Entrepreneurs and Entrepreneurial Development in State-Owned Enterprises Reform in China: Problems and Corruption

Baiwei Fu

Wright State University - Main Campus

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Entrepreneurs and Entrepreneurial Development in State-Owned Enterprises Reform in China: Problems and Corruption

An internship report submitted in partial fulfillment of the requirements for the degree of Master of Science

By

Baiwei Fu
B.A., Jianghan University, 1995
M.B.A., Wright State University, 1996

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Tran H. Dung, Ph. D.
Faculty Supervisor

Evan W. Osborne, Ph.D.
Faculty Reader

Roger Sylvester, Director
M.S. in Social and Applied Economics
ABSTRACT


The report focuses on microeconomic reform in China, especially on entrepreneur problems and corruption in State-Owned Enterprises (SOEs). China has about 145,000 SOEs employing 113 million people. State enterprises account for 70 percent of fixed assets but only 34 percent of industrial output. The total state enterprise debt is greater than China’s bank deposit base. In some cases, SOEs are unable to afford to pay worker salaries or make pension payments. Reforms caused large-scale lay-offs and plant closures in recent years.

Entrepreneurs’ corruption contributes negative effects to SOE reform. Corruption is one way of getting around political control and poor property rights but causes problems of its own. Poorly defined property rights in China are one reason for corruption in SOEs. The Chinese government is being pressured to reform the inefficiencies of the enterprise system, including entrepreneurial development in SOEs. Though China has worked to develop new plans and to improve existing plans of reform in the past 10 years, over-employment, inefficiency, entrepreneurs’ corruption and state-agency problems continue to contribute to poor performance. The SOE reform has become the central link in economic restructuring in China. The Chinese government is no longer considering whether to implement further reform in SOE, but how.
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Chapter One: Introduction

While China’s economic performance has been widely praised around the world, the country faces serious challenges at the macro and micro levels. By the late 1980s, China had established a comprehensive modern industrial system predominantly in State-Owned Enterprises (SOEs), a system that was capable of producing a wide range of products and domestic consumer goods. Although China’s long-term industrial growth rate has been one of the highest in the world, China has paid a price due to SOE problems. Chinese industry has suffered from fundamental weaknesses that have made it very inefficient. In order to attain economic growth along with stability, China has achieved its phenomenal economic boom by applying a policy of gradual state enterprise reform, rather than Shock Therapy. China is widely seen as a model for successful economic reforms as it attempts to establish a successful socialist market economy.

One of the most important remaining issues in China’s transition to a market economy is SOE reform. When reform started in late 1978, SOEs dominated China’s industrial sectors. After 21 years of gradual transition, the SOE’s share in China’s total industrial output has declined from 77.6 percent in 1978 to 28.8 percent in 1996. However, in 1996, due to inefficient labor-intensive production techniques, SOEs still employed 57.4 percent of urban workers and possessed 52.2 percent of total investment in industrial fixed assets. China has about 145,000 SOEs employing 113 million people. State enterprises account for 70 percent of fixed assets, but only 34 percent of industrial output. The total state enterprise debt is greater than China’s bank deposit base (Economic Condition & Forecasts, Sept. 1998). In some cases SOEs are unable to afford to pay worker salaries or to make pension payments. Because of inefficiency and low productivity, and the need to shift from Soviet-style extensive growth to intensive growth based on improved resource allocation, SOE reform has become a high priority in China. This reform can be understood as an effort to shift from a system in which planning and administrative
directives guided the allocation of resources to one in which allocation is determined by the market. China is nurturing 120 of its larger state enterprises. The remaining 304,000 small and medium-sized state enterprises are being released from state ownership and left to sink or swim. Improving SOE performance is crucial for social stability and sustained growth in China (*Business China*, June 1997).

Reforms have caused large-scale lay offs or plant closures in recent years. The problem of laid-off workers in SOEs was the other major topic at a national conference on May 15, 1998. China’s new Premier Zhu RongJi pointed out that mass layoffs were unavoidable and necessary for China’s economic reform and development because SOEs have had many years of reckless investment, overproduction and capital starvation, and poor technology. Bankruptcies and layoffs have become widespread as the market economy forced the state sector to increase its efficiency, and as banks are no longer required to lend money to state firms at a loss. But these were positive actions for China in the long term. Zhu RongJi also promoted training centers to help re-employ laid-off workers. The enterprises are responsible for providing laid-off workers with basic living expenses, social insurance payments and training fees. Central and local authorities will also supply funds to meet social insurance payments (*China’s Digest*, 1999).

It appears that the need to reduce government subsidies and to raise investment capital has taken precedence over political concerns in order to make enterprises more efficient. The Chinese government plans to phase out the ‘modern enterprise system’ pilot program initiated in 1994. (The program helped SOEs reorganize and supplied them with capital.) In 1998, the Chinese government laid out a new plan to implement a shareholding system within SOEs that would transfer stock to ordinary citizens or to organizations. It is still unclear to what extent the authorities are prepared to let individuals participate and prosper in the market. Other major obstacles confronting China’s securities markets stem from lack of rational pricing and production, but establishing the stock exchange marks a significant step forward in China’s attempt to reform its economy (*Journal of Economic Issues*, Sept. 1997).
Entrepreneurial development, agency problems, and SOE corruption are the top issues for the current government. China cannot become a modern nation until it changes the mindset of its bureaucrats and learns the art of dealing with officials and people, especially state entrepreneurs. Except for low productivity, entrepreneur problems such as corruption, bribery, and other wrongdoing were not serious before the reforms because of the absence of managerial autonomy. The increased competition of a market economy should have eliminated or at least mitigated these agency problems. However, agency problems in SOEs have worsened in spite of the intensification of competition. Some entrepreneurs in large SOEs, who were appointed by the state government, transferred huge amounts of state-owned property to themselves. This was an abuse of their managerial power. A few of them escaped and fled overseas. Corruption in top management of SOEs negatively affects SOE reform.

