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Constructing the foundations of microeconomic analysis of Chinese economics: based on the theory of classified reform of state-owned enterprise

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Abstract

Purpose – Since the core issue of Chinese economics is to elucidate the logical relationship between socialism and the market economy, it necessitates a robust foundation for microeconomic analysis to uncover the behavioral patterns and characteristics of microeconomic agents in a socialist market economy and identify the conditions and methods for the functioning of market mechanisms.

Design/methodology/approach – The core issue of microeconomics with Chinese characteristics is to identify the economic logic of how market mechanisms play a decisive role in resource allocation under the basic socialist economic system based on China's reform.

Findings – The core issue in building the foundation of microeconomic analysis of Chinese economics is addressing the compatibility issue between SOEs and a market economy.

Originality/value – In the author's view, this can be achieved under the logic of classified reform so as to build the microeconomic foundation for the effective functioning of a socialist market economy.

Keywords Chinese economics, Foundation of microeconomic analysis, State-owned enterprise, Classified reform, Market mechanism

Paper type Translated paper

China's unique path of reform has contributed to China's economic "miracle." The essence of the Chinese model is to promote market-oriented reform while adhering to the basic socialist economic system, enabling market mechanisms to play a decisive role in resource allocation while optimizing the role of government. Allowing markets to play a decisive role in resource allocation represents a new achievement in the sinicization of Marxism, signifying the development of a new stage in the socialist market economy and standing as a core issue in the study of Chinese economics.

1. Building the foundations of microeconomic analysis is necessary for developing Chinese economics

Each mature economic theory possesses a specific research paradigm, consisting of a set of conceptual frameworks and analytic methods accepted and employed by a group of theorists and practitioners within a discipline. Economic theories typically include aggregate



(macroeconomic) and individual (microeconomic) analyses, investigating the function of the national economy as a whole and the allocation of fixed resource quantities, respectively. There is a close relationship between macroeconomic and microeconomic analyses as the overall aggregates are composed of individual microelements, and any analysis of the economy as a whole is based on the analysis of certain individual behaviors.

Adam Smith, the pioneer of mainstream Western economics, established an enduring framework for microeconomic analysis in *The Wealth of Nations*, which investigates how scarce resources can be optimally allocated under the assumptions of economic man and scarcity. The decision-making process of microeconomic agents involves considerations regarding production choices, output levels and operational strategies, which encompass decision-making mechanisms, exchange systems and the overall functioning of the economy, and microeconomic agents make optimal decisions based on comparing costs and benefits, thereby developing the framework for individualistic cost-benefit analysis. This theory demonstrates that a full market competition automatically achieves Pareto optimality in resource allocation because market mechanisms perform functions such as distributing income, transmitting information and stimulating efficiency, while the prerequisite for the functioning of market mechanisms is the hard budget constraint on microeconomic agents under private property conditions, which demonstrates that a market economy under private ownership can automatically achieve Pareto optimal resource allocation. The underlying values behind this logic are individualism and liberalism.

According to the holistic class-interest analysis method developed by Marx and Engels, the founders of political economy, under the assumption of economic man, this research paradigm established the theory of surplus value based on the labor theory of value, starting from the cellular organization of commodities under capitalism, arguing that the fundamental contradictions of capitalism will intensify with the development of productive forces, leading to the demise of capitalism. The microeconomic foundation of the future society is characterized by the free and well-rounded development of people and common prosperity for all, followed by the replacement of private ownership by public ownership and the disappearance of the commodity-money relation. Following a collectivist value perspective, this theory theoretically demonstrated the historical inevitability of socialism replacing capitalism with collectivism as its underlying value. During the era of the former Soviet Union, the political economy evolved into the traditional political economy focusing on a planned economy represented by Stalin's *The Economic Problems of Socialism in the U.S.S.R.*, with micro-foundations resting on a unified state-operated enterprise system regarding ownership structure, centralized decision-making in decision-making structure where enterprises are entirely subordinate to the government, top-down command planning regarding information structure and egalitarian distribution replacing material incentives regarding the economic driver.

At the inception of the People's Republic of China, the country implemented a highly centralized planned economy, basically replicating the former Soviet model. Soft budget constraints on state-operated enterprises under paternalism led to investment and import hunger, culminating in recurring scarcity phenomena when insatiable investment demands met resource constraints. The Third Plenary Session of the 11th Central Committee of the Communist Party of China held in 1978 initiated the reform to the inefficient planned economic system, with a focus on introducing the market factor. The deepening reform in China has led to an enhanced comprehension of the relationship between planning and market forces. The initial proposal in China was to establish a planning system based on the law of value, followed by a planned commodity economy in the early to mid-1980s, and eventually transitioning into a socialist commodity economy in the late 1980s, which aimed at establishing an economic operational mechanism in which the state regulates the market, and the market guides enterprises. After the speech by Deng Xiaoping during his southern tour in China, the goal of economic system reform—establishing a socialist market economy—was

established, and the economic system reform entered a new era after the 18th National Congress of the CPC held in 2012, which aims at making the market play a decisive role in resource allocation and giving play to the government's role better. The reform and opening-up of China created China's economic "miracle." According to General Secretary Xi Jinping's speech at the grand gathering to celebrate the 40th anniversary of reform and opening up in 2019, the reform and opening up for forty years has transformed China, the Chinese nation, the Chinese people and the Communist Party of China profoundly: the Chinese nation has achieved a tremendous transformation from standing up and growing prosperous to becoming strong, the socialism with Chinese characteristics has undergone great transition from establishment, development to improvement, the living standards of Chinese people have been raised from bare subsistence to moderate prosperity, and the Chinese nation now stands tall and firm in the East with an entirely new posture (Xi, 2018).

