State-Owned Enterprise in China: Reform, Performance, and Prospects

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Abstract

State-owned enterprise reform in China has travelled a long and uneven road. Arguably, its key driver has been the introduction of competition across China's transforming economy, both the surge of new forms of domestic ownership and the ever-expanding access to technology and business methods from abroad. By highlighting the public good character of China's SOEs, this paper underscores the importance of a clear Coasian assignment of property rights and reduced transaction costs. The paper then reviews the three stages of the reform of China's state sector over the past 30 years, drawing on the literature that describes the intentions, achievements, and shortcomings of China's reform program. Finally, the paper reviews the 2015 reform guidelines and the recent literature assessing these guidelines, including the intent of the guidelines to clearly distinguish between the public service and commercial mission of individual SOEs, so that the latter SOEs can be more rigorously accountable to corporate fiduciary responsibilities.

1. Introduction

This essay pursues four objectives. The first, set forth in the following section, is to offer a succinct overview of the governance and statistical dimensions of China's state-owned enterprise sector. This overview provides a useful context for the remainder of the paper. The second objective developed in Section 3 is to set forth an analytical framework, or model, of the phenomenon of the state-owned enterprise, intended to provide a helpful perspective for understanding China's SOE problem. The third objective, developed in Section 4 is to summarize the key phases of the reform of China's state-owned enterprise sector. With this background, Section 5 then summarizes key highlights of the literature and commentary on China's most recent economic reform initiatives and the prospects for substantially restructuring China's enterprise sector. Section 6 concludes this review while offering some perspective on what is at stake in recent efforts to advance China's state-owned enterprise reform and the prospects for such reform.

2. Governance and Statistical Overview

This overview consists of two parts: the governance and charter or mission of China's state-owned enterprise sector and a summary of the structural role and dimensions of SOEs in China's economy.

Governance and Charter. The website of China's State Asset Supervision and Administration Commission (SASAC), which reports to China's State Council, sets forth nine key functions of the commission.[1] The most notable of these are: (i) "performs investor's responsibilities, supervises and manages the state-owned assets of the enterprises under the supervision of the Central Government (excluding financial enterprises)…," (ii) "guides and pushes forward the reform and restructuring of state-owned enterprises (include their sale, mergers and acquisition), advances the establishment of modern enterprise systems in SOEs, improves corporate governance, and propels the strategic adjustment of the layout and structure

[1] http://en.sasac.gov.cn/n1408028/n1408521/index.html

of the state economy;" and (iii) "appoints and removes the top executives of the supervised enterprises…."

The SASAC website further sets forth the "Policies, Laws & Regulations: Guidelines to the State-owned Enterprises Directly under the Central Government on Fulfilling Corporate Social Responsibilities." These Guidelines are intended to "give impetus" to the centrally – supervised SOEs (i.e., the CSOEs), the largest state-owned enterprises in China's key industries, "to earnestly fulfill corporate social responsibilities (CSR)…for promoting the socialist harmonious society and… thoroughly implement(ing) China's new ideas about economic development, social progress and environmental protection." The CSOEs also "have a vital bearing on national security."

While SASAC's guidelines for CSOEs explicitly relate to the large centrally-managed SOEs, it is clear that SASAC retains authority for the supervision of China's local SOEs. According to SASAC's mandate, "SASAC is responsible for the fundamental management of the state-owned assets of enterprises, works out draft laws and regulations on the management of the state-owned assets, establishes related rules and regulations and directs and supervises the management work of local state-owned assets according to law." In practice, it is likely that local governments that exercise direct day-to-day control over local SOEs, at least in principle, are subject to the corporate social responsibility principles set forth by the central government, although local governments are likely to exercise substantial autonomy in their practical applications of the central government's CSR principles.

SASAC's statement of "corporate social responsibilities" clearly distinguishes the "mission and responsibility" of the CSOE from that of the canonical corporation in a conventional capitalist economy, such as the United States in which the sole purpose of the corporation is to maximize shareholder profit. This deviation of the CSOEs from the singular mission of a capitalist corporation, instead loading the CSOE with a multiplicity of social purposes, of course complicates the task of evaluating the performance of the China's centrally-controlled SOEs.

Structure: Role and Dimensions: As shown in Table 1, according to the annual report of China's National Bureau of Statistics (2015), in 2014 Chinese industry included 17,830 state-owned and state-controlled enterprises.[2] A substantial number of state-owned and state-controlled enterprises operate outside the industrial sector in fields ranging from banking and insurance to hotels. The four largest commercial banks are all state-owned. The largest of the industrial CSOEs reside within one or another of the approximately 110 state-owned conglomerates administered by SASAC; however, most of the SOEs in China are supervised by local governments. According to an OECD report (2009, Table 2), drawing on data from the Finance Yearbook of China, in 2008, 18.1% of China's SOEs were controlled directly by the central government. Of course, although their numbers are in the minority, these CSOEs control the vast majority of the assets of the state-owned and state-controlled sector.

