

Klenner, Wolfgang

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## Economic Reforms in the Industrial Sector of the People's Republic of China

by Wolfgang Klenner, Hamburg\*

**At the end of the 1970s there occurred a re-orientation of development policy in the People's Republic of China. Changes were introduced in the sectoral development priorities, the guiding principles of the State's incomes and foreign trade policies and in the organization of agricultural production. Above all, initial steps were taken to realign the administrative control system in the industrial sector more towards a market-oriented economic system. This article examines the guiding ideas behind the reform of the industrial sector and the measures taken so far. Emphasis is placed on the introduction of taxation on enterprises' profits which was recently decided and had long been a subject of dispute.**

The basic ideas underlying the economic reform can be summarized under four headings. Firstly, entrepreneurial decisions oriented towards profit-making are given a major role in the economic process; sectors and branches in which the State and those in which the enterprises are to have the prime role in controlling the economic processes are being determined. Secondly, the formulation of a pricing system oriented towards scarcity prices is considered important. Thirdly, specific concepts exist concerning the allocation of competences between the State and enterprises when deciding upon capital investments and, fourthly, upon the employment of the labour force.

### Varying Degrees of State Control

Unlike the past system, the State is no longer to exercise, as far as possible, direct control over the entire economy but is to be restricted to a narrowly defined sector. The intention is to divide the economy into three sectors which, although economically interlinked, are clearly separate with regard to the intensity of the State's interventions; these are the sectors with continued administrative control, indirect control and no State control.

The administratively controlled sector is to include the larger enterprises producing goods which are considered particularly important for development strategies or for the subsistence of the population, such

as coal, timber, basic chemical substances and some types of steel. The State will continue to set them compulsory production targets. The products will usually be allocated to purchasers directly by the State. By this means the central authorities intend to ensure that, whatever the circumstances, these essential goods will be supplied to the regions, economic sectors, population groups and individual projects stipulated in the National Economic Plan.

According to information issued by the Chinese Planning Commission, this will involve some 100 products and only a few thousand large enterprises. They will, however, represent approximately 20-30 % of gross industrial output. After the reform the State would still have direct powers over a considerable proportion of production; the more conservative wing of the Chinese economic leadership, i.e. those who attach more importance to a planned economy, consider this proviso to be essential if China is to develop in accordance with the principles of a planned economy.

The indirectly controlled sector is to consist of enterprises producing goods which are also of major importance for the national economy, such as engines or certain chemical products. They are not, however, in particularly short supply and so in their case the State intends to abstain from direct intervention. Consequently, those enterprises will be allowed to take largely independent decisions concerning employment, production and sales. However, the State is to formulate

\* HWWA-Institut für Wirtschaftsforschung-Hamburg.

guidelines and enforce them with the help of a suitable range of economic-policy instruments. A system of economic levers (prices, interest rates, taxes) is under consideration whereby the enterprises' profitability can be influenced in such a way that, in order to produce profits, they will adopt decisions which accord with the State's objectives.

No State intervention or even guidelines but, at most, so-called consultations are planned with regard to decisions on the production, procurement and sales of the enterprises in the uncontrolled sector. Nonetheless, special regulations, which will be examined in more detail below, do exist in relation to capital investments and the employment of labour.

This uncontrolled sector includes, for example, enterprises producing goods available in department stores: stationery, textiles from man-made fibres, shoes, etc. They are very important for supplying the population but have no existential significance for development strategies or the people. Small producers' products also fall within this group which accounts for between 20 % and 30 % of gross industrial output.

### **Pricing System**

To ensure that the individual enterprises' price- and profit-oriented decisions produce good overall economic results, scarcity prices are to be realized for the majority of the products, i.e. the prices which have hitherto been fixed by the administration will progressively be decontrolled. This measure is to relate principally to products from the indirectly controlled and uncontrolled sectors.

The decontrol of prices will cause considerable price changes because in many cases present prices reflect

neither scarcities nor costs as for many products the prices fixed in the early 1950s have remained unchanged or have only slightly been adjusted even though the demand and supply situation has in some cases altered fundamentally since that period. For instance, the cost of producing domestic electrical appliances has dropped because of the switch to mass production while the cost of certain mining products has increased because, in order to meet the rising demand, less cost-effective deposits have had to be exploited. The economic postulate of price stability was mistakenly equated with price rigidity. Thus prices have become increasingly distorted when compared with imputed scarcity prices, i.e. market prices, and have lost any allocatory function.

