

## **Chapter Two**

### **China's Centrally Planned Economy**

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#### **Introduction**

In Chapter 1 we made some remarks about evolutionary path dependent processes. From that perspective we suggested that China's transition to a market economy could best be considered as a process of incremental change. To understand China's transition of today it is necessary to know where the system comes from, what the roots are. For that reason we analyse in this chapter the centrally planned economy, as it existed three decades before the market oriented reforms started.

Before 1949, the Chinese economy was traditionally based on agriculture. At the founding of the People's Republic of China in 1949, the government pursued an essentially soviet-style approach to the economic system, which was characterised by the undivided power of the Marxist-Leninist Party, the dominant position of state ownership, and a preponderance of bureaucratic coordination through central planning (Kornai, 1992). The Centrally Planned Economy (CPE) of China initiated and guided the process of industrialisation for about thirty years. The country transformed from an agricultural to an industrial society. Despite disruptions and waste caused by the devastating "Great Leap Forward" (1958 – 1960) and the "Cultural Revolution" (1966 – 1976), China built a complete industrial system and had the capability to produce almost every kind of major industrial product by the end of 1970s. However, the planned economy exhibited a lot of problems. It generated the waste of production on a large scale; it abandoned the capitalist production for profit, but failed to replace it with a socialist or communist production for use; it eliminated the short-termism of competitive capitalism only to substitute it for the short-termism of current plan fulfilment (Nolan and Ash, 1995). After 30 years of planned development, China still remained a poor country.

We first describe the informal institutions in Section 2.1 and the formal ones in Section 2.2. In Section 2.3, some concluding remarks will be made about the failures of the Chinese CPE.

## 2.1 Informal Institutions in the Chinese Central Planned Economy

The long history of Confucianism is one of the most important elements of China's civilization. It features specific Chinese character and Chinese mindset, such as family-ism and group orientation (Xing, 1995). In the period of the Centrally Planned Economy (CPE) from 1949 to 1979 the culture had a strong influence on the development of the planned economy: family-ism, collectivism and equalitarianism (Yuan, 1999) are considered to be central. We first briefly review Confucianism.

### *Confucianism*

As a moral system, Confucianism focuses on the relationship between persons, which is defined by five virtues: *Ren* (humanity/benevolence), *Yi* (righteousness), *Li* (propriety/ritual/etiquette), *Zhi* (wisdom) and *Xin* (trustworthiness). These five virtues used to be the leading criteria and principles guiding social behaviour. Almost all the concrete moral and legal rules, for individual conduct, are derived from the five virtues. For example, *Li*, which is very difficult to translate into English, provides principles, standards and rules for social relationships and social behaviour. In ancient China, there was no "civil law" and "commercial law" (or "mercantile law"), because *Li* dealt with the relations and behaviour in daily life, including family life and all other social communications. The Chinese consider *Li* to be primary, while the law is secondary; *Li* is prior while the law is subordinate; *Li* is fundamental while the law is incidental; *Li* enters into the law and resides in it, while the law depends on *Li* and supports it. So a "good" man should "have" *Li*.

Another focus is on the hierarchical relationships between father and son, ruler and ruled, husband and wife, and the elder and younger brother: ruler guides subjects, father guides son, and husband guides wife. The relation between friends is an equal relation also important in Confucianism. Society is seen as a hierarchical pyramid of roles that entail fairly well established norms governing how people should act and behave in relation to people in other roles (Luo, W., 2000). Social hierarchy and relations of subordination and superiority are considered natural.

For thousands of years China has been a society of a highly centralised state power. People are told to respect the rulers and should accept the government's guide (Yuan, 1999). In the economic system all economic power should be with the central government. More importantly, also a change in these principles should not come from the decentralised level of households and firms, but if a change was

needed it was government that should initiate it. This insight will be important for understanding the role of the state in reforming the economy.

### *Chinese Family-ism*

Chinese families, as a basic unit of society, act to provide not only shelter and food but also an environment within which people socialise and play the roles defined by Confucius. As a form of social immortality families have something of the character of a religion that, at times, is enhanced by the ritual of ancestor worship (Luo, W., 2000). The family consciousness has penetrated deeply into the Chinese soul: a strong and lingering belief is that when one dies, his or her self lives on in the “greater stream of the family life”.