China's economic system reform aims to establish a socialist market economy, which has contributed to China's economic "miracle." However, there are challenges in explaining the combination of the basic socialist economic system and the market economy from the theoretical perspective. Although the traditional political economy and mainstream Western economics are fundamentally contrary regarding values and theoretical logic, they reach similar conclusions regarding the incompatibility between socialism and the market economy. Mainstream Western economics argued that the institutional foundation for resource allocation by market mechanisms is private ownership, and full-scale privatization is the precondition for economic transformation from a planned economy to a market economy, while traditional political economy believed that with the elimination of private ownership, the commodity-money relation will disappear, and production, consumption and distribution will be subject to central planning. However, China's reform practice has proven that socialism can be combined with a market economy. China's reform has gone beyond the theories, thus necessitating innovation in economic theories to create an economic theory with Chinese characteristics. On April 25, 2022, General Secretary Xi Jinping, during a visit to Renmin University of China, indicated that the priority of developing the philosophy and social sciences with Chinese characteristics is to establish an independent knowledge system, stressed studying China's issues based on China's reality while focusing on the times, and urged efforts to make the philosophy and social sciences with Chinese characteristics an important part of the world's academic arena by advancing innovation in knowledge, theory and methodologies and promoting the creative transformation and innovative development of fine Chinese traditional culture (Xinhuanet, 2022). Chinese economics differs from country economics and thus should possess certain research paradigms as an independent economic theory system. The essence of Chinese economics is to form conceptions of regularity derived from solving practical bottlenecks and key issues in China's reform and development, inheriting and developing fine Chinese traditional culture and drawing on useful components of the existing economic analysis system under the guidance of Marxist political economy based on China's reality and the times and thereby develop a scientific independent knowledge system of Chinese economics, which encompasses regularity system based on the scientific conception of China's reality, category system derived from regularity conceptions, theoretical analysis system built upon the categories and the logical relationship between the categories, discourse and academic system based on the theoretical analysis system and methodology system that links theory with practice.

Chinese economics is a general economic theory derived from the "Chinese Path" and the "Chinese Model" based on the unity of practice and theory. The Chinese model primarily exhibits the following key characteristics: establishing a socialist market economy regarding the reform objectives; adhering to the basic economic system with public ownership playing a leading role and all forms of ownership growing side by side regarding the basic institutional framework; allowing market mechanisms to play a decisive role and optimizing the role of government regarding the economic operational mechanism; gradually promoting the reform

following the Party's leadership and achieving a balance between top-level plan and the pilot practice regarding the reform approach; and balancing reform, development and stability in terms of the reform environment. Since the core issue of Chinese economics is to elucidate the logical relationship between socialism and the market economy, it necessitates a robust foundation for microeconomic analysis to uncover the behavioral patterns and characteristics of microeconomic agents in a socialist market economy and identify the conditions and methods for the functioning of market mechanisms.

Analyzing the micro agents' behaviors is a weakness of the traditional political economy, which believes that under socialism, planning is the only way to allocate resources due to the demise of the commodity-money relation. Not only the ownership but also the decision-making authority of enterprises belongs to the government. Thus, the enterprises' behaviors are totally subject to governments, independent market entities are nonexistent, and market mechanisms fail to function, limiting the analysis of micro agents' behaviors. In contrast, mainstream Western economics can well explain the facts of resource allocation by market mechanisms based on private ownership. Thus, its general laws of market economic function can be referenced, but uncritically copying Western mainstream economics in Chinese economics is unwise. Since the market mechanism plays a decisive role in resource allocation in China under the economic ownership system where public ownership plays a leading role and all forms of ownership grow side by side, applying Western microeconomics, of which the precondition is privatization, as the foundation for microeconomic analysis of Chinese economics is inconsistent with China's situation.

Regarding building the foundation of microeconomic analysis of Chinese economics, the following facts must be considered: first, China is in the primary stage of socialism; second, China is a super-sized developing country; third, China is ongoing a transformation marked by marketization, industrialization and urbanization; fourth, China has an open economy, and fifth, China has caught up and taken the lead in the digital economy. These constraint conditions are external factors that producers, consumers, governments and other agents must consider when making microeconomic decisions, which are also key factors that distinguish microeconomics with Chinese characteristics from traditional Western microeconomics. The core issue of microeconomics with Chinese characteristics is to identify the economic logic of how market mechanisms play a decisive role in resource allocation under the basic socialist economic system based on China's reform.

