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Long live China's state-owned enterprises: deflating the myth of poor financial performance

Carsten A. Holz*

Social Science Division, Hong Kong University of Science & Technology, Clear Water Bay, Kowloon, Hong Kong

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Abstract

China's industrial state-owned enterprises (SOEs) are commonly perceived as performing poorly. This leads authors to conclude that SOE reform so far has been a failure, and to recommend all-out privatization. Industrial SOE profitability indeed declined drastically in the course of the reform period, and industrial SOEs are always less profitable than industrial non-SOEs. However, the gap between SOEs and non-SOEs can be explained by just two factors: SOEs face higher circulation tax rates than non-SOEs, and have a higher capital intensity. In as far as these are the result of government policies and historical factors discriminating against SOEs, privatization of SOEs may improve these enterprises' profitability levels, but privatization is not a necessary condition. The decline in SOE profitability over time furthermore is well explained by economic transition factors; non-SOE profitability declined following a similar time pattern, and non-SOEs are no better suited to withstand shocks such as the 1989–1990 economic downturn.
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1. Introduction

China's state-owned enterprises (SOEs) are commonly perceived as performing poorly. Production function estimations show total factor productivity (TFP) growth in SOEs to be

* Tel.: +852-2719-8557; fax: +852-2719-8557.
E-mail address: socholz@ust.hk (C.A. Holz).

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low and lagging behind that in enterprises in other ownership forms. Thus, for example, Jefferson, Rawski and Zheng (1996) find TFP growth in collective-owned industry to consistently outpace TFP growth in the state sector in 1980 through 1992. TFP growth in industrial SOEs by the mid-1990s may even have turned negative (Jefferson, Rawski, Wang & Zheng, 2000; Laurenceson & Chai, 2000).[1] Much discussion centers on data issues such as the proper price deflators for capital, material inputs, and output measures, or the exact share of fixed assets and labor in productive use. The conclusion on the poor performance of SOEs is uncontested.

Yet ultimately it is profitability that determines the economic viability of an enterprise, rather than efficiency. A second approach to evaluating the performance of SOEs—an approach also adopted in this paper—therefore focuses on profitability. Industrial SOE profitability declined drastically over the reform period. Losses increased 20-fold between 1978 and 1997.

This leads authors to conclude that SOEs are in urgent need of radical reform. Thus Lardy (1998, p. 22) tentatively concluded that "reforms to date have failed in large portions of the state-owned sector and that their ultimate success will depend on the willingness of the Chinese Communist Party to embrace privatization." Sachs (1998) argues: "Now China has reached the stage where it cannot delay the process (of state enterprise reform) any longer because there are too many problems. The losses are too great; the financial loss resulting from the money-losing state sector is too serious" (p. 13). In the long run, "China must go along the way of privatization" (p. 19).

This paper first questions the view that non-SOE profitability by far exceeds SOE profitability. Various industrial SOE profitability indicators indeed all declined over time, but so did profitability of non-SOEs. The dissimilarity between SOE and non-SOE profitability lies not in the time trend, but in an over time for most profitability indicators rather constant gap in favor of non-SOEs.

The relative inferiority of SOEs has been explained with historical and systemic arguments. Thus SOEs are burdened with excessive capital and labor, heavy pension and other social welfare obligations, and face distorted output prices; SOEs' governance structure leads to poor incentives for management and workers, and often comes with a soft budget constraint.[2] But the data show that the gap in profitability (in the case of industrial enterprises) can be explained by just two factors, namely a higher rate of circulation taxes for SOEs, and higher SOE capital intensity. Both can be traced to historical and policy factors. While privatization is unlikely to change an enterprise's circulation tax burden, it might lower an enterprise's capital intensity. Yet a relative reduction in capital intensity does not require privatization.

Second, the decline in industrial SOE profitability itself is primarily the healthy outcome of economic transition. An administratively orchestrated economic downturn in 1989–1990 caused SOE profitability to plummet in the late 1980s. Severe after-effects prevented a recovery in the early 1990s; an increase in competition as prices were freed and entry barriers across many industrial sectors lowered did not help. Repeated changes to the definition of profit, and rising financial and administrative charges in the early and mid-1990s all had a negative impact on profit. Throughout the reform period, the time trend of non-SOE profitability matched that of SOEs, suggesting that privatization is not a cure for

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