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## Market-Economic Experiments in China's Planned Economy

by Wolfgang Klenner, Hamburg\*

**Aware of the limitations of central economic planning, the Chinese leaders have issued instructions to complement the economic order, at least on an experimental scale, by elements of the market economy. The author attended the deliberations on the new Ten-Year Plan last autumn, and here he draws a picture of the intentions underlying the reform proposals and the problems likely to arise.**

It is now widely accepted in authoritative economic circles in China that paramount for a solution of the country's present economic problems (sectoral imbalances, low productivity rates, inappropriate production programmes) is the encouragement of initiative at the level of the individual enterprise: To give freer play to initiative, the latter must be allowed enough scope for decision-making. This marks a turn-round in Chinese thinking on the desirable economic order. Only a year ago the intention was still to grapple with the encountered economic difficulties by focusing on central planning. The problems are now to be tackled in a different way because it has been realized in the meantime that the economic administration has come up against the performance limits set by its present structure and currently used planning methods.

Bottlenecks and surplus capacities have made themselves felt mainly between the enterprises and between enterprises and consumers. That is why the enterprises are to be given a chance to seek their own remedies and to safeguard trouble-free operations.

Appropriate institutional prerequisites have to be created for this purpose. To give an example: The enterprises need sufficient market transparency to see where outputs are excessive and where requirements are not met in full, i. e. to recognize the input and supply scarcities which vary in degree. They must also be enabled to respond to such scarcities by adjustments to their production ranges and capacities. Moreover, they must be sufficiently motivated to act as circumstances demand.

These preconditions existed in the past only in very limited measure if at all. As far as the state-owned enterprises are concerned — and they make the largest and economically most important contribution to GNP — most of the tasks beyond the actual production, such as procurement of inputs, sales of products, investments for plant replacement and extensions, were handled by the economic administration. Chinese state enterprises therefore bore a closer resemblance to the workshops of western firms than to independent economic units. They had no perception of the sales and purchasing conditions and were, in principle, not meant to concern themselves with such matters but to concentrate on production tasks in a narrower sense.

### Limits to Central Planning

Smooth and rational distribution of resources through central planning bureaux proved, however, to be inordinately difficult: They often did not have enough information about the latest data and all the relevant interdependences, or were unable to take them into account in time because of administrative detours. In recent years it was not even possible to strike a balance between the most important sectors, for instance between those generating and those consuming energy.

Following the decision in 1979 to give more attention to the development of the consumer goods area, it was to be expected that the rigidity of central planning would give rise to a multitude of problems, for decentralized planning is essential if the range of

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supplies is to be extended as far as possible and production and commerce are to adjust flexibly to demand, in order to satisfy the consumers' wishes at the highest possible level.

### Gradual Reforms

In future the enterprises are therefore to shoulder much of the responsibility for procuring inputs, installations and capital and for selling their products<sup>1</sup> and, as far as possible, conduct their affairs as do firms in a competitive economy. The state ownership of the means of production is however to be retained in any circumstances. In addition to executing production plans, the enterprises will have to take business decisions, the success or non-success of which is to be judged chiefly by their profits or losses.

The translation of the concept into reality will be phased; succeeding steps will probably be taken in the light of the results achieved in the preceding stages.

The reforms are being launched first as an experiment in several thousand selected state enterprises in various industries and regions. Still embraced in the state allocation system, they receive from the state – i. e. from state trading agencies and other state enterprises – inputs as required for producing the product quantities laid down in the state plan and have to surrender to the state product quantities as stipulated in the distribution plan. They have, however, been given leave to procure certain additional quantities of the required inputs outside the state allocation system and to dispose, themselves, of the product quantities which they produce over and above the plan target.