There are theoretical challenges in reconstructing the foundation of microeconomic analysis of Chinese economics. The first issue is how to restructure market entities while adhering to the basic socialist economic system, including reforming state-operated enterprises and developing the private sector, especially how to transform SOEs into market competitors operating independently with sole responsibility for their own profit or loss while maintaining the dominant position of the state-owned sector. The second issue is how to establish a distribution system that aligns with the essential requirements of a socialist market economy. The balance between fairness and efficiency and common prosperity is the embodiment of the socialist relations of distribution. Different forms of ownership constitute various production conditions under the conditions of a socialist market economy, and the distribution of production conditions among different social members and different production sectors directly affects the fairness of the distribution of incomes. To match such a kind of ownership structure, China has adopted a distribution system that combines distribution according to work and according to factors of production. The third issue is to explain the market-based reform with Chinese characteristics. The primary task of Chinese economics is, based on a thorough study of China's experience of reform, to explain why China's gradual reform is a viable approach and cause for the transition to a socialist market economy. The fourth issue is to elucidate the method of resource allocation by market mechanisms under conditions of heterogeneous microeconomic foundations. China's

economy is undergoing a transformation characterized by significant heterogeneity in its microeconomic foundations, manifested by imbalanced development among regions and between urban and rural areas, imbalance in income distribution and economic structural imbalance. When the microeconomic foundation is heterogeneous, the process of resource allocation by market mechanisms is complex. Therefore, one must not simply copy mainstream Western microeconomics but elucidate the specific methods and approaches by which market mechanisms allocate resources based on China's circumstances. The fifth issue is to explore the relationship between the government and the market with Chinese characteristics. China's growth model and reform experience differ from the hands-off government approach advocated by Western microeconomics and the interventionist approach emphasized by the traditional theory of developmental state; instead, China pursues a cooperative win-win approach between the government and the market. Therefore, the role of government should be optimized when the market plays its decisive role in resource allocation.

2. The compatibility between SOEs and market economy is the core issue in the foundation of microeconomic analysis of Chinese economics

China's economic system reform aims to establish a socialist market economy under the basic principle of allowing the market mechanism to play a decisive role in resource allocation under the condition of public ownership playing a leading role and all forms of ownership growing side by side. To this end, it is imperative to establish the dominant role of public ownership by ensuring the leading position of state-owned capital in industries related to public welfare, the national economy and people's livelihood. The market is not omnipotent—it is vulnerable to market failures caused by externalities and information asymmetry. State-owned enterprises can serve as an effective mechanism to address market failures, as they not only prioritize microeconomic efficiency but also shoulder substantial social responsibilities. In addition, China is currently transforming on all fronts, such as in the system and structure. It has become evident that the market mechanism is insufficient to accomplish the national economic goal of great-leap-forward development, whereas SOEs play a crucial role in directing limited resources, such as capital and technology, toward key industries, thereby providing the conditions essential for economic progress. This is particularly significant given the backdrop of global competition, where the rivalry between nations often manifests through their enterprises. Therefore, bolstering and expanding state-owned capital and fostering globally competitive leading SOEs through the state-owned sector's strategic adjustments and mixed-ownership reform is pivotal in enhancing China's overall competitiveness and fulfilling the national objectives within the global competitive landscape.

Under the condition of giving full play to the dominant role of the state-owned sector, reform is imperative to ensure that market mechanisms assume a decisive role in resource allocation. For effective resource allocation, the market mechanism must satisfy the following conditions: First, there are hard budget constraints on microeconomic agents; second, with clear property rights, actors engaging in market exchanges enjoy complete freedom of choice in terms of the trade of goods or services and participate in the fair competition; third, the actors must assume full responsibility for the consequences of their decisions; fourth, under the condition of decentralized decision-making authority, market prices provide information and incentives for actors to make choices and coordinate their rational choice behaviors; and fifth, the government plays its role better. In other words, the essence of market transactions is to transfer the property rights. The functioning of the market mechanism relies on market entities with strict budget constraints responding sensitively and promptly to changes in market signals. Therefore, it is imperative to address the compatibility issue between SOEs

and the market economy. This can be achieved by promoting the reform of the SOE's property rights system while actively developing the private sector to transform SOEs into market entities operating independently and responsible for their profits and losses.

However, theoretical challenges exist when addressing the compatibility between state-owned enterprises and a market economy. Mainstream Western economics asserts that transactions are essentially property exchanges and that only private property rights can enforce hard budget constraints on market actors, thereby clearly defining expectations and objectives. The absence of well-defined property rights undermines the development of market mechanisms and further hinders market efficiency. The tragedy of the commons has illustrated that property rights ambiguity leads to resource overuse. Thus, applying this theory to guide SOE reform suggests that privatization seems to be the only viable approach. However, developing a market economy within a socialist framework through privatization is impractical. Classical political economy, grounded in labor and surplus value theories, exposes the inherent class contradictions between the proletariat and bourgeoisie. The individual laborer's interests can only be maximized under the collective liberation of the whole working class, which can only be realized through the abolition of private ownership and the development of public ownership. As private ownership gives way to public ownership, the planned economy replaces market economies, and public ownership is the foundation for a planned economy regarding the ownership system. According to this logic, adhering to socialism requires maintaining public ownership, and a market economy is compatible only with private ownership.

However, the theoretical contradictions cannot obscure the fact that the above two theory systems fail to define the role state-owned enterprises should play in a socialist market economy. However, the practice has transcended the theoretical limitations. Since the focus of China's economic reform shifted from rural to urban areas in the early 1980s, China has recognized the reform of SOEs as a pivotal component of the urban economic system and has been exploring diverse organizational forms of SOEs that enable them to operate as independent market entities with sole responsibility for their profits and losses through reform while maintaining the institution featuring the dominance of public ownership, aiming to find the ways and approaches of achieving the compatibility between state-owned enterprises and the market economy.

The first phase of reform was the reform of SOEs with power delegation and interest concessions in the early- and mid-1980s.

