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. Throughout, 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 commons/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 their intent to clearly distinguish between the public service and commercial mission of individual SOEs, so that state-owned firms can be more rigorously accountable to their fiduciary responsibilities. Arguably, the key issue for China's successful SOE reform is whether successful reform of China's state sector can be achieved at the firm level on a firm-by-firm basis or if, instead, it can only be achieved through deep institutional and political reform.

Keywords: state-owned enterprise reform, public good, 2015 Guidelines, majority ownership, shareholders

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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 the current functions and challenges of China's SOE. The third objective, developed in Section 4, is to summarize the distinct phases of China's state-owned enterprise reform. 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; this last section also suggests a research agenda that closely relates to the on-going challenges of China's SOEs.

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

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

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."[2]

While SASAC's guidelines for CSOEs explicitly relate to the large centrally-managed SOEs, it is clear that SASAC also retains authority for the supervision of China's local SOEs. According to SASAC's mandate, "SASAC…directs and supervises the management work of local state-owned assets according to law." In practice, while it is likely that local governments exercise substantially autonomous direct day-to-day control over local SOEs, at least in principle, the local sub-jurisdictions are subject to the fiduciary and corporate social responsibility principles set forth by the Central Government.

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 the capitalist corporation, instead loading the CSOE with a multiplicity of social responsibilities, of course complicates the task of understanding the appropriate ownership structure and of evaluating the performance of the China's centrally-controlled SOEs. Given this quasi-public mission, a measure of state-ownership may be necessary and appropriate.

Structure: Share of the Total Economy: 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 106 state-owned enterprises administered by SASAC; however, most of the SOEs in China are supervised by local governments. Although their numbers are a small minority of the country's total number of

[2] http://en.sasac.gov.cn/n1408035/c1477196/content.html

SOEs, the CSOEs control the vast majority of the assets of the state-owned and state-controlled sector.

As shown in Table 1, according to the annual Statistical Yearbook prepared by China's National Bureau of Statistics (2015), in 2014 Chinese industry included 18,808 state-owned and state-controlled enterprises. 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 over 50% of industrial output. By 2004, that output share had fallen to 36% of industrial output. Figure 1 shows over the first decade of the new millennium this secular decline in the SOE share of industrial sales as well as industrial assets and profits. Figure 2, shows a detailed breakdown in industrial output by ownership shares at the end of the decade, distinguishing between state-owned enterprises and the state-controlled, share-holding corporations. The figure shows that in 2009, the output share of the state industrial sector was about 24%, of which 11% were registered as state-owned enterprises and 13% were registered as share-holding corporations, most of originated with large publicly-traded state-controlled share-holding enterprises. Thus, by 2009, the majority of the "state-owned and state-controlled" industrial output originated with state-controlled share-holding corporations.

Figure 3 is particularly revealing of the relative fluctuations and trends of the profitability 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 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 industrial output share remained relatively constant at about 23-24% over the period 2009 (Figure 2) to 2014 (Table 1) is evidence of the 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. Figure 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.

By 2016, China's state-owned enterprise sector had become dramatically restructured relative to 2 years earlier. While it had come to represent a more compact and concentrated slice of the Chinese economy, its strategic importance both persisted and expanded in certain industries. Most of the institutional concerns and weaknesses that had prompted SOE reform in earlier periods have persisted to the present.

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 commons that often transition to a canonical public good.[3] The commons-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 legitimate 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 to the detriment of China's financial system and macroeconomy.

As commons and/or public goods, the assets of the SOEs become substantially *non-excludable*, which results when agents who hold responsibility fail to effectively monitor the

[3] See Jefferson (1998).

assets of the SOEs? Given the condition of weak monitoring, SOEs could simply function as a commons, in which, as with say an unmonitored forest, the resources of the entity disappear over time, say as a result of individuals felling trees for lumber or firewood. However, as public goods, not only are the assets of SOEs non-excludable, they are also *non-diminishable* or *non-rivalrous*. Non-diminishability results when the state intervenes to replenish assets that have been siphoned off by inept monitoring or corruption.

The non-excludability condition results from 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]

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. This incentive has been enabled, in turn, by the decentralization of governance power to SOE managers, itself an important reform policy. Hence, mismatched compensation within a system of institutional weaknesses, including weak supervision, facilitates corrupt practices as well as other poor management practices.

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

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

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.[5]

Standard & Poor's 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 the 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 government securities.[6] 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.