In the period of the planned economy, the concept of the Chinese family was transformed into “family-ism”, which pervaded almost every social organisation, including business. Employees were provided with housing, free medical care and education for their children by the organisation they worked for. Their activities and personal lives were closely connected to the organisations whose management functioned as the parents of the extended families in many ways, and were responsible for both business and solving the personal problems of the employees. Hiring, selecting, compensating and other management decisions involve “family-ism” (Xing, 1995)

### *Collectivism*

Chinese group orientation is also identified with Confucian doctrines that emphasise ties of kinship and close personal relationships. The individuals exist for the benefit of the group; group pressure is applied to ensure conformity through eliciting shame (“losing face”), and conflict is generally handled through intra-group mediation rather than by an external legal system (Chen, 1995). The individuals are perceived as part of a network of social relations and they find their own identities with reference to others around them and adopt group goals and opinions in exchange for reciprocal care and protection. For understanding the process of institutionalisation and the forming of peoples’ mental maps, insight in the value of collectivism is crucial.

In the period of the planned economy, the importance of groups was reflected in the form of the family-ism claim for solidarity. The group orientation was expressed by the “*Danwei*” (work unit), where the focus was not only on work-related activities, but also on private non-work areas. Most Chinese persons worked in one enterprise for all their lives and viewed the enterprise as their home. Workers depended on the enterprises for their permanent employment, free housing, free medical care and other fringe benefits. As a result, the social needs of the people in a workplace tended to be ranked higher than autonomy and the need of self-actualisation, whereas also the need for a national social security system was

not felt. In business the famous *Guanxi* (interpersonal connections) guided and still guides the business relationships instead of the formal organisational structures. Business contracts were often specified in legal terms, but the implementation relied heavily on trust and personal relationships (Xing, 1995).

The Chinese cultural tradition emphasises the priority of public benefit over personal benefits. The planned-economy inherited these values from the Confucian tradition, in which the value of taking individuals, organisations and the nation as a whole is an important element (Earley, 1993).

### *Equalitarianism*

Sun Tzu was a famous Chinese strategist living thousands of years ago, who had a great influence on actors' behaviour in the Chinese planned economic system. In his famous work, "The Art of War", Sun Tzu summarised several basic elements for the success of a war: moral influence of the ruler, ability of the general, the conditions of climate and terrain, comparative strengths of the troops, the implementation of laws and rules, training of officers and soldiers and the use of rewards and punishments (Luo, W., 2000). His military strategy provided insights to management especially concerning the motivation of employees. To make employees, like soldiers, willing to put all their energy into the firm, Sun Tzu emphasised that the quality of being a leader was not easily acquired, the qualifications of a leader were more of a natural nature. His technical capabilities could be acquired, but that was not the first criterion to select leaders and managers. Sun Tzu provided an important principle for leaders to motivate: if a general treats his soldiers as his own beloved sons, they would stand by him until death. Management should try as much as possible to formulate common corporate goals to be shared by all employees, so everyone perceives him, or herself as member of the group "crossing a river in the same boat". Equalitarianism was regarded in China's cultural tradition as an important value (Yuan, 1999).

In the planned economic mechanism, equalitarianism had an important influence on the distribution system. The Chinese government established a uniform national wage system. Every employee received his wage according to one uniform system and his salary was not affected by the performance of his enterprise. The improvement of wages would be the result of a government order applicable to the whole nation. Managers and workers shared one system, but had different series: an 8-grade system for workers and a 16-grade for managers. The grades in one series corresponded to the ones in another series. For example, when a worker was promoted to be a manager, it was easy for him to find his wage grade in the management's series according to his former grade in the worker's series. "*Let's get rich together*" was the common slogan in the planned-economy society.