Before the implementation of economic reform, China operated a highly centralized planned economic system, and state-operated enterprises were the form of achieving public ownership. The state-operated enterprise system is a kind of enterprise system in which the government owns the means of production and directly operates the enterprises, forming the microeconomic foundation for a highly centralized planned economy. State-operated enterprises' vertical dependence on the government led to their soft budget constraints. Enterprises could not operate independently nor be responsible for profit and loss solely, resulting in a strong desire for expansion and investment, which, in turn, created shortage phenomena manifested by queuing, waiting, mandatory substitution, and ticket rationing.

The Third Plenary Session of the 11th Central Committee of the Communist Party of China held in 1978 marked the beginning of China's reform and opening-up, from establishing the plan based on the law of value to developing a planned commodity economic system and recognizing that a commodity economy was an unavoidable stage of socialist economic development. Looking to Eastern European economics about centralization and decentralization, China attempted to transform SOEs into relatively independent commodity producers and operators that operate independently with sole responsibility for profits and losses through power delegation and interest concessions. During this period, the enterprises' managerial autonomy was expanded mainly through the following aspects:

first, allowing state-owned enterprises to have partial autonomy in production planning, product sales, fund utilization, etc.; second, implementing a profit retention system initiated in Sichuan, including base profit retention plus incremental profit retention, profit contract, exceeding-quota contract and loss contract; and third, implementing reforms of the two-step replacement of profit delivery by taxes and the appropriation-to-loan reform nationwide in terms of revenue and expenditure. The reform at this stage is characterized by expanding the autonomy of enterprises, especially the disposal right of incremental income, and introducing the stimulation mechanism of material interests to mobilize the enthusiasm of enterprises in production on the premise of not changing the original subordination and ownership of state-owned enterprises. As a result, enterprises became more sensitive to market signals and profits, and their business performance improved. However, the reform of power delegation and interest concessions only granted enterprises partial control over incremental earnings and partial management rights without fundamentally changing the situation that the governments owned enterprises and held the most managerial authority. Thus, soft budget constraints on state-owned enterprises did not change fundamentally.

The second phase of reform was the reform of SOEs to separate the ownership and management in the mid- and late-1980s.

The 13th CPC National Congress in 1987 proposed the establishment of a socialist commodity economy along with an economic operational mechanism in which the state regulates the market and the market guides enterprises. In February 1988, the State Council issued the Interim Regulations on the Contractual Responsibility System for Industrial Enterprises Owned by the Whole People, which defines the relationship between the state and enterprises regarding responsibilities, rights and profits by signing contracts under the principle of separating ownership and management, following the basic principles of fixing the base, ensuring delivery, retaining excess revenue and making up shortfalls, with the following main forms: contract of incremental profit and tax contribution; contract of profit contribution with fixed base and sharing excess earnings; contract of fixed-sum profit contribution by marginally profitable enterprises; and contract of reduced losses of loss-making enterprises. The reform at this stage was characterized by granting the enterprises managerial autonomy and corresponding responsibilities through contracts without changing the ownership of the enterprises and reconstructing the microinterest mechanism and subject of rights of SOEs; moreover, qualified SOEs in some pilot areas of the reform conducted the trial implementation of shareholding reform under the principle of separating ownership and management.

The reform separating ownership and management has changed the nature of traditional state-operated enterprises, as enterprises can independently act according to changes in market signals according to their own profit goals without engaging in illegal or irregular behavior and are responsible for the consequences of their decisions during the contract or lease period. The government cannot arbitrarily intervene in the enterprise's operations. The reform of separating ownership and management has transformed state-operated enterprises into state-owned enterprises. The significant distinction between state-owned enterprises and traditional state-operated enterprises is that enterprises are no longer affiliated to the government; instead, they are relatively independent commodity producers and operators with managerial autonomy. Nevertheless, the separation of ownership and management did not solve the problems of blurred boundaries between government and enterprises and the ambiguity of property rights in SOEs, particularly the dependence of SOEs on both the government and the market, which resulted in a situation that the government could delegate powers but found it challenging to delegate responsibilities; namely, the enterprises could bear profits but were unwilling to take losses. The relatively short lease periods also led to a typical short-term behavioral tendency in the operation of the enterprises: the contractors mostly considered matters within the contract period, neglecting the enterprises' long-term development and even exploiting resources without considering long-term sustainability.

The third phase of reform was SOE's shareholding reform to diversify ownership following Deng Xiaoping's Southern Tour Speech in the 1990s.

In the early 1990s, Deng Xiaoping, during his southern tour in 1992, indicated that the plan and the market are two different methods of resource allocation, and the reform aims to establish a socialist market economy. The 14th National Congress of the CPC in 1992 stated that the direction of SOE reform is to develop a modern enterprise system adapted to the requirements of market economy and large-scale social production, featuring "clearly defined property rights and responsibilities, separation of government and business, and scientific management," with the following focuses: first, standardizing the shareholding reform, including confirming the state's shareholding in the joint-stock enterprises through open and transparent assessments of enterprise assets and granting the corresponding rights to earnings and control based on the shareholding; second, allowing other investors to have shares in joint-stock enterprises, creating mixed-ownership enterprises where shares are held by both the state and other investors and ensuring clear property relations by diversifying property rights; third, undergoing public offerings—many restructured state-owned enterprises were listed on the stock exchanges of the Chinese mainland, the Hong Kong Stock Exchange, and foreign markets, formalizing the legal separation of enterprise ownership and management through public offering; fourth, improving corporate governance structures and enhancing the operational efficiency of state assets.