Corruption is one way of getting around political control and poorly defined property rights. This has negatively impacted the Chinese reform process. Poorly defined property rights in China are considered a principal cause of corruption in SOEs. Bribery is the major cause of SOEs’ corruption. Bribery is common in about 80 percent of SOEs. At a national conference sponsored by the Chinese government in 1998, corruption in SOEs was one of the major topics. The Chinese government is experiencing pressures to reform inefficiencies in the enterprise system, including entrepreneurial development in SOEs. Although China has worked to develop new and to improve existing plans of reform in the past ten years, over employment, inefficiency, entrepreneurs’ corruption and state agency problems continue to plague many SOEs. SOE reform has become the central link in economic restructuring in China. The Chinese government is no longer considering whether to implement further reform in SOEs, but rather how (China News Digest Oct. 1997).
Chapter Two: Managing the Transition to a Market Economy: 
SOE Reform Burdens and Obstacles

1. Reform Burdens Put SOEs in a Less Competitive Position in a Market Economy

During the economic reform process SOEs have encountered many burdens, including the following:

(1) The capital intensity of many large SOEs is too high, despite capital scarcity, due to political decisions. SOEs cannot survive without reform if they have to pay market-determined interest rates and face market competition, especially competition from the capital abundant economies. In the first few years of reform, both SOE investments and working capital came from interest-bearing loans and fiscal appropriations. Government protection was gradually eliminated in the 1990s. In a capital-scarce economy the capital-intensive industries are not internationally competitive. However, the state views such capital-intensive industries as strategically important to the Chinese economy and so SOEs are instructed to operate within those industries. Capital intensive SOEs employed more than 50 percent of urban workers and possessed more than 50 percent of total investment in industrial fixed assets in China in 1997. This put SOEs in a less competitive position internationally (International Financial Law review, May 1997).

(2) SOEs bear a heavy burden of costs for retirement pensions, other social-welfare costs and for redundant workers. Before reforms the state adopted a low minimum-wage policy. The wage was only enough to cover an employee's current expenses. The SOEs were responsible for their employees' retirement pensions, housing, medical costs, and other needs. The cost of these benefits did not impose any extra burden on the SOEs because the state covered SOE expenditures by fiscal appropriation. However, after managerial reform, SOEs have had to be responsible for the wages and social welfare not only of the incumbent employees, but also for
their retired workers. The older the SOE is, the more retirees it has, and the heavier the financial burden from pensions and social-welfare expenditures. Before reform, capital-intensive industries did not create enough jobs for urban residents. SOEs were forced to employ many redundant workers who became a heavy burden during SOE reform (European Economic Review, Sept. 1990).

(3) SOEs’ output prices are still distorted. Before reform the prices of energy, raw materials, and other products or services, which were considered as inputs to heavy-industry projects, were artificially suppressed. After two decades of reform most prices have been liberalized. However, the prices of energy, transportation, and a few other products are still kept below the market equilibrium level. These prices often cannot cover production costs.

The above policy-induced burdens put the SOEs at a disadvantage in competing with non-state enterprises. Because each SOE was established at a different time, each has a somewhat different technology and capital intensity, as well as a different number of retired and redundant workers. Therefore, the impact of such policy on the competitiveness of each SOE is different. Competition among the SOEs or between the SOEs and non-state enterprises is not the same as in a traditional free market economy. In addition, the expansion of the managerial autonomy of SOEs will worsen agency problems because state agencies have power over entrepreneurial development. Bribery, corruption and abuse of power will spread in SOEs and state agencies.

The state should be responsible only for SOE losses that arise from policy burdens. However, in a planned economy, it is hard for the state to distinguish between the policy-induced losses and operational losses caused by mismanagement. The top management of SOEs will always attribute some losses to the state's policies, no matter if the losses are due to government directives or to their own poor management. Consequently, in practice, the state becomes responsible for all SOE losses. As a result, the budget constraints of SOEs will become soft and in turn worsen the moral hazard, managerial slack, on-the-job consumption, and other agency
problems. To correct such agency problems the government must alter the relationship between ownership (capital investment) and control (management of SOEs).

Although by definition the state owns the SOE, the state cannot operate an enterprise by itself. Rather, it needs to delegate control to the enterprise's managers. The separation of ownership and control is a common feature of any large modern corporation in China today. Due to this separation of management and enterprise ownership, the success of any SOE reform depends on the issues of incentive incompatibility and information asymmetry. These problems often arise because of the enterprise's inability to overcome these problems. In practice qualified management in large state corporations is either impossible or prohibitively costly to obtain. Due to the free-rider problem individual entrepreneurs have no incentive to improve their management skills. In China, state enterprises do not have real owners in the same sense that property rights are viewed in the West.

Government reform will be necessary to mitigate existing problems encountered in the current SOE reform. Market competition cannot exist when the government owns the SOEs and state agencies assign top executives and managers who risk their jobs if they do not follow government rules. In a true market economy the success or failure of the CEO, as well as his personal wealth, is directly linked to his company’s profitability. As long as the problems of control and property rights exist, managers do not have any incentive to improve company performance. This is the root of SOE problems in China.

2. Surplus Labor and Debt Problems in SOEs

Reform in the labor system of SOEs has not been very effective in improving worker's incentives and discipline, or encouraging more efficient allocation of labor. The lifetime employment system in state enterprises is fundamental in making labor reform more difficult, along with the concomitant burden of providing social services to workers. Allocation of labor
remains the least reformed part of the system. At the beginning of the reform movement, most newly hired regular workers in state-owned industrial enterprises were given fixed-term (usually three-year) contracts. This measure was intended to increase labor discipline, strengthen performance-based incentives for workers, and weaken the traditional “iron rice bowl” system, under which workers were effectively guaranteed the right to keep their jobs for their entire career. This measure was intended to make labor contracts renewable, allowing workers to be terminated based on their performance. In practice this rarely happens. A more important development was the authority given to managers in the mid-1990’s to better control their work force within the SOEs, by taking surplus workers out of production and segregating them in separate teams engaged in miscellaneous tasks or training. Any labor contract changes will require modifications to how worker pensions, housing and social welfare benefits are derived. It still remains difficult to terminate regular employees in SOEs.