In sum, the 30-year planned economy was built upon the cultural traditions in China. In the process of the transition to a market economy, the central government recognised that the culture with the neglect of economic interests of individuals

was one of major factors to cause a low efficiency (Yuan, 1999). The enterprise (*Danwei*) was later named the “iron rice-bowl”. In the “iron rice-bowl” system, the enterprise had a 100% marginal tax rate. Every enterprise, except those in deficit, had to hand over all its profit to the government and then government redistributed all profits evenly among all members in the society. The income level of the employees in a poorly performing enterprise would not be decreased, because enterprises would get the allowance from the government. Workers were illusively praised as “masters of the house”. They were assigned to the enterprise by the outside Labour or Personnel Bureau, according to the state plan. They were effectively guaranteed the right to keep their jobs for their entire careers regardless their performance. Workers who were thought to have a high level of “political consciousness” would be promoted to be managers. Their salaries were also fixed by the general wage system and not much higher than those of skilled workers. Over time it became clear that attempts to motivate workers through ideology and politics were less and less effective as material incentives were more and more valued. The lack of labour discipline and motivation gave rise to widespread job shirking, low morality, and high absenteeism in the workplace (Lockett, 1990). So both managers and workers didn't care about the performance of their enterprise and nobody was willing to work hard to produce high quality products. This system directly led to a decrease of productivity and to national poverty. To transform the CPE into a more market type economy demanded a change in values: the balance between private and public interests should change in favour of the former.

## **2.2 Formal Institutions**

After 1949, China established a Centrally Planned Economy with prices determined by administrative rather than market mechanisms and resources allocated by central planners rather than by forces of supply and demand. Along the lines of the Soviet Union, preference was given to the development of heavy industry over light industry and to industrial output over agriculture. Enterprises were state-owned and inputs of labour, capital and land were allocated by bureaucrats and not by the market. Producers were given target output levels to achieve and were not charged with the objective of maximising profits. Such planning and control mechanisms were extended to the agricultural sector with the move to collectively owned agricultural production units in the mid-1950s.

### **2.2.1 The economic strategy of a Centrally Planned Economy**

At the founding of the People's Republic in 1949, the Chinese government inherited a devastated agrarian economy. Government set the priority to build the capacity to produce capital goods and military materials (Lin, J. Y. et al., 1996). In the beginning of the 1950s the Chinese economy was not well fit for that goal. The construction of a capital-intensive heavy-industry project requires a long gestation

period, equipment imported from more advanced economies and a large lump-sum investment. However, in the early 1950s, the Chinese economy had limited capital available and interest rates were high. Foreign exchange was scarce and expensive because exportable goods were limitedly available and consisted primarily of low-priced agricultural products. The economic surplus was small due to the poor agrarian economy. Government was convinced that a spontaneous market process would not provide enough capital to be invested into the heavy industry and embarked on an interventionist policy (Lin, J. Y. et al., 1996).

The development strategy was implemented through a series of Five-Year Plans. At the beginning of the First Five-Year Plan, the government created a “distorted” macro economic environment that featured artificially low interest rates, overvalued exchange rates, low nominal wage rates, and low prices for basic consumer goods and raw materials. Low interest rates and overvalued exchange rates reduced the costs both of interest payments and of importing equipment. Meanwhile, to secure enough funds for industrial expansion, a policy of low input prices - including nominal wage rates for workers and prices for raw materials, energy, and transportation - evolved alongside the adoption of this development strategy (Lin, J. Y. et al., 1996). The assumption was that the low prices would enable the enterprises to create profits large enough to repay the loans or to accumulate enough funds for investments. If the enterprises were privately owned, the state was not sure private entrepreneurs to reinvest the profits created by government policy into the projects selected by government in the Five-Year Plan. Therefore, private banking and industrial enterprises were soon after 1949 nationalised to secure state control. Meanwhile, to make the low nominal-wage policy feasible, government had to provide urban residents with inexpensive food and other necessities, including housing, medical care and clothing. The low interest rates, overvalued exchange rates, low nominal wage rates, and low prices for raw materials and living necessities constituted the basic macro policy environment.

The development strategy and the resulting policy environment and allocation system also shaped the evolution of agricultural institutions in China. To secure cheap supplies of grain and other agricultural products to the people in the cities, a compulsory procurement policy was imposed in the rural areas in 1953. This policy obliged peasants to sell fixed quantities of their production, including grain, cotton, and edible oils, to the state at prices determined by government (Perkins, 1996).

