Success of SOEs Reforms; Its relation to Governance and Business Environment

The cases of Russia Federation and China

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New Economic Policy (NEP) in 1920s

- Encouraged private trade of agricultural surpluses ; launched a gold-backed parallel currency; stopped forced placement of government bonds
- Nationalization of small-scale industry reversed. Mid-sized factories in the state's control leased out to private contractors on the basis of fixed payments to the state.
- A substantially lower tax-in-kind system than the requisitioning of grains under war communism installed.
- Results: production picked up, and inflation was down [By September 1923, about 75% of retail trade was conducted privately. By 1925, both agricultural and industrial output had recovered strongly (Turley 2010, 24–28)].

An Example of Gorbachev's Tepid "Reforms"

- Gorbachev in his 1985 creation of state quality control board (*Gospriemka*)

    -announced individual enterprises were allowed to make their own business plans and make production decisions.

- However, a system of state orders (*goszakaz*) took the place of the old system. The state still controlled all raw materials and inputs necessary for the production

Yeltsin’s Political, not economic, Agenda

- Yeltsin’s administration privatization: a mean to create powerful business owners to bulwark his hold on the power (not for laying a foundation for the market economy and creating a middle-class)
- Yegor Gaidar on Yeltsin’s massive privatization: “In my opinion, the major motive at that moment was a political one, connected with providing stability and not allowing the return of the Communists to power”

Yeltsin's Political, not economic, Agenda (Continued)

- Anatoly Chubias, Deputy Prime Minister of Russia in 1990s (in charge of the sale of the state assets):

"…I need to find something, especially in view of the future election…P*rivatization at that time, and the whole of privatization until 1997, was not the economic process*. It was the process of fighting with Communists, getting each company just sell to the private owners who kill the Communists" (Chubias 2000. Italics added)

Economic Reforms in Russian Federation

- Lack of consensus on the *ultimate purpose* of the reform among the powerful groups
- Devoted their resources and energies into eliminating the rival economic programs, chaotic transition occurred without coherent policies for the first ten years of reform.
- Against the Background of Loss of Traditional Revenue

Russian Voucher Privatizations

Mode of privatizations (World Devt. Report 1996)
- Sale to outside owners
- Management-employee buyout
- Equal access voucher privatization
- Spontaneous privatization

- "Loans-for-Shares" deal: Sale of highly valuable state-owned natural resource firms at rock bottom prices in mid-1990s to a select group of businessmen (financiers of Yeltsin's election campaigns)

Source of revenues in planned economy

- In a planned economy, the state planning bureau determined the desired physical output level
- Using statistical properties of input output relationships, the Bureau
  - derived production matrixes
  - solved for the required inputs (machinery, raw materials and human labor);
  - Set prices of inputs and outputs

Source of revenues in planned economy (continued)

- output of one industry =input for the other
- the whole planning system was defined in terms of material units (ton of coal and steel).
- The role of financial system: to mirror the physical targets with budget allowances (credit), performing accounting ledger book functions.
- No role of taxes! Budget revenue came from appropriating the profits of state-owned enterprises

  (the state's revenue = ~50% of GDP up until mid-1980s).
- Only 91 tax inspectors in the Department of Main State Tax Inspectorate (MSTI) of Soviet Union Ministry of Finance.

Coping with the Loss of the state's revenue during the transition

- Failure to establish the tax system preordained the state to resort to liquidating of state assets
- Taxing by inflation : v. high and unpredictable inflation (reaching over 2,500 percent annually)
- Borrowing through short-term treasury bonds issuance with dire consequences (Defaults) for general transition process

Chinese Economic Reforms

- Agricultural origins of Chinese reforms
- Decollectivization, Household Responsibility System and Emergence of Township and Village Enterprises (TVEs)

Chinese approach to economic reform

- Deng Xiaoping reminisced in 1987 on the emergence of TVEs:

"All sorts of small enterprises bloomed in the countryside, as if a strange army suddenly appeared from nowhere…[The rise of these startup firms] was not something I had thought about. Nor had the other comrades. This surprised us"

- Chinese policy makers did not optimize their choices after having all relevant information they needed, as many economists surmise in theory.