The key criterion historically used to define state-owned enterprises was the state's complete ownership of the enterprise. After the implementation of shareholding reforms, state-owned enterprises have evolved into three forms: wholly state-owned enterprises, state-holding enterprises and enterprises with state-owned shares. The latter two forms are typical mixed-ownership enterprises, and SOEs do not only refer to wholly state-owned companies but also state-holding companies. The 14th National Congress of the CPC stated that a mixed-ownership economy is a form of realizing public ownership. From a macro perspective, it can be concluded that public ownership still holds a dominant position in the national economy as long as SOEs maintain control over key sectors of the national economy and critical industries, and from a micro perspective, the state ownership of an enterprise can be acknowledged as long as the state-owned shareholding in this enterprise maintains the control of the enterprise.

In response to the widening losses in state-owned enterprises, China implemented policies such as "invigorating large enterprises while relaxing control over small ones" and "strategic reorganization" while constructing the modern enterprise system in the late 1990s, fulfilling the "three-year revitalization" plan for SOEs. The central government introduced a series of policy measures, including mergers and reorganizations, separating main and side businesses and establishing four financial asset management companies specialized in implementing the "debt-to-equity" reform for some key qualified distressed enterprises.

The fourth phase of the reform is the reform of the state asset oversight system to improve the ownership constraints beginning in the early 21st century.

To improve the state-owned capital ownership constraints and ensure the preservation and appreciation of state assets, China established the State-owned Assets Supervision and Administration Commission (SASAC) in 2003, aiming to decouple government bodies from the business entities they own and those directly affiliated to them based on separating the government's public management functions from its role as the owner of state assets to make SASAC truly perform the duties of an investor. After that, the reform of the state asset oversight system encompasses the following key aspects: First, enhancing the functions of ownership entities: SASAC exercises the ownership rights of the state assets on behalf of the nation, thereby uniting the rights, obligations and responsibilities and establishing state assets oversight entities integrating assets, personnel and businesses; second, implementing a hierarchical management system of the state assets: The central and local authorities exercise ownership functions on behalf of the nation over central and local SOEs,

respectively, through central SASAC, which oversees state assets in central enterprises, and local SASACs, which oversees state assets in local SOEs; third, regulating shareholding reform to prevent any potential loss of state assets; fourth, shifting the focus of SASAC's oversight system from state assets to state-owned capital; fifth, standardizing and improving the corporate governance structure; and sixth, further promoting the separation of SOEs' main and side businesses and reorganization of the side-business entities.

Before the 18th CPC National Congress held in 2012, SOEs had gradually transformed to be market-based through reform with nearly three decades of painstaking efforts, reflected in the following aspects: The SOEs have transformed from affiliates of the government to entities with greater managerial autonomy, from simply pursuing maximized output value to becoming market entities strongly sensitive to profits, from rigid operational system to having independent property rights as corporate bodies, from single ownership structure to diversified property ownership and from administrative monopoly to competitive market structure. The state asset oversight agencies also shifted their focus from overseeing the enterprises and assets to overseeing the capital. With the deepening reform, the organizational form of state ownership transformed from state-owned enterprises to state-owned and mixed-ownership enterprises, and the state sector was embodied by state-owned capital in addition to state-owned enterprises. The deepened SOE reform significantly improved the compatibility between SOEs and the market economy.

The achievements of SOE reform are conspicuous, but all the reforms mentioned have not fully resolved the compatibility problem between SOEs and the market economy. There are still challenges to overcome before realizing the goal of reform: One of them is that the issue of blurred boundaries between the functions of government and enterprises has not been fully addressed. If SOEs are true market entities, they will be separated from the governments and rid of the administrative intervention by the government. However, the nature of state ownership dictates that only the government can exercise the ownership on behalf of the state, and the outright failure to exercise the functions of owners may cause the state ownership to cease to exist except in name. The other is that the issue of free transfer of ownership has not yet been solved. If SOEs are true market entities, their ownership will be transferred freely, which is not only the natural requirement of market mechanisms for allocating resources but also the condition for ensuring that shareholders can effectively constrain the enterprises through their shareholding by exercising their right of withdrawal. However, once the shares of SOEs are freely transferred, it becomes challenging to maintain state ownership. The shareholding reform implemented in SOEs under the circumstances of blurred boundaries between government and businesses and untransferable ownership is inadequate to define property rights, as well as other powers and responsibilities, related to the SOEs. What's worse, it may easily result in "insider control," which may lead to the loss of state assets.

3. Developing microeconomic foundation for compatibility between SOEs and market economy under classified reform

The core issue in building the foundation of microeconomic analysis of Chinese economics is addressing the compatibility issue between SOEs and a market economy. In my view, this can be achieved under the logic of classified reform so as to build the microeconomic foundation for the effective functioning of a socialist market economy.

3.1 Classifying and reconstructing the microeconomic foundation for coordinated development of state-owned and private sectors

Since China embarked on the market-oriented reform, the debate over the relationship between SOEs and the private sector has been ongoing. Opinions vary on whether "the state

should advance, and the private sector should retreat” or vice versa. Although developing state-owned or private-sector proponents hold opposing views, they share an underlying logic. They believe that the development of the private sector and the dominant role of the state-owned sector are contradictory and that developing the private sector will undermine the position of the state-owned sector, and expanding and strengthening SOEs will jeopardize the development environment for the private sector. However, these either/or viewpoints fail to acknowledge the socialist market economy, the distinctive feature of socialism with Chinese characteristics regarding the economic system.