A contentious point is whether the prices of goods of particular economic importance from the directly controlled sector should also be decontrolled – the progressive reforming wing advocates such a step (in this context "progressive" is used in the sense of "market-oriented"). Scarcity prices should at least be employed as "shadow prices" in optimization models so that the State can make economically rational decisions. The forces which hold power in the Chinese economic leadership do, however, take the view that in a planned economy the prices of the most important products should not be determined by the market and should not be constantly realigned with market conditions. The essential prices, e.g. for coal, should be fixed by the State on the basis of social considerations and then kept stable.

### **Capital Investment**

Administrative controls over capital investments are to be eased. The intention is to allow a certain amount of

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latitude for investment decisions by individual enterprises but, in the view of the currently predominant reforming wing, that latitude should be relatively narrow because the enormous development tasks, such as the removal of bottlenecks in the energy and transport sectors, will for a long time yet require that the central authorities have control of the economic resources.

On the other hand, enterprises are in principle to be allowed freedom to decide upon small capital investments, especially for modernizing their equipment, most of which is entirely obsolete. Finance will no longer be obtained solely from budget allocations but also from retained profits and bank loans. The criterion for investments is to be the expected profitability of the investment project.

The State does, however, intend to influence the enterprises' investment decisions indirectly by interest-policy measures and also, if necessary, by direct administrative action. Thus enterprises in certain regions or sectors whose development is to be particularly promoted are to receive loans on special conditions. This would also make it possible to implement projects on which the return is relatively low from the point of view of the individual enterprise but whose benefits for the national economy are considered very large. Conversely, larger projects funded from the enterprise's own resources are to be subject to approval in order to prevent the implementation of projects which, although highly profitable from the point of view of the enterprise concerned, are of little value to the economy as a whole. It is also intended to fix compulsory sectoral priorities for the banks when granting loans.

In contrast, the progressive reformers would like as quickly as possible to extend the enterprises' latitude for decisions on capital investments. They point out that many of the central authorities' investment decisions do no more to promote the national economic interest than those taken by the enterprises themselves because those authorities have neither sufficient knowledge of future needs nor of the potential production alternatives. All too often, it is argued, the central authorities are idealized and seen as an homogeneous decision-making centre which always adopts rational decisions. In reality, however, they are made up of a larger number of disparate opinions and interests of separate committees, ministries, banks, etc. If a decision is eventually reached, no one can any longer identify himself with it and no one bears responsibility for it.

Although the criticism of centralized investment decisions is shared by many economists in China itself,

authoritative quarters confute such criticism by claiming that, at least in the case of investment decisions, the State's targets must be enforced – otherwise there would no longer be any question of a planned economy. Furthermore, owing to the price distortions which cannot be entirely remedied for a long time to come, conditions suitable for rational investment calculations by the enterprises could in any case scarcely exist – a line of argument which is not entirely implausible.

### Employment

The latitude allowed to individual enterprises when deciding upon the allocation of the labour force is to be expanded but will still be much narrower than is really necessary from the purely economic point of view.

The authorities are afraid of the political and social effects of any liberalisation of the labour market. They fear, for instance, a dramatic increase in unemployment if enterprises which often employ anything up to 50 % more personnel than they need were to adjust the number of staff to their actual requirements. There is also an awareness of the potential for social disruption that would be connected with a more pronounced differentiation of earnings.

Consequently, all the reforming politicians agree that for a long time yet only limited use can be made of the allocatory function of wages. Nonetheless, enterprises are to be granted a certain latitude when deciding upon the recruitment and dismissal of workers. They are also to be allowed to adjust individual earnings by paying bonuses from profits for the worker's individual performances – but on the basis of wage categories fixed by the State. Conversely, operating losses are to be partially offset by recourse to the employees' earnings.

### Implementation of the Guiding Ideas

In the late 1970s a start was made on reforming the entire economic system in order to put these guiding ideas into practical effect. Selected enterprises were released from the clutch of the economic administration. They can retain part of their profits and take their own decisions on production, procurement, sales, investment and employment of labour within a certain area of latitude.

Institutional changes were applied outside the enterprises' sphere in order to underpin the reforms. Steps were taken to prepare the economic administration, by means of structural changes and training of the personnel, for such management

functions resulting from the progressive conversion of the economic system from administrative to indirect control.