The shift from labor intensive, Soviet-style to intensive growth based on improved resource allocation and advanced technology has caused a huge amount of surplus labor in SOEs. In 1995, China’s 340,000 SOEs employed more than 110 million workers but contributed less than 30 percent of the country’s industrial output compared to 62 percent in 1986 (Asiamoney, Dec 1997/Jan 1998). According to a 1995 survey conducted by the International Labor Organization in conjunction with China’s Ministry of Labor, the labor market is faced with problems of increasing “surplus” labor in SOEs. More than ten years after reform of China’s employment system began, the private sector has been unable to absorb the state sector’s surplus labor. Because the SOE still has little control over labor recruitment in China, the burden of social welfare will increase costs. There are more than 300,000 SOEs in China employing 110 million workers, a number nearly equal to the entire U.S. workforce. These SOEs are a drag on the economy. At least 40 percent of them are unprofitable. Consequently, China permits massive layoffs at these state companies. Furthermore, the labor force grows annually by 15 million people with more than 100 million already unemployed. Massive unemployment will create
major political problems. The reason is that if the government permits layoffs at SOEs, workers will lose their benefits from SOEs, which they depend on to survive, resulting in dangerous social instability. China’s SOEs must generate programs to help unemployed workers and their families with housing, transportation, education, healthcare, recreational activities, and pensions in economic reform.

Another problem facing China’s SOEs is their staggering debt. The state banking system is reeling under a SOE debt burden currently estimated at US$600 billion. Of this, US$125-$180 billion is probably unrecoverable. The emergence and development of markets in China have increased market competition and caused difficulties for many SOEs. This problem has become more serious in recent years. It is estimated that more than 45 percent of the SOEs are losing money. In the past several years, China lacked a policy solution for the SOE problem. In 1996, the government developed a plan and specific measures to reform the country’s SOEs systematically. The government plans to solve the SOE problems in about four years. Through a policy known as ‘grasping the large, letting the small go,’ the government has developed different strategies toward large and small SOEs. For large SOEs, the government plans to support and develop a number of large or super large SOEs in each industry. The new Chinese government intends to help larger SOEs become profitable by retaining shareholdings in roughly 1000 industrial SOEs. Smaller SOEs, meanwhile, will be allowed more flexibility. The general idea is to transform these firms so that they operate and develop, or else die under market competition. This has allowed government to reform the largest SOEs in a very short time (The Economist, Nov.1998). For example, in the electronics industry, the government will support six large Chinese firms. In 1996, the government supported a total of 300 large SOEs and fifty-seven conglomerate groups. By the end of 1998, it will have increased its support to 512 large SOEs and 120 conglomerates. Moreover, the government has chosen six super large companies from this group for additional assistance and intends to help them find a place among the 500 largest companies in the world by the year 2010. These six companies are in the steel making, home
appliance, electronics, ship building, and pharmaceutical industries. The government has instituted favorable policies to support the development of large SOEs. For example, the government will help these firms cooperate with foreign companies to acquire advanced technology. Some firms enjoy tax benefits. In addition, the Chinese government plans to spend some $5 billion to absorb the bad debts of these large firms (People's Daily, January 20, 1998).

For small SOEs, the government has adopted a ‘let go’ strategy. The government does not plan to support these firms, instead letting them die or grow under market competition. The government will allow small SOEs that are unprofitable to go bankrupt or to transfer ownership to private owners or employees. The government also encourages successful Chinese as well as foreign companies to acquire or merge with troubled small SOEs. In some cases, individuals can lease small firms for a few years and then transfer the ownership to the manager. Without government control, many small firms will become truly private firms (People's Daily, January 21, 1998).

The 1997 economic reforms have been implemented to enhance the overall performance of State Enterprises, satisfying an objective of the Chinese government this year. Under this reform, the Chinese government will release the strict control it exercised over large firms under the old central planning system. These companies will enjoy a high degree of autonomy so they can operate in competitive markets. Most of these firms can issue stock, with the government serving as a shareholder. The government will help these SOEs issue some $12.5 billion of stock (People's Daily, December 18, 1997). To support large SOEs, Beijing also intends to revise bankruptcy laws, the system of contract responsibility, and public shareholding.
3. SOEs Internal and External Problems

After almost two decades of economic reform most large-scale state enterprises still operate under state control. From the Chinese political and historical point of view, the internal and external environments of an enterprise would not allow entrepreneurship in SOE.

Entrepreneurial studies in China have increasingly earned a more significant and important role alongside economic reform. Under a planned economy the country and its people own both the SOEs and its property. The system does not allow state entrepreneurs to take risks and enjoy the wealth they generate. The definition of a socialist entrepreneur is rather controversial and is even more complicated in China. From the historical point of view, the Chinese culture did not encourage entrepreneurship. China possessed no real entrepreneurs in SOEs under the planned economy because the market exchange mechanisms and profit retention did not exist. All the factory managers were approved by or assigned by the state government. In other words, they were just government officials who took charge of an enterprise. The economic and production responsibility system never allowed factory managers to take risks and enjoy the wealth they generated. (Li, Yining., Jan 3-5, 1989).

In that way competition was suppressed and profits ceased to be the measure of an enterprise’s efficiency. Because of the lack of market discipline, managerial discretion was potentially a serious problem. Managers of state enterprises lacked autonomy to mitigate problems. Under the government control, the production of state enterprises was dictated by mandatory plans and was furnished with material inputs through an administrative allocation system. Government agencies controlled the circulation of their products. The wages and salaries of workers and managers were determined not by their performance but by their education, age, position, and other criteria according to a national wage scale.