China’s market economy has been developing under the basic socialist economic system based on the ownership system characterized by public ownership playing a leading role and all forms of ownership growing side by side. Developing and strengthening the state-owned sector that controls the lifeline of the national economy plays a critical role in leveraging the advantages of the socialist system, enhancing the leadership of the Party and bolstering China’s economic and defense capabilities as well as national cohesion. Thus, the reform oriented to “private sector advance and state retreat” is not applicable, let alone the reform toward privatization.

Establishing a socialist market economy means allowing market mechanisms to play a decisive role in resource allocation, and effective market mechanisms require corresponding microeconomic foundations, which include hard budget constraints on enterprises that have clear property rights and operate independently with sole responsibility for their profit and loss; free and equal market competition order and market system; flexible price determination based on supply and demand; open market access, and government regulation of economy primarily through economic means. Since the essence of market transactions is the transaction of property rights, promoting the reform of the property rights system is critical in establishing the socialist market economy, involving developing the private sector vigorously while transforming SOEs into market entities that operate independently with sole responsibilities for their profits and losses through the SOE reform. Therefore, the private sector is, in reality, an indispensable component of the socialist market economy, and the reform toward “state advance and private sector retreat” is not advisable.

The mindset leading to the “state vs. private” conflict results not only from biases regarding theories but also from the misalignment of the fields where state-owned and private sectors play their roles, namely, excessive marketization in sectors where the state-owned sector plays its role, which leads to market failures, failing to meet societal needs and excessive involvement of SOEs in sectors that should be marketized, which leads to the competition between state and the private enterprises for profits and the distortion of market mechanisms. The microeconomic foundations that meet the requirements of a socialist market economy should neither favor “state advance and private sector retreat” nor “private sector advance and state retreat”; instead, both the state and private sector should “advance,” that is, the state-owned sector and private sector should promote, integrate and penetrate each other to achieve coordinated development rather than fall into mutual fragmentation and exclusion. According to the Report to the 19th National Congress of the CPC, efforts should be made to unswervingly consolidate and develop the public sector of the economy while unswervingly encouraging, supporting and guiding the development of the nonpublic sector of the economy. General Secretary Xi (2014, p. 79) has expounded on the above unswerving commitment in the Explanatory Notes for the “Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform”: “On functional positioning, the *Decision* points out that both the public and non-public sectors of the economy are important components of the socialist market economy and an important basis for China’s economic and social development. On the protection of property rights, the *Decision* points out that the property rights of both the public and non-public sectors of the economy are inviolable. On policy treatment, the *Decision*

stresses equal rights, opportunities, rules, and a unified market access system. The *Decision* encourages non-public enterprises to participate in the reform of SOEs, encourages the development of mixed-ownership enterprises in which private capital holds majority shares, and encourages qualified private enterprises to establish a modern corporate system.” The key to developing the microeconomic foundation of a socialist market economy that advances both state-owned and private sectors is improving the layout of the state-owned sector, allowing both state-owned and private sectors to leverage their respective strengths in different sectors and promote mutual growth.

3.2 Promoting classified reforms of SOE at the macro level to improve the layout of national economy

Improving the layout of the national economy is the key to effectively giving play to the dominant role of the state-owned sector while harnessing the decisive role of market mechanisms in resource allocation. A broad-based layout of the state-owned sector might hinder the decisive role of market mechanisms, whereas an excessively narrow layout of the state-owned sector may hinder the dominant role of the state-owned sector. State-owned capital should prioritize some sectors while divesting from others to advance the economy effectively. The state-owned sector should promote the channeling of state-owned capital to industries vital to national security and economy, to key sectors essential to people’s well-being, such as those providing public services, developing emergency capacity and improving public welfare, and to future-oriented, strategic emerging industries as well as new infrastructure construction. A range of world-class leading enterprises should be nurtured to enhance the country’s competitiveness, innovation, control, influence and risk resistance in the national economy, technology, defense, security, etc. State-owned enterprises should not only be the market entities with core competitiveness through reform but also play a more significant role in industrial innovation, improving the industrial and supply chain, guaranteeing public services, addressing major challenges and safeguarding national economic security. Special efforts should be made to develop the real economy and core businesses and create economic and social value with high quality at a high level efficiently, building a solid foundation for the high-quality development of SOEs. State-owned capital should be withdrawn from average competitive SOEs with low efficiency and small scale, high market competition and rapid changes in demand, low industrial significance and correlation and risks more than the submitted profits through privatization.

The key to improving the layout of the state-owned sector is defining the criteria or standards for government capital’s entry and withdrawal, thereby defining the respective investment and business scope of the state-owned and private sectors. In my papers published in journals such as *Economic Research Journal* in the mid-1990s, I proposed the logic and detailed reform schemes for the classified SOE reform (Yang, 1995, 1997; Yang *et al.*, 2017). Specifically, I adopted a principal-agent analysis framework to demonstrate that under the condition of state holding, shareholding reform would be insufficient to prevent the loss of state assets when efficiency has been improved, arguing that not all SOEs should undergo a market-based reform; instead, they should adopt different reform models according to their specific industry and products to be improved. The basics of the classified SOE reform strategy are classifying the industries of SOEs into competitive and noncompetitive industries and the SOEs’ products into public and private products. Enterprises in administrative monopoly industries and providing public goods should adopt the state ownership and government operating model; natural monopoly SOEs developing private goods should adopt the state-holding company model; large competitive SOEs should adopt shareholding reform with diversified property rights, while small- and medium-sized competitive SOEs should adopt privatization reform. Subsequently, I further improved the

classified SOE reform scheme according to the nature of products and the industrial features (Yang *et al.*, 2017).