Loss of revenue streams, but no upshoot in deficits

- The central government's revenue declined
  - from 34.4% (1978), to 12.7% (1994) of GDP
- budget deficit remained ~2% to ~2.5% of GDP from 1978 through 1994, except in the year 1979
- From 1986-1994, the PBOC's transfers to the SOEs : from 2.4% - 3.2% of GDP
- Hofmann 1998 : from 1986-1994, consolidated government debt = from 4.9% to 5.7% of GDP

(based on assumption of 80% -60% of loans was not repaid by the SOEs)

- Why was China able to keep deficit in this range?

Chinese fiscal decentralization and its benefits

- Decentralized fiscal system existed during the full planning period (1950-1978).
- State was gradually weaned off the appropriation of the profits of the state-owned enterprises
- the country's tax sharing system between the central government and provinces became a major reliable source of revenue for the state
- Conflicts always existed between the Chinese line ministries and the Chinese provinces, which had direct revenue sharing system with the central government.

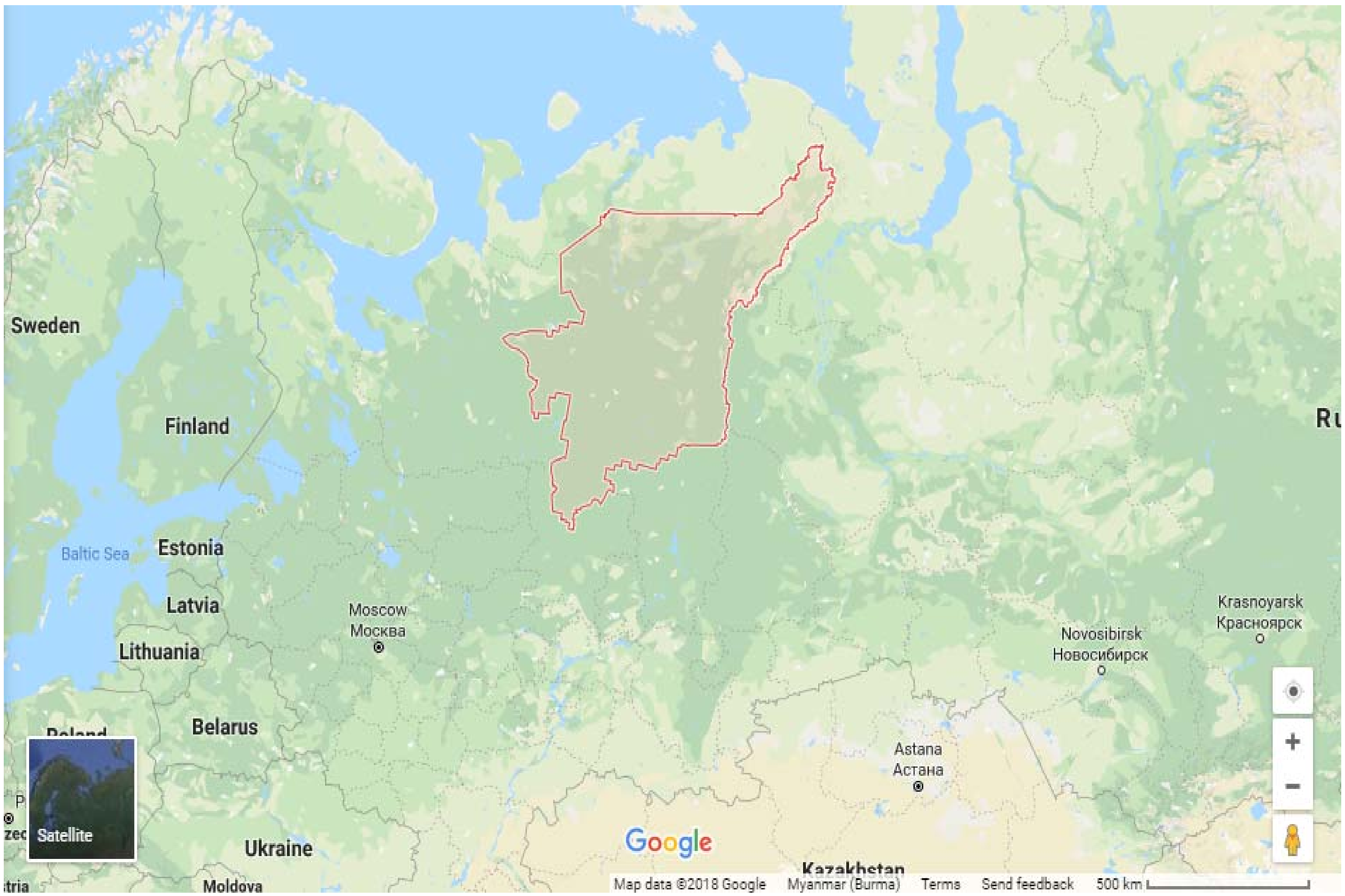
Juxtaposition: Russian vs. Chinese

- Soviet economy : run by line ministries. Soviet republics had little leeway in the centralized budgeting processes
- Conflicts always existed between the Chinese line ministries and the Chinese provinces
- Chinese Provinces had direct revenue sharing system with the central government. Many SOEs in China were under the control of local governments
- 3 cycles in Chinese centralization/decentralization : 1950-1962, 1963-1973, and 1974-1978 (Increases followed by decreases in each)
- central government's share of revenue: fixed; the provinces retained the remainder➔ provided the provinces with stronger incentives to enlarge their tax bases.

Juxtaposition: Russian vs. Chinese (continued)

- Chinese Tax system : central taxes (principally special consumption tax and resource tax), local taxes (corporate and personal income taxes), and shared taxes (VAT)
- Russian tax *collection:* Fully centralized.
- Russian republics reliance on Federal Funds: Over 2/3 of the revenues of regional governments came from the central government
- incentives for central government: To maximize intake from all regions
- the incentives for regions: to maximize distributions from the Federal Govt.

Russian Republic of Komi



Russian Governance and Business Environment

- Local governments had no great incentives to grow local businesses and to expand their tax base.