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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 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

[5] A third source – an undervalued currency – enables the accumulation of foreign exchange reserves to hedge against financial crisis by maintaining confidence in the system.
[6]http://www.sjsu.edu/faculty/watkins/chinasoes.htm

people" (*quanmin suoyouzhi*), precludes a clear assignment or property rights and low transaction costs. Arguably, when "all the people" own the asset, no one effectively assumes responsibility for managing the asset. This diffusion of authority creates serious "principal-agent" problems for effectively managing and preserving the state-owned assets.

Furthermore, by itself, state ownership creates insuperable transaction costs for SOEs retained by the state, thereby impeding their sale to agents capable of achieving the "highest and best use" of the assets. Whereas in a well-developed market economy the sale or restructuring of a privately- owned firm is likely or feasible when it is poorly-managed, in China the relevant agents for SOEs (e.g. SASAC) face limited rights to negotiate and consummate the sale and exchange of the poorly-managed state-owned asset. 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. By rendering the sale of a badly managed SOE infeasible, transaction cost or barriers to transfer reduce the opportunity cost of inefficient and corrupt management. These conditions together conspire to sustain the condition of the public good character of the canonical SOE.

And yet, as mentioned at the beginning of this section, SOEs may function as legitimately sanctioned public goods or public purposes. In their article, "The Multi-Task Theory of State-Owned Enterprise Reform, Bai et at (2001) emphasize the public good contribution of China's SOEs during the country's transition from plan to market:

> During transition, maintaining employment and providing a social safety net to the unemployed are important to social stability, which in turn is crucial for the productivity of the whole economy. Because independent institutions for social safety are lacking and firms with strong profit incentives have little incentives to promote social stability due to its public good nature, state-owned enterprises (SOEs) are needed to continue their role in providing social welfare. Charged with the multi-tasks of efficient production as well as social welfare provision, SOEs continue to be given low profit incentives, and consequently their financial performance continues to be poor.

Hence, in the absence of the construction of a comprehensive social insurance system covering unemployment, health and disability insurance, Bai et al suggest that the premature dismantling of SOEs may contribute to China's social instability and overall economic productivity.

Furthermore, the Chinese government has designated certain industries as ‘strategic”, such as defense and energy, or “pillar” industries, such as the automotive and telecommunications industries, with the implication that state ownership and/or direct subsidies plays a constructive 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 purposes 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. In this section, we have sought to situate the state-owned enterprises within the overall structure and functioning of China’s economic system. The bottom line is that boundaries need to be placed on the public good feature of the country’s SOEs so as to limit the corrosive features of SOEs of while enabling them to effectively serve the legitimate public purposes of an advanced, institutionally-complete, and disciplined market system.

4. Reform Overview: Three Stages

This section outlines three discrete phases of China’s SOE reform: (i) entry and competition (1980-95), (ii) “retain the large; release the small” initiative (1996-2007), and (iii) restructuring the large enterprises (2008 to present).[7]

Stage I. Entry and competition: As shown in Table 1, during 1978 to 1994, the number of reported industrial enterprises grew dramatically from 348,400 to **10.02 million, the peak count for industrial enterprises during the post 1980-reform period. In 1978, the 83,700 SOEs accounted for 78% of China’s gross industrial output; the 264,700 collective enterprises accounted for most of the balance of China’s industrial sector output. Sixteen years later, in 1994, among the 10.02 million enterprises, the number of SOEs had grown only modestly to 102,200, whereas the number of collectives, including township and village enterprises expanded to 1.86 million, and the number** of “individual-owned” and “other” enterprises surged to over **800 thousand**. These represented 37.4%, 37.7% and 11.3% of total gross output respectively.

[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.

This rapid surge in new entry was produced in substantial part by the dual track system, which opened the door to the marketization of much of China's domestic economy. Marketization and competition were further heightened by the liberalization of trade and foreign investment, during which China's trade ratio surged from 13% in 1980 to 38% in 1995, even as **China real GDP had grown by more than six fold.**[8] Hence, while the state sector dominated industrial output during the early 1980s, as a result of China's domestic market liberalization and opening to foreign trade and investment, the SOE share of the total number of industrial enterprises fell from 24.0% in 1980 to 10.2% in 1994 as their share in industrial output over the same period fell from 78.0% in 1978 (NBS, 1986, pp. 233, 273) to 37.4% (1995, p. 401, Table 12-1).