Table 1 further shows the proportion of industrial output produced by each of the major ownership categories. In 1998, SOEs and state-controlled enterprises accounted for nearly 50% of industrial output. By 2004, that share had fallen to 38% of industrial output. Later, in 2014, the share of total sales revenue captured by the state sector declined to 23.4% This secular decline over the decade of 2000 in the SOE share of industrial sales as well as industrial assets and profits is shown in Figure 1. Figure 2, shows a detailed breakdown in industrial output by ownership shares, distinguishing between state-owned enterprises and the state-controlled, share-holding corporations. Figure 3 is particularly revealing of the relative trajectories of state-owned and non-state-owned firms. Of particular note is the absolute and relative increase in the returns on investment in the state-owned sector relative to the non-state sector from 2000 to 2007. In fact, this rise and convergence of returns began in the mid-1990s, largely as a result of the massive lay-off of workers from SOEs and subsequent sale of many of the weaker SOEs, as China prepared for its accession to the World Trade Organization that materialized in 2001. Still more dramatic is the rapid decline beginning in 2008 in the absolute and relative return on SOE assets and their subsequent stabilization at a level of returns in the range of just one-half that of the non-state sector. This decline in absolute and relative terms was largely due to the central role that state-owned industry played in leading China's substantial stimulus of 2008-2009. That the state-owned output share remained relatively constant at about 24% over the period 2009 to

[2] According to the 2015 Yearbook , in 2004, among the SOE total count, 3,450 enterprises were "state-owned enterprises" and "3,003" were limited liability "state solely-funded corporations." This likely implies that the majority of the balance were limited liability "shareholding corporations," in which the state owned a majority of the shares. The 2011 Yearbook reports that in 2010, there were 8,726 state-owned enterprises and 1,479 state solely funded corporations. These numbers show a substantial shift in ownership compensation within the state sector.

2014 is evidence of enlarged role China's industrial SOEs played in the post-2008 period with the associated pause in SOE reform.

Notwithstanding the overall long-term decline in the state-owned share of industrial output and profits, several of China's key industries continue to be dominated by large CSOEs. As shown in Table 2, fully 19 of China's 20 largest companies are state-owned or state-controlled. In 2014, only one – the Nobel Group, headquartered in Hong Kong – was non-state owned. Table 4 shows that across all of the 98 Chinese firms listed in the Fortune Global 500, about one-third of their sales were associated with the energy sector, one-third with the finance sector, and the remaining third consisted of the engineering and construction, telecommunications, and motor vehicles and parts industries.

3. State-Owned Enterprises: The Public Good Problem

Possibly, the most succinct and insightful way of understanding the problem of China's state-owned enterprise problem is to appreciate their resemblance to a fundamental economic phenomenon – that of the canonical public good.[3] The public good problem is an iconic, ubiquitous, and enduring problem associated with the operation of state-owned enterprises. As suggested by SASAC's corporate responsibility guidelines in the previous section, having China's CSOEs exhibit a public good quality need not be inimical to the public interest. Indeed, using CSOEs to promote "…the socialist harmonious society and…to thoroughly implement China's new ideas about economic development, social progress and environmental protection" may serve as a bonafide public purpose. Whether pursuing such a public purpose or encountering surreptitious private greed, SOEs are liable to suffer from the draining of assets for purposes other than their commercial goals. What follows is a description of the way in which in the case of unsanctioned extractions of assets, the public good feature of China's SOE sector functions.

As public goods, the assets of the SOEs become substantially *non-excludable,* which results when agents who hold responsibility fail to effectively monitor the assets of the SOEs. Given the conduct of weak monitoring, SOEs could simply function as commons, in which, as with say an unmonitored publicly-owned forest, the resources of the entity disappear over time.

[3] See Jefferson (1998).

However, as public goods, not only are the assets of SOEs non-excludable, they are also *non-diminishable*. The non-diminishability results when the state intervenes to replenish assets that have been siphoned off by inept monitoring or corruption.

The non-excludability problem is reflected in conditions such as weak managerial oversight, lack of accountability, and corruption, which depress levels of productivity and profitability relative to firms producing similar goods and services operating under other forms of governance. One example of weak oversight and accountability is the following account:

> The National Audit Office recently uncovered fraud in 11 SOEs, finding that some managers spent company funds on luxury goods and entertainment. This is in addition to 35 cases of bribery and embezzlement uncovered earlier this year. Corruption associated with SOEs and, more broadly, state assets owned by the "princelings" and other cronies has recently been exposed in a comprehensive state crackdown on corruption.[4]

The non-diminishability problem results from the chronic tendency for China's political economy to replenish the diminished resources of the SOEs. This occurs through direct subsidies from various levels of government, including through lending from the banking sector, primarily the four large commercial banks, which are themselves state owned. The result is that due to the non-excludability of un-creditworthy borrowers, the state-owned banks, themselves, accumulate losses in the form of non-performing loans. To close the loop, China's central government has two potential sources from which to generate the income required to replenish the extracted assets. One is to provide subsidies to the banks or to the enterprises directly through the diversion of tax revenue, thereby imposing higher taxes on the public or diverting government spending from other public purposes. The second method entails the printing of money by the central bank, the People's Bank of China, which can be used to replenish the outflow of bad loans from the state-owned banking system, thereby creating the risk of imposing an inflation tax on the rest of the economy.

Standard & Poor's, for example, estimated that at the end of 1999 the proportion of non-performing loans in China's state commercial banks was in the range of 50% to 70%. The People's Bank of China reported that that proportion was at least 25%. To partially remedy this problem, in 2000 the government organized a recapitalization of the state commercial banks in which non-performing loans with a nominal value equivalent to $157 billion were transferred from the state banks to state agencies, called *asset management companies*, in exchange for

[4] http://thediplomat.com/2014/06/chinas-changing-state-owned-enterprise-landscape/

government securities.[5] These back-up agencies were intended to perform the function of investment banks that are mandated to restructure and sell off the non-performing loans held by the state-owned banks. Thus, by replenishing the diminished resources of the state-owned banking system, the banking system too acquires the properties of a public good.