- Local officials imposed frontloaded costs on businesses by corruption ➔Destroyed wealth before any wealth was created.
- Russian local and regional governments considered their control as one time game, instead of a repeated game.

Chinese Way to SOEs Reforms

- estimated number of surplus labor: 10% to 32% of the workforce
- Banking system was to provide SOEs with credit, enabling SOEs to absorb slower-to-adjust part of the local workforce and provide social stability
- Only after
  - 1994 Labor Law was passed
  - national insurance system for unemployment and retirement was set up and became operational,

  did the mass lay-off begin in earnest in the mid-1990s.

  - 80,000 SOEs (mid-1990s)
  - 26,101 (2006, end)

Resource Leakage from SOEs to Private Firms: China

- **Trade credit**: extended by the public sector firms to the private firms (**Triangle Debt**)
- **Loan rerouting:** either by banks themselves or by SOEs (
  - SOEs with more allocated credit: more likely to provide credit to private firms
  - Transfer may be more discreet: set up joint venture with the recipient private firms
  - funds transfer observed consistently from capital-scarce inland provinces to more affluent coastal provinces
  - from the listed SOEs to the firms in the private sector (Tsingtao beer)
- **"stripping" and "tunneling" assets** of the SOEs
  - In "restructuring" spin off a subsidiary with most productive assets and workforce of the old SOE, leaving the old SOE with debt, obsolete machinery, and old workers

Juxtaposition of Russian & Chinese reforms: a crucial difference

- Russia did not offer an environment that the private business could thrive. Russia’s institutions, especially the local governance, were not conducive for the conduct of businesses.
- Leakage of resources from the state sector to the private sector was not efficiently used

Bank restructuring under perestroika

- Gosbank was named the central bank
- Five specialist banks: Sberbank (Savings), Vneshekonbank (Foreign Trade), Promstroibank (Industry and Construction), Agroprombank (Agro-industry), Zhilsotsbank (Community Services).
- Accidental emergence of 358 non-state banks in USSR
  - The Law on Cooperatives (26 May 1988) allowed the state-owned enterprises to set up their owned banks
  - "pocket banks" (SOEs) and "Zero Banks" (other entities)
- 775 new banks also created out of branches of the five SOCBs