The government also viewed collectivisation as an important vehicle for realising the state's low-priced procurement program of grain and other agricultural products (Luo, H., 1985). Income distribution in the collectives was in theory based on each collective member's contribution to agricultural production. Each worker was credited with work points for the job that he or she performed each day and according to how well the tasks were performed. At the end of the year the income was distributed according to the work points accumulated in the year. However, monitoring a member's effort was extremely difficult in agricultural production due

to dimensions of time and space. In fact the remuneration system in the collectives was basically egalitarian (Lin, J. Y., 1988). The basic allocation of income was related to “need” rather than to “effort”. Grain was allocated to households according to family size and age structure. About 70% of grain was allocated according to egalitarian principles and not according to effort (Pyle, 1997).

**Table 2.1 China's Historical Growth Record (average rate of growth, %)**

	1952-1957	1957-1976	1976-1978
Normal GDP	6,76	5,91	10,98
Net material product	8,88	4,82	10,03
Agricultural net value output	3,73	1,49	0,66
Industrial net value output	19,6	8,96	15,94
Industrial gross value output	17,98	9,47	14,08
<i>Of which:</i> Light industry	12,88	8,00	12,68
Heavy industry	25,45	10,78	15,14

Source: China State Statistical Bureau (SSB) (1993).

In the pre-reform period from 1957 to 1978, the gross value of agricultural output (in real terms) grew at a rate of about 3% per year (Nolan, 1988, p.66). However, over the same period China's population continued to grow at about 2% per year, which meant that output per head of the population grew only very slowly (Pyle, 1997). Furthermore labour productivity in farming hardly changed during the twenty years from 1957. The poor performance in collectivised agriculture was attributed to the absence of the right incentives and the possibly considerable monitoring costs under a socialised agricultural system. NIE provides important insights into these issues.

## **2.2.2 The development of the centrally planned economic system in China<sup>4</sup>**

### *The establishment*

In 1953, with the help of Soviet experts, China began to implement its first Five-Year Plan (1953-57). The plan centred around 694 large projects which 156

<sup>4</sup> Information in this section is from Qian (1999), otherwise noted.

key projects were designed by the Soviets. By the end of 1956, China established the basic framework of the central planning system, which featured concentration of authority in the central government. The number of enterprises subordinated to the central government increased from 2,800 in 1953 to 9,300 in 1957, and their output accounted for 50% in state industry. The number of material items allocated by the central government increased from 227 in 1953 to 532 in 1957. The main emphasis in planning was on industrial branches (*Tiaotiao*), rather than regions (*Kuaikuai*). During the first five-year period, the central government's budget accounted for 75% and local government for 25% of the production. The role of local governments was very limited and so was the enterprise autonomy.

In the mid-1950s, Mao Zedong, being the powerful chairman of China, criticised the over-centralisation in the economy and encouraged incentives at decentralised level. He believed in people's initiatives and incentives, but not profits or material incentives. Mao's two formulas were: decentralization of government authority from central to local levels, and mobilization of people's consciousness through political campaigns and mass movements. In his 1956 speech, *"On Ten Important Relationships,"* Mao (1977) argued:

*"Our territory is so vast, our population is so large and the conditions are so complex that it is far better to have the initiatives come from both the central and the local authorities than from one source alone. We must not follow the example of the Soviet Union in concentrating everything in the hands of the central authorities, shackling the local authorities and denying them the right to independent action."*

The central authorities should give scope to initiatives of provinces and municipalities, and the latter in return should do the same for the prefectures, counties, districts and townships; lower levels be put in a strait-jacket.

In September-October 1957, the Third Plenum of the 8th Party Congress adopted important decisions for improving management in industry, commerce, and the fiscal relationships between the central and local governments respectively. Although the decisions also included expanding enterprise autonomy, the main concern was clearly about improving the central and local relationships. The decisions proposed to delegate supervision authority of all state enterprises, except large ones<sup>5</sup>, to the local governments and at the same time to expand local government authority in fiscal affairs, material allocation, planning, pricing of non-important goods, personnel management, etc.

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<sup>5</sup> The criterion of large enterprises, which is defined by the government, varies in different industries and at different periods. The 2003 version from State Statistic Bureau defines large enterprises as those that show RMB 0.3 billion in sales, RMB 0.4 billion in assets, and above 2000 number of employees. According to this criterion, China had 1,588 large enterprises in 2003.