Internal Problems encountered by state entrepreneurs include the following:

a. Poor communication
b. Poor management and development strategy
c. Poorly educated employees
d. Out-of-date technology

External problems include the following:

a. Slow sales and poor working environment
b. Policy burdens and administration controls
c. Ill-defined property rights

The following comments are illustrative for both external and internal problem experienced by SOEs' managers:

"We suffer from slow sales, poor technology, insufficient capital injection and poor working environments. Everything is obsolete: the factory, the plant, the product and the workers as well. We have been operating in the red for a long, long time. I suggest some strategic moves to rescue the enterprise. However I face criticism and negative comments from colleagues."

They resolve their problems by employing some strategic measures.

"I decided to transform my factory. On the manufacturing side, I drop all old products contract out the low margin obsolete products and invest capital to produce new products. On the sales side I maintain a tight control over the sales team and restructure the sales organization. Implementing a straight commission system instead of straight salary system to motivates my salesmen. These measures should secure sales and proper cash flow. First, I resolve to stick by my decision, as I strongly believe that it is the only way to rescue the enterprise that has been running at a loss account for a long time. I use current data, both internal figures and external market demand, to justify my decisions. In addition, I seek support from my superiors--the government officials in the Industry Bureau for 'arbitration'. Both workers and opponents then give up or keep silence. I hope the strategic management, improved marketing and good communication skills are effective measures to resolve these problems."
It seems that strategic management, marketing flavor, advanced technology, and good communication skills are effective measures to solve these problems.

4. The Characteristics and Problems of SOEs’ Entrepreneurship
Political/Regulatory Environments and Strategic Orientation

As China slowly becomes integrated into the world economy, the relevance of Western models becomes a practical matter (Peng & Heath, 1996; Shenkar & von Glinow, 1994; Tan & Litschert, 1994). Since China differs from Western countries in culture, society, and political and economic system, it potentially represents the most serious challenge to the managerial paradigm developed and empirically tested primarily in the West. Furthermore, since more people work for organizations in China than in any other country, there is a gap between different institutional environments, including economies in transition. The question for the Chinese government is how to fill this gap by examining the relationship between regulatory environment and entrepreneurial strategic orientation in China, an economy undergoing transition toward a market-driven economy.

SOEs’ entrepreneurship can be divided into specific activities within a macro or a micro view, yet all address the conceptual nature of entrepreneurship (Aldrich & Wiedenmayer, 1993). The micro view examines the socialist entrepreneur’s personal characteristics that have identifying traits and behavioral orientations that are common to successful entrepreneurs. Some of the identifying traits and behavioral orientations are innovation, opportunistic orientations, and education level. Success depending on individual entrepreneurs has been challenged by individual ecological thinking. Which argues that the search for a single psychological profile of the entrepreneur is bound to fail according to the numerous counter examples in the most SOEs.

Instead, the focus of the macro view is on environmental factors external to the entrepreneurial business, which are capable of creating or destroying entrepreneurship by the nature of the climate they establish (Aldrich & Wiedenmayer, 1993). The environmental context
refers to those sets of circumstances, government actions, and macro vs. microeconomic policies that impact the strategic orientation of the entrepreneur. The external processes are sometimes beyond the control of the individual. For example, the Chinese government gave the private sector equal status with the state owned sector. It was a major change. The non-state sector – including private enterprises, collectives, and joint venture companies – is booming. It accounts for 70 percent of China’s gross value of industrial output, while the share of state enterprises has declined to 28 percent in 1996 (Mariko Hayashibara, p34). Entrepreneurs perceive the political and regulatory sectors to be the most influential, most complicated, but at the same time the least predictable among the several environmental factors that affect strategic decisions. (Aldrich & Wiedenmayer, 1993). Underdevelopment of state entrepreneurial activities is clearly rooted in the political regime and government policy in China. It is important to examine entrepreneurial orientations within the specific environmental contexts in which strategic decisions are made instead of just counting failures of individual state entrepreneurs. Therefore, the macro view of entrepreneurship presents a broad array of factors that relate to success or failure in SOE reform. The principal challenge of the macro view is to predict the environmental circumstances that influence SOEs’ entrepreneurial decisions.

Although policymakers have been struggling for two decades to reshape China’s top executives as efficient players in a competitive marketplace with state enterprises, entrepreneurs still have to face constant pressures both from government and market competition since reform. The following are a few examples:

(1) Golden Summit, one of the most successful companies in the mid-sized city of Shanxi in western China, is owned by the state, as is Dadu River Steel. Bai is a deputy manager, a senior engineer and an accountant. He has been running the steel mill ever since it was opened and now is taking it over, even though it offers no personal benefits for him, only headaches. "To put it nicely, I was helping the government overcome its
difficulties. I am loyal to the party and state government” he says. "You could also say that I was forced to do it."

(2) Golden Summit Joint-Stock Co. Ltd. is an SOE that has undergone wave after wave of reforms. First came bonuses to motivate workers and managers, and then came foreign investment, followed by public stock offerings to raise capital and expose the company to market pressures. However Golden Summit’s experiences suggest that as long as the state remains the major shareholder, local officials are apt to make it impossible for managers to focus on purely commercial goals. Therefore it will be hard for state companies to compete with multinationals, which have fewer political burdens.

In summary Golden Summit and Golden Summit Joint-Stock Co. Ltd cases point to the problem of too many of government’s "mothers-in-law" interfering with SOE operations and strategic orientation. This is one of the problems of which Beijing is aware. The Chinese government must solve this problem as long as the State remains determined to keep a core of companies in state hands. Clarifying ownership is the first step toward limiting the demands government can make.

The term ‘entrepreneur’ as defined in SOEs is both controversial and complicated in China. An expectation from the government is that top SOE executives in China are those who are attempting to take risks and to assume responsibility in order to create personal wealth as well as profit for the country and party. They may be the founders of new enterprises or may be the managers in traditional state-owned or collective enterprise. In practice, there is a big gap between the government’s definition of entrepreneur and the actual practice in China.