The selected enterprises are free to negotiate on their own the prices for their above-plan production. Only for certain important goods, e. g. a few types of steel or textiles, have general ceiling and threshold prices been laid down on the basis of the plan prices for planned outputs. The enterprises are given a share of the profits they earn as an incentive to produce goods in excess of their plan target. How much of the profit is left to the enterprise is fixed for each of them individually.

### Learning Process

The free sale of above-plan outputs is intended to induce the state enterprises to try to determine which products and product quantities can be sold with the

best results and which are the best input sources. They are to learn to scrutinize input and sales markets, – in and outside China, to make the best choice among possible trade partners from a business point of view, and to make their own independent contractual arrangements with other enterprises. In concrete terms, they are to adapt their outputs, grades and assortments to the demand, establish purchasing and sales organizations, if necessary, and attract business partners by guarantee and service offers. The risks incurred in the reform (through lack of market transparency and inexperience in handling contracts) are deemed to be slight because these – to most state enterprises unfamiliar – tasks will at first be undertaken only for a relatively small section of production. The enterprises will thus start gaining experience, albeit on a small scale.

If the enterprises are given more scope for independent action, and their knowledge of the market is thereby improved, the central economic administration will also be better informed. Hitherto, the administration staff has had only an incomplete picture of the production capacities and the market. One of the reasons for this was that many enterprises rated their capacity figures as low as possible when negotiating with the planning authorities so as to avoid being given high plan targets and correspondingly increased production tasks. Profit participation is to be introduced to make larger outputs and extra capacity loading rewarding and attractive for the enterprises. The administration will be able to observe the course of market-led production and in this way obtain more accurate information as regards capacities. It can, besides, gain an insight into the market mechanisms. China's economic leaders want these functional mechanisms to be used for converting the existing direct volume planning step by step to indirect planning by the aid of monetary control mechanisms.

### Profit Participation

The level of profit participation has not yet been fixed uniformly for all the selected enterprises. Some of them will keep a fixed percentage of the aggregate profit, others will in addition receive a certain share of the incremental profit. In the case of others, the extent of profit participation is calculated by means of rather complicated formulas which may include profit per turnover or invested capital.

It has not yet been established which is the best solution. A generally applicable regulation may eventually be reached by a process of trial and error.

<sup>1</sup> Cf. Xue Mugiao: *Zhongguo shehui zhuyi jingji wenti yanjiu*, Beijing 1979, p. 180 ff.

The profit left to the enterprises after deduction of tax is to be used for bonus payments and investment. The fixing of the bonus component involves relatively few problems. It is agreed that the remuneration (basic wage plus bonus) paid in individual enterprises for comparable work are to diverge as little as possible. The bonus rate has therefore been limited to a general maximum of 20 or 30 % of the basic wages which are still regulated uniformly for all enterprises in China. Conversely, it is envisaged that in a few instances the workforce will have to bear part of possible losses. Assuming that the adverse result is definitely due to misjudgement or negligence on the part of the enterprise and not to extraneous factors beyond its control, the basic wage may be cut by 10-20 %.

Problems do, however, arise in regard to the investment component of retained profits. Of what order such "self-financed" investments ought to be will probably have to be determined in the light of general economic considerations and in the context of the initiated reform of corporate finance.

Until now, enterprises have been receiving state budget funds to cover the cost of additional fixed assets and equip them with more current assets. Only marginal circulating capital requirements were met by the banks. The funds from the state budget did not carry interest, nor had they to be repaid. The

enterprises were therefore under no economic pressure to make advantageous use of their capital, with the consequence that enterprises left production capacities partly unused or accumulated excessive inventories. To obviate such conduct and curb wasteful use of capital, it is intended to do away with finance through the budget or at least to cut it back hard. The enterprises are instead to borrow from the banks whatever capital they require and pay it back with interest, or else retain it from profits.