### *The Administrative Decentralisation in 1958*

In 1958, the “Great Leap Forward” was launched in China, which called for a high growth rate aiming at overtaking Great Britain and catching up with the United States in fifteen years. In this setting, two main institutional changes took place: ownership changes in rural areas by establishing the People's Communes; and decentralisation within the planning system to alter the relationship between the central and local governments.

Mao was enthusiastic about the People's Communes because it combined “industry, agriculture, military, learning, and commerce” into one entity, which fitted well into his dream of a new world of communism. Under Mao's initiatives, within two or three months, 99% of the peasants were organized into People's Communes, with an average size of about 5.000 households.

In 1958, after only one year of the central planning system's full establishment, China began to restructure in the urban areas to achieve fast industrialization. The government proposed to divide the country into seven "cooperative regions" (*Xiezuoqu*), requiring each of them to have a complete industrial structure. The so-called "administrative decentralisation" had several major features. First, most State Owned Enterprises (SOEs) were delegated to local governments. The number of enterprises subordinated to the central government was reduced from 9.300 in 1957 to 1.200 in 1958. The share of national industrial output produced by SOEs under the central government's supervision shrunk from 40% to 14%. Second, central planning was changed from national level to regional level. Correspondingly, the number of products controlled by the Planning Commission at the central government was reduced from over 300 in 1957 to 215 in 1959, and material allocation by 75%. Third, most decisions over fixed investments were made by local governments, and for large projects, local government was only required to submit a brief planning report to the central government. Fourth, local expenditures were determined by revenue; the ratio of expenditures to revenue was supposed to be fixed for five years (but it later changed to one year). As a result, the share of central revenue decreased from 75% to about 50%.

Initially, both the communes and decentralisation were welcomed by the people. Communes became all embracing communities providing education, nurseries, dining facilities and policing as well as agricultural and industrial organisation. People shared the food and it did not really matter how much they worked. The institution of communes and their public dining halls quickly both turned out to be disasters. Together with bad weather conditions, the institution led to the biggest famine in China's history, causing about 20-30 million deaths. Between 1958 and 1962, the agricultural net output value, light industry net output value and the national income declined respectively by 5,9%, 2%, and 3,1% annually.

The economic disaster forced the government to reverse the 1958 policy. In January 1961, a new policy of "readjustment, consolidation, replenishment, and upgrading standards" was adopted. In agriculture, the government adopted more

liberal policies. The scale of production units was decreased to 40-50 households, while communes became less powerful. The farmers were allowed to cultivate small private plots, run sideline productions and to open rural free markets. In urban areas, the recentralisation of planning was initiated. Beginning in 1961 all large and medium-sized industrial enterprises were again subordinated to the central government. Between 1959 and 1965 the number of SOEs directly controlled by the central government increased from 2.400 to 10.533. By 1965 their industrial output increased to 42,2% of the national total. The number of planning indicators was restored to the 1957 level. Material allocated by the central government increased from 132 types in 1958 to 503 in 1961 and then to 579 in 1965. The number of industrial products under central government planning was about 60% in terms of output value, 70% for agricultural goods and retail. The central government also took back the approval authority of all large fixed investments.

### *The Administrative Decentralization in 1970*

In 1962 Mao was forced to review his 1958 policy, but he really did not favour recentralisation neither free markets. Mao's dislike of bureaucracy increased as the effort to recentralise continued in the first half of the 1960s. Eventually he initiated the Cultural Revolution in 1966 in order to create a "new world," a system relying on political campaigns and mass movement rather than bureaucracy and market.

In 1967 and 1968, the whole society was put into chaos. The Planning Commission at the central government did not make annual plans in 1967 and 1968. Planning at the central government level essentially stopped. This seriously damaged the economy, but not critically. In 1969, the political issues were settled and the economy recovered strongly: agricultural and industrial output increased by 23,8% over the previous year. In 1970, nine government ministries, including the State Planning Commission, the Economic Commission, the Price Commission, the Statistical Bureau, the Labour Ministry, and the Material Ministry, were merged to form a new State Planning Committee with only 619 employees, about 11,6% of the original staff before the Culture Revolution. In the same year, the second wave of administrative decentralisation began. In 1970, the government proposed dividing the country into 10 "cooperative regions" (*Xiezuoqu*), making each a relatively complete and self-sufficient industrial system. The planning system was changed along mainly "regional lines", as Mao put it: "Planning must rely on local governments, mainly on provinces" (Zhou, 1984, p.233).