Arguably, no single paragraph captures the critical role of this competitive impulse in China's economic transformation 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…

New entry and rising competition led to the dramatic decline in state sector profitability shown in Figure 5. As Jefferson and Rawski (1994a, 1994b) demonstrate, during this early period, in accord with North, by making the search for new forms of technology and governance and the resultant learning essential for survival, competition was the critical driver of SOE reform. They show that the same increase in competition that eroded profitability led to rising productivity. Groves et al (1994, 1996) further 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 had begun to emerge thereby demonstrating the ability of reform to strengthen managerial incentives to substantially improve the performance of a subset of state-owned enterprises.

Stage II. Retain-the-large; release-the-small: Following 1995, motivated in part by the determination to ready China for membership in the World Trade Organization, China initiated

[8] World Bank trade data, http://data.worldbank.org/indicator/NE.TRD.GNFS.ZS?locations=CN and *Chinese Statistical Yearbook* (1996).

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, from 59% to 32% of total urban employment.[9] The second transformative initiative was the 1996 "*jueda fangxiao*" edict 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. A year later, the State Council approved a huge formal shift of SOE ownership from the central government to municipalities with the explicit goal of expediting conversions to non-state ownership.

Subsequently, this second reform period saw the emergence of growing SOE sales and 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 specific laws, regulations, and policies that served to clarify the ownership rights of state-owned assets, thus further enabling their sale and exchange among state agencies and private actors within China's emerging market for corporate assets.

The result of the "retain the large; release the small" initiative combined with the evolution of China's legal and regulatory corporate environment was the sale or ownership restructuring of tens of thousands of former SOEs. As shown in Table 1, by 2004, the number of above-scale state-owned and state-controlled enterprises had fallen from 64,737 in 1998, the first year in which the NBS reported the "above scale" enterprise data,[10] to nearly half that number, i.e., 35,597, in 2004.[11] According to Gan (2008), between 1995 and 2005, close to 100,000 firms with 11.4 trillion RMB worth of assets were privatized. Together these comprised two-thirds of China's SOEs and state assets, "making China's privatization by far the largest in human history." The impacts on performance were palpable.

Using the "above scale" industrial firm-level data, three studies largely concur on the impact of the reform on SOE firm performance. Jefferson, Zhang, and Rawski (2008) find

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

[10] In 1998, China' statistic's bureau altered its reporting of industrial statistics from "independent accounting units" that covered a large number of enterprises that were independently registered whose output was principally focused on industrial production to "above scale" enterprises whose annual sales exceeded 5 million renminbi (approximately $600,000 at the 1998 exchange rate. As a result, the number of reported enterprises was reduced to a fraction of what had been regularly reported up until 1998.

[11] NBS (2005), Table 14-9, p. 499.

substantial productivity gains during 1998 to 2005 for both SOEs and private firms. Hsieh and Zhang (2015), confirm this result for 1998-2007 and further find that surge in SOE-firm productivity resulting in significant [part due to the fact that the exiting firms were typically smaller, exhibiting lower productivity than the surviving SOEs.[12] They further estimate that during this period, reforms of the state sector were responsible for 24 percent of China's aggregate TFP growth. Finally, Brandt et al (2012) conclude that for the full sample of above-scale enterprises, over this period approximately one-half of total TFP growth resulted from the restructuring exit-entry dynamic of China's manufacturing sector, both SOEs and non-SOEs. Clearly, the "retain-the-large; release-the-small" initiative had a substantial effect of China's enterprise sector. Together, Figures 1 and 4 show that after bottoming out in 1996/7, profits from the state sector rise rather continuously, showing near convergence with non-state-owned firms in 2006-07.

Still, notwithstanding the extensive restructuring, productivity and profitability gains, and reduction in the number of firms and their share of total industrial output, serious efficiency problems persisted. At the center, a more limited number of highly mega-firms emerged with concentrations of economic and political power that aggravated resource and market distortions across the economy. Naughton's assessment (2008, p. 8) of the prospects for deep, sustained reform of the CSOEs that emerged from the "retain the large; release the small" initiative. According to Naughton:

> Efforts to subject these firms to increased transparency and greater regularity have paid some dividends to be sure. But efforts to restrict their money and resources have had no effect whatsoever….Central state firms can present themselves as national champions, and in this respect at least can draw on a measure of public support…. SASAC's mandate is to "own" these corporations and to manage them in the public interest. SASAC is thus ally *and* adversary of the central enterprises.