The concept of classified SOE reform has been further clarified after the 18th National Congress of the CPC. According to the Guiding Opinions on Deepening the Reform of State-Owned Enterprises (Zhong Fa [2015] No. 22) issued in 2015, a classified reform, development, oversight, definition of responsibilities and assessment approach should be implemented through defining functions and classifying categories to enhance the precision of reform, the effectiveness of oversight, and the rationality of assessment, and further promote the deep integration of SOEs into the market economy, fostering the comprehensive unity of SOEs' economic and social benefits. This document classified SOEs into commercial and public welfare SOEs, and the commercial category is further divided into commercial SOEs with main businesses in fully competitive industries and domains (referred to as "Commercial Category I") and those in vital sectors and domains related to national security and national economic lifelines or mainly undertaking major special tasks (referred to as "Commercial Category II"). The SOEs of Commercial Category I should adopt shareholding corporation reform, where the state-owned capital may hold an absolute or relative holding of the company or may hold a minority of shares, while public welfare SOEs should adopt the wholly state-ownership model but allow participation of non-state enterprises. SOEs of Commercial Category II in vital industries and domains or mainly undertaking major special tasks should maintain the position of state holding. The Guiding Opinions on Promoting Central Enterprise Structural Adjustment and Restructuring" (Guo Ban Fa [2016] No. 56) issued in 2016 further proposed the connection between state-owned capital operation and industrial transformation and upgrading, apart from the requirements of the above-classified reforms, thereby outlining the function of SOEs in implementing industrial policies and macroeconomic regulation. The Three-Year Action Plan for State-Owned Enterprise Reform further called for classified and tiered implementation of SOE's mixed-ownership reform. The criteria for distinguishing between competitive and noncompetitive SOEs and between public welfare and commercial SOEs are fundamentally similar, with focuses varying slightly—public welfare and natural monopoly sectors fall under the noncompetitive category, and the enterprises of Commercial Category I are generally competitive.

The prerequisite for implementing classified reform is a precise definition of classification standards, defining the areas suitable for giving play to the government's role. To avoid excessive discretionary power of the enterprise administration department or uncertainty in reform direction that hinders the progress of SOE reform, it is imperative to establish objective and measurable criteria for classifying SOEs instead of relying on subjective factors such as "the capital contributor classifies the reform." Specifically, drawing from the criteria of the National Development and Reform Commission for classifying the industries in formulating and implementing industrial policies or international principles of segmenting industries in industrial formulation to segment the key sectors and domains of public goods, public welfare products, national security and national economic lifelines, and publicize the negative lists of segmented industries while defining the competitive sectors or industries of Commercial Category I. When each SOE adopts a specific reform model, whether it is more oriented toward solving market failures, implementing national industrial policies or pursuing social benefits, it will not be simply subject to the investors; instead, it is the objective classification criteria that determine the government is absolute state-holding, relative state-holding or have a minority of shares of the SOE or withdraw from the enterprise. Following objective classification standards, except for retaining wholly state ownership of enterprises in domains providing public goods and basic public services, natural monopoly SOEs should actively promote the mixed-ownership reform while keeping the state-holding condition, reforming the oversight system for state-owned capital. The government should maintain control, participate in and withdraw from SOEs in competitive

industries where necessary. By improving the layout of the state-owned sector, the state-owned and private sectors can mutually promote and codevelop in their respective advantageous domains.

3.3 Promoting classified reform of SOEs at the micro level to enhance their market competitiveness

To deepen the SOE reform adapted to the requirements of a socialist market economy, not only macro but also micro-level classified SOE reform should be promoted. The macro-level classified reform refers to classifying the SOEs based on their respective industries and the nature of their products to improve the layout of the state-owned sector, while the micro-level classified reform refers to implementing reforms of different types in the SOEs that have diversified the property rights according to their respective property rights structures.

First, implementing reforms of different types in the subsidiaries of natural monopoly enterprises that have undergone corporation system reform. The Three-Year Action Plan for SOE Reform proposes a layered classification approach to deepen mixed-ownership reform, especially in subsidiaries invested by the government and contributed by the operation company. Generally speaking, the mixed-ownership reform of subsidiaries of Commercial Category I allows for state-holding or a minority government shareholding, while the mixed-ownership reform of subsidiaries of Commercial Category II must keep state-holding position. However, it is worth noting that since the 1990s, numerous monopoly SOEs in China have undergone domestic and overseas public offerings after implementing mixed-ownership reforms. This has resulted in complex holding structures and multi-layered agency relationships, leading to diversified business operations. Many central enterprises have capitalized on their dominant market position and financing advantages derived from monopoly to expand profitable side businesses, resulting in inadequate investment in core businesses and conflicts of interest with private enterprises. For instance, many central enterprises heavily invested in the real property sector, contributing significantly to the property bubble. Therefore, the mixed-ownership reform of SOEs should be implemented under the micro-level classification, specifically, accelerating the separation of the main and side businesses of SOEs and implementing the mixed-ownership reform regarding the SOEs' main businesses related to national welfare and the people's livelihood under state-holding while shareholding reform with classified property rights regarding the SOEs' side businesses in general competitive fields, which may be private-holding. According to the Opinions on Accelerating the Improvement of the Socialist Market System issued by the Central Committee of CPC and the State Council, the mixed-ownership economy should be developed under the principles of improving governance, strengthening incentives, highlighting main businesses and improving efficiency in critical domains. In other words, the mixed-ownership reform in noncompetitive sectors should strengthen the dominant role of state-owned capital and focus on improving the operational mechanism, while state-owned shares can be converted to preferred shares in competitive sectors, which emphasize the earnings of state-owned capital rather than the control right.