Compared to entrepreneurs in the West, state corporate managers have their own 'way' to achieve a single goal in China: the modernization of China. They are not actually real entrepreneurs according to the western definition. Top executives in western countries are those who attempt to take risks and to assume responsibility in order to create personal wealth. The
term 'entrepreneurship' is capitalistic in nature, and it may make sense to conceive of the entrepreneur as an individual who is opportunistic, proactive, action oriented, value driven, risk accepting, and whose creative ideas take the form of organizational birth, growth, or transformation (Bird, 1989). Entrepreneurial development was not active in The Peoples Republic of China (PRC) before economic reform. “The merit of Chinese managers' tradition is their concern for their people and country. They know that the prosperity of the country is a prerequisite for a supportive and favorable environment to develop their enterprises. Their fates have virtually become merged with that of the country and the people”(China's Digest, Feb 1997). They place less emphasis on their individual wealth. Many SOE entrepreneurs, even as they climb to managerial positions, still live in the small house allocated to them many years ago and earn almost the same salary as their employees. They use part of the retained profit to build apartments for their employees rather than to allocate it as a bonus. Their personal wealth increases very little. They stress the economic performance of these factories. For example, Ma Shenli, one of the first 20 outstanding SOE top executives in paper manufacturing, was paid only $200 Chinese yuan after he retired. He found it difficult to maintain his former living standard. And his was not a special case. The following are excerpts from a 1984 speech by Wang Guang-ying, a typical entrepreneur with ventures in Mainland China and Hong Kong between 1940 and 1990. He is also the brother-in-law of Liu Shaoqi, president of China in the 1970s. The speech reflects the state of contemporary corporate entrepreneurship in China.

"The tradition of Chinese entrepreneurs is the spirit of arduous struggle and defying hardships. In old China when the country was in the abyss of misery SOE top executives, like other Chinese people were harshly suppressed and exploited. It was under these adverse circumstances that they came to realize that only with dedication, courage and perseverance could they survive and grow" (Chi Ying, p23.).

After the failures and successes of almost 20 years of managerial reforms in SOEs, state government now places severe budget constraints on SOEs that are trying to improve their
performance through gradual privatization reform. However as long as government policies remain the same, and even if the SOEs are privatized, the state cannot excuse itself from policy-induced losses, and the lack of budget constraints will persist during the reform process. In order for reform to be effective it is necessary to remove the burdens of present government policy and to provide SOEs with a level economic playing field. Enterprise improvement measures can be introduced to counteract government policy. One possible way out for top executives is to oversee the managers' actions directly and to reward the managers according to their managerial efforts.

As soon as it gives up control the state is no longer accountable for SOE failures and can thus impose hard budget constraints on them. Without state subsidies state corporate executives can resist unnecessary political intervention in their operations. Certainly a level playing field does not guarantee that state corporate performances will necessarily be good. If an SOE fails to perform well other enterprises will have the incentive to take over, replace managers, improve efficiency, and profit from the takeover. Without government interference the SOE should be able to make a normal profit with a normal management strategy. It remains to be seen whether privatization is in fact, necessary for improving the efficiency of contemporary SOEs (*Asian Business*, Jan. 1998).

**Chapter Three: Managerial Problems and Corruption**

1. **The Root of the SOE problems**

One explanation for the government's lack of enthusiasm toward developing real entrepreneurs is socialist ideology, still upheld today. The root of SOE problems is the separation of ownership and control, and the often-criticized soft-budget constraints that arise from various state-imposed policy burdens, which make the state accountable for the poor performance of
Some problems facing Chinese entrepreneurs are political in nature and some are related to the government's macroeconomic policy. While responsible for profits and losses, corporate managers defer to state regulations as long as the state retains control or else they risk being fired. In order to foster entrepreneurial development the government must provide a more supportive business environment and give CEOs more control. Figure 1 illustrates the standard managerial hierarchy for SOEs in China. After two decades of reform some large state enterprises still operate this way (*Guangzhou Daily News*, July 1999). The key to successful SOE reform is to remove governmental policy burdens and to create a level playing field so that competition in the market place can be used to judge managerial performance and make managers' incentives compatible with the market.

**Figure 1, Managerial Hierarchy for SOEs in China**
Although, by definition, the state owns SOEs, the state cannot operate them by itself and needs to delegate their control to the enterprises’ managers. The separation of ownership and control is a common feature of any large modern corporation in China. Due to this separation, the issues of incentive, incompatibility, and information asymmetry often arise between the managers and the owners. State agency problems such as moral hazard and managerial slack and discretion may surface. The success of any large corporate institution depends on its ability to overcome these problems. Intuitively, one possible way for the owners is to oversee the managers’ actions directly and to reward the managers according to their managerial efforts (Alchian and Demsetz, 1972). In practice, total observation of managerial actions in a large corporation is either impossible or prohibitively costly. Moreover, the owners of large corporations are numerous. Because of the free-rider problem, any individual owner of a firm will not have the incentive to oversee the detailed activities of the firm.

The large Chinese corporation does not have owners in the same sense as in the property-rights literature. For example, an institutional investor may own a large share of a firm in the West. However, in China the institutional investor is the government, whose state agent may not have incentives to adequately monitor managers. Additionally, the owners of the institution’s funds may not have incentives to monitor the institutional investor either. Incentive compatibility between the owners and the managers can be achieved in two ways. The first is direct, where the owners can design a managerial labor market about-compensation schema that is based on the industrial average or on the rank of the firm’s performance in the industry (Holmstrom, 1982). The second is indirect, where a firm’s performance in a competitive market provides a signal to the managerial labor market about the manager’s talent and behavior, and the signal determines the manager’s future wages (Fama, 1980). Access to sufficient statistical information will aid in these tasks. The prevalence of large SOE corporations in the market economy indicates that some institutional arrangements like direct and indirect ways to mitigate the state agency problems exist.
2. Entrepreneurs’ Social Responsibility, Family Stress and Business Ethics

Four issues have been identified that must be solved for SOE reform to succeed:

a. The Social Responsibility of SOE and Business Ethics. SOEs have been small societies on their own. On behalf of the state, they bear various social responsibilities for their employees, from housing and medical care to retirement payments. For example, in a glass factory in North China with 6000 members, there are 3000 retired workers whose medicine costs alone are twenty millions of Yuan per year. With such heavy financial loads, SOEs find it difficult to compete with market enterprises (Brown, 1996). After almost twenty years of economic reform, new business laws and rules, increased unemployment, serious environmental issues, and other issues call for ethical discussion, whether one approves of reform or not.