Stage III. Restructuring the large SOEs – 2008 to present: The profile of surviving SOEs shows that the reform of China's centrally state-owned and state-controlled enterprises has

[12] 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.

proceeded along two important avenues. The first is their consolidation into a limited number of merged mega-firms, presently numbered at 106. As previously referenced in Table 2, among China's 20 largest companies, 19 are currently state-owned or state-controlled firms, for which the majority state-owned shares are mostly publicly traded on the Hong Kong or other international exchanges. Among the Chinese companies on the Fortune 2014 Global 500 list, 98 companies are based in China, including those headquartered in Hong Kong. According to Fortune News, that number 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, of the 98 Chinese companies on the list, 22 are private.[13]

Notwithstanding this concentration of CSOE activity in 106 mega-firms, SOEs continue to pervade the Chinese economy, extending well outside the industrial and financial sectors. China State Construction Engineering, for example, is the largest home builder in the world with a wide range of subsidiaries involved in domestic and international subsidies, including those specializing in public facilities and highways. In the view of Chen Zhiwu[14], 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."

The second key reform initiative for China's CSOEs materialized on September 13, 2015 when China's CCP and State Council issued guidelines that update and extend the government's effort to achieve meaningful reform of its SOEs.[15] 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.

[13] http://fortune.com/2015/07/22/china-global-500-government-owned/
[14] Chen is a finance professor at Yale University and former adviser to China's cabinet in 2007.
[15] "Guiding Opinions of the Communist Party of China Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises," September 2015

- 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.

As shown below, the 2015 reforms have led to varied reaction regarding their likely effect.

Assessing the 2015 reform guidelines. In her Brooking-sponsored paper, 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." Leutert, however, sets forth three specific challenges, or tensions, 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 administration's 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.

Indeed, as presaged by Naughton in 2008, even public pronouncements within China responding to the 2015 Guidelines 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.[16] The plan wants to increase financial returns but also calls for strengthening party control. Hence the guidelines and much of the related commentary acknowledges the tensions, enumerated by Luetert above that may persist in hindering restructuring progress.

As Leutert suggests in her assessment, even the commercial-oriented firms will arguably be critical for support of 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. All of the CSOEs are also credible candidates as National Champions enabling China to be on the global map in the highly visible finance, telecommunications, automobile manufacturing, aerospace, and defense industries. Retaining these National Champion candidates within the pool of CSOEs enables the government to employ subsidies, pursue mergers and acquisitions, block competition, and other measures intended to "advance the interests of the nation."

Journalists who follow China's SOE reform progress express mixed expectations regarding the success of the State Council's 2015 restructuring guidelines. Gabriel Wildau of the *Financial Times* offered a rather pessimistic assessment. In her article, "China's state-owned zombie economy,"[17] Wildau (2016) argues that rather than undertake the break-up and sale of unprofitable enterprises, most of the emphasis has been on consolidation. 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 while retaining majority control. Far from shrinking its role in the economy, the leadership believes the answer lies in strengthening the ruling party's grip on state assets, while making SOEs more competitive." Wildau 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 intended to strengthen the leadership's Silk Road initiative.

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.

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[16] https://www.ft.com/content/5eeeb84a-5aaa-11e5-97e9-7f0bf5e7177b

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

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."

Contrasting with these pessimistic assessments by Wildau and *The Economist* above, other assessments by *The Economist* are more optimistic. Writing on August 30, 2014, more than a year before the 2015 guidelines,[18] *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.

The optimistic assessment of *The Economist* may not be misplaced. To a significant degree each of these expectations has in fact come to pass. Such incremental progress may represent the ability of SASAC to make progress "…slowly and tentatively as it grinds against the formidable power of large, wealthy, and politically connected organizations." (Naughton, 2008, p. 8)

5. Restructuring China's Remaining SOEs: Corporate reform vs. Institutional reform?

As shown above, one notable feature of the literature that addresses China's recent initiatives to reform its SOE 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 from academic research to media outlets and non-academic policy sources is likely the result of several conditions. First, with the shrinking number of SOEs and the fact that more than 90% of their assets are held by

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

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. Furthermore, most of the major SOEs are either publicly traded or are 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 enterprises have come to acquire such interest and scrutiny by the financial community and financial press is itself a powerful statement of the extent and consequence of China's SOE reform over the past three decades.