If enterprises sell products abroad, they are to keep part of the foreign currency proceeds. Such an arrangement is already in force for certain enterprises covered by the reform which have been provided in this way with foreign currency accounts on which they can draw to finance the importation of smaller items for installation in their plants. Credit financing is also already being practised by some of the selected enterprises. This does not rule out the possibility of continuing budget allocations for certain purposes such as major projects. At all events, appropriations are, however, to be cut down drastically and credit finance and "self-finance" facilities are to be extended correspondingly.

#### Price Reform

Another proposed reform has the object of modifying price relations. The present officially fixed prices very

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rarely reflect relative scarcities. For the most part, they are not even reasonably related to the costs. The prices of some articles, including many products of light industry, are many times higher than the unit costs. Wrist watches, for instance, are priced at over 1000 % of the unit costs. Other prices, like those of energy materials, are below the costs of marginal suppliers (and this although the energy supply is one of the most serious bottlenecks).

Chinese economists attribute such price distortions primarily to the fact that most prices have been kept constant since the fifties when they at least still tended to bear a relation to the scarcities at that time. Since productivity and demand have meanwhile changed, and for some articles quite drastically, these old prices are now quite "wrong". This did not matter very much under the predominantly central volume planning in force until now, because the prices within the public sector (as used for goods moved between state enterprises) served for the most part only for settlement purposes. But if enterprises are, as intended, to take by and large autonomous decisions and the prices are thus to perform important allocatory functions, the present price system cannot be expected to work satisfactorily for the Chinese economy as a whole. It is therefore intended to alter the prices in stages, as far as possible to fit in with the relative scarcities at any given time. They are at the very least to bear a reasonable relation to actual costs.

To get an idea of the direction in which prices would have to move it is intended to keep a watch on the prices negotiated by the selected enterprises for their free surplus sales. If they stay above the officially fixed plan prices, this will be seen as a sign that the official prices are too low. If they move lower, the plan prices will be assumed to be too high. On the strength of the information thus gained, "wrong" administrative prices are to be adapted to scarcities.

More allocatory functions could be assigned to the prices as "rational" price relations are established, and it would then also be possible to get away from the rigid volume planning and administrative plan targets.

### **No Across-the-Board Reforms Yet**

The various reform measures are bound to cause many difficulties during the transition phase. The following problem for instance will arise through the tentative liberalization of procurement and sales: The additional inputs for the production of "above-plan outputs" presuppose above-plan outputs by upstream

enterprises. At present it may still be rather difficult to find suitable suppliers because the reform measures have not been introduced for all the enterprises which are involved. This particular problem is to be solved in the next stage when all enterprises in an — as yet undefined — region or town are to be given the same degree of autonomy in regard to the production and sale of above-plan products.

The rating of profit tax also poses problems. The tax must not be fixed too high, or else there will be no sufficient incentive for the enterprises to expand their turnover and lower their costs through technical innovations and input economies. There is, on the other hand, a danger from a general economic point of view that excessive "self-finance" will move capital into fields where it does not produce the largest possible return for the economy as a whole. An "optimum mix" of various methods of finance will have to be found.

Budget considerations play a role in this context. Until recently, almost all profits had to be surrendered to the state and probably accounted for nearly half the budget revenues. They are an important revenue item and needed for purely fiscal reasons not only to finance the investments stipulated by the budget but to meet expenditure for administration or education. This being so, all enterprises together cannot be allowed to retain more of their profits than would otherwise be appropriated to them out of the budget. However, adherence to this rule need not cause any budgetary problems because the consequent shortfall of budget revenues would be matched by the cutback of appropriations.

In 1979, the first year of reforms, the pertinent measures did not work entirely without friction. Contrary to expectations, the enterprises selected for the reform refrained — whether as a precautionary measure or for other, unknown reasons — from carrying out all the plan investments. The state felt prompted to fill the investment gaps and financed appropriate projects out of the budget. Its revenues had, however, been trimmed back in line with the profit allocations to enterprises, and this contributed to a significant budget deficit. (The state revenues amounted in 1979 to yuan 110 bn, the state expenditure to yuan 127 bn.)

