What is Economic Reform?

Thomas Rawski
Department of Economics
University of Pittsburg

Transition and Macro Adjustment Division
Policy Research Department
World Bank
Washington, D.C.
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I. INTRODUCTION

Chinese economists often employ the term jingji xiaoyi. They use many statistical indicators to measure changes in jingji xiaoyi. The most commonly used include

A. The ratio of net to gross industrial output.

B. The ratio of profit plus tax to total capital.

C. The ratio of profit plus tax to sales.

Writers who discuss jingji xiaoyi apparently believe that favorable economic circumstances are associated with high or rising values of indicators such as A, B, and C, and that the sort of decline that we see for these indicators in Chinese industry during the 1980's reflects serious economic problems. Discussions of jingji xiaoyi seem to assume that the rise or fall of measures like A, B, and C is somehow related to the concept of efficiency used in microeconomic theory. Translators even use the word efficiency as the English-language equivalent of jingji xiaoyi.

The purpose of this essay is to show that there is no consistent relationship between jingji xiaoyi and economic efficiency. Indicators like A, B, and C may rise when efficiency falls, and vice versa.

1. The author acknowledges comments and suggestions from Fan Gang, Wang Hongchang, and Zheng Yuxin. Professor Wang kindly translated this paper into Chinese. The views expressed here are those of the author alone.


Microeconomic theory distinguishes three varieties of efficiency: allocative efficiency, technical efficiency (X-efficiency), and dynamic efficiency (the rate of innovation). In Figure 1, a movement from G to E illustrates an improvement in *allocative efficiency*; a shift from F to E represents a rise in *X-efficiency*; *dynamic efficiency* rises if the outward movement of the production frontier KGEL accelerates with no change in the underlying resource base. What is the effect of changes in efficiency on *jingji xiaoyi*?

*Allocative efficiency* and *jingji xiaoyi* often move in opposite directions. A shift from competition to monopoly will lead to a reduction in output and a rise in profit. Allocative efficiency (as well as X-efficiency) declines, but *jingji xiaoyi* rises! A shift from monopoly to competition will raise output and erode profit margins. Allocative efficiency (and X-efficiency) will rise, but *jingji xiaoyi* will fall! Many Chinese writers recognize that excessive vertical integration (proliferation of "daerquan" and "xiaoerquan" enterprises) reduces allocative efficiency. But a shift in the direction of specialization and division of labor causes the gross value of industrial output to rise faster than the net value of industrial output, so that indicators A and C may decline rapidly as allocative efficiency improves! Increases in both competition and division of labor are prominent features of China’s industrial economy during the 1980’s. Both are highly beneficial. Yet both trends push the indicators of *jingji xiaoyi* downward.

Improvements in *technical efficiency* -- movements toward a fixed production frontier like KGEL -- may arise, for example, from better incentive arrangements. Such changes seem to have occurred in China’s state-owned industries during the 1980s. Data from samples covering hundreds of state firms reveal a strong positive association between bonuses per worker and retained earnings per worker in various branches of industry (textiles, ferrous metallurgy, etc.). In this case, we expect technical efficiency and *jingji xiaoyi* to move together. But if growing competition reduces profit margins, forcing enterprises to take greater advantage of opportunities to reduce costs, as occurred in China during the 1980s, X-efficiency and *jingji xiaoyi* may diverge.

The relationship between *dynamic efficiency* (technical progress) and *jingji xiaoyi* is more complex. If a firm successfully markets a new or improved product, it enjoys a temporary monopoly, which leads to high profitability and increased levels of *jingji xiaoyi*. Once rival firms produce competing versions of the original innovation, both profit rates and *jingji xiaoyi* will decline. The evolution of China’s consumer durables industry (televisions,

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washing machines, etc.) during the 1970s and 1980s illustrates this progression. Although both phrases -- initial breakthrough and subsequent popularization of novel products -- produce large economic benefits, only the first phrase is associated with improvements in jingji xiaoyi.

What of the long-term behavior of indicators associated with jingji xiaoyi? Historical evidence from major market economies reveals no upward tendency for the ratio of net to gross output. As for profits, Karl Marx claimed that structural imperatives would depress the rate of profit in market economies. This prediction turned out to be inaccurate. The contrary expectation of rising profits implicit in recent writings about jingji xiaoyi seems no more promising.

The mistaken belief that high or rising indicators of jingji xiaoyi reflect economically sound growth patterns can have unfortunate consequences. Shao Ning and Han Wenxiu, for example, suggest reducing the interest rates paid on savings deposits and "reducing interest rates on bank loans as much as possible," policies that would encourage both inflation and unemployment, simply because these measures might generate improvements in some indicators of jingji xiaoyi. 10

If jingji xiaoyi has no systematic connection with economic efficiency, what does it represent? Changes in indicators like A, B, and C appear to be closely and positively correlated with changes in government’s share of national income. 11 A rise in the ratio of net output (which includes turnover taxes as well as profits -- the main sources of China’s tax revenues) to gross output, or in the ratio of profit and tax to capital or sales, will surely increase the ratio of government revenue to total output. If indicators like A, B, and C decline, government’s share of national product will fall.

Welfare economics distinguishes between "private" benefits or costs, which reflect the financial interest of individual agents in the economy, and "social" benefits or costs, which reflect the broader interests of society as a whole. Divergence between private and social costs or benefits may invalidate the "invisible hand" theorem linking individual pursuit of self-interest with progress toward a social optimum.