However, certain of the academic literature has taken a different slant on the 2015 Guidelines. While the media and public policy institute literature has largely focused on the prospects for implementing the corporate reform agenda embedded in the 2015 Guidelines, the academic literature has focused more on the issue of whether the goals set forth in the Guidelines, even if pursued in a diligent and demonstrable manner, can truly improve the performance of the SOE sector. Based on the restructuring experience of the past two decades, several researchers are skeptical that the principal-agent problem – and by extension the public good problem – can be alleviated through mixed ownership involving minority ownership interests being effectively represented through the agency of independent directors.

Among those emphasizing the overriding importance of the legal and regulatory environment in which all firms operate – whether state, mixed, or privately-owned – are Milhoupt and Zheng (undated). After surveying the ownership structure and relative performance of a substantial number of large Chinese firms of various ownership forms spanning the continuum of state-owned to private owned firms, they stress the importance of "market-neutral institutions" over individual firm ownership.

> …Ownership of the firm *as such* provides relatively little information about the incentives of management, the innovative capacity of the firm (and whether it is directed at generating consumer surplus or capturing state rents), or the degree of autonomy the firm enjoys from the state….But because the Chinese party-state retains (relatively undefined) residual control rights in firms of all (ownership) types, corporate "ownership" is less central to understanding the attributes of the Chinese firm as compared to firms operating under market-neutral institutions and relatively robust constraints on state intervention.

While Gan and his colleagues (2008) find that ownership does matter – they find that only manager-owned forms show substantial performance improvement – they agree with Milhoupt-Zheng that *mixed* ownership is not a solution to the chronic principal-agent problem in China's corporate system. Using a unique hand-collected nationwide survey of a sample of generally small and medium-sized enterprises, Gan et al (2008) conclude:

> …privatization in China has improved performance, but only for firms bought by managers (MBOs). Consistent with improved performance, MBO firms are less likely to be influenced by the state in their daily operation and are more likely to take various restructuring measures. We also find city governments with stronger fiscal disciplines and with less political burdens of disposing of laid-off workers tend to use the MBO method to privatize.

One reason why configurations of mixed, minority ownership may not succeed is the lack of efficacy of representatives of minority ownership, i.e., the independent director. In 2001, the China Securities Regulatory Commission (CSRC) issued its *Guidance Opinion on the Establishment of an Independent Director System in Listed Companies*, covering all companies listed on Chinese stock exchanges (but not Chinese companies listed overseas). As explained by Clarke (2006), the Opinion constitutes the most comprehensive measure taken to date by the CSRC—or indeed by any Chinese governmental authority—to regulate internal corporate governance through the institution of the independent director.

Clarke's assessment (2006) of the impact of the growing practice of appointing independent members of the corporate board, notably those that were publicly traded, dates back to the mid-1990s. The article, based on a review of the empirical research on the relationship between independent directors and corporate performance in the United States, as well as in China, and finds that the research yields similar conclusions: there is no strong link. Clark concludes that proponents of the institution of independent directors misconceive the nature of the corporate governance problem in China, as well as the requirements for the effective functioning of independent directors in the United States. Specifically, according to Clarke, the usual complements and substitutes for shareholder monitoring as a means of disciplining managers—shareholder litigation, the managerial labor market, the input and product market, and the market for corporate control—do not, with the exception of input and product markets, function at all well in China.

Regulatory authorities in China have limited resources, and civil litigation by shareholders is tightly restricted. Because these methods of monitoring management and making it accountable do not work well, the state should not place constraints around the one mechanism that might work well: large shareholding. It should not block concentration of shareholding or make it difficult for majority shareholders to exercise control over the company by making the board too independent.

The implication of the combined findings of Milhoupt and Zheng (undated), Gan et al (2008), and Clarke (2006) would appear to be that the only remedy for the classic principal-agent problem, as manifested in China, is to encourage privatization of existing SOEs by MBOs and hopefully majority ownership. Given the weakness of the legal and regulatory structure that enables smaller shareholders, sometimes acting as independent directors, to affect firm performance, privatizations without majority management control appear to perform consistently weaker than those with owners performing the managerial function.

These research findings offer little encouragement for a key element of the Government's 2015 SOE reform guidelines – that is, mixed ownership with the appointment of independent directors. Contrary to the objective of the 2015 Guidelines, the available research would seem to suggest that failing the legal avenues and remedies for disparate owners to orchestrate their influence, regardless of the sheer number of independent directors, mixed ownership does not appear to be an effective reform vehicle.