Although the Chinese leadership was not at fault in using budget funds in the place of unused funds in the hands of Chinese enterprises, the apparent budget deficit caused alarm in the country with its generally highly conservative ideas on budget matters. This may put a brake on the reform experiments, with the result

that the enterprises will for the time being be left with only a small part of their profits and the authorities will move gingerly in adding to their financial resources.

### **Corporate Taxation Policy**

A variety of profit tax formulas have been devised, and are calculated separately for each enterprise, so as to make sure that the enterprises feel that their after-tax profits reflect their performance fairly. This could not yet be done by means of a uniform tax formula for all enterprises, for whether an enterprise earns a high profit or a low one or even works at a loss has little or nothing to do with its performance but depends on the price relations. The only significant conclusion to be drawn from a comparison of the returns of various enterprises is that the prices of the high-profit enterprises have been officially fixed high above their unit costs and those of low-profit enterprises have not.

As far as the costs are concerned, different enterprises start from very different positions in regard to their technical equipment. They cannot be held responsible for differences in costs – and hence also in profits – resulting from such varying equipment quality levels, as their plants are essentially as allocated to them by the state. Extensions, which might have “optimized” their size, modernization moves and even machine replacements were in principle permitted only if officially authorised, and the depreciation rates were in any case far too low.

For a “fair” assessment of the performance of an enterprise the profits (or losses) should therefore be corrected for price distortions and for cost variations due to the technical state of the equipment; the profits resulting from these should be taxed away (and consequent profit shortfalls should be subsidized). Tax formulas have been devised on a case-to-case basis so as to allow as far as possible for these various factors. They are, however, in part so complicated that it is almost impossible for the managements, let alone the workforces, to see any clear relation between their performance and the retained profits, which should be the object of the exercise.

China's economic leaders are therefore now inclined to set transparency and simplicity above absolute equity in corporate taxation. Relatively simple solutions, however, still require the drafting of specific tax formulas for the individual enterprises or at least for various groups of enterprises, and these cannot be standardized until significant advances have been made in carrying out the price reform.

Considerable difficulties have still to be overcome in the reform of the prices. It should be relatively easy to effect price changes for raw materials, intermediate products and equipment remaining in the corporate sector, for price changes of this kind may have the desired effects on decisions about factor allocation but have no substantial repercussions on the distribution of incomes. The enterprises would, however, have to accustom themselves to possible changes in plant costs and input prices which previously did not occur, accordingly adapting their costing and accounting practices. Substantial price movements may quite well occur, especially in the transition period.

Greater problems may arise in regard to goods in the case of which price changes affect incomes. This happens with consumer goods in particular, but also applies to industrial inputs for agriculture (such as farm implements, fertilizers or motor fuel) because the incomes of the rural producer cooperatives are a residual item. Most foodstuffs and important industrial inputs for agriculture are as a matter of fact heavily subsidized for the sake of certain distribution objectives in towns and countryside. Price adjustments for these goods to existing scarcities or costs would run counter to income policy aims, and this limits the scope for price reforms for the time being.

### **The Role of Management**

The success of China's market-economic experiments will depend on intelligent coordination of the steps to give to the enterprises a greater latitude in procurement, sales, price determination and profit fund application, just as the success of the introduction of market economy elements into individual sectors of the Chinese economy will also primarily depend on whether the freedom of decision of enterprises in complementary areas is extended or not. The speed with which managements can and will take on the additional tasks and commitments will also be of great importance. The managements of the enterprises formed hitherto a lower stratum of the economic bureaucracy and were thus the main executive organs for the enactment of directives from higher levels. They will have to develop quite different modes of conduct and additional skills if they are to cope with management functions. It will be important in this connection that the cadres of the economic bureaucracy support the reforms inspired by the zeal of the central authorities and many enterprises, and that they should not obstruct them for fear of losing status.