SOE Reform in China: Lessons for North Korea?

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I. Background

China’s industrial sector entered China’s reform movement, beginning in 1979, with a number of distinctive features. These include an emphasis on heavy industry that was a pillar of China’s planned socialist economy, a highly decentralized system in which many provinces developed a wide range of industries, and extensive rural industry which had its origins in the rural commune structure. Total industry employed nearly 60 million workers representing a generally high level of literacy for a low-income developing economy.

While most might date China’s enterprise reform from the mid-1980s, when the initial reform of China’s SOEs began, from a system perspective industrial reform in China began with the stirrings of decollectivization in 1979 leading within 2-3 years to the transformation of China’s rural commune factories to township and village-owned enterprises. By themselves these reconstituted rural enterprises provided an important organizational innovation; they also created both competition for and complementarities with the state sector thus facilitating its restructuring. With the establishment of the coastal Special Economic Zones, FDI began its entry into China, combining with state-owned enterprises to open export markets. As such, China’s SOE reform should be viewed through the pincer of indigenous enterprise development and overseas investment.

II. Stages of China’s industrial reform

China’s enterprise reform has spanned four interrelated stages. The first is the liberalization of industrial markets allowing for the entry of large numbers of new non-state enterprises and expanded role for product and factor markets. The second is the reform of managerial control rights within established systems of public ownership, including the strengthening of managerial incentives through the enterprise contract responsibility system. The third phase of China’s enterprise reform involved the change in asset structures resulting from non-state investment in the state sector. The fourth phase of ownership reform has involved the outright formal conversion of China’s publicly-owned enterprises, usually from state- or collective-ownership to some other formal ownership classification. This privatization of large numbers of state and collective enterprises was the logical outcome of the three preceding stages of reform. A brief description of each stage follows.

Market liberalization and new entry. Several key initiatives in the early half of the 1980s, relating to market liberalization and entry, created the conditions that initiated the restructuring of China’s public sector. The first of these was the introduction of the dual track system, which enabled many state-owned enterprises, first in light industry and then increasingly across all sectors of China’s industrial economy, to sell a portion of their output at market prices. As the portion of sales and shipments subject to planned prices remained fixed or shrunk while the market share increased many SOEs increasingly “grew out of the plan,” so that by the mid-1990s many SOEs were operating exclusively in product markets. On the input side, by the end of the 1980s, the state’s labor allocation system had been effectively abolished thus enabling
labor markets to become the dominant channel of labor recruitment and mobility.

Until the mid-1990s, the most dramatic method of industrial restructuring reform in Chinese industry was the entry of new non-state firms through three avenues. The first was the proliferation of collectives, principally, township and village enterprises (TVEs) during the 1980s. Second, the number of individually owned enterprises (getihu) having eight or fewer employees increased rapidly into the millions during the 1980s and into the next decade. The third source of new entry was foreign investment, from investors in Hong Kong, Taiwan, and Macao (HMT) and from foreign sources (FOR), primarily OECD and Southeast Asian countries. Although many of these FOR and HMT firms had previously been wholly-state or collective-owned enterprises that were converted to joint ventures as a vehicle for foreign direct investment (FDI), the restructuring of these firms represented an important form of new entry into China’s industrial enterprise system. From the perspective of SOE reform, the most important consequence of these three forms of new entry was the expanded, sometimes intense, competition in many sectors that spurred a secular decline in profitability across all ownership types. The resulting erosion of monopoly rents in state industry motivated a search for technical innovations and new mechanisms of governance throughout Chinese industry, including the state sector.

A major theme in the restructuring literature is the important role played by competition in motivating government officials particularly those at the provincial and local level, to initiate the privatization of state-owned enterprises.

The contract responsibility system. The introduction of the enterprise contract responsibility system in the mid-1980s was intended to strengthen and clarify the system of incentives and rewards for SOE managers and workers, while avoiding the politically sensitive move to formal ownership change. Jefferson et al. (1998a, 1998b) document the vertical reassignment of control rights from government supervisory agencies to enterprises and the horizontal allocation of managerial control rights among managers, workers’ councils, and party secretaries within enterprises. McMillan and Naughton (1992) find that managers responded to expanded autonomy, including greater profit retention, by strengthening worker discipline, increasing the proportion of workers’ income paid in the form of bonuses, and raising the fraction of workers on fixed-term contracts. However, although Jefferson et al. (2000) compute efficiency gains in the state sector, productivity growth in state industry nonetheless lagged behind that outside the state sector. An important outcome of these reforms was the creation of a nascent managerial class that had a strong vested interest in privatization.