In fact, even when majority shareholders or full ownership dominates, Milhoupt and Zheng (undated), appear to be arguing that in China, corporate ownership simply does not matter; the institutions within which they operate do. Moreover SOE reform is inseparable from deep institutional and political reform. According to the authors, "…in China, growth potential, due to its close association with political legitimacy, is the key currency with which to obtain state backing irrespective of ownership." Outlining the necessary scope for effective reform, Milhoupt and Zheng (undated) assert:

> Thus, a shift toward the creation of a true private sector in China will require more than the commonly proffered prescriptions of privatizing SOEs and shrinking the state's share of the economy. It will require the formation of robust market-neutral institutions: a corporate law that permits entrepreneurs to contract away from state-favored organizational forms, a robust and neutrally enforced antimonopoly law, and elimination of preferential access to bank finance and the capital markets for state-favored firms, to name a few key reforms….Our

analysis indicates that the state sector must be curtailed through massive institutional reforms, not through changes in ownership alone….. In light of these complexities, our analysis casts doubt on how far China can go in reducing the role of the state in its economy without significant political reforms.

Still, a degree of optimism persists in the financial press regarding the potential benefits of mixed ownership. As reported by *The Economist*, among these promising initiatives is that of Guangdong Province, which offered mixed ownership in 50 different SOEs and that of Shanghai, which sold a 12% stake in a subsidiary of the Jin Jiang hotel group to Hony Capital, a local private-equity firm. "There is a lot of room for reform before touching political red lines," says Andrew Batson of Gavekal Dragonomics.[19] In August, 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.

With little more 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". By 2020, the results of the 2015 Guidelines should be clear, including which of the remaining SOEs will be released and which of these will be retained effective ownership, while the sets of rights and responsibilities of those retained should be made more clear. As this process unfolds, the outcomes should make clear whether the ownership and institutional reform as embedded in the 2015 Guidelines is sufficient given the generally status quo legal and political context in which they unfold or if indeed, as a number of observers argue, far deeper institutional change is a pre-requisite for the dynamically evolving competitive world class corporate structure that China seeks.

6. Final remarks and future research directions

[19] http://research.gavekal.com/author/andrew-batson

During the 20-year period 1987-2007, the reform of China's SOEs contributed substantially to the nation's overall economic and productivity advance. This is not to suggest that the SOEs were a model of corporate governance. Indeed, although over the period 1997-2007, via sale, merger, and restructuring, SOE productivity converged toward that of the non-SOE sector, SOE productivity continued to lag behind that of the non-SOEs. Moreover, by capturing far more than its share of financial resources and impairing competition in both product and capital markets, the SOEs – both those in the industrial sector and otherwise, including the state-owned banks – likely impaired the growth and productivity of the non-SOE sector.

As a central instrument for carrying out the nation's stimulus program during 2008-2010, the SOEs were an important vehicle for stabilizing an economy facing a collapse of demand among China's sources of growth abroad. Since then, there is little evidence of palpable SOE reform that has improved SOE efficiency or reduced the role of SOEs in China's overall economy. Indeed, over the past decade, as profitability and productivity in the SOE sector has fallen or stagnated, China's surviving SOEs may be contributing to China's economic growth slowdown.

Key among drivers of reform has been China's evolving institutional structure. Again according to North (p. 261) "The organizations that come into existence will reflect the opportunities provided by the institutional matrix," an emphasis on the clear assignment of property rights and low transaction costs (Coase). Arguably, whether the manufacturing system or the financial system, a growing openness of the Chinese economy, both domestically and internationally will persist as the key driver of China's incentive and capacity to drive home the reform to which its 2015 Guidelines have given rhetorical support.

This review identifies a number of unresolved issues warranting further research for China's SOE reform. Among these are:

- How China will distinguish in principle and execution the distinction between the commercial and public service function, both in the overall economy, strategic sectors, and for individual firms.

- How to reconcile the intent of the Party and the State to exercise managerial and personnel control at the firm level with the need to enable market-determined outcomes for firm exit and entry, products, and capital.
- Whether these issues can be resolved case-by-case at the firm level or if indeed, as some insist, their resolution will require "massive institutional reforms."

