

OVERINVESTMENT IN THE CHINESE ECONOMIC SYSTEM⁺

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I

Recently, the Chinese government has released information revealing an over-emphasis on national economic accumulation. There had been a tremendous increase in investment in basic construction as against a low ratio of new completed fixed assets¹. Heavy industry received an overwhelming portion of investment funds at the expense of light industry and the agricultural sector. The economy thus experienced a very high marginal capital-output ratio. As a result, investment in basic construction was in a state resembling an overextended battle line, and suffered from disorder and waste.

This paper, aimed at evaluating the causes and consequences of Chinese basic construction, uses a microeconomic theory to interpret the phenomena mentioned. Section II portrays a general picture of the Chinese investment in basic construction. In Section III a microeconomic model is presented, depicting the demand for investment funds in China. To test the model, some verifications from the historical development of the Chinese investment in basic construction are made in Section IV, which is followed by a conclusion in Section V.

II

The People's Republic of China dedicated great efforts to the reconstruction of the economy right after its establishment in 1949. Of total state expenditure, basic construction had a share as high as 37 % during the First Five-year Plan (see Table 1).

⁺) A research grant from The Chinese University of Hong Kong is greatly appreciated.

Table 1: Accumulation, Investment in Basic Construction and New Fixed Assets in China 1950-1979; Chinese Sources 8

	Restoration (1950-52)	First 5- Year Plan (1953-57)	Second 5- Year Plan (1958-62)	Readjust- ment (1963-65)	Third 5- Year Plan (1966-70)	Fourth 5- Year Plan (1971-75)	Fifth 5- Year Plan (1976-79)	Average
<u>Basic construction</u> Public expenditure	%	37.0a	46.2a	30.2a	38.7a	40.2a	40.7a+	39.2
<u>Accumulation</u> National income	%	NA	24.2b	22.7b	26.3b	33.0b	33.4c	28.6
<u>New fixed assets</u> Investment in basic construction	%	78.8d	83.7d	71.4d	87.1d	61.0f	79.0 ^g ++	68.0 ^j
<u>Non productive investment</u> Investment in basic construction	%	NA	28.3h	13.2h	17.0h	10.6h	13.4h	17.8i++
<u>△ Accumulation</u> △ National income		NA	1.68 ^j	73.7 ^j	0.92 ^j	2.32 ^j	3.76 ^j	3.20 ^j \$\$

Source: a. Sun (1980), p. 10; b. Sun (1980), p. 10, and Lin, Zhou and Tan (1980), p. 28; c. Sun (1980), p. 10 and Yao (1980. 8. 31); d. Renmin Ribao (1979. 3. 24); e. Renmin Ribao (1979. 3. 24), Shen, Ke and Gong (1980) and the author's estimate; f. Shen, Ke and Gong (1980); g. Yao (1980. 9. 2); h. Wu (1980), p. 13; i. Renmin Ribao (1979. 6. 28 and 1980. 5. 1); j. Lin, Zhou and Tan (1980), p. 27.

Note: + 1978; ++ 1978-79; \$ 1953-78; \$\$ 1976-78.

NA: Not available

During the period of the Great Leap Forward this ratio was pushed up to 46.2 %. It then fell to 30.2 % in the Readjustment period (1963-65). Following the Cultural Revolution, the ratio resumed an upward trend, i.e. 38.7 % and 40.2 % in the periods of the Third and Fourth Five-year Plans. After the downfall of the Gang of Four, the ratio was still 40.7 % in 1978.

Due to the high level of state investment, plus other investments from the private sector (before 1957) and the collective enterprises, the ratio of capital accumulation to national income followed suit. The average accumulation ratio was as high as 24.2 % in the period of the First Five-year Plan. It then jumped to an average ratio of 30.8 % during the period of the Great Leap Forward and stood at 43.8 % in 1959 and 39.3 % in 1960. The ratio was curbed to 22.7 % during the Readjustment period. However, it was again on the upward trend from the start of the Third Five-year Plan on and reached its peak of 36.6 % in 1978, which was called another leap forward².

Meanwhile, the ratio of new fixed assets completed from investment in basic construction - with the exception of 83.7 % in the time of the First Five-year Plan and 87.1 % in the Readjustment period - did not exceed 80 %. It fell to a mere 60 % in the period of the Gang of Four. In other words, 30 % to 40 % of investment funds were outside the scope of production activity. As a result, capital productivity declined drastically. The marginal capital-output ratio was as low as 1.68 during the First Five-year Plan period. It went up to the astronomical figure of 73.7 in the Second Five-year Plan. Since the Readjustment period the marginal capital-output ratio regained an upward movement (see Table 1). Capital productivity in the 1970s was just over half of that in the period of the First Five-year Plan³.

The Chinese state investment in basic construction was biased towards heavy industry. As shown in Table 2, some 46.5 % of the state budget was spent on heavy industry, around 56 % in the periods of the Second, Third and Fourth Five-year Plans. Even in 1978, when overinvestment in heavy industry was under serious attack by economists and officialdom, the ratio was still as high as 54.7 %, in contrast to 5.4 % for the light industry, and 10.7 % for the agricultural sector.

On the other hand, the share of nonproductive investment fell from 28.3 % in the period of the First Five-year Plan down to between 18 % and 11 % in the period 1963-1979 (see Table 1). Noticeably, when economic policy was dominated by ultra leftists, the ratio was at a trough, 13.2 % in the Second Five-year Plan, 10.6 % and 13.4 % in the periods of the Third and Fourth Five-year Plans.

Chinese sources indicate that there were at least six financial channels for basic construction in the past. The number increased to eight at present⁴, namely (1) direct appropriations for basic construction from the state budget; (2) investment appropriations allocated from other areas in the state budget,

Table 2: Investment in Heavy and Light Industries and in the Agricultural Sector in China, 1952-79

	First 5- Year Plan	Second 5- Year Plan	Readjust- ment	Third 5- Year Plan	Fourth 5- Year Plan	Fifth 5- Year Plan	1978	1979
Distribution of investment in %								
Heavy industry	72.4 ^a			76 ^c			76.3 ^h	73.0 ^h
Light industry	13.0 ^a			>24c<			7.7 ^h	8.7 ^h
Agricultural sector	14.6 ^a						16.0 ^h	18.3 ^h
Share of investment out of state budget in %								
Heavy industry	46.5 ^b	56.1 ^d	49.8 ^d	57.4 ^d	54.8 ^d	50.0 ^e 8.3 ^f	54.7 ^g	
Light industry	5.9 ^b	5.2 ^d	3.9 ^d	4.0 ^d	5.4 ^d	6.0 ^e i	5.4 ^g	
Agricultural sector	7.8 ^b	12.3 ^{d+}	18.8 ^d	11.8 ^d	11.3 ^g	NA	10.7 ^g	

Source: a. State Statistical Bureau (1960), pp. 57, 61; b. Liu and Zhou (1979), p. 12; c. Wu (1980), p. 13; d. Meng and Song (1981), p. 35; e. the author's estimate; f. Renmin Ribao (1979.10.20); g. Renmin Ribao (1979.6.22); h. State Statistical Bureau, Beijing.

Note: + Average of 1958-60

NA: Not available

such as subsidies to five small industrial enterprises⁵, simple commercial building and various facility allowances etc.; (3) self-financed basic construction by local budget; (4) enterprise depreciation, replacement and technical renovation funds⁶; (5) foreign capital; (6) bank loans; (7) joint venture enterprises; and (8) communes and production team enterprises. There is no efficient way to bring all these channels under state control. As a result, the tendency to overinvest in basic construction was not effectively checked in the period under review.

III

Consider now the total retained yield of a production unit from an investment as

$$R = sr X \quad (1)$$

where R : total retained yield of a production unit
 X : investment funds
 r : anticipated return per dollar invested
 s : ratio of yield retained in a production unit

The expected value of (1) is

$$\begin{aligned} E(R) &= E(sr X) \\ &= E(sr) X = \dot{s} \dot{r} X \end{aligned} \quad (2)$$

On the other hand, the variance of retained yield can be defined as

$$\begin{aligned} V(R) &= E[sr X - E(sr X)]^2 \\ &= E[sr - E(sr)]^2 X^2 \\ &= \sigma^2 X^2 \end{aligned} \quad (3)$$

where σ^2 : variance of sr , stands for the risk in the investment.

We hypothesize that a production unit, *ceteris paribus*, prefers to have more retained yield and to take less risk. Thus the preference function of a production unit can be specified⁷

$$U = E(R) - V(R) \quad (4)$$

Maximization of the preference function after substituting (2) and (3) into (4) gives us

$$\begin{aligned} \frac{dU}{dX} &= \frac{d}{dX} [\dot{s} \dot{r} X - \sigma^2 X^2] = \dot{s} \dot{r} - 2\sigma^2 X = 0 \\ \text{i.e. } X &= \frac{\dot{s} \dot{r}}{2\sigma^2} \end{aligned} \quad (5)$$

Equation (5) expresses the fundamental law of the acquisition of investment funds for a production unit. The investment funds (X) sought are positively related to \dot{s} and \dot{r} , and are negatively related to σ^2 . Thus, there are at least three cases relevant to Chinese basic construction:

- (i) under the condition of a fixed risk (σ^2), the larger the values of \dot{s} and \dot{r} , the more investment funds a production unit will seek;
- (ii) given the fixed amounts of \dot{s} and \dot{r} , the smaller the σ^2 , the more investment funds a production unit will seek;
- (iii) under the normal condition, risk (σ^2) is positively related to the anticipated return (\dot{r}). In addition, \dot{s} and \dot{r} are changeable according to the production scale and market demand. Therefore, the best decision of a production unit is not necessarily to acquire the largest amount of investment funds.

For the purpose of illustration, two diagrams are graphed in Figures 1 and 2.

In Figure 1, we assume that there are three different size of investment projects, $A > B > C$. To fit the Chinese case, we assume that the larger the project, the less the risk an enterprise will bear (See Quadrant I). For simplicity we assume that there is a long-run earnings schedule for the various projects oq , while project B is the most profitable (Quadrant II). It is further assumed that the ratio of retained yield ($\dot{s}\dot{r}$) per dollar investment is fixed at a certain level, ee , regardless of the condition of operation (Quadrant III). We start off with some prespecified points a, b, c for the three projects A, B, C in Quadrant I (the dotted lines oc, ob, oa are supposed to be nonexistent). There is no difficulty to obtain three intersections a''', b''', c''' in Quadrant IV. It is found that three preference functions U_A, U_B, U_C pass through these three points. We then conclude that the largest project A will be picked out because of $U_A > U_B > U_C$.

In Figure 2, we change one of the assumptions mentioned above. The ratio of retained yield is positively related to the degree of earnings of a production unit so that the earning-retained yield schedule appears as of . Following the same procedure as for Figure 1, it is easily to derive that project B will be selected because of $U_B > U_A > U_C$.

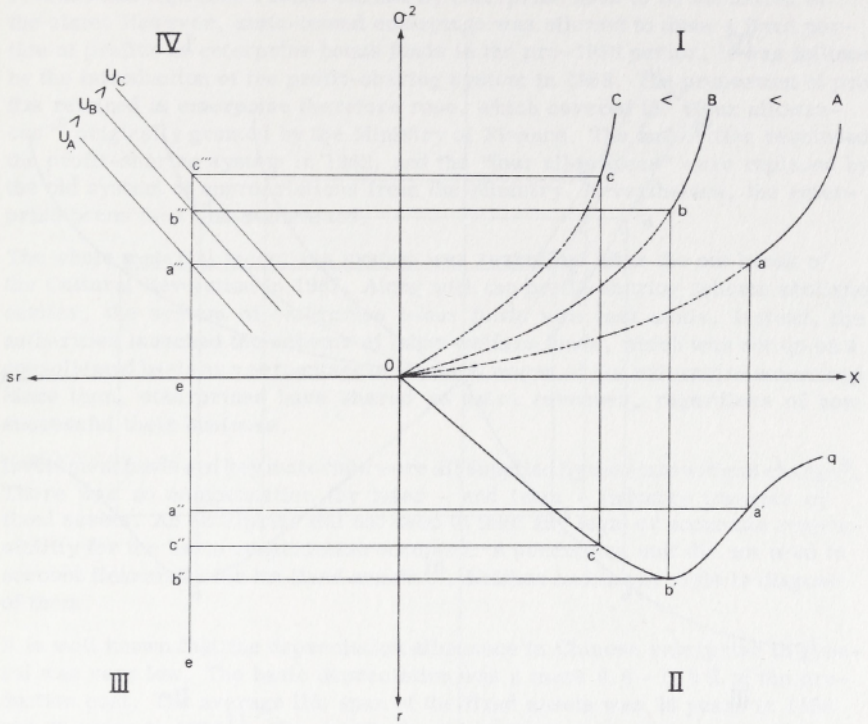


Figure 1: Fixed Yield and Investment Fund Sought

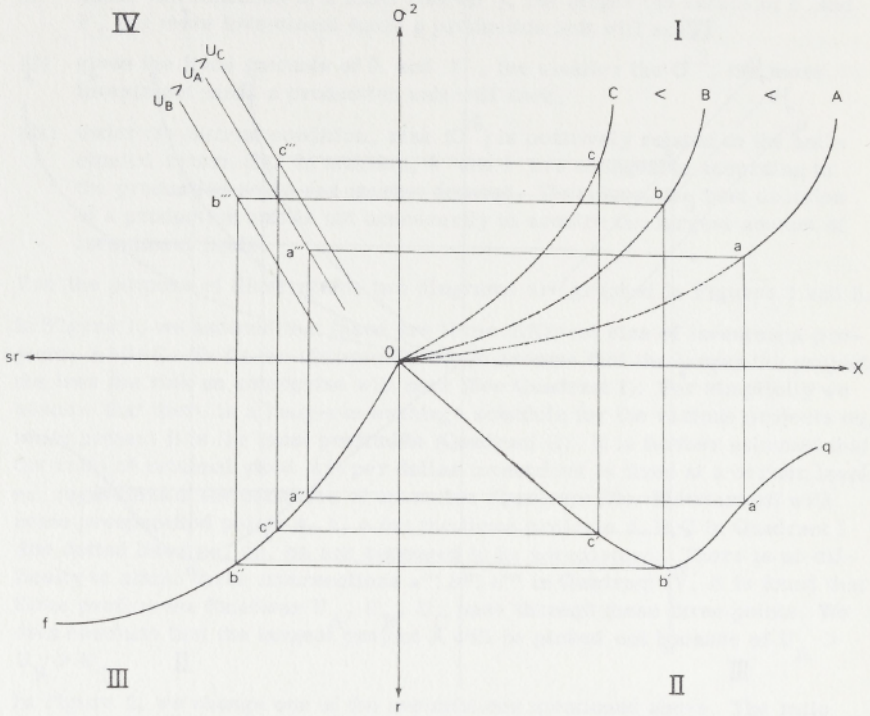


Figure 2: Variable Yield and Investment Fund Sought

IV

China adopted the basic construction system mainly from the Soviet Union in the early 1950s. The essence of the system consists of state monopoly for revenue and expense. Profits earned by enterprise have to be submitted to the state. However, state-owned enterprise was allowed to draw a fixed portion of profits as enterprise bonus funds in the pre-1958 period. It was followed by the introduction of the profit-sharing system in 1958. The proportion of profits retained in enterprise therefore rose, which covered the "four allowances"⁸ originally granted by the Ministry of Finance. The authorities rescinded the profit-sharing system in 1962, and the "four allowances" were replaced by the old system of appropriations from the Ministry. Nevertheless, the enterprise bonus fund was maintained.

The whole material incentives system was reshuffled after the out break of the Cultural Revolution in 1967. Along with the profit-sharing scheme abolished earlier, the system of enterprise bonus funds was cast aside. Instead, the authorities launched the scheme of labor welfare funds, which was set up on a consolidated basis as a percentage of the total wages of the enterprise concerned. Since then, enterprises have shared no extra revenues, regardless of how successful their business.

Investment funds and key materials were all supplied by the state without charge⁹. There was no compensation for inter - and intra - industry transfer of fixed assets. An enterprise did not need to take any legal or economic responsibility for the basic construction occupied. A production unit did not need to account financially for its fixed assets¹⁰. Neither had it any right to dispose of them.

It is well known that the depreciation allowance in Chinese enterprise in general was very low. The basic depreciation was a mere 0.8 - 0.9 % of the production cost. The average life span of the fixed assets was 26 years in 1958 and 27 years in 1979¹¹. The details for the various sectors were: 25.3 years for the smelting industry; 26.5 years for machinery manufacture; 28.2 years for electrical engineering manufacture; 32.5 years for the electrical industry; 20.5 years for the coal industry; 27.2 years for light industry; 30.5 years for the textile industry and 31.4 years for the food industry¹².

In the period up to 1966, the depreciation funds in state enterprises had to be remitted to the state. The state then handed them back to the enterprise under a comprehensive scheme. The replacement and rebuilding allowances were all supplied from the state budget. In the period 1967-77, the basic depreciation allowance was retained by the enterprise concerned and its supervision department. This often caused the enterprise to divert the allowance to basic construction¹³. In 1978 the authorities divided the depreciation allowance into two equal parts, one part retained in the enterprise and another accompanying the enterprise profits remitted to the state.

The administration of basic construction has several branches¹⁴. The highest administration bodies are the State Planning Commission and State Construction Commission at central level. The former is responsible for planning, the latter for execution. The ladders go vertically from the central down to provincial, municipal and autonomous regional levels. There is no formal interconnection between these two commissions and between their subordinate units on the same level. As far as the execution of plans went, there was hardly any horizontal coordination among the production units at local level.

There was no interest cost for the storage of unused materials. The unused and unsaleable equipment and materials were not counted as inventory costs for the enterprise concerned, but were, in effect, an implicit cost to the state.

Under these circumstances, the best policy for the production units to adopt was to make every effort to apply for more funds and more materials for basic construction because they were conducive to more room for further expansion and there was less risk of having insufficient funds.

Some statistics for the construction budget are presented below:¹⁵

	1954	1955	1956	1957
Percent of excess value of the budget proposed	14.4	1.9 ~ 6.1	5.3 ~ 6.5	5.5

The waste in the basic construction sector was inevitable and widespread. In 1955, the authorities asked the production units to cut down the investment in basic construction and total allowances by about 15 %¹⁶. In 1957, it was decreed that investment costs in basic construction be reduced by 7-10 % at the central level and 3-5 % at local level¹⁷. The funds saved could be disposed of by the production units. We are informed that nationwide the unused equipment was equal to about one-third of total annual investment in basic construction¹⁸.

An investigation on 45 items of civil engineering completed in 1978 by the Construction Bank indicates that of the total increase in construction costs, some 44 % was unreasonable¹⁹.

The basic construction system went through a fundamental reform in 1979. Shanghai, Jilin and Henan provinces experimented with loans bearing interest rates from the Construction Bank instead of the former direct appropriations without charge. It was extended to 1,500 production units in 1980. Bank loans were offered to light industry, as well as the textile, electricity, coal, petroleum, transport, construction engineering, machinery, building materials industry, commerce, foreign trade, culture and pharmaceutical industries. It was decided by the State Council that the loans would be extended to other

industries with an independent accounting system and capable of making repayment. The annual interest rates were stipulated as 3 % for a general loan; 2,4 % for coal mining, the lumber trade and post and telecommunications, and 3.6 % for machinery, light industry, textile and petroleum processing industries and petro-chemical engineering²⁰.

In addition to the restoration of enterprise funds in 1978, the profit-sharing scheme was relaunched on an experimental basis in 1979. Although the exact sharing rate has never been explicitly stipulated for the enterprises, it fell normally within a range of 15 % ~ 10 % of net profit. In addition, following the enlargement of state enterprise autonomy, there has been an experiment with 8 state enterprises in Guangdong and 11 state enterprises in Beijing. These state enterprises have been allowed to take sole responsibility for their profits and losses. The authorities impose a user tax on the fixed assets and working capital held²¹.

In Shandong Qinghe, a chemical engineering factory planned to spend 4 million investment funds on the construction of a plant with a capacity of 6 million boxes of tape. After taking into account carefully the interest rates, profit shares, and demand market, the factory decided to reduce the production capacity to 1.5 million boxes and made a bank loan of merely 2.7 million yuan²².

In Shanghai, a non-ferrous metal rolling factory was allowed to spend 6.85 million yuan on building a workshop in which rolling mills were installed with a capacity three times higher than the actual needs. After the loan scheme was introduced, the factory changed the plan originally scheduled and asked for a loan of 3 million yuan only²³.

V

In this paper it has been demonstrated that a risk-yield retained model can illustrate why the Chinese investment in basic construction caused the "over-extended battle line" syndrome, disorder and waste, particularly in the period 1967-1978. As argued in the text, the main reasons are that, apart from the fact that the larger the investment funds a production unit could obtain, the less risk it would bear, an enterprise was not able to share the extra profits resulting from cost reduction, technology improvement, good management, and better work efforts.

Since 1979, China has reformed the investment funds system from direct state supply to indirect bank loans bearing interest rates, from free charge on the occupation of fixed assets to an imposition of user tax on the assets, and from the profit-surrendered scheme to a profit-sharing measure. These reforms were adopted on an experimental basis in a certain category of enterprise and

are to be extended to other industries. Under these circumstances, an enterprise which has more investment funds will naturally bear more risk. The production unit has to take into consideration the profitability of business in connection with market demand and investment costs before the funds are granted. Thus, weighing up the risk and the yield retained, an enterprise can seek the best allocation of the resources available, according to economic criteria instead of administrative regulations.

Notes:

- 1) For the meaning of the Chinese basic construction (or capital construction) it can be best illustrated as below:

Accumulation	{	basic construction
		increase in working capital in kind

By and large, the Chinese accumulation concept resembles the Western concept of net domestic investment. And the Chinese basic construction refers to construction, expansion, reconstruction and restoration of projects throughout all sectors of the national economy, as well as purchases and installations of machinery, equipment, vehicles, ships and planes, etc. Generally, the Chinese basic construction resembles the Western concept of fixed investment.

- 2) See Xue (1980).
 3) See Li and Shen (1980), and Shen, Ke and Gong (1980).
 4) See also Special Commentator (1980); Xu, Chen and Tao (1980), and Wang (1978).
 5) These five small enterprises include iron and steel, coal, chemical fertilizer, cement, and machinery.
 6) Because there is no penalty concerning the switching of funds originally designated elsewhere, some part of the replacement and technical renovation funds was diverted to basic construction. Wen (1980) gives some information about such a switch during each Five-year Plan:

<u>1st</u>	<u>3rd</u>	<u>4th</u>	<u>5th</u>
4.2 %	27.7 %	31.7 %	>40 %

See also Liang and Tian (1980).

- 7) Given the fact that the exact preference function for a production unit is unknown, a linear function is adopted for first approximation. For a similar treatment see also Sharpe (1963), pp. 277-279.
 8) Four allowances include expenses for technical renovation, trial manufac-

ture of new products, facilities of labor security, and for miscellaneous purchases of fixed assets. See also Du, Hu and Zhao (1980), p. 17; and Ecklund (1966), pp. 80-82.

- 9) Some minor changes in the basic construction system were implemented in the 50s. For example, in 1957 the authorities changed the policy of free charge on fixed working capital from the Ministry of Finance to a system in which 70 % was supplied by the Ministry without charge and 30 % came from bank loans bearing interest rates. The ratios were changed to 80 %: 20 % in 1961. In 1958, the authorities introduced a system of shared responsibility and gain. An enterprise could dispose of the funds saved from basic construction if it was able to fulfil the management criteria and caused no deterioration in the quality of the engineering works. See also Collected Laws and Regulation ... July-December 1957, p. 346, July 1960-December 1961, p. 73, and July-December 1958, pp. 123-124.
- 10) See also Zhou, Tan and Lin (1979), p. 14 and Liang and Tian (1979), p. 16.
- 11) See Xu (1958), p. 66 and Liang and Tian (1979), p. 18.
- 12) See Xu (1958), p. 66.
- 13) See Liang and Tian (1980).
- 14) See Ji (1980), pp. 22-23.
- 15) See Chen (1957), p. 12 and Ma (1958), p. 17.
- 16) See Collected Laws and Regulations ... July-December 1955, pp. 387-388.
- 17) See Collected Laws and Regulations ... July-December 1957, p. 329.
- 18) See Liang and Tian (1979), p. 17.
- 19) See Lin, Zhou and Tan (1980), p. 26.
- 20) See Renmin Ribao (1980. 11. 27).
- 21) See Renmin Ribao (1980. 10. 20; 1980. 10. 28).
- 22) See Jian Zhong (1980).
- 23) Liao (1980), pp. 23, 206-207.

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Judgment on Euro-summit a matter for the future

Summit meetings of EEC heads of government are held so often that they cannot regularly achieve visible results. Exceptions prove the rule.

One was in 1978, when at three summits Helmut Schmidt and Valéry Giscard d'Estaing gradually put together the European Monetary System.

The December 1982 Copenhagen session of the European Council, as the EEC summit is known, may prove to have been a further exception.

There seems to have been progress on several issues yet, surprisingly, neither the 10 EEC leaders nor the European Commission's Gaston Thorn felt white-

ness of any kind among German taxpayers.

The immediate result would be an increase in EEC agricultural spending, with Bonn footing much of the bill.

If President Mitterrand of France were to abide by his part of the deal, however, swifter progress could be made on EEC membership negotiations with Spain and Portugal.

The second deadline provides for EEC loans totalling an unprecedented DM7bn to be floated by the end of March.

The Chancellor did want...



ret Thatcher with
in Copenhagen.
(Photo: APG)

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gaining of
from neglecte
But even if
would be us