Cheng (2004) finds that China's state-owned enterprises (SOEs) have been harmed greatly by corrupt practices committed by insiders, especially those by the general managers. That article explores why SOE general managers abuse their power and how they manage to do so. First, the author argues that given the limited compensation provided by SOEs, many managers have strong incentives to enrich themselves by absconding with cash or other SOE resources. Second, by decentralizating the managerial power of SOEs, an important reform policy, has enabled general managers to control the most lucrative activities of the enterprises. Hence, mismatched compensation within a system of institutional weaknesses, including weak supervision, facilitates corrupt practices.

One conspicuous result of this porous system of state-owned enterprises is the accumulation of extreme wealth with little accountability. The public good nature of the state-owned enterprise system described above is likely a principal source of the extraordinary concentration of wealth within China's top political elites. As reported in the Huran Report, which tracks China's wealthy residents, the net worth of the 70 richest delegates in China's National People's Congress rose to 565.8 billion yuan ($89.8 billion) in 2011, a gain of $11.5 billion from 2010. That compares with the $7.5 billion net worth of all 660 top officials in the three branches of the U.S. government.[6]

The favorable access of SOEs to bank finance, crowding out access to capital by non-SOEs, and the uneven application of Chinese law, such as the more lax application of anti-trust law to SOE monopolies, severely biases competition and the legal system against private firms and individuals. This uneven application of resources and law are a further expression of the public good nature of SOEs and the privileged access they require, so that these entities are able to replenish their weakly-monitored resources.

One way to understand the public good problem is to view the typical SOE within the context of Coase's seminal article, "The Problem of Social Cost" (1960). In the absence of the

[5]http://www.sjsu.edu/faculty/watkins/chinasoes.htm
[6] http://www.bloomberg.com/news/articles/2012-02-26/china-s-billionaire-lawmakers-make-u-s-peers-look-like-paupers

two key conditions that frame the Coase Theorem, the functioning of SOEs resembles those of public goods. The two absent conditions are, first, clearly assigned property rights and, second, low transaction costs. State ownership, also known as enterprises that are "owned by all the people" (*suoyouzhi*), precludes a clear assignment or property rights and low transaction costs. Furthermore, by itself, state ownership creates insuperable transaction costs for SOEs retained by the state, whereas the sale or restructuring of others that might be for sale often face ambiguous rights with respect to the agents that have the authority to negotiate and consummate a sale. Also for a given SOE under the supervision of a state authority, when a form of embezzlement or bribery does occur, the presence of an underdeveloped and under-resourced legal system, compounded by political influence, further interferes with the functioning of market-based outcomes. These conditions together conspire to sustain the condition of the public good character of the canonical SOE.

As mentioned at the beginning of this section, SOEs may function as legitimately sanctioned public goods. For example, the Chinese government has designated certain industries as 'strategic", such as defense and energy, or "pillar", such as the automotive and telecommunications industries, with the implication that state ownership will continue to play a significant ownership role in these industries. Such industries may, for example, serve national industrial or geopolitical goals, including national security or technological advance, that in themselves constitute public goods in the sense that the goals cannot be suitably provided exclusively within the context of the private market. This public purpose motive will be addressed in a later section of this paper.

4. Reform Overview: Three Stages

This section outlines three phases of China's SOE reform: (i) entry and competition (1980-85), (ii) "retain the large; release the small (1995-2010), and (iii) restructuring the large enterprises (2000 to present).[7]

Entry and competition: During 1978 to 1994, the number of reported industrial enterprises grew dramatically from 348,400 to 10.02 million, the peak count for industrial

[7] As an overview spanning the period from the beginning of the reforms until 2006, Naughton (2007) offers a clear, well-documented account of China's SOE reform program.

enterprises during the post 1980-reform period. In 1978, the number of SOEs was 83,700, accounting for 78% of China's gross industrial output; the 264,700 collective enterprises accounted for most of the balance of the China's industrial sector. In 1994, among the 10.02 million enterprises, the number of SOEs had grown modestly to 102,200, the number of collectives, including township and village enterprises, to 1.86 million, and the number of "individual-owned" and "other" enterprises had surged to over 800 million. The distribution of gross output stood at 37.3% for SOEs; collective-owned enterprises accounted for 37.3%, while the remaining 25% was produced by the myriad of individual-owned and other enterprises, dominated by the "individual-owned" category defined as enterprises with eight or fewer employees.

This rapid surge in new entry was accompanied by the growing marketization of China's domestic economy through the unfolding of the "dual track system." Marketization and competition were further heightened by the liberalization of trade and foreign investment, during which China's trade ratio grew from 13% in 1980 to 38% in 1995.[8] Arguably, no single paragraph captures the critical role of the competitive impulse in economic change more vividly than that of Douglass North (1994, p. 362):

> While idle curiosity will result in learning, the rate of learning will reflect the intensity of competition among organizations. Competition…induces organizations to engage in learning to survive. The degree of competition can and does vary. The greater the degree of monopoly power, the lower is the incentive to learn…

Indeed as Jefferson and Rawski (1994a, 1994b) demonstrate, during this early period, by making the search for new forms technology and governance essential for survival, competition was the critical driver of SOE reform. Absent reforms, the entry of new firms and growing competition eroded the market share of SOEs while motivating their more skilled and motivated workers to transfer to non-state enterprises. Facing increasing competition and the erosion of profitability, supervisory authorities were motivated to introduce management reforms. Groves et al (1994) document the efficacy of reforms designed to incentivize managers through material rewards and increased autonomy. By 1995, within the population of SOEs, winners and losers

[8] World Bank trade data, http://data.worldbank.org/indicator/NE.TRD.GNFS.ZS?locations=CN

had begun to emerge demonstrating the ability of the reform to of managerial incentives to make a difference in the productivity and profitability of state-owned enterprises.