As much progress as China's enterprise reforms have achieved, the reform issues are qualitatively similar to those that have persisted over the past three decades. Although the scope of the reform challenge has contracted to a far more limited number of SOEs, the remaining mega-firms persist in dominating major portions of strategic sectors, such as energy, building materials, and banking that impair market outcomes throughout the economy.

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Table 1. Ownership composition: number of enterprises & % of industrial sales/output								
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 corpor-ations	Foreign and HMT-invested	Collective enterprises	Other, including private
1978	348,400	83,700	80.8	0.0	0.0	19.2	0.0
1994	10,200,000	102,200	37.4	4.2	9.5	37.7	11.3
1998	7,974,600 (165,080)#	64,737 (64,737)#	28.2 (52.3)#	7.8 (3.6)#	14.9 (24.3)#	38.4 (11.1)#	20.7 (8.7)#
2004	301,961#	35,597	35.9	n.a.*	32.7	5.7	25.7*
2014	377,888#	18,808	23.7	9.5	22.8	0.6	43.4
Sources: NBS, Science and Technology Yearbook, various years; #above scale only; *the figure for non-state-owned shareholding corporations is not available; it is included in the other column;								

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

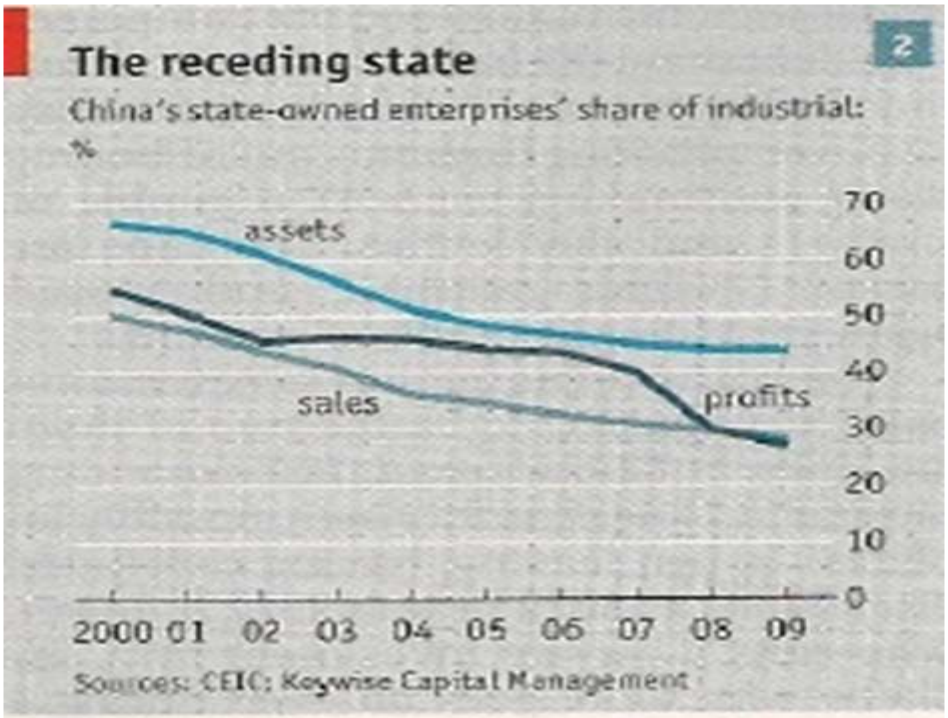


Figure 2. Industrial Output by Ownership, 2009

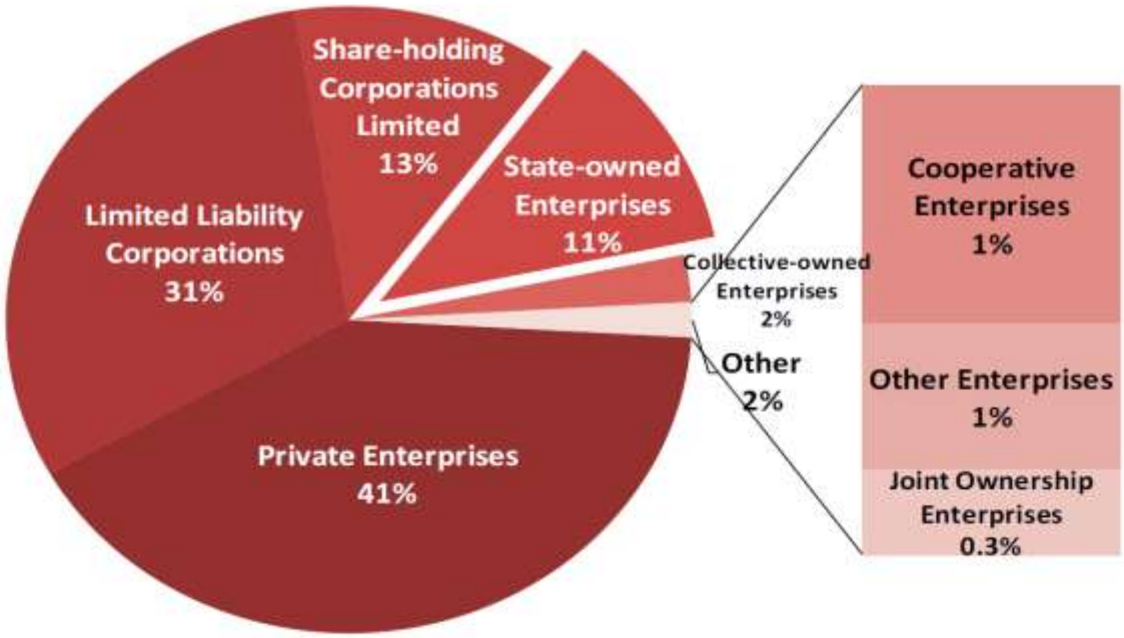


Figure 3. Return on Assets of China's Industrial Firms

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

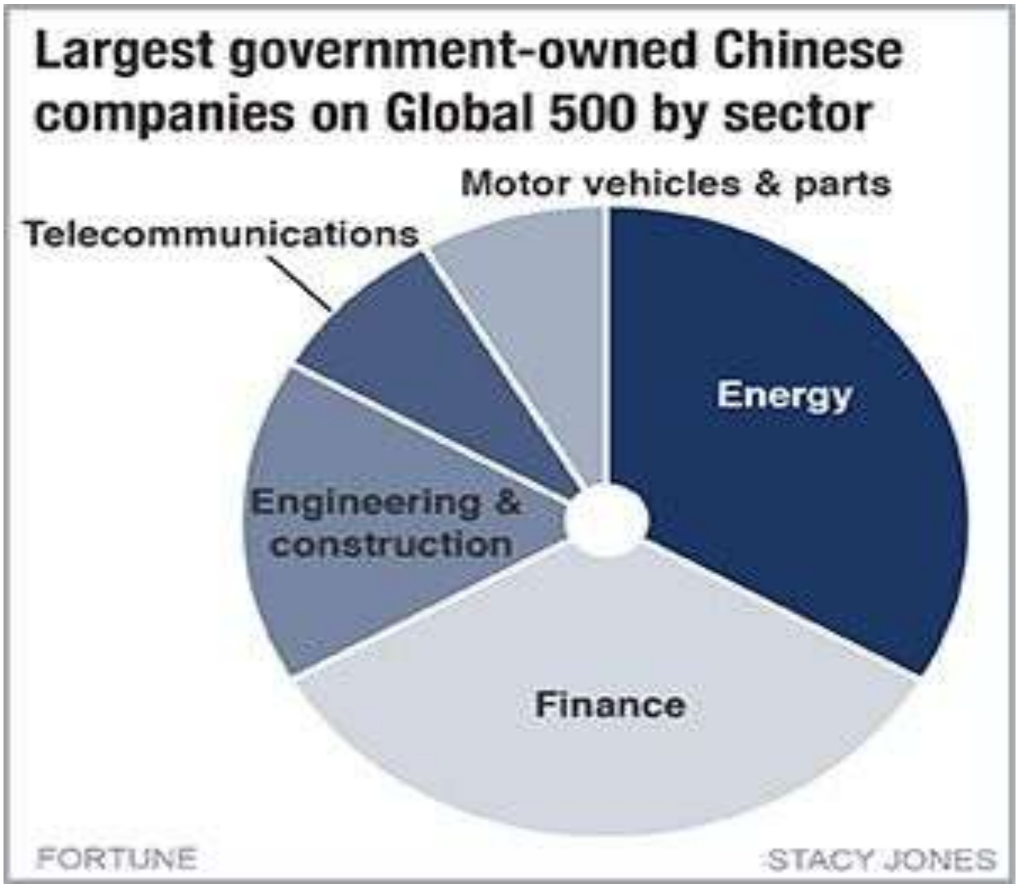