The administration is now collecting initial experiences with the use of the "economic levers". The banking system which had hitherto been only an extended arm of the finance ministry is also being re-organized. The guiding concept is a central bank which is largely independent of the Government and which, by means of interest and minimum reserve policies, controls the money supply and adjusts it to the economy's production potential.

#### **Profit-sharing by the Enterprises**

The profit-sharing method whose effects can best be monitored and which is technically the simplest and most closely aligned with the guiding ideas would be a uniform tax scale to be applied to every enterprise. But such an arrangement would cause problems under present circumstances: at present profits or losses have little relation to the enterprises' performance. Some

branches of the economy have achieved high profits because the administration has fixed the sales price well above the average unit costs of the branch. For example, the prices for wrist-watches are many times the unit costs. Conversely, entire branches, such as the coal industry, are showing losses and depend upon State subsidies because the prices do not cover their costs.

A standard tax rate or tax scale for every enterprise would therefore be unfair. Any such form of taxation would simply increase the disparities for which the individual branches and enterprises are not responsible because the branches and enterprises which have so far been receiving favourable treatment would continue to achieve higher profits and thus have better prospects of growth and because those which have not received such treatment could achieve smaller or even no profits and thus have no possibility of developing. An equitable and economically sensible tax arrangement would instead have to be designed in such a way that those components of profits and losses which have little

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relation to the enterprise's performance are skimmed off by a special tax or offset by subsidies, respectively.

Quite apart from these technical problems, various groups concerned with economic policies objected to a solution based on taxation. "Conservative" forces in the economic administration and especially in the Finance Ministry demanded that under no circumstances should the economic reform be carried so far that the Party and State could forfeit its influence on the economy; it would still have to be possible to oblige the enterprises' managements to comply with the orders or – as they are now called – the advice of the economic administration. As tax-paying units, enterprises could too easily evade intervention by the State's economic administration by insisting that they had fulfilled their obligations on the State by paying their taxes. According to this line of argument, it would hardly be possible to enforce the State's planning targets under those circumstances. If socialist enterprises are at all times to be used for the common good as defined by the Party and the administration, they must remain closely linked with the administration despite all the reforms. This would best be achieved by the "profit-retention" system whereby for each individual enterprise the administration decides the proportion of its profits which it may retain with due allowance for the State's current financial needs, on the one hand, and the financial needs of the enterprise in question, on the other.

In view of the technical reservations about a solution achieved by taxation and the reservations adduced by important groups concerned with their own interests it is not surprising that the more conservative profit-retention system was applied in most of the enterprises covered by the reforms (just under 6,000 of the almost 400,000 enterprises in the country). The regional administrative units were free to decide upon the procedure by which the enterprises' total profits were divided between the State and the enterprise and upon the amount of the retained profits. These units made use of their freedom and showed great powers of invention in constructing a wide range of, in some cases, extremely complicated procedures.

Experiments with different tax arrangements have also been carried out in a small number of enterprises – just over 400 up to the end of 1982. A common feature of these arrangements is that the profit tax consists of a special and a general component. The special component is intended to skim off the portion of the profit which is unrelated to the enterprise's performance and derives only from distortions in the pricing system or different technical equipments. In the course of

decontrol of prices and their approximation to scarcity relations, the special component would have to be gradually eliminated until eventually it disappeared entirely and only the standard tax scale remained.

As pointed out above, however, experiments with profit-retention methods formed the focal point of the industrial reforms. Profit taxes were given little mention in the press and one received the impression that no general introduction of a profit tax could be expected in the foreseeable future, especially since in 1982 the Chinese economic administration decided, for the time being, to carry out no further reform experiments. It was said that first of all the experiences gained so far were to be collected and evaluated.

So the decision to introduce a profit tax on all enterprises in the foreseeable future came somewhat unexpected when it was announced at the beginning of the year.<sup>1</sup> According to the reports so far available, initially every enterprise will be taxed on a standard basis and the remaining, economically unjustified balances of profit are to be skimmed off by a special regulatory tax. The lobby in favour of a tax solution has obviously managed to dispel the doubts of the administration and especially of the Finance Ministry. As a precaution, however, when the decision on tax policy was published it was also said that under no circumstances was the State revenue to be detrimentally affected by the profit tax.