In addition to these factors, the influence of foreign business ethics, the inheritance of Chinese traditional ethics, and the influence of Marxist philosophy and ethics should be discussed. In traditional Chinese ethics the relationship between ‘Yi’ and ‘Li’ is a very old and recurrent topic. ‘Li’ means benefits or profits and ‘Yi’ refers to the principle or norms of obtaining and distributing benefits or profits. So ‘Yi’ as the core notion in Chinese traditional ethics has an indissoluble bond to ‘Li’ (Cheng Lin, 1993). The connection between them is expressed by the deep-rooted Confucian view that ‘a person of noble character can understand Yi, but a low person only knows Li’. Although Confucians are not completely against ‘Li’ they want to put ‘Yi’ into ‘Li’ or to achieve ‘Li’ in a moral way. The relationship of ‘Yi’ and ‘Li’ turns to the central question of business and ethics. Its related concepts became the questions of entrepreneurs’ efficiency and fairness, desire for material reward and social ‘requirements of moral or spiritual norms’ (Journal of Business Ethics, Oct., 1997). For example, it is important for enterprises to realize that offering good quality and reliable products to their customers and providing a healthy and safe working environment for the staff are important goals. Given the connection between ‘Yi’ and ‘Li’ or business and ethics for an enterprise must solve the problems
of fair rewards, working conditions, and efficiency for its employees. According to the *Statistical Yearbook of China*, there were more than 38,000 industrial fires in 1993 as a result of management’s lack of concern for its workers. These fires caused nearly 2,500 deaths (*Guangzhou Daily News*, pp. 1, 1999).

b. The Responsibility of Enterprises for the Environment. The issue of environmental pollution is serious. Some firms and managers are not aware of their responsibility for the environment. Some have the awareness, but lack the necessary funds to protect the environment. Recent changes in environmental laws show some concern for the environment. However, there is still much to do on the part of both businesses and government.

c. Ethical Issues of SOE Management. One SOE manager defines his concept of ‘success and failure ‘way’ for managers’, which is a Chinese term to define his management experience, and which may be a reflection of others, as follows:

"Way' should have a goal, try to reach the goal and be aware of the risks. It pays off...I have participated in the economic reform and this supports economic development which in turn improves the quality of people's lives and living standards in our under-developed country. My business experiences would be useful examples for the followers. Newcomers may gain from my good or bad experiences, no matter failure or success. They will then find a better 'road' or 'way' that leads them to success and keeps them away from failure."

"First, I try my very best to meet the target or quota set by the Industry Bureau. This is the first and most important objective of a state entrepreneur. Second make all contributions to the society, party or country, not to individual persons. I receive the same compensation as general workers even though I make more effort and no matter how much profit the enterprise has made"

It is not strange that SOE managers pay little attention to personal objectives such as wealth and financial reward. When personal objectives conflict with social objectives, managers find a way to get out of the government controls. But the controls and regulations then give rise to corruption opportunities. The simplistic view of corruption is that all politicians and government officials – like everyone else – are constrained self-maximizers. Therefore, they
establish or maintain regulations and controls with the intent to facilitate corruption. Under private enterprise, where resources are transferable and movable, competition limits the ability to corrupt. However, in state enterprises, limiting corruption through competition is difficult. Take the example of price controls in China. With the exception of farm price supports in the United States, most price controls are set below the market price. Why is this true? It is because it is relatively uneasy for corruption to exist when the controlled price is above the market price. Take steel in Beijing as an example. The controlled price is one-third to one-half of the market price. Certain officials are entitled to rationing power over steel. They have the opportunity to make gains derived from this power to ration, because the price of steel is controlled below the market price. According to the magazine *Chinese Entrepreneurs*, half of the first outstanding 20 entrepreneurs in the 1980s escaped overseas to avoid prosecution, or are behind bars because they transferred huge amounts of money to foreign countries or into their own accounts (Xiang, p 32).

d. In the Chinese culture the SOE Manager’s Family is a Critical Issue. Added pressure is placed on managers’ families because they work long hours and do not have regular vacations. Managers must work longer hours than their employees, and travel extensively for business purposes. They must bear pressure from both from the government and the market. Because they have to travel out of town frequently, they have to cultivate ‘Ren Gi Guan Xi’, a Chinese term for close connections with local government officials and others who have business relationships with them. They do not have much time for their families. One female SOE manager commented, “One third of my time is out of town on business. I feel pain when I cannot stay alongside my mother and father when they are passing away. I also feel great guilt and sadness as I cannot take care of my children and thus they are poor in health and perform poorly in school” *GuangZhou Daily News*, 1999.)
3. Entrepreneurs’ Corruption

In 1997, five or six well-known executives who had been outstanding during past SOE reforms were arrested for mismanagement. Others resigned, while some fled overseas, and a few committed suicide when they faced pressure from state government. In China, people named 1997 as “corruption’s year” (*China’s Digest*, p 21). What happened then? Why are these people who used to be successful in business failing today? What defines corruption in SOEs?