Retain the large; release the small: Following 1995, largely motivated by the determination to ready China for membership in the World Trade Organization, China initiated two transformative reforms. The first was "xiagang," the furlough of workers, which led to the dramatic layoff and decline in the size of the SOE workforce. Between 1995 and 2001, the year China joined the WTO, the number of jobs in the urban state sector fell by 36 million—or from 59% to 32% of total urban employment.[9] The second initiative was the "jueda fangxiao" initiative in which the State Council endorsed a policy to retain the large SOEs while authorizing the transfer outside the state sector of the majority of smaller SOEs. In 1997, the State Council approved a huge shift of ownership from the central government to municipalities with the explicit goal of expediting conversions to non-state ownership. By 2004, the number of above-scale state-owned and state-controlled enterprises had fallen from 118,000 in 1995 to 24,961.

The result of the "retain the large; release the small" policy initiative has been the sale or ownership restructuring of tens of thousands of former SOEs. While most of the smaller SOEs were outright privatized, with ownership transferred to managers, workers, or private investors, among the larger SOEs, forms of mixed ownership evolved in which the state retained majority ownership and control. According to Gan (undated), "between 1995 and 2005, close to 100,000 firms with 11.4 trillion RMB worth of assets were privatized, comprising two-thirds of China's SOEs and state assets and making China's privatization by far the largest in human history."

This second reform period also saw the emergence of growing merger and acquisition activity. In their article, "China's Emerging Market for Property Rights," Jefferson and Rawski (2002) describe the development of a market for China's SOEs resulting in the transfer of state-owned assets. This article chronicles the development and promulgation of laws, regulations, and policies that served to clarify the ownership rights of state-owned assets and further enabled their sale and exchange among state agencies and private actors within China's emerging market for the sale, merger, and acquisition of corporate assets.

Over the past three decades, a key feature of China's enterprise reform process has been the mixing of ownership both within and outside the state sector. This has consisted of simultaneous migration of state capital to build assets in the non-state enterprises combined with

[9] The Economist (Sept. 3, 2011), "Capitalism Confined," http://www.economist.com/node/21528262

the inflow of non-state capital into previously exclusively state-owned enterprises. The result has been a continuum of ownership in which the conventional NBS categories of state-owned, state controlled, shareholding, and even private and foreign-invested enterprises are often a mixture of asset ownership that imply a far different ownership and governance structure than that implied by the formal ownership label reported by the National Bureau of Statistics. Hence, one spur to SOE productivity has been the foothold that private and foreign capital have been able to establish within the boundaries of the state sector. Another has been the exit of relatively unproductive SOEs.

Using detailed firm-level data, Hsieh and Zheng (2015) show that from 1998 to 2007 state-owned firms that were closed were smaller and had low labor and capital productivity than the surviving SOEs. During this 1998-2007 period, the authors conclude that closure of the less productive SOEs contributed to the tendency labor productivity within the state-owned firms to converge toward that of private firms.[10] They estimate that during this period, reforms of the state sector were responsible for 24 percent of China's aggregate TFP growth.

Restructuring the large SOEs. The reform of China's centrally state-owned and state-controlled enterprises has proceeded along two important dimensions. The first is their consolidation into a limited number, approximately 110 conglomerates. As previously referenced in Table 2, China's 20 largest companies include 19 state-owned or state-controlled firms, the latter publicly traded on international exchanges. Among the Chinese companies on Fortune Global 500 list, 98 companies are based in China, including those headquartered in Hong Kong.[11] That places China second only to the U.S., which has 128 companies on the list. Comparing these 2015 figures with the recent past, China's rise is even more spectacular. China had just 46 companies appearing on the list in 2010 and only 10 in 2000. The U.S., on the other hand, has trended in the other direction: 139 American companies made the list in 2010 and 179 in 2000. Notably, the top 12 Chinese companies are all state-owned; of the 98 Chinese companies on the list, 22 are private.

[10] In their study of the surge in patenting during 1995-2001, Hu and Jefferson (2008) conjecture that the clarification of enterprise property rights led to the more aggressive assertion of patent rights. They find that the changing ownership structure of Chinese industry — the accelerated exit of state-owned enterprises and entry of non-state enterprises —produced a 10% increase in patent applications of the enterprises in their sample from 1995 to 2001.

[11] http://fortune.com/2015/07/22/china-global-500-government-owned/

The second on-going reform, associated with the first, is the increasing concentration of SOE assets and business activity in a limited number of sectors that are most closely related to the public and corporate responsibility goals set forth by SASAC in Section 2. Again, as shown in Figure 4, among China's largest companies, approximately one-third of the state-owned and controlled assets are in the energy sector, another one-third are in the finance sector, and the remaining one-third are largely distributed over just three other industries. As shown in Table 2, the largest of the Chinese SOEs includes banks and oil companies that are under the supervision of SASAC, which appoints CEOs and makes decisions on large investments.