The 1970 decentralisation shared many features of the 1958 decentralisation but went much further. First, most large-scale SOEs were again delegated to provincial and municipality governments. After decentralisation, the central government only supervised 142 SOEs, down from 10.533 in 1965, and the share of industrial output produced by SOEs under the central government's control dropped from about 50% in 1965 to only 8% in 1970. Second, local governments were made to be

responsible for material allocation and the types of material allocated through the central government were reduced from 579 in 1966 to 217 in 1971. Third, local governments gained more authority over fixed investment. The share of fixed investment by local governments increased to 27% in 1974 from the 14% level in 1969. During this period, 52% of investment in the steel and iron industries came from local governments (Wong, 1985). Fourth, fiscal contracting (*Dabaogan*) was introduced. Provinces contracted with the central government. Local governments handed over all their revenues to the central government and then received a fixed sum back for spending. The sum was negotiated on an annual basis. The local government could retain all savings after their spending.

But again administrative decentralisation created chaos and some recentralisation began in 1973 under the name of "consolidation" (*Zhengdun*). For example, the amount of material allocated through the central government increased to 617, back to the level of 1965. But in comparison with 1958, the extent of the 1970 decentralisation was greater and the recentralisation afterwards was much weaker. Common in both waves of decentralisation was that the administrative decentralisation focused only on the relationship between the central and local governments and not on the one between the government and enterprises. As a result, government control over enterprises remained very tight.

### **2.2.3 The governance structure**

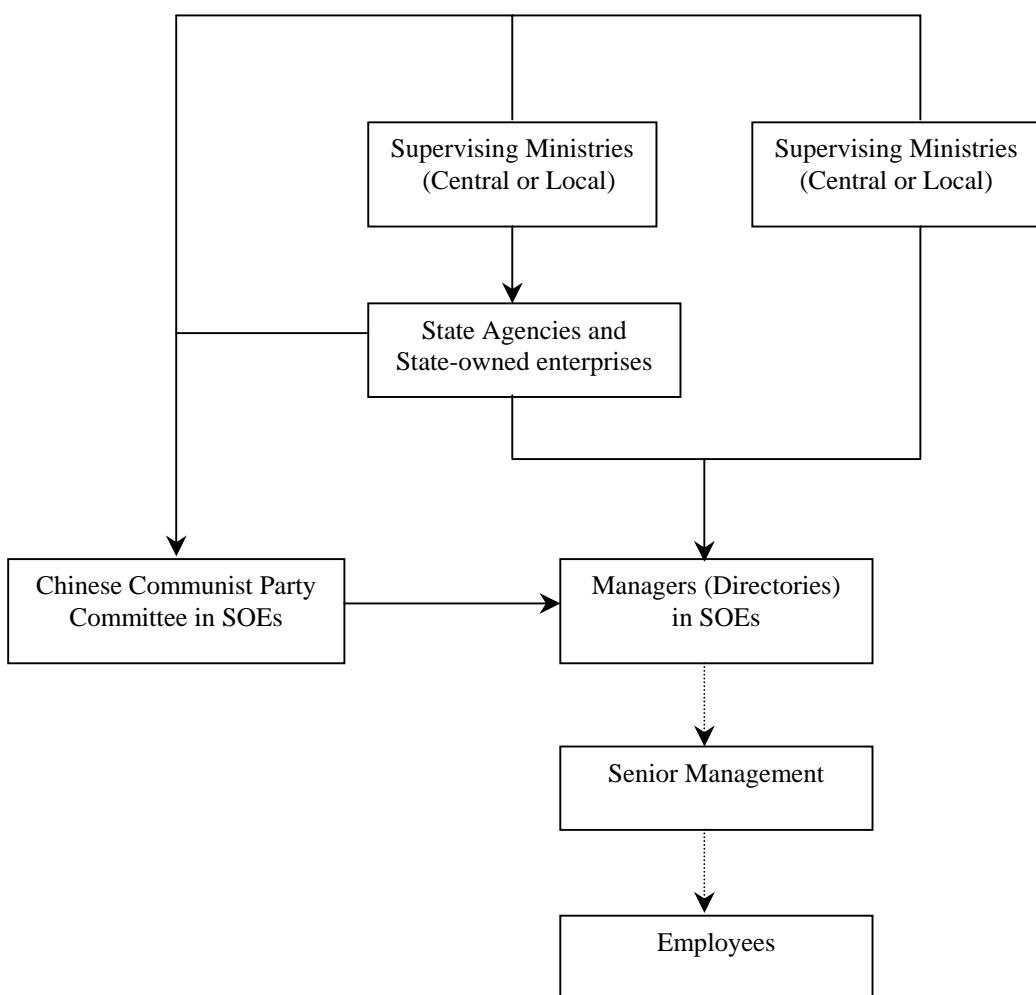
The basic production unit of the economy during the pre-reform period was the SOE, which was also named the *Danwei* at that time. In 1978 SOEs accounted for almost 80% of the value of industrial output, the rest coming from the collective sector (Chen, D., 1995, p.54). Its governance structure, that is to say who makes decisions and who is in control and accountable to whom, is shown in Figure 2.1.

