

# Must China's State Enterprises Follow the Path of Western Governance to Thrive?

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**Abstract.** The prevailing discourse on the Chinese state and state enterprises is colored by equating these institutions with their Western counterparts. This had prevented a balanced assessment of their role and led to flawed policy prescriptions. Recognizing the historic and cultural context of these institutions would lead not only to better appreciation of their role but also to the conclusion that convergence to Western models and norms of governance is far from inevitable.

**Keywords:** state, state enterprises, efficiency, governance, privatization

## 1. Introduction

China's arrival at centre stage has made it the focus of attention among Western and Western-trained commentators in general and economists in particular. Because the country's impressive economic advance has been achieved under a political system and using strategies that are antithetical to dominant Western thinking, this attention has generally been hostile.

State enterprises, key institutions of the state, have been targets of this unwelcome attention. Many commentators are of the view that this subsector is made up of loss-making, 'moribund' enterprises that distort resource allocation, is a drag on the economy and needs to be reformed through privatization or liquidation (see, for instance, Dorn 2000, Lall 2006).

This paper argues that such a view is premised on the notion of China as a nation state, and that the private sector, not state enterprises, should be preeminent in the economy. This paper presents an alternative view, arguing that these enterprises are part and parcel of the role of the state that for China cannot be understood in these terms. Hence, convergence to Western governance models and norms as the path to prosperity cannot be assumed.

## 2. The Chinese State in Historical Context

In economic terms, the dominant Western view of the state is as an internalizer of externalities and a provider of public goods.<sup>1</sup> However, the role of the state in China is much more important for both historical and cultural reasons. Historians (Fairbank 1987, Kuhn 2002, Shambaugh 2000) recognized that the modern Chinese state has been shaped more by its long history than by the current prevailing model of a nation state, the history of which is quite recent. Despite transitions from millennia of imperial rule through republicanism, Leninism and to the 'market socialism' of today, the indigenous Chinese state has endured, absorbing external models of governance, but never submerged by them.

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<sup>1</sup> Other theories – public choice theory, agency theory, and property rights theory – seek to explain differences between state and private sector performance. Their conclusion, that private enterprises perform better than state enterprises, are based particular assumptions that, in China, are not necessarily satisfied (see, for instance, Yung 2009). It is not the purpose of this paper to assess the applicability of these theories to China, however.

Historians also recognize Confucianism, which dates back over two millennia and is the abiding cultural-political ideology for the entire history of imperial China, as the basis of the Chinese view of the state. Since it sees the state as part of Chinese civilization and as the apex of an orderly social hierarchy below which are the family and the individual,<sup>2</sup> it is not difficult to explain how important the Chinese state is.

History and culture have also ensured the continuity and perpetuation of the Chinese state through its enduring missions, which are defence of the realm and guardianship of its civilization and its people, including economic modernization and society transformation (Jacques 2001: 2; Shambaugh 2000: 2). The second mission gives the Chinese state its distinctiveness – in the state lies the entire civilization. The Chinese state’s boundaries are defined not just legalistically but also socio-culturally.

This characterization of the Chinese state has three implications. First, the assimilation of new concepts of state governance should not necessarily be seen as total endorsement of these concepts but as responses needed to fulfil its missions in a world in which these concepts have gained ascendance. This means that the belief that China’s future depends on its convergence to Western norms of state and governance is misplaced. Second, these missions go well beyond the mandate, and hence define a role if not size far larger than that, of the nation state.<sup>3</sup> Finally, the distinction between Chinese state and society is nowhere as sharp as Western notions assume.

Year	% of Urban Workers	% of Industrial Enterprises			% of Listed Companies	% of Value of Exports
		No. of Enterprises	Output	No. of Employees		
1994	66.4					
1998	56.6	39.2	49.6	60.5	85.4	
2000					82.2	
2002	46.7	22.7	40.8	43.9	79.3	37.7
2003					75.1	
2004					70.2	25.9
2006	34.0	8.3	31.2	24.5		19.7
2007						18.5

Source: Lee (2009), Tables 1, 3, 4, 8.

Table 1: Indicators Showing the Important Economic Role of Chinese State Enterprises.

### 3. Characterising the Chinese State Enterprise

China’s state enterprises have been viewed through Western economic lenses as possessing all the weaknesses of the Western state enterprise stereotype (e.g. Lall 2006). Thus, judged on grounds of economic efficiency and profitability, both market economy constructs, Chinese state enterprises have been accused of increasing economic vulnerability, damaging the private sector, and retarding the country’s long-term economic growth. This narrative is framed in terms of private vs. government ownership, with the former preferred over the latter. This, and the fact that state enterprises remain a significant if diminishing economic player (Table 1), argues, according to this view, for privatization as the ultimate goal in reform.<sup>4</sup>

<sup>2</sup> 'To rightly govern the state, it is necessary first to regulate one's own family.' (Great Learning, c. ix., v. 1.), cited in Dawson (2005: 172). The original text is: 礼记, 大学: "古之欲明明德于天下者; 先治其国; 欲治其国者, 先齐其家; 欲齐其家者, 先修其身; 欲修其身者, 先正其心; .....心正而后身修, 身修而后家齐, 家齐而后国治, 国治而后天下平。"

<sup>3</sup> Fairbank (1987: 17) noted the small size of the Chinese state in relation to its considerable mandate.

<sup>4</sup> This state-private dichotomy is encapsulated by such titles as 'China state enterprises advance, private sector retreats' (Chovanec 2010). See also Kwan (2006).

However, this argument assumes that a clear distinction between state and private enterprises can be made. This is not easy, for reasons beyond that associated with the nature of the state already described. Thanks to numerous reform experiments, state ownership of enterprises now ranges from 100 percent (strategic enterprises) to minority shareholdings, is differentiated according to administrations (central, provincial and local governments) (see, for instance, Hu 2004) and also includes quasi-state entities (Scissors 2011). Ownership ambiguities have prompted attempts to distinguish them through control (for instance, Chen, Firth and Rui 2006). But to the extent that many state enterprises are managed and run like private firms (Guthrie and Wang 2007), this is a classification that is no easier to make.

Nor do Chinese state enterprises fit comfortably into the mould of such enterprises as understood in Western public economics. For instance, far from being mismanaged, enterprises like the Guangzhou Metro Corporation are considered among the best managed in the country (Tse 2006). Conyon and He (2010: 35) concluded that factors determining executive compensation, including firm performance, in China were no different from those for the US. As a final example, a recently completed research project on China's state enterprises reported that state-owned and state holding enterprises' net profit in 2008 were over three times that in 2001, although these profit figures were made possible by subsidies, a lower tax burden and cost of funds than non-state enterprises (Jiang 2011)

This blurring of the lines between state and private probably helps account for the finding of productivity growth and converging firm performance among both state and non-state domestic and foreign enterprises.<sup>5</sup> Indeed, it is now recognized that many Chinese state enterprises, the largest among them, are state-private sector hybrids, and represent a new corporate form materially different from all others (Woetzel 2008). It also means that for China, the distinction between private and state enterprises is less meaningful than it would appear.<sup>6</sup>

#### **4. Efficiency as *the* Measure of State Enterprise Performance**

Explanations of the gap between state and non-state enterprise performance are also coloured by economic ideology. Western economics provides at least two explanations – market competition from the private sector and the need for state enterprises to meet conflicting efficiency and social objectives. The latter burden Chinese state enterprises clearly carried until about 2000; prior reforms to enhance efficiency did not permit state enterprises to shed workers. The need to provide a social safety net provides a good explanation for the positive changes in productivity and profitability of Chinese state enterprises in the last decade of the 20<sup>th</sup> century and the first decade of the 21<sup>st</sup>.

Prior to the beginning of transition in 1978, state enterprises accounted for three-quarters of China's industrial output, employed two-thirds of all industrial employees, and were responsible for their welfare, e.g. pensions and housing. They also contributed 90 percent of all fiscal revenues (Dong and Putterman 2003: 112). State enterprise reform altered this picture drastically. In the first decade and a half of transition, state enterprises reforms to improve financial discipline through restructuring incentives and increase competition while hardening budget constraints did not also give enterprise managers the autonomy to dismiss workers, leaving this social safety net largely intact, but at rising cost to these enterprises and to the state. But subsequent reforms to reduce and eventually eliminate these costs saw state enterprises shedding their social role. Thus, reforms based at least in part on Western-style corporate restructuring had led to the dismantling of the traditional distributive role of Chinese state enterprises, leaving in its wake a vacuum that had to be filled through experimentation with social security.<sup>7</sup>

Yet existing literature on assessing these enterprises has been dominated by discussions about efficiency, measured by economic growth, total factor productivity, and profitability, with scant attention to the role state enterprises played in providing social safety nets. This preoccupation with efficiency clearly reflects

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<sup>5</sup> Li and Putterman (2008) provided an excellent review of empirical studies, including more recent ones that found productivity growth among state and non-state enterprises. Lee (2009, Table 6) showed the rate of return on assets per employee in state enterprises rising from just 16 percent of that of private enterprises in 1998 to 80 percent in 2006.

<sup>6</sup> This lack of a clear distinction raises questions about the applicability of theories, such as public choice and property rights, which premise their conclusions on the basis of ownership.

<sup>7</sup> The rehiring of workers laid off during the late 1990s reforms, lauded as a 'best practice' by the ILO (2002), represented in fact just band-aid to ease the pain in the interim.

neo-liberal economic ideology at work.<sup>8</sup> Recognition of this redistributive role, as well as the positive externality of social stability state enterprises provided to the non-state sector (Li and Lotspeich 2010) would have forced reconsideration of the push for privatization as the panacea for state enterprise development. At a minimum, the pace of privatization would have been coordinated with progress towards establishing a comprehensive social safety net. Fortunately recent studies showing the positive results of experiments like corporatizations without privatisation and the onset of the Global Financial Crisis in 2008 have dented the credentials of neoliberal ideology.

## 5. Conclusion

Equating the Chinese state and state enterprises to their Western stereotypes has hampered balanced assessment of the latter's role and led to policy prescriptions that are at best dubious. Neoliberal economic ideology, abetted by a host of emerging theories, has also biased the prevailing discourse in favor of only one aspect of the state enterprise's mandate. Understanding China's historical and cultural context would have allowed better appreciation of both the role of state enterprises in discharging their mandate and the blurring of the lines between them and enterprises in the non-state sector that render comparisons between these sectors increasingly less meaningful. This means that the transfer of ownership that has been traditionally labeled as privatization is also becoming less relevant. Finally, while adopting aspects of Western corporate governance such as transparency and accountability has had salutary effects on Chinese state enterprises' performance, such adoption should be understood as China's absorption of best practices into an indigenous model of governance that is evolving, a practice it has followed repeatedly in its long history.

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<sup>8</sup> See a survey of these findings in Sachs and Woo (2003, p. 12). Naughton (1995) ascribes this bias to right-wing academic dogmatism by Western researchers. A notable exception is Walter (2010).

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