The diversification of asset ownership structures. In China’s enterprise sector, the association between formal ownership classification and the ownership structure of the assets has become increasingly fluid. In 1999, the population of China’s large and medium-size enterprises (LMEs) was split about evenly between state-owned and non-state-owned enterprises. In that year, 1,417 of the approximately 10,000 these LME-SOE s reported minority state asset ownership shares while 1,935, nearly 20
percent, of the non-SOEs reported that a majority of their assets were state owned. This counterintuitive pattern of asset ownership across the range of ownership classifications calls into question the economic significance of China’s formal classification system. By creating de facto conversion, this accumulation of non-state assets in the state sector played an important role in the historical progression of ownership reform in China, in many cases rendering conversion a mere formality.

Formal conversion and privatization: In the mid-1990s, these three reform stages described above, i.e., new entry, the reform of control rights, and changing asset structures, created pressures for deep restructuring, including the formal conversion of SOEs. At the same time, the accumulation of non-performing loans and the attention given to financial stability due to the Asian financial crisis and the Chinese leadership’s quest for entry into the World Trade Organization magnified pressures for enterprise restructuring. Filtered by the need for restructuring avenues that avoided the ideological and political perils of overt private ownership, three restructuring policies were initiated during the mid-1990s. The first was a furlough policy (xiagang), which, according to Rawski (2002), at the end of the decade led to the layoff of approximately six million out of 44 million workers in the industrial state sector. By diminishing the role of the state sector as the locus of guaranteed employment, the government’s furlough program made conversion more politically and commercially feasible. Two policies focusing on enterprise conversion followed, namely, a mandate for the conversion of most SOEs and the intensification of the shareholding experiment. Under the slogan “retain the large, release the small” (juada fangxiao), China’s leadership mandated, in principle, the conversion of all but the largest 300 or so of the nation’s industrial SOEs.

The principal response to these mandates was a rapid acceleration in the number of conversions across both China’s state and collective sectors. While formal privatization was ruled out for ideological reasons, the shareholding experiment was viewed widely as a covert mandate for privatization, as Li et al. (2000) claim.

The number of industrial SOEs reported in China’s statistical system declined precipitously from a two decade high of 127,600 in 1996 to nearly one-half that number in 1998; from 1998 to 2001, the number fell to 34,530, another decline of one-half. According to Fan (2002), in some regions during this period, more than 70 percent of the small SOEs were privatized or restructured. However, conversion of SOEs enterprises was not limited to small-size enterprises. During the period from 1997 to 2001, the number of large and medium-size SOEs declined from 14,811 to 8,675; this decline was mirrored by the rise in the number of large and medium-size shareholding enterprises which rose from 1,801 to 5,659. Furthermore, the conversion process extended to collective-owned enterprises, including the township and village enterprise sector that had only a few years earlier been celebrated for its competitive performance, e.g., Weitzman and Xu (1994), Li and Rozelle (2000). Among TVEs, the privatization of rural industry was deep and fundamental; more than 50 percent of local government-owned firms transferred shares, either partially or completely, to the private sector, mostly insider managers and workers and local
residents. This process of conversion has been extensive even among the largest, most successful collective-owned enterprises (COEs). In three years, from 1998 to 2001, the number of large and medium-size COEs declined by 35 percent—from 3,613 to 2,465 in 2001. By 2008 among the 417,000 small, medium, and large size (above scale) industrial enterprises in China, only 9,682 — just 2.3 percent of the total — were SOEs; nearly 60 percent were classified as “private” enterprises. This is a remarkable turnaround from a decade earlier when the word “private” was widely viewed as too politically incorrect to use in the Chinese enterprise lexicon.

To summarize, the convergence of three factors, i.e., new entry and competition, strengthened managerial control, and the accumulation of non-state assets, created the conditions for formal conversion of SOEs beginning in the latter half of the 1990s in China. Many local governments were anxious to rid themselves of loss-making enterprises, or to sell profitable ones before they became loss-making. Insider managers were poised to secure greater control over these enterprises and asset structures were often already extensively diversified. Taken together, these conditions provided a strong motive to complete the administrative formalities of shareholder conversion. Still, there other institutional features of China’s industrial landscape that were critical to understanding China’s industrial restructuring.