The SOE was an economic producer that was attached to a central or local planning agency (Tenev and Zhang, 2002). It had little economic independence and it was usually only permitted to make certain products and services by command. SOEs received production quotas, guaranteed outlets for products, and received the necessary resources from the budget to reach production targets. The targets of each of the products were also determined by the relevant ministry, acting upon the national plan. The means of achieving these production targets, which was, the required amounts of raw materials, capital and labour were also allocated by the bureaucracy. Firms had to accept the allocated resources and targets, which gave rise to opportunistic behaviour and information distortion (Pyle, 1997).

Kornai (1992) described the socialist allocation system as "vertical bargaining". At the time when production targets and input allocations were set, it was in the interest of the SOE managers to claim that his productive capacity was smaller than it really was, in order to get a lower output target or a higher input allocation or some combination of both. Of course, the central bureaucracy was aware of this incentive facing the enterprise managers and so scarce resources would be

allocated in a bargaining process about quotas and inputs. In that situation the managers of the SOEs had a substantial information advantage. As part of the negotiating strategy the enterprise manager would have to make sure that he just achieved last year's production target and used all inputs. Under such a system managers had no incentive to be efficient with resources, for as long as they do not have to "pay" for any additional resource with an increase in output target, resources are to them, at least, a free good (Pyle, 1997).

**Figure 2.1 The Governance Structure of State-owned Enterprise (*Danwei*)**



Prices, both for outputs and inputs, were usually decided centrally, although often by a different part of the bureaucracy as that which determined quantities. The overall impression was of a command economy where economic management and control was carried out by means of a series of commands passed down to the individual enterprise. Kornai (1992) indicated that very little freedom was given to individual enterprise managers to pursue more efficient solutions to production problems and that there was very little incentive for them to respond to shortages and surpluses in the supply of particular goods or to take risk and be innovative.

The freedom of managers was further constrained by the presence of the communist party committee in SOEs (Pyle, 1997). The committee would ensure that the manager's decisions were politically correct because SOEs were also a political institution in that period. The Committee was an administrative body that exercised control on behalf of the party and state. Like the manager (directory), the chairman of the committee was appointed by the Supervising Ministry (central or local) and got his salary from the firm. The key role of the Chinese Communist Party (CCP) Committee was to monitor directories to follow directives from the Supervising Ministry. The directory should consult with CCP Committee before he made any important business decision. The committee also should motivate people's behaviour in the firm to be consisted with the policy of the government and the party. Because of no constraint from other stakeholders in the firm, the CCP Committee in some cases was at the top of the governance structure and controlled in fact the business. If there was a conflict between the chairman of CCP Committee and the manager, the Supervising Ministry had the responsibility to replace one of them.

In a planned economy, firms could not go bankrupt. Kornai (1992) introduced the concept of "the soft budget constraint" in order to explain how loss-making SOEs could continue to operate in centrally planned economies. Also in the CPE of China all means of production were owned by the state; no individual (including managers) had residual property rights. The soft budget constraint was a form of insurance in which the planner perfectly insured the manager against poor enterprise performance. This could be achieved in different ways: direct subsidy by the state was a possibility, or management was allowed to negotiate a reduction in the rate of "corporate taxation" or was given cheap credit facilities, whereas also negotiation on the prices of output was a possibility. This insurance led to moral hazard, because the manager had no incentive to use the resources in the most efficient way (Lichtenstein, 1996).