Second, implementing classified reform in SOEs in different industrial chains of monopoly industries. Maintaining the dominant role of the state-owned sector in natural monopoly industries does not imply excluding market competition in these domains. Natural monopoly industries play a pivotal role in supporting the national economy, and state-owned capital should generally maintain dominance in enterprises in these industries. However, since the monopoly industries consist of long industrial chains with some competitive segments, government control over such segments may lead to inefficiency. Therefore, the Opinions on Accelerating the Improvement of the Socialist market economy by the Central Committee of CPC and the State Council emphasize introducing market mechanisms in competitive segments in monopoly industries to promote the reform in

natural monopoly industries steadily. In addition to promoting the reforms of monopoly enterprises in decoupling government bodies from the business entities they own and those directly affiliated to them, separating the government's public management functions from its role as the owner of state assets, granting franchises and improving government oversight, efforts should be made to accelerate the marketization of competitive segments in monopoly industries and eliminate discrimination regarding enterprise ownership in all aspects including factor acquisition, market access permits, business operations, government procurement and bidding, ensuring fair competition among various ownership entities, breaking administrative monopolies and preventing market monopolies. For example, orderly opening up electricity planning and competitive segment pricing, timely liberalizing natural gas sources and pricing, promoting fair access to oil and gas pipeline networks for market entities, introducing moderate competition in railway transportation businesses participated by various market entities and relaxing market access in the service industry. Regulatory measures necessary for monopolies and the promotion of market-oriented reforms in competitive segments of monopoly industries not only enhance monopolies' operational efficiency but also protect consumers' interests.

Third, establishing classified state asset oversight models. The State-owned Assets Supervision and Administration Commission (SASAC) mainly exercises ownership over commercial state assets on behalf of the state. The management of public welfare SOEs is recommended to be implemented by the Ministry of Finance or a relatively independent noncommercial state assets oversight department established under SASAC. State assets should be managed at multilayers, and the separation of government bodies and business entities they own and those directly affiliated to them should be fulfilled based on separating the government's public management functions from its role as the owner of state assets. Specifically, SASAC is responsible for supervising state assets of central enterprises, with the focus of the oversight model shifting from asset to capital. It no longer directly intervenes in enterprises' daily operations but instead focuses on preserving and increasing the value of state assets. The reform of the authorized operation mechanism for state-owned capital should be promoted to avoid excessive intervention by SASAC or company headquarters in subsidiaries' daily operations, transforming the group headquarters into a holding company responsible for capital management and building a three-tier state-owned capital oversight system consisting of SASAC, state-capital authorized operation companies and joint-stock companies. For state assets in local SOEs under the oversight of local SASACs, state-asset operation companies may be established as independent legal entities for asset oversight on behalf of local SASACs, and preservation and appreciation of state asset value may be guaranteed by equity constraints, forming the three-tiered authorized agency relation consisting of local SASACs, state-capital operation companies and joint-stock companies.

Fourth, improving the classified governance models of SOEs. Given that modern corporate governance has been transforming from maximizing shareholders' interests to maximizing stakeholders' interests, and publicly owned enterprises are more focused on labor rights, innovations in the governance of SOEs should not merely replicate Western models but meet the requirements of modern market economies while maintaining Chinese characteristics, fully following the Party leadership, the requirements of market competition and the logic of material capital, as well as sharing ownership with human capital. Specifically, the institutional nature of SOEs should be maintained by enhancing the leadership role of party organizations, and the detailed governance mechanisms should be reconstructed by combining shared governance with contingent governance following the principles of classified SOE reform. The shared governance model consists of two parallel governance systems: the board of directors and the board of supervisors. The shared governance mechanism of the board of directors ensures that entities of equity have equal opportunities to participate in major corporate decisions, while the board of supervisors

guarantees that all entities of equity enjoy equal supervisory rights, thereby achieving checks and balances. The mechanism of contingent governance is predicated on the state-contingent characteristics of the enterprise ownership, aiming to ensure adequate institutional support for affected stakeholders to navigate renegotiation processes during abnormal operating conditions.

Fifth, improving the classified operational systems of SOEs based on the various shareholding statuses of state-owned capital. Except for some wholly state-owned companies, most SOEs have adopted various ownership structures after the mixed-ownership reform, including absolute state-holding, relative state-holding and government holding the minority of shares. Accordingly, various operational mechanisms should be developed to align with these ownership structures. Particularly, enterprises under relative state-holding or with a minority of shares owned by the government should improve the market-based operational mechanism, involving utilizing more market-based recruitment methods to select enterprise managers, introducing a tenure system and contract-based management for the manager-level personnel, implementing labor marketization across the board, improving the market-based salary distribution mechanism and providing executives and technicians with flexible and diversified incentives in the medium and long term, aiming to transform these enterprises into market entities and continuously improve their market competitiveness.

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