes.com/2012/10/26/business/global/family-of-wen-jiabao-holds-a-hidden-fortune-in-china.html?pagewanted=all.

[17] McgGregor, James, *No Ancient Wisdom, No Followers: The Challenges of Chinese Authoritarian Capitalism*, Prospecta Press, 2012.


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"every government enterprise not only lowers the social utilities of the consumers by forcing the allocation of funds to other ends than those desired by the public; it lowers the utility of everyone (including the utilities of some government officials) by distorting the market and spreading calculational chaos. The greater the extent of government ownership, of course, the more powerful will this impact become"[18] – then any social ambition related to public enterprises is highly problematic.

## Conclusions

In this paper I have tried to put the current ambitions of the Chinese industrial policy in the light of economic theory and in the context of empirical observations concerning the quality of management in state-owned companies. Despite the political rhetoric and efforts to improve the efficiency of these companies, a number of issues will continue to plague the attempts to reform public firms. In my view, only the change of the property regime (privatization) can pave the way for increasing the productivity in China's economy.

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[18] Rothbard, Murray, *Man, Economy, and State*, p. 953.


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