The simplistic view of corruption in China is that all politicians and government officials— including SOE managers—will do anything for personal gain. They take chances, transferring SOE property and financial resources to themselves. Under the Chinese economic system such property and resources properly belong to the people and the country. In fact SOE managers do not have any special rewards connected with their successful efforts. They are paid almost the same as other employees. Therefore, they establish and maintain regulations and controls with the intent of facilitating corruption, which then becomes a major source of income for them. Are they just greedy? Some economists in China feel that the socialist system of property rights encourages corruption. In a private enterprise system, where resources are transferable and movable, competition limits corruption. However, for Chinese enterprises limiting corruption through competition is difficult because there are no certain property rights.

Sometimes corruption can help offset the inefficiencies of a planned economy or hierarchical system in SOEs, because the state government must pay attention to the system’s shortcomings as the economy makes a transition toward private property. However the danger is that corruption will become institutionalized. Managers and market competitors cannot limit corruption in a system of complete control without guaranteed property rights. Without the guarantee of property rights and financial rewards, managers will lack motivation to improve their business, and are more likely to focus on the maximization of their own benefits instead of on their enterprise’s profits or social goals. In conclusion, the imbalanced growth caused by
gradually changing the planned economy into a private property market system will not lessen corruption. It may, in fact, worsen it (The Economist, May 1997).

Since 1978, the Chinese economy has combined these two systems. Top SOE executives have faced and experienced a more complicated business environment than their counterparts in the West. The Chinese government is developing a “system of separation of two rights in SOE reform” – meaning the separation of management rights and owner rights and trying fundamentally to reform and change the SOE system.

The first is a system based on private property rights. Under this system, rights and privileges are ranked according to the property individuals own without regard to politics. How many cars you can buy depends on your property rights over resources. Poorly defined property rights are a sensitive issue in China. All resources and property belong to the country and people, but the problem is that a resource becomes overused when too many agents have the rights to use it. Due to poorly defined property rights state entrepreneurs have no incentive to operate a business under strategic management guidelines. The major reason for inefficient resource allocation of resources to SOEs is that politicians and bureaucrats have excessive control over much of the economy. Establishing property rights is, therefore, equivalent to reducing political control over top executives, managers and employees in China. Inefficient structure and control of rights and poor enforcement of contracts in the SOE are two aspects of the current property rights problem (Cato Journal, Fall 1996).

The second is the socialist economic system in which rights are determined by hierarchical ranking (Refer to Figure 1). It has nothing to do with whether one is wealthy or intelligent. The most important factor is obedience to the state agent. The question is by what standard of success or failure is the efforts of SOE entrepreneurs measured today? In fact the standards vary and do not consider human rights. It will take a long time to reform the socialist system in present-day China, because people often try to circumvent the law. Reforming the
political and economic systems simultaneously would be the ideal solution, including the establishment of an unbiased judicial system (International Journal of Management, Dec. 1997).

Moving from a hierarchical ranking of rights to one of private property rights is painful, especially since it would preclude corruption, which is endemic to SOE management today. Since 1979, China has faced a lot of problems in merging the systems. To define a system of private property rights is difficult enough. Systematically preventing corruption is even more difficult. Present-day corruption is based on locality or territorial rights, on classified commodity rights, on classified trade rights and others. The only effective way of getting rid of corruption among SOE executives is to get rid of controls and regulations. Conversely lack of all controls may encourage other kinds of corruption. As things stand today, controls and regulations may be created and/or maintained by politicians, thus facilitating corruption. Therefore, the prevention of corruption must rest on the successful establishment of a system under which government controls and regulations are minimal. This is a system of well-defined property rights, creating a true market-economy system. Beijing implemented the “modern enterprise system” pilot program in 1994. The program sought ways to save 2,700 SOEs from financial collapse -100 designated by the State Council and 1,700 chosen by local government – by helping them to reorganize, implementing market competition, freeing them from housing and medical care responsibilities for their employees, and giving entrepreneurs proper rewards for their efforts. The program, however, has been criticized for the lack of improvement in these operations, despite preferential treatment (Hayashibara, p v34n6).

In China corruption is similar to that in other developing countries. Corruption occurs at all levels of government and management and so is almost impossible to control. The type of corruption in China is spread from the bottom of management to the highest-level management. “Exchange of money and rights” is common among state enterprises and government bribery is common among managers (Qi, p 2-3).
Chinese Entrepreneurs magazine has a survey of “Excellent Entrepreneurs Award Winners of 1988” (Economic Management 1988) and “1989” (Economic Management) in China that investigates the SOE’s top executives. Of the first twenty excellent top SOE executives interviewed, only four are still in their management positions. Of the others, one has died, one escaped overseas, five retired, and six quit or were fired by state government. Three became state governors. For some reason they were successful for a period of time but finally failed. They bribed state agencies to maximize their own personal gain. The survey revealed that most SOE managers thought their enterprises failed not only because of strategic management problems, but also because of China’s property rights system and interference by the government (China News Digest p 16-18).

Chapter Four: Summary and Recommendations

1. Summary

In 1999 the Hong Kong Standard reported that the Chinese Communist Party would adopt a policy to separate management and ownership of the SOEs as a key step to modernize them (Gilley, Apr. 9, 1999). An economic researcher in the State Development Planning Commission said that the separation was also an important and effective measure to carry out the withdrawal of government from state enterprises. Such fundamental reform would cause a whole set of changes in other existing policies regarding personnel, salaries, and employment, as well as determining the role that the Communist Party plays in state enterprises. According to an official source, reform needs the party's support in harmonizing various party and government departments. The pending plenum of the party's Central Committee, to be held in late September 1999, is expected to approve the policy. In a keynote address on June 26, 1999, to leaders of six eastern provinces, President Jiang Zemin gave priority to the separation of management of state enterprises from their ownership. This was the fourth of Jiang Zemin's speeches on state-owned
enterprises this year. In his speech Jiang said that while the state enjoys the rights and benefits of owner and investor, it should not get directly involved in the operation of an enterprise. Nor should the state bear unlimited responsibility for an enterprise. According to the proposed reform, a board of directors is to be established in large state enterprises. The board will consist of representatives from the Communist Party committees and other relevant government departments. The board will choose the management through open competition. Managers’ performances will be measured by goals and objectives defined at hiring (Saywell, Dec. 1998).