Notwithstanding this concentration of CSOE activity in 98 companies, SOEs continue to pervade the Chinese economy, extending well outside the industrial sector. In the view of Chen Zhiwu[12], the impact of the SOEs on private enterprise is becoming more damaging as the economy's growth slows. Chen expresses the widely held view that notwithstanding the restructuring of China's state-owned economy over the past decades, "Many of China's structural distortions, both economic and otherwise, are due to the dominating positions of the SOEs."

Most recently, on September 13, 2015, China's State Council and CCP issued guidelines that update and extend the government's effort to achieve meaningful reform of its SOEs.[13] The more notable highlights of these guidelines are:

- SOEs will be divided into two categories – for profit entities with a mandate to provide public goods and services – and for-profit entities, dedicated to commercial operations.
- The new guidelines include specific provisions: i) SOE boards of directors are intended to have more autonomy, in part facilitated by restrictions on government agency intervention, ii) managers will be more strictly supervised while professional quality and compensation will be upgraded; and iii) mixed ownership will be encouraged through public offerings, share sales to employees, and means for non-state companies to employ convertible bonds, rights swaps and other measures to acquire SOE assets.
- The timeline for achieving major reforms is 2020.

[12] Chen is a finance professor at Yale University and former adviser to China's cabinet in 2007.
[13] "Guiding Opinions of the Communist Party of China Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises," September 2015

Viewed in relation to the public good model developed in Section 3, the Xinhua News account conveys promising intent. According to Xinhua's account of the guidelines, "Supervision will be intensified both from inside and outside SOEs to prevent abuse of power and the erosion of state-owned assets, and a mechanism for accountability will be established to track violations, including corruption and embezzlement." However, also from the perspective of the model, the guidelines convey a puzzle. This arises from the intent to separate SOEs explicitly into those strictly performing a commercial purpose and those dedicated to public welfare. With this distinction, a key question is why it is not possible to simply privatize all of the SOEs that are intended to be "be market-based and stick to commercial operations," as characterized by the Xinhua News release. Recent clarification from China's State Council proclaimed, "The latest guideline emphasizes restructuring of central SOEs and requires those with prolonged losses be forced out of the market in non-strategic sectors."[14] As suggested by Leutert (2016), these commercial firms will, most likely. continue to support various public policy goals, such as fostering indigenous innovation, supporting social stability, and advancing key economic initiatives, such as the Silk Road "One Belt, One Road" initiative.

Much of the recent literature focuses on the publicly-announced initiative to implement reform of the Chinese Government's remaining state-owned enterprises, including assessments of its progress, success, and challenges. We review some of that literature in the following section.

5. Restructuring China's Remaining SOEs: Literature Review

One notable feature of the literature that addresses China's recent initiatives to reform its SOEs sector is that a large portion of the commentary and analysis originates with news-related periodicals, including *The Economist, Forbes,* the *Financial Times,* and the *Wall Street Journal*, as well as news and perspectives published by analysts associated with financial organizations and public policy institutes. This shift is likely to result of several conditions. First, with the shrinking number of SOEs and the fact that more than 90% of their assets are held by the 98 firms in the Forbes Global 500 Companies, the SOE reform story is increasingly that of a relatively small number of highly visible firms for which information is more readily available;

[14] http://english.gov.cn/policies/policy_watch/2016/07/28/content_281475403400292.htm

second, most of the major SOEs are either publicly traded or anticipated to be in the queue for public offerings and other forms of financial transactions with the outside world. Given the scale of the assets involved and the potential for sizeable commercial transactions, the global financial community is eager to receive timely information and analysis relating to China's reform innovations. That China's state-owned enterprise sector has evolved into a sector with such focus and financial interest is itself a powerful statement of the extent of China's SOE reform over the past three decades and the expectation for substantial continuing restructuring and commercial opportunity for the remaining SOEs. Assessments and expectations concerning the likelihood and the impact of such structural change are divided. We examine these below.

Leutert (2016) emphasizes the potentially transformative significance of the September 2015 guidelines: "Categorizing SOEs into a public class (*gongyilei*) and a commercial class (*shangyelei*) is a transformative move at the heart of the new reforms. Firms will be divided by function into those dedicated to public welfare and those seeking profit." In her Brookings-sponsored paper, she sets forth three specific challenges for the implementation of the 2015 guidelines. These are:

- determining how and when to grant market forces a greater role: the Government must effectively manage the tension between continuing government-directed mergers that are likely to lead to greater market concentration while opening protected sectors to more robust competition;
- aligning mismatched managerial interests and incentives: while the Xi administrations top-down practice of appointing, removing, and reshuffling top company leaders may curtail the amount of malfeasance and corruption in some CSOEs, it undermines a key reform guideline entailing the devolution of greater autonomy to boards of directors who are charged with exercising better oversight and strengthening managerial incentives.
- changing the internal bureaucracy and culture of large SOEs: the size and complexity of the CSOEs, combined with their privileged competitive advantages, are a serious impediment to transforming the deeply-embedded cadre culture of SOEs that frustrates internal reform.

The Economist elaborates on the problem of rotating management assignments in which managers of SOEs are rotated within the same industry, notably airlines, energy, and banks. This practice, observes *The Economist*, "makes a mockery of competition, as does the fact that China's State firms are rarely targeted by antitrust authorities."

Leutert's concludes that whether these difficulties can be surmounted will ultimately determine the success of Xi's reform agenda and China's economic transformation.