Measures of jingji xiaoyi provide a sort of index of what might be called "private" benefits to the state in its role as the largest owner of capital in China’s economy. From this perspective, preference for high or rising levels of jingji xiaoyi seems equivalent to recommending the transfer of resources from enterprises or households to the government. Although there are circumstances in which such transfers are desirable, many economists


11. Liu Shibai states that "the decline of jingji xiaoyi...affects the state’s fiscal revenue" ["Jingji xiaoyi texu xiajiang zhi yuanjin tansuo," Jingji yanjiu 11 (1991): 40]; Ma and Sun identify "guoying qiye xiaoyi" as "the mainspring of fiscal revenue" [Zhongguojingji xingshi yu zhanwang, p. 148].
anticipate that the net effect of such transfers is typically negative, especially when, as in China, government's initial share of overall resources is rather large.

Economists in China (and elsewhere) often assume that government serves the national (or social) interest. Nobel laureate James Buchanan argues that economic models should portray public officials, like consumers, workers, and entrepreneurs, as "economically rational" -- i.e. we should expect government employees and departments to pursue their own objectives even when these goals conflict with the public interest. Several United States examples can illustrate the problems associated with resource transfers to the state.

Most governments do a poor job of cost control. The U.S. federal government spends several dollars merely to issue a single check! Some departments are so disorganized that they cannot tell how many local offices they operate!

Inflexibility is a hallmark of government programs. In the U.S., the number of farmers has declined enormously over the past half-century, but the number of employees of the federal Department of Agriculture has risen.

Government agencies often become virtual captives of special interest groups. The Department of Agriculture recently threatened legal action against growers who proposed to sell undersized fruit to retailers in low-income communities. The fruit was eventually destroyed in accordance with regulations designed to benefit large growers.

Inconsistency among government programs is commonplace. While some departments of the United States government seek to control inflation, others act with equal energy to inflate domestic prices, for example, by restricting imports of textiles and other low cost products from China.

China's government is beset with similar problems. Although economic reform has transferred an enormous variety of tasks from the government to China's enterprises and farms, employment in government has not declined. Public officials are avid consumers of imported automobiles, foreign travel, and other luxuries that absorb state funds but convey little social benefit. In China, as in America, public policy is often at war with itself: China's government is anxious to reduce unemployment, but pursues a variety of policies -- maintaining an artificially high wage-rental ratio, discriminating against private business, restricting the growth of service industries, etc. -- that have limited the growth of urban labor demand for several decades.¹²

As China’s capital markets expand, we may anticipate that provincial and local governments, now faced with intense competition from other localities to attract investment from both foreign and domestic enterprises, experience far more pressure than the center to use funds wisely. Slow growth of government spending, especially at the center, restricts the availability of subsidies and increases pressure for improved performance at the enterprise level.

In conclusion, the argument advanced here is that the concept of *jingji xiaoyi* has no foundation either in microeconomic theory or in the historical experience of market economies. The indicators associated with *jingji xiaoyi* have no normative significance. A rise in *jingji xiaoyi* need not indicate improved economic efficiency. The examples of monopoly, competition, popularization of new products, and specialization all show that economic efficiency and *jingji xiaoyi* often move in opposite directions. *Jingji xiaoyi* seems more closely related to government’s share in total output than to economic efficiency. There is considerable reason to doubt the social benefit of raising government’s share of national product; a stable or declining ratio of public revenue to total output may sharpen incentives to improve managerial effectiveness in government and business alike.

China’s economic statisticians face the demanding task of restructuring the formerly plan-oriented statistical system to reflect new realities. Much has been accomplished, but much remains to be done. One item of unfinished business is the removal of *jingji xiaoyi*, as measured by such indicators as A, B, and C, from the vocabulary of the Chinese economics community.
What is Jingji Xiaoyi?

**CHINESE TERMINOLOGY IN THE TEXT**

**jingji xiaoyi** - Economic efficiency

**daerquan** - Large and having everything

**xiaoerquan** - small and having everything

**jingji xiaoyi**

经济 效 益

**daerquan**

大 而 全

**xiaoerquan**

小 而 全

Shao Ning

邵 宁

Han Wenxiu

韩 文 秀

"reducing interest rates..."

尽量降低贷款利率

**zonghe jingji xiaoyi**

综合 经 济 效 益
NOTES

1. The author acknowledges comments and suggestions from Fan Gang, Wang Hongchang, and Zheng Yuxin. Professor Wang kindly translated this paper into Chinese. The views expressed here are those of the author alone.


8 What is Jingji Xiaoyi?


5. For instance, Zhang Xinchuan and Xue Chuanzhao, "Gangtie gongye de jingji xiaoyi," in Ma

张信传 薛春剑 钢铁工业的经济效益
Hong, Zhou Shulian and Wang Haibo eds., vol. 1, p. 154; Ma and Sun, 1991-1992

Zhongguo jingji, pp. 42, 50, 148.


Zhongguo gongyejingji tongji nianjian 中国工业经济统计年鉴
Zhongguo gongye jingji yanjiu 中国工业经济研究

7. "If enterprises depend on price reductions to attract customers... this directly affects jingji

只依靠降价来招揽顾客……直接影响了企业的经济效益
xiaoyi" [Guo Yuping, "Guanyu gaohuo dazhong qiye de wenjundiaocha baogao,"

郭玉平 关于搞活大中型企业的问卷调查报告
Zhongguo gongye jingji yanjiu 6 (1991): 72].

8. For example, Ma and Sun, 1991-1992 Zhongguo jingji, p. 88.


The Political Economy of Privatization and Public Enterprise in Post-Communist and


11. Liu Shibai states that "the decline of jingji xiaoyi... affects the state’s fiscal revenue" ["Jingji

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