III. More on the institutional context and remaining challenges

Financial system reform. China’s financial system reform has been fitful and has generally lagging behind that of the industrial enterprises. For the most part, lending by the four state-owned banks has been channeled to the state-owned economy, although in recent years, this channel of state-owned bank loans to SOEs has become increasingly relaxed. Across Chinese industry, much of the working capital and investment resources by the enterprise sector are secured from retained earnings. By international standards, retained earnings in the enterprise sector are exceptionally large.

Somewhat similar to the industrial sector, China’s financial sector has allowed, if not encouraged entry, that has allowed for the emergence of a “hybrid sector.” In their paper, Allen, Qian, and Qian (2005), we find that the most successful part of the financial system, in terms of supporting the growth of the overall economy, is not the formal banking sector or stock market, but rather a sector of alternative financing channels, such as internal financing and trade credits, and coalitions of various forms among firms, investors, and local governments. Many of these financing channels rely on alternative governance mechanisms, such as competition in product and input markets, and trust, reputation, and relationships. Together these methods of financing and governance have supported the growth of a “Hybrid Sector” of non-state, non-listed firms with various types of ownership structures. Firms that are partially owned by local governments (e.g., Township Village Enterprises or TVEs) are also included in the Hybrid Sector, because: first, despite the ownership stake of local governments and the sometimes ambiguous ownership structure and property rights, the operation of these firms resembles more closely that of a for profit,
privately-owned firm than that of a state-owned firm; and second, the ownership stake of local governments in many of these firms has been privatized. The growth of the Hybrid Sector has been much higher than that of the state sector (state-owned enterprises or SOEs, and all firms where the central government has ultimate control) and the Listed Sector (publicly listed and traded firms with most of them converted from the state sector), and contributes to most of the capital in the non-state sector.

Oversight of the SOEs. According to The State Council Institution Reform Plan passed at the first session of the 10th National People’s Congress of PRC held in 2003, the State Council established the State-owned Assets Supervision and Administration Commission of the State Council (SASAC). By assuming investment oversight of the state-owned assets, SASAC creates the institutional framework that separates the fiduciary responsibility for the state-owned assets from the government’s social and public management functions. The 2003 initiative also requires the establishment of state-owned assets supervision and management organizations at provincial and city (region) levels. The establishment of SASAC and related statutes and regulations creates the institutional framework to oversee SOE management reform and restructuring.

The main responsibilities of SASAC include: (i) perform the responsibilities as the investor of the State-owned asset on behalf of the central government; (ii) integrate the various responsibilities held by other agencies for guiding SOE’s reform and management, and (iii) guide the reform and restructuring of the state-owned enterprises, as well as maintaining and appreciating the value of SOE assets.

In principle, SASAC approves the sale or acquisition and merger of all state-owned assets. Through its local government affiliates, it also exercises oversight over the sale and transfer of the SOEs for which restructuring is initiated at the local level. SASAC’s role, therefore, would be to oversee the role of the reclassification and restructuring of China’s SOEs, clarifying and integrating the responsibilities of a variety of agencies mandated to perform these functions prior to 2003.

Political economy: Some argue that without Mao’s excesses during the 1960s and early 1970s – notably the Great Leap and the Cultural Revolution, in which the latter brought some of China’s key political leadership to the brink of extinction (e.g. Deng Xiaoping) – the commitment to economic reform would not have been sufficiently durable to sustain it through the economic and political challenges that China encountered during the 1980s and 1990s. Still, Deng and his associates embraced a gradual, measured approach to economic restructuring. The aversion to western notions of private ownership delayed adoption of the formal ownership category of private (i.e., 私营 siying). Non-state enterprises that had gravitated into the realm of private ownership often sought to insulate themselves from ideological attack or illicit resource extractions by referring to themselves as collective enterprises or other form of ownership; such firms were facetiously said to be “wearing a red hat.” The slow drift toward a more permissive attitude toward private ownership passed a landmark in 2001 when the National Bureau of Statistics first included “private ownership” in its list of formal ownership classifications. That is, 20 years of economic reform
were required to achieve this landmark underscores the gradual nature of the shift, at least in official circles, of the ideological overlay of China’s economic reform process.

The reluctance of China’s leadership to accelerate its transition to a market economy with extensive private ownership reflects underlying political conditions. The linkage between economic reform and political liberalization has particularly worried the leadership. This concern is based on the belief that economic reform will produce new interests that will demand political expression, and that demands for the institutionalization of such pluralism eventually will lead to political liberalization. This perceived link between deep economic reform and pressures for political reform clearly present China’s leadership with a dilemma. In order to legitimize the power base of the CCP, China’s leadership clearly needs to facilitate ever-rising living standards. However, the openness and legal framework needed for continuing economic prosperity may eventually undo the regime.