The latest plan aims to improve SOE efficiency and competitiveness without relying on outright privatization. The question is whether incremental changes, including minority stake sales, stock market listings and changes to how directors and executives are appointed will be sufficient to fundamentally reshape the state sector. Public pronouncements exhibit ambivalence. The call to promote "mixed ownership" of SOEs — a euphemism for partial privatization — is followed by caution to protect against the "leaching away of state assets", a reference to worries about national wealth being sold off on the cheap. The plan wants to increase financial returns but also calls for strengthening party control. Recent commentary among economists and analysts in the financial industry and press has been mixed.

Subsequent to the State Council, 2015 announcement of its new restructuring guidelines, Gabriel Wildau of the *Financial Times* offered a rather pessimistic assessment. In her article, "China's state-owned zombie economy,"[15] Wildau argues that rather than undertake the break-up and sale of unprofitable enterprises, most of the emphasis has been on consolidation. Citing Leutert, Wildau writes, "merging centrally owned firms will increase their market share at the risk of long-term competitiveness and efficiency gains." According to Wildau, SASAC has only "cautiously experimented with 'mixed ownership,' a euphemism for selling minority shares. Far from shrinking its role in the economy, however, the leadership believes the answer lies in strengthening the ruling party's grip on state assets, while making SOEs more competitive." Yes, she observes that "mega mergers are also seen as a way to eliminate 'malicious competition' between state groups," such as that between the country's two largest manufacturers of railway equipment in 2014, likely to strengthen the leadership's Silk Road initiative.

In their article, "Uncovering China SOEs," three columnists for Bloomberg Gadfly examined 346 state-owned companies tracking their reform progress and changes over the three year period from the end 2012/early 2013 to the end of 2015.[16] Surveying their sample of firms across five performance measures – average time for SOEs to be paid, profitability, overcapacity, extent of deleveraging, and debt servicing – the authors conclude:

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[15] http://www.ft.com/cms/s/0/253d7eb0-ca6c-11e5-84df-70594b99fc47.html#axzz4H3k6Gl2j

[16] The three authors are: Andy Mukherjee, Nisha Gopalan, and Rani Molla. https://www.bloomberg.com/gadfly/articles/2016-04-29/uncovering-china-s-stalled-soe-reform

> Three years after President Xi Jingping vowed to shake up state-owned enterprises, there looking worse than ever. And not just in traditional smokestack industries such as coal and steel – the malaise has spread to consumer and health-care firms….While the government continues to insist on an overhaul of its sclerotic state firms, its efforts to prop up the economy are bearing fruit – reduced pressure for change.

"Uncovering China's SOEs" reports on a number of individual SOEs, however, the study largely depends on the five selected performance measures in 2015 as compared with 2012/2013, when China's overall macroeconomy was considerably stronger. It would, for example, be helpful to profile comparisons with counterpart firms in China's non-state sector.

Notwithstanding these pessimistic assessments by analysts with the *Financial Times* and *Bloomberg*, *The Economist*'s assessments are more optimistic. Writing on August 30, 2014, more than a year before the 2015 guidelines,[17] *The Economist* contends, "China is in the midst of the biggest attempt in more than a decade to fix the country's brand of state capitalism…" In support of its assertion, *The Economist* recounts the following examples:

- Sinopec, Asia's biggest refiner, is close to selling a $16 billion stake in its retail unit, a potentially lucrative opening for private investors.
- CITIC Group, China's biggest conglomerate, is poised to become a publicly traded company by injecting its assets into a subsidiary on the Hong Kong stock exchange, for $37 billion. Within the financial sector, Citic Group, laid down a model for SOE reform last year when it injected $37bn worth of unlisted assets into a Hong Kong-listed subsidiary.
- After its initial reluctance, SASAC announced reforms at six companies. They are to experiment with larger private stakes and greater independence for directors.
- With more than 100 officials from PetroChina, the biggest SOE of all, now under investigation for corruption, Mr Xi has flexed his muscles. His call this month for strict pay caps on the bosses of big SOEs should be read as a warning to them to fall in line."

Although generating fewer headlines, moves by local governments to sell their companies could be even more significant for the Chinese economy. Local SOEs have performed worse than their central counterparts, meaning there is plenty of scope for improvement. They

[17] *The Economist*, "Fixing China Inc.: Reform of the state companies is back on the agenda," Aug. 30, 2014.

are more accessible to private investors since they are concentrated in non-strategic sectors. “It’s opening wide up. There is a ridiculous amount of deal flow coming our way,” says a manager with an international private-equity firm. The southern province of Guangdong recently held a meeting at which it offered stakes in 50 different SOEs, according to people present. Shanghai has also been at the forefront. In June, it sold a 12% stake in a subsidiary of the Jin Jiang hotel group to Hony Capital, a local private-equity firm. Analysts say that this will encourage better management practices at Jin Jiang, including stock-option incentives for executives, and that it could serve as a template for future such deals.

Bolder experiments with privatization would be far preferable, but the political reality is that the state wants to retain control of banks, trains and more. These constraints, though, are not suffocating. “There is a lot of room for reform before touching political red lines,” says Andrew Batson of Gavekal Dragonomics. Selling stakes in companies that the government itself says it has no business owning, from petrol stations to hotels, is a good start. Within the financial sector, Citic Securities’ parent company, Citic Group, laid down a model for SOE reform last year when it injected $37bn worth of unlisted assets into a Hong Kong-listed subsidiary.