SOEs represented a classic case of the principal-agent problem. Under a system of ownership by the public (state ownership), property rights belonged to everyone and to no one in particular. "State property belongs to all and to none" (Kornai, 1992, p.75). The state took the role as representative of the people and acted as the principal (owner) on behalf of the public in delegating day-to-day operational power over enterprises to managers (agents). All residual claims (profits) or risks (losses) were socialised and simply passed on to the public at large; neither

politicians and bureaucrats, nor managers felt the incentive to be efficient at the loss of money or position. C. Lin (2000) indicated that the relationship between the bearing of residual risk and the exercise of control was separated. Systemic features of SOEs such as soft-budget constraints, the lack of independent financial accountability and the impossibility of bankruptcy, undermined the incentives and disciplinary mechanisms essential to corporate governance (Lin, C., 2000). Furthermore, the multi-tiered control structure (central, provincial, municipal) gave rise to serious problems of conflicting objectives and information asymmetries. Local authorities were highly susceptible to the problem of “capture” when they become easily an instrument of the SOEs’ (Lin, C., 2000).

On the other hand, the role played by the managers of the SOEs was not disciplined by a managerial job market and a competitive product market, or by a market for corporate control. All managers were appointed by the different layers of government and objectives were realised through negotiation with the bureaucracy. The planning bureaucracy maximised their utility function with wealth, prestige and power subject to a set of constraints, which were determined by the ideology, culture, tradition, politics and communist party objectives (Qian, 1999). How did the planning bureaucracy get the manager to meet their objectives? This principal-agent problem could not be efficiently solved by monitoring or bonding: because of the information asymmetry and bounded rationality: the costs would be extremely high. As long as the Central Planned Economy set quantitative targets for management the principal-agent problem could not be solved. Several reforms of the system maintaining the target planning were doomed to fail, also the introduction of parametric planning could not solve the basic problems (Brus, 1989).

### **2.3 Concluding Remarks: the Failure of Chinese Planned Economy**

The Chinese economy faced serious economic problems in the 1970s caused by two kinds of inefficiency: allocative inefficiency and X-inefficiency. The first type of inefficiency arose because prices were determined in an administrative way instead of the forces of supply and demand. Consumers’ preferences then had no influence on the quantities of goods and services produced by the SOEs. The main problem of the pre-reform system was its overwhelming reliance on administrative control and central planning (Tenev and Zhang, 2002). The economic administration by industrial branch (*Tiaotiao*) and region (*Kuaikuai*) produced a hierarchical and bureaucratic culture. The institutional rules defined how annual plans were constructed, how SOEs should realise the targets, how output and income were to be distributed between consumption and investment and among the different income categories, and the rewards and penalties to motivate managers (Lichtenstein, 1996).

In practice insurmountable information problems prohibited an efficient control of the managers by the bureaucrats:

*“The enormous complexity of planning precludes the possibility of developing and using measures that could grade and calibrate all of the characteristics of the products produced under the plan. This gives rise to adverse selection while planners are kept in the dark about the performance of their agents” (Lichtenstein, 1996, p.254).*

The second type of inefficiency associate with SOEs is X-inefficiency, which arose because producers had no incentive to minimise costs. Incentives that aimed at improving efficiency were very weak in SOEs. There was no threat in making a loss and no reward in making a profit. As a consequence, SOEs exhibited what Kornai (1992, p.146) called “weak price responsiveness”. As a consequence consumers had very little influence on the goods and services produced, managers had no incentive the look for more efficient production techniques and when targets were not met management had ample opportunity to reduce the quality of the products.

But after decades of economic failure the central government leaders and top bureaucrats had incentives to make the economy better, because they were virtually the partial residual claimants. The Third Plenum of the 11th Congress of the Communist Party of China, which was held in December 1978, marked the beginning of the transition to market-oriented economy. Economic development was set as the prime goal of the nation and far-reaching economic reforms started after that meeting.