Remaining challenges. During the period 1998-2005, China’s SOE’s registered the highest rates of multi-factor productivity growth, but that productivity surge resulted in only the partial catch-up of these firms that improved their efficiency with managerial restructuring. While closing the gap, on average in 2005 they still lagged behind their non-state sector counterparts. The firms in the most technologically dynamic industries – telecommunications equipment, software, machinery – continue to be dominated by non-state enterprises. Although formally under private ownership or other forms of non-state ownership, many of these companies continue to be governed with substantial state oversight and operate in an environment with a weak and irregular legal system, critical skill deficiencies, and a physical infrastructure, which, while rapidly improving, operates with uneven quality.

In 2004, the Chinese National Bureau of Statistics introduced a new category of ownership – “state-owned and state holding enterprises.” Previously state-owned included all enterprises that were designated as state-owned regardless of the ownership composition, being in some cases majority non-state owned. However, beginning in 2004, only those enterprises classified as “state-owned” with 100 percent of the assets owned by the state were registered as “state-owned” enterprises. Other enterprises, in which the state owned a plurality of the asset, whether the enterprise was formally registered as state-owned or some other ownership form (e.g. shareholding) would also be classified as a state-holding enterprise. Hence, once this category was included in the roster of ownership types, due to double counting the sum of all the classifications exceeded the total enterprise count.

By including only state-owned enterprises that are 100 percent state-owned, the state-owned category for 2004 and beyond includes fewer than the SOE count of earlier years. With the data for 2004 and beyond including firms with a plurality of state-owned assets, but not registered as state-owned, the state-owned and state-holding count now exceeds the count that would have resulted from the old SOE classification.
As shown in Table 1, while the 2008 SOE count consists of only 2.3 percent of all of China’s 426,000 registered firms; the state-owned and state-holding firms account for closer to five percent of the total. More telling, where as the strict SOE category represents only 9.2 percent of total industrial output, the broader state category represents 28.4 percent of total industrial output. Furthermore, the broader category of state firms accounts for 43.8 percent of China’s total industrial assets. These figures show that state-ownership and control extends far further into China’s industrial economy than might be inferred from the narrow SOE measure.

IV. Lessons for North Korea?

North Korean initiatives. It appears that the North Korean leadership itself has at times believed that it can learn from China’s industrial reforms. According to Kang and Lee (1992) and McMillan (1996), these initiatives were taken after Kim II Song and Kim Jong II visited China in the mid-1980s.

Following their visit, there were some minor efforts toward relaxing central control of the economy that involved industrial enterprises, including efforts to implement an independent accounting system. Under the system, factory managers still are assigned output targets but are given more discretion in making decisions about labor, equipment, materials, and funds. They are also able to retain a portion of the earned profit, which they allocated autonomously to bonuses, welfare payments, and factory investments.

In addition, local enterprises have been granted more market autonomy allowing for the establishment of sales outlets, so that enterprises can provide direct sales to consumers. The movement is characterized as a third sector in the production of consumer goods, alongside centrally controlled light industry and locally controlled traditional light industry.

The changes, popularly identified as the open door policy, included an increasing emphasis on foreign trade, a readiness to accept direct foreign investment by enacting a joint venture law, the decision to open the country to international tourism, and economic cooperation with South Korea. The Third Seven-Year Plan (1987-93) gave a great deal of attention to developing foreign trade and joint ventures, the first time a plan has addressed these issues.

Following a 1988 decision by the South Korean Government to allow trade with the North, trade between the countries increased from $18.8 million in 1989 to $333.4 million in 1999, much of it processing or assembly work undertaken in the North. In the late 1990s and most of the 2000s, North-South relations warmed under the Sunshine Policy of South Korean President Kim Dae Jung. Two-way trade between North and South Korea, legalized in 1988, rose to more than $1.68 billion by 2009, much of it related to out-processing or assembly work undertaken by South Korean firms in the Kaesong Industrial Complex (KIC), just north of the demilitarized zone.
Many firms have agreed to invest in North Korea. As of December 2009, there were 117 South Korean firms manufacturing goods in the KIC, employing more than 42,560 North Korean workers. North Korea has restricted the number of South Korean businesspeople crossing to and from KIC, but factories employing the 42,560 North Koreans continue to operate.