Following issuance of the December 2015 guidelines, on the August 11, 2016, The Economist’s correspondent, wrote:

> The vast majority of Chinese state-owned enterprises have upgraded their internal governance and senior management teams including appointing external independent directors or foreign senior managers. Many of these enterprises have taken steps to introduce mixed private ownership to improve managerial autonomy.

Earlier, in “If China embarked on mass privatization: the greatest sale on earth,” *The Economist* set forth recommendations for a successful enduring broad privatization initiative. These include:

- The privatization campaign should start soon and be orderly, so as to not wait until a crisis forces a rapid sell off that could result in the assets ending up in the hands of China’s “princelings”, who could become the Chinese equivalent of Russia’s oligarchs.
- The privatizations could secure the most public support and benefit if: they were sold in pubic auctions with the relevant legal reforms that would put domestic and foreign investors on legal footing. Investing a substantial amount of the proceeds into government pension funds would help to create more transparency and spread the proceeds of the sales.

- The government should avoid selling off pieces of the SOEs without yielding management control.

With less than a year having transpired since the State Council's issue of the December 2015 guidelines, clearly there is substantial expectation – both hopeful and skeptical – in the foreign, business, and academic/policy communities as to whether this initiative will lead to a meaningful episode of SOE reform in any way comparable to that undertaken two decades ago with the furlough of millions of surplus SOE workers and the mandate to "retain the large" and "release the small". The key to the period between now and 2020 effective ownership, rights, and responsibilities of the remaining SOEs will be released and which of these will be retained.

6. Conclusions and final remarks

The global financial crisis resulted in a major setback, or at least, a substantial pause in China's SOE reform agenda. Arguably, given the response of the U.S. Government in bailing out its banks, insurance, and automobile companies, China was not alone in growing back into the plan. That China relied heavily on its SOEs to implement its stimulus, resulting in a hemorrhaging of their profitability has led China's leadership to a challenging juncture. On the one hand, the experience of the past eight years has underscored the weakness and unsustainability of the existing system of SOE governance; yet the experience also served to highlight the important role that state-ownership plays as an instrument to address potential episodes of social and economic instability.

The model of the SOE as public good outlined in Section 3 provides a useful framework for evaluating China's SOE reform agenda and progress. It demonstrates how China's non-financial SOEs are embedded in a larger system of extra-mural financial subsidies, bailouts, and anti-competitive behavior. As back-up to the non-financial SOEs, the financial SOEs, principally the four large commercial banks, likewise rely on a system of extra-mural subsidies, bailouts, and monopoly for their survival. This interdependence of the layering and interactions of state-owned structures underscores the fact that, ultimately, the success of SOE reforms will be linked inextricably with progress in broader financial and legal reforms. As suggested in this review, arguably the most important condition is exposure to robust competitive markets, which render transparent the relative inefficiencies and structural shortcomings of the SOE governance system. With such transparency, policy makers, perhaps event with the impact of public opinion, can address the visible costs of corporate profligacy. A critical part of this exercise, as intended by the 2013 Guidelines, is to clearly distinguish firms that are intended to serve a well-defined public purpose from those that are expected to perform according to competitive commercial standards.

The means through which China will achieve its SOE reform objectives – empowering boards of directors , expanding marketization, and strategic privatization – will require concerted reform outside the state sector. Such general reforms include legal regulations to protect minority shareholders and greater transparency in accounting procedures. A further obstacle is that despite considerable progress in financial reforms, Beijing is still struggling to get commercial state-owned banks to extend more credit to private firms instead of to SOEs. Such reforms are needed both to invigorate private sector activity and also, in turn, to enable it to strengthen its ability to compete with the SOEs to make transparent the inimical features of the public good character of China's SOEs.

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Table 1. ownership composition of industrial sales/output (above-scale only)							
Number of enterprises			Share of sales/output (%)				
	All industry, number of enterprises	Of which: state-owned and state controlled	State-owned and state controlled	Share-holding corporations	Foreign and HMT-invested	Collective enterprises	Private
2014	361,286	17,830	23.4	9.5	23.2	0.7	33.8
2004**	301,961	24,961	38.0	42.1	30.8	5.3	15.1
1998	165,080	64,737	49.6	6.4	24.7	19.6	n.a.
Sources: NBS, Science and Technology Yearbook, various years; *principal business revenue only;**the numbers add to > 100% due to double counting; principally of enterprises that were both state-controlled and share-holding.							

Table 2: Largest Chinese Corporations (ranked by Fortune) (non-state owned in bold italics)						
Rank	Fortune 500 rank	Name	Headquarters	2014 revenue US$ billion	2014 profits US$ billion	Industry
1	3	Sinopec	Beijing	457.201	8.932	Oil
2	4	China National Petroleum	Beijing	432.007	18.504	Oil
3	7	State Grid Corporation	Beijing	333.386	7.982	Utilities
4	25	Industrial and Commercial Bank of China	Beijing	148.802	42.718	Banking
5	38	China Construction Bank	Beijing	125.397	34.912	Banking
6	47	Agricultural Bank of China	Beijing	115.392	27.050	Banking
7	52	China State Construction Engineering	Beijing	110.811	1.853	Construction
8	55	China Mobile	Beijing	107.647	9.197	Telecommunications
9	59	Bank of China	Beijing	105.622	25.520	Banking
10	***76***	***Noble Group***	***Hong Kong***	***97.878***	***0.234***	***Conglomerate***
11	79	China National Offshore Oil	Beijing	95.971	7.700	Oil
12	80	China Railway Construction	Beijing	95.746	0.986	Construction
13	85	SAIC Motor	Shanghai	92.024	4.034	Automotive
14	86	China Railway Group	Beijing	91.152	1.524	Construction
15	98	China Life Insurance	Beijing	80.909	0.594	Insurance
16	107	Sinochem Group	Beijing	75.939	0.755	Oil/Chemicals
17	111	FAW Group	Changchun	75.005	3.263	Automotive
18	113	Dongfeng Motor Group	Wuhan	74.008	1,.48	Automotive
19	115	China Southern Power Grid	Guangzhou	72.697	1.325	Utilities
20	122	China Development Bank	Beijing	71.305	12.949	Banking