It will be impossible to prevent arbitrary decisions when determining the rate of the regulatory tax. It is still an open question whether the reforming impetus will be sufficient to keep this to a minimum or whether the administration will use it as an opportunity for further regimentation of the enterprises. A further problem will be a standard definition of the trading profit as a basis for determining the tax payable.

### Problems of the Reform

To sum up, a few comments on the guiding ideas, the reforming measures and the prospects of the reform:

The guiding ideas of the economic reform indicate the pronounced pragmatism which is undoubtedly one of the strengths of Chinese economic policy: rather than constructing an ideal regulative model "in a vacuum", it closely orients itself towards the conditions obtaining in the individual sub-sectors of the economy.

Although the guiding ideas do in fact conform to an overall pattern, no concept exists concerning the combined effects of the individual sub-sectors. The

<sup>1</sup> Cf. Renmin, Ribao, 24. 8. 1983.

functional relationships between the planning and the market elements have not yet been adequately thought out and this is bound to cause problems when the reforming ideas are put into practice. For example, inconsistencies exist between the State's intention to allow the enterprises to keep a proportion of their profits, on the one hand, and, on the other hand, its intention to control the investment structure and, in fact, individual investment projects. Consequently, an enterprise will simply find it futile to work hard to achieve high profits when it can invest them only after time-consuming procedures for obtaining approval and must actually allow for a ban in investment.

Generally, the dynamic element of economic processes has so far been given insufficient attention in the deliberations on reform. No practical solutions have yet been found concerning the combined operation of the plan and the market in introducing technical innovations, developing new products or enforcing organizational changes. Nor, by the way, do the East European reforming countries have a consistent concept for these important matters. The leading reforming politicians do indeed attach great importance to more independence of the individual enterprises in this area too. Yet there is also an opinion to the effect that questions concerning investments, technical innovations, etc., should best be transferred to the centralized management of trust-like groupings of enterprises.

This approach which is directed more towards technological aspects and was advocated right back in the early 1960s does, however, involve the risk that the economy may become monopolized and that innovation processes may become subject to too much red tape and thus, in the last analysis, may be impeded.

To begin with, experiments with a wide range of profit-sharing methods were carried out at the lower levels over several years. Only when sufficient experience had been acquired was a standard taxation concept adopted by the central authorities. This process indicates the interplay between the central authorities and the "economic basis" when innovations are tested and enforced, an interplay which is in fact typical of China: first of all, the central authorities lay down very general guidelines and the lower levels begin to carry out reform experiments based on those guidelines. Only when sufficient experience has been acquired do the central authorities evaluate the experiments and finally issue precise instructions for dealing with the matter.

This process has undeniable advantages. Experience is collected from individual pilot projects. If

the results are negative, they affect only sub-sectors of the economy. Remedial measures can then be prepared in good time for the further procedure. In addition, soundings can also be taken of resistance in the social sector. Even in the event of opposition in the initial stages, careful action often makes it possible to achieve a final consensus.

Yet this process can have some drawbacks. Solutions which are correct in themselves may produce unsatisfactory results if they are not applied with sufficient determination and if the necessary supplementary measures are not carried out at the same time. For instance, as frequently happened when the reforms began, it is futile to grant enterprises more freedom in connection with production and sales without, at the same time, liberalizing the factor markets because the enterprises are unable to procure the necessary volumes of inputs. Other examples can easily be cited: when decontrolling prices, it must be ensured that active competition prevails. Otherwise, the enterprises exploit their market power and prices only move upwards. Any delaying process and the lack of complementary measures would merely exacerbate the transitional problems.

### Prospects

Finally, a few comments on the prospects of the reform: The success of the reform will largely depend on the extent to which a system of complementary regulative measures can be enforced. Price reform will play a special part because measures which impede reform, such as special taxes to skim off profits unrelated to performance, and also the State's involvement in the enterprises' investment decisions, will become superfluous only when prices reflect the relative scarcities, i.e. when market prices apply, since a system of scarcity prices provides pointers for rational decisions by the individual enterprises. The success will also depend upon organizing properly functioning competition but the need for this has not yet been fully recognized in China. There is still too much attachment to the concept of large enterprises and to trusts which as far as possible comprise all the enterprises in any particular industry. It is also important for the regulative and the procedural policies to be satisfactorily synchronized. This synchronization has so far been insufficiently achieved, as the high rates of inflation demonstrate. Finally, the success of the reform will depend upon the political leadership's determination in continuing to support the reforms and whether it will succeed in achieving a balance between the various interests.