Alternative reform scenarios. One can imagine three contrasting reform scenarios. The first is the continuation of a sovereign North Korean state, which gradually opens its doors to broad-based economic reform against the background of a single-party political system. The second is an East German-style “big-bang” reunification with South Korea. The third is one in which North Korea undertakes a period of sovereign reform in anticipation of unification. Under this scenario, North Korea focuses on the set of changes that serves to substantially align prices and market structures with those of the South in order to facilitate a more orderly economic unification.

Lessons. Clearly, under the first of the scenarios, that involving economic reform in an independent, sovereign state, the Chinese experience is most relevant. However, even under this limited reform scenario, North Korea should recognize mistakes committed by China’s reform leadership. Most notable among these has been the inability to expedite the exit, whether through restructuring or outright liquidation – of a larger portion of inefficient SOEs. As robust as new entry was, its impact was limited by the slow pace of exit. Two factors stand out as principal sources of this lagging pace of SOE exit, which allowed for a fairly consistent rate of growth in the sheer number of SOEs a decade and a half into the reform process. These were:

- the slow financial sector reform under which SOE soft budget constraints led to the accumulation of non-performing loans highly inefficient resource allocation, and
- The absence of a state-run social safety net that addressed the unemployment and labor realignment challenges by relieving individual SOEs of their extensive welfare functions.

Other areas in which North Korea could improve upon China’s gradual reform experience include bypassing or shortening the multitude of localized experiments that were used to test the efficacy of foreign investment, price reform, housing reform, and financial innovation. These lessons are quite well established.

Under the second reform scenario involving a rapid unification of the North and South, the arduous task of building new institutions in the North can be shortcut by the North importing the established commercial laws and regulations of the South. As McMillan (1996) observes, to the extent that the North can obtain these institutions for free, the path to an advanced market economy can be much shorter and direct than following the indirect, uncoordinated, and gradual steps undertaken by China. A key choice is whether to limit the exchange of goods, capital, and labor
between North and South; with controls, the North can conceivably “grow out of the plan” as China’s economy did. Without the controls, arbitrage will quickly equalize prices and returns; the flow of goods, capital, and labor will be rapid and complete.

Of course, the third avenue would entail a gradual removal of controls between the two countries in order to avoid the upheaval that would likely pursue from the rapid reunification of two economies with such deep differences in their institutional structure and living standards. Under this scenario, the North might seek to compress a sequence of phased reforms drawing of the Chinese experience. These would entail more rapid price liberalization, more rapid labor market reform, a more rapid opening to foreign capital and management, and a more rapid hardening of budget constraints leading to privatization.

V. Conclusions

China’s leadership emphasizes that China’s reform is marked by “special characteristics.” Depending on the nature of a hypothetical North Korean transition, China’s reform conveys numerous lessons for China, both characteristics to emulate and those to avoid. Whatever the preferred pace of transition – gradual or rapid – North Korea should benefit enormously from the proximity of South Korea, China, Japan, and other dynamic E. Asian economies that have ample reserves of capital, entrepreneurial talent, technology, and market demand to drive North Korea’s transition with a variety of speed-composition scenarios that suit the relevant political circumstances. The lessons from China are both general and specific. The general lesson is the central role of entry, competition, factor markets, and international flows of goods, capital, technology, and skilled labor. The specific lessons generally relate to alternative policies and administrative procedures for achieving these outcomes. For example, China’s admission to the WTO was a key factor to creating the pre-conditions that helped shape the resolve and follow-through for Prime Minister Zhu Rongji to carry out the furlough of millions of workers in the sector and hardening of lending practices of the state-owned banks. The period after WTO ascension has entailed the scheduled reductions in tariffs and meaningful liberalization of China’s financial system.

Clearly, a North Korean transition carries with it challenges that are unique to North Korea. One of these is the possible migration of millions of workers from North to South. Given the income differential between North and South, such a migration would cause unthinkable disruption to the South, which makes some form of gradual transition, whether in the context of continuing sovereign states or a scheduled reunification, a likely aspect of the transition. One possibility to stem the migration would be to give North Koreans ownership rights in their places of residence and share-holding rights in their businesses that would reinforce their sense of place.

In conclusion, China’s reform experience provides North Korea with a rich trove of experience and knowledge capital that its future leadership can potentially use
selectively to more deeply understand and easily facilitate a transition can lead to a dramatic improvement in living standards. Many lessons are relevant; few are to be mimicked.