Figure 1. Change in state-owned and controlled industry shares,
The Economist, March 12, 2011

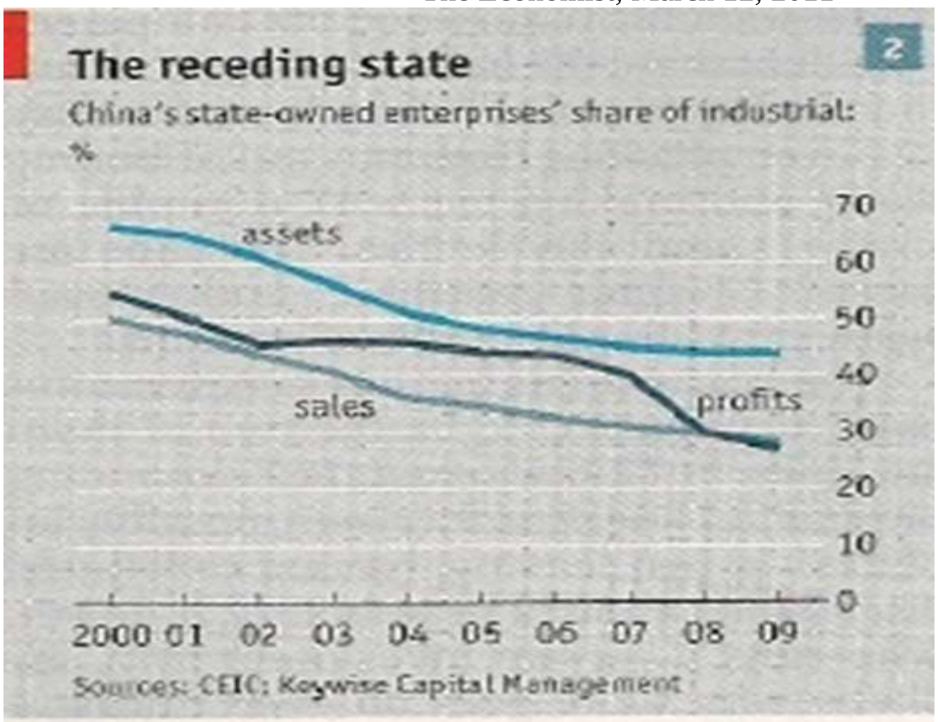

Figure 2. Industrial Output by Ownership, 2009

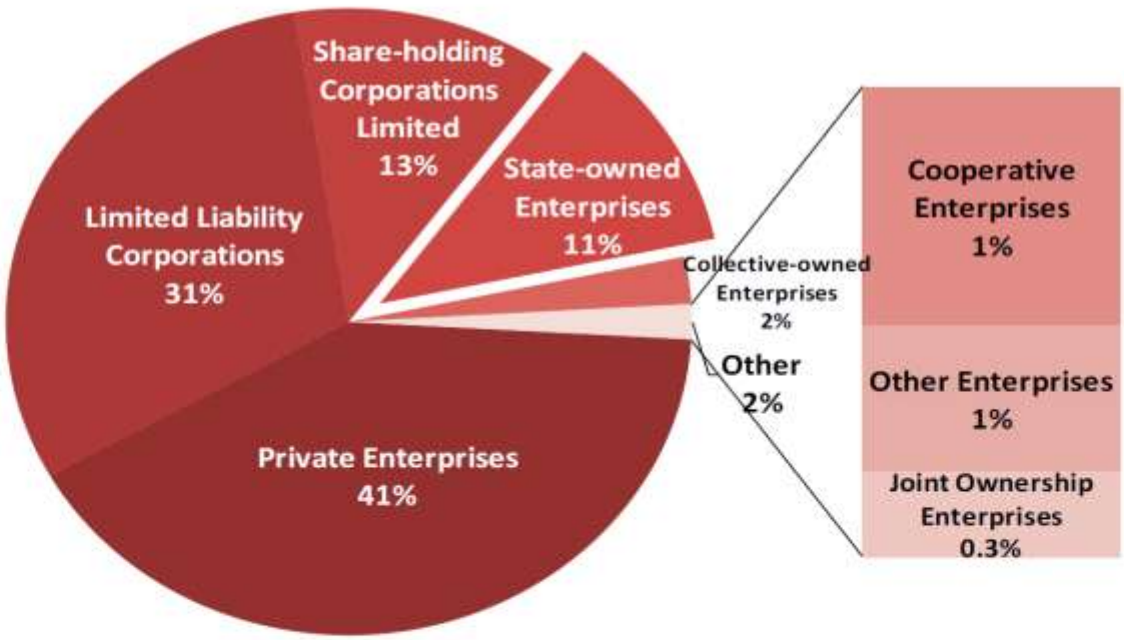

Figure 3. Return on Assets of China's Industrial Firms

Figure 4: Key Sectors of China's Largest Government-Owned Enterprises