Briefing
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State-owned enterprise (SOE) reforms in China: A decisive role for the market at last?

SUMMARY

SOEs continue to play a key role in China's political economy, although after more than three decades of experimental and gradual reforms, aimed at preserving rather than eliminating them, their economic significance in terms of output, profit and employment has diminished with the expansion of the private sector.

Since the Chinese government uses SOEs as a tool to pursue social, industrial and foreign policy objectives, they benefit from direct and indirect subsidies for factor costs (notably capital, energy and land) and regulatory preference, not least under competition law, in public procurement and as a result of a highly restrictive (foreign direct) investment regime. This has allowed them to maintain their position as administrative monopolies in a broad range of sectors. Despite their privileges, however, SOEs tend to lag behind the private sector in terms of efficiency and profitability and suffer heavily from over-capacity and debt.

SOE reform is an important part of China's transition to a market-driven economy. However, despite the Chinese leadership's pledge at the Third Plenum of the Chinese Communist Party (CCP) in 2013 to let the market play a 'decisive role' in resource allocation, the current reform design suggests that SOEs are likely to retain many of their privileges, hindering private domestic and foreign firms in their attempts to compete with SOEs on a more equal footing in and outside China in the future.

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China's gradualist approach to SOE reform

The strong position of SOEs in China's economy – today less in terms of their number than of their assets, political influence and vested interests – is a legacy of the Soviet-style planned economy established under Mao Zedong's rule in the 1950s. As private ownership was abolished, monolithic SOEs operating under the control of central or local government dominated the industrial sector. In 1978, when China embarked on economic reform and opening up, SOEs generated almost 80% of industrial output, and provided the bulk of industrial lifetime employment ('iron rice bowl'). Production targets, inputs and prices were planned by ministries, with SOEs reduced to work units deprived of any decision-making powers or incentives.

Of the three main ways to drive SOE reform – ownership change, exposure to competition and managerial and institutional reform – the Chinese government privileged the latter two until the 1990s, allowing for a gradualist reform path guaranteeing social stability. Western-style full privatisation as a shock therapy was considered the least viable option on ideological grounds, and owing to the absence of a state-run social security system to take care of mass dismissals.

Key elements of past reform rounds

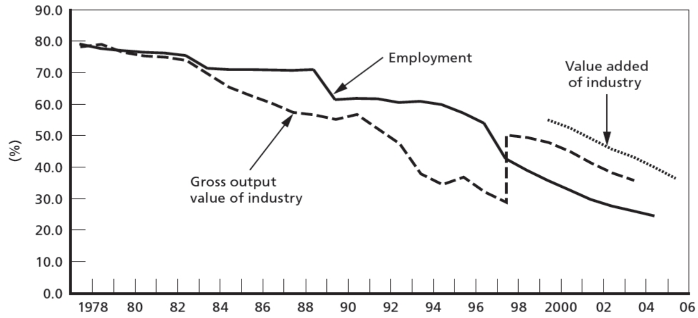
Figure 1 – Timeline of SOE reforms

Data source: Author's own compilation.

In the 1980s, SOE reform concentrated on exposing SOEs to competition, mainly from township and village enterprises (TVEs), and on introducing incentive schemes for SOE workers and management to increase productivity and efficiency. SOEs won more operational autonomy to sell output beyond the mandatory plan quotas to the market at higher prices than those set by the state, and to retain profits. This dual-track system (plan and market) was a unique feature of China's gradual transition from central planning to a market-oriented economy until the 1992 price reform. But the reform did not improve SOE profitability, as it favoured short-term interests. Managers were obliged to achieve specific profit targets under the 'contract responsibility system', but the large price differentials created incentives for arbitrage gains. The profit tax rate negotiated for each SOE and the ambiguous status of the ultimate SOE owner ('the whole people'), represented by multiple state agencies, resulted in no single entity being responsible for an SOE's bottom line, leading to rent-seeking, collusion with superiors and losses.

After China's embrace of a *socialist* market economy as a national objective in 1992, the adoption of the 1993 Company Law provided the legal basis for SOEs to be corporatised into shareholding companies with a modern corporate board structure, creating a variety of corporate forms of SOE. However, soft budget constraints – i.e. insufficient incentives to avoid making losses given the implicit bailout guarantee from state-owned banks – state intervention through the SOE chairman, usually the firm's party secretary, and lax supervision persisted. Ownership diversification was limited, as the state remained the majority stakeholder of most listed corporations and shares were non-tradable until 2005.

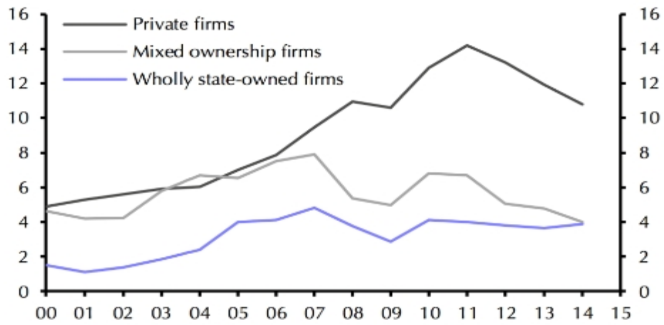
Figure 2 – Share of SOEs in industrial production and employment



Data source: Banking system reform in China, Okazaki, K., 2007, p. 8.

By the mid-1990s, non-performing loans of unprofitable SOEs became unsustainable for China's state-owned banks. After the 1997 Asian Financial Crisis and in preparation for China's 2001 WTO accession, SOE reform was pursued between 1998 and 2002 under the slogan 'Grasp the big, let go of the small' with considerable job losses. Under this scheme, local governments privatised large numbers of small SOEs through management buyouts, share issue privatisation, joint ventures with foreign firms and mergers. Central and local government maintained control over large SOEs in *strategic* industries (defence, electricity generation and distribution, petroleum and petrochemicals, telecommunications, coal, civil aviation and waterway transport) and *pillar* industries (machinery, automobiles, information technology, construction, steel, base metals and chemicals) where the state has absolute control or a major influence respectively, but withdrew from some competitive sectors. Large SOEs were merged into conglomerates whose increased assets and business size yielded gains from economies of scale and improved profitability.

Figure 3 – Return on asset of industrial firms in %



Data source: CEIC, Capital Economics in Fortune.16 September 2015.

In 2003 the State-owned Assets Supervision and Administrative Commission (SASAC) was established. It acts as *both* shareholder *and* regulator of non-financial SOEs. Apart from this major institutional change, the reform drive stalled and was even reversed, i.e. the SOE sector re-expanded at the expense of the private sector. First, large SOEs, backed by policy banks, spearheaded China's 'going out' policy by expanding overseas to seek natural resources and new export markets. Second, the 2008 stimulus package launched in the face of the global financial crisis spurred further expansion of large SOEs. Although most resources were allocated to SOE-dominated sectors linked to large-scale infrastructure projects, this did not improve the deteriorating trend of SOE fundamentals. While SOEs (roughly 155 000 local and central SOEs in 2013) now account for 30% of China's corporate assets and absorb the bulk of bank loans, they contribute only 22% of profit and 17% of employment. The private sector surpasses them in terms of job creation, profitability and innovation. Previous SOE reforms have thus failed to achieve a shift from state-led to market-based resource allocation, as evidenced by the over-capacity and debt levels of industrial SOEs.

The current direction of SOE reform

SOE reform was high on the 2013 Third Plenum reform agenda. It aimed to strengthen SOE profitability and international competiveness rather than reduce their importance. According to the 2015 reform guidelines, SOEs will be classified as either commercial or public welfare entities, but the list of sectors assigned to the two categories is not yet available. Although the mixed ownership concept seeks to attract private equity to break up administrative monopolies through competition, in parallel large-scale mergers of the remaining 100 or so large central government SOEs into 40 mega SOEs are going ahead, further consolidating SOEs' monopolistic position. This runs counter to the 2013 *China 2030* World Bank report's recommendations that allocative efficiency be sought by enhancing competition between SOEs and private firms.

While corporate governance is to be improved by aligning management incentives with firm performance, introducing transparency requirements for central SOEs and sending discipline inspection teams into SOEs, the appointment of senior management by the CCP or SASAC is not questioned. Some SOEs will be transformed into state-owned capital investment companies and integrated as an additional vertical layer to separate SASAC's owner and regulator functions. Dividend payments will increase from 5-15% to 30% by 2020, but given the state's practice of recycling dividends to SOEs as subsidies, this is doomed to produce little effect on the state's social expenditure budget. So far only a few SOEs participate in central government pilot projects, with provinces designing their own pilots.

SOE reform is criticised for lagging behind, for its old approaches, low level of ambition and the gap between rhetoric and action. Analysts doubt there will be a market-oriented outcome for China's mixed ownership reform unless the state cedes substantial control – not just minority ownership – to private investors, and moves ahead with institutional reforms. Reform tools like mega mergers will support SOEs' growing footprint and competitiveness abroad but they are unlikely to level the playing field for EU companies in China.

In its resolution of 9 October 2013 on EU-China negotiations for a bilateral investment agreement, the EP recommended that the European Commission negotiate strong and binding provisions on transparency and fair competition to secure a level playing-field for SOEs 'and sovereign wealth funds' investment practices'.

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