The year 1999 has been a good one for China's economic development. China attained an 8.3 percent gross domestic product (GDP) growth rate for the first quarter in 1999, according to the governor of China's central bank in Macao. Governor Dai Xianglong was optimistic about meeting the seven percent annual growth target, taking into account a slowdown in the second quarter (Jing. p 17).

At the same time China's economic transition also reached a critical stage. Significant internal developments were and still are forcing the government to consider more aggressive reforms. Meeting some of the government's greatest challenges has already begun. These challenges include SOE reform, sustaining economic growth and coping with the Asian financial crisis. Overcoming these challenges will have a critical impact on China's economic transition and development in the next decade.

SOE reform and the development of a market economy in China have increased market competition, but at the same time caused difficulties for many SOEs. This problem has become more serious in recent years. It is estimated that more than 45 percent of the SOEs in China are losing money. In previous years China lacked a definite policy to deal with SOE problems. In 1996, the government developed a plan to systematically reform SOEs. The general idea is to transform these firms so that they operate and develop profitably or else go bankrupt under market competition. One initiative, announced by the State Council in April 1997, entails setting up a special task force to deal with bankruptcies caused by SOE mergers and with the resultant
problems of unemployed workers. The task force will have the authority to shut down unprofitable firms and to auction off their assets. The Chinese government appears to be facilitating the bankruptcy process by allowing liquidation of assets (Cheung, p.1-5).

The government has developed different strategies toward large and small SOEs. The government plans to support and develop a number of large or super SOEs in each industry (the government calls this "grasp big" policy.) For example, in the electronics industry, the government will support six mega - firms. In 1996, the government supported a total of 300 large SOEs and fifty-seven enterprise groups. By the end of 1998, it had increased its support to 512 large SOEs and 120 conglomerates. Moreover, the government has chosen six companies from this group for additional assistance and intends to help them find a place among the 500 largest companies in the world by the year 2010. These six companies are in steel making, home appliance, electronics, shipbuilding, and pharmaceutical industries. In total, the government plans to support some 1000 large SOEs or groups in the near future (People's Daily, January 20,1998).

2. Recommendations

First is the Chinese government should relax its strict control over SOEs. The government should also permit SOEs to enjoy a high degree of autonomy so they can operate in competitive markets. SOEs should be able to issue stock, with the government serving as a shareholder to support their operation. The key for successful SOE reform is to remove bureaucratic regulations and to create a level playing field so that market competition can prevail. Capable managers should share in corporate profits. For a long time the government has functioned as a "helping hand" for economic development, promoting economic growth. Government power is exercised through coercion in order to shape the enterprise and the behavior of top executives in SOE. For example, the government should permit the managers of each selected enterprise the flexibility to reorganize as they see fit, without being responsible for the social welfare problems of a downsized work force (Liao, Sept/Oct 1997).
Second, the Chinese government must design a program to support the development of SOE reform. For example, the government should have strategy policies to help SOEs cooperate with foreign companies to acquire advanced technology. In addition, the Chinese government has to have plans to manage the bad debts of SOEs to make these companies become key players in their respective business sectors.

Third, a corporate bankruptcy law should be promulgated in China and implemented on a trial basis. While local regulations exist in some areas, the new law should be aimed at making SOEs more fiscally responsible. Bankruptcy law implementation in China will increase its social cost, with massive layoffs and unrecoverable debt. To be successful the government will have to support the bankruptcy laws and create training centers to assist laid-off workers.

Fourth, because property rights depend on the nature of their reallocation, the state should shift management responsibility for SOE operations from government officials to top SOE executives. Stronger financial incentives that effectively increase the entrepreneur’s income will result in improved output of the SOE. Decentralizing the central government’s fiscal policy will provide incentives for local government to form "township and village enterprises", in which top SOE executives will take responsibility only for their businesses and will be freed from responsibility for the social welfare of their employees. This will aid the local economy, which in turn will help reduce unemployment. Property-rights reform must be associated with decentralization and devolution of government economic authority. Authoritarian property rights in China are known as “fiat property rights” in contrast to “evolved property rights”. Fiat property rights do not rely only on government decree, but also depend on the careers of individual politicians. In general, property rights are either lacking or ill-defined. A major policy change of China's central government has shifted some decision-making from higher levels of government down to local governments and, in some cases, even to individuals. However, the central government retains the prerogatives to administer, adjust, and even to revoke these policies and regularly demonstrates these prerogatives. As such, the new fiat property rights are
not evolutionary developments, but little more than adjustments within the framework of China's autocratic tradition. China's post-1978 property rights laws continue to be a fundamental determinant of property rights allocation for SOEs.

Finally, the Chinese government must enforce Intellectual Property Rights (IPR) in all enterprise sectors. Increased enforcement has produced noticeable results such as raids against pirate CD factories. IPR violators have to been fined and imprisoned to prevent IPR abuse. It is important to have a sustained campaign to disseminate IPR rules to government officials and to enterprise managers in order to make them aware of IPR issues. The emphasis on state-centered enforcement highlights problems of technical proficiency and training in IPR issues, as the state becomes the primary source for and consumer of technical knowledge for all businesses and individuals. Further, as state officials have had to decide which of the increasing number of violations receive a portion of the limited resources, corruption and influence-peddling have grown, which in turn has effected the consistency of IPR enforcement. Moreover, state-centered enforcement makes economic factors dependent on the good will of state agencies, hardly a circumstance likely to contribute to the emergence of a market economy in China. It is still too early to reach conclusions on the extent to which criminal penalties are imposed and on their possible deterrent effect on business and individuals if managers do not really understand the concept of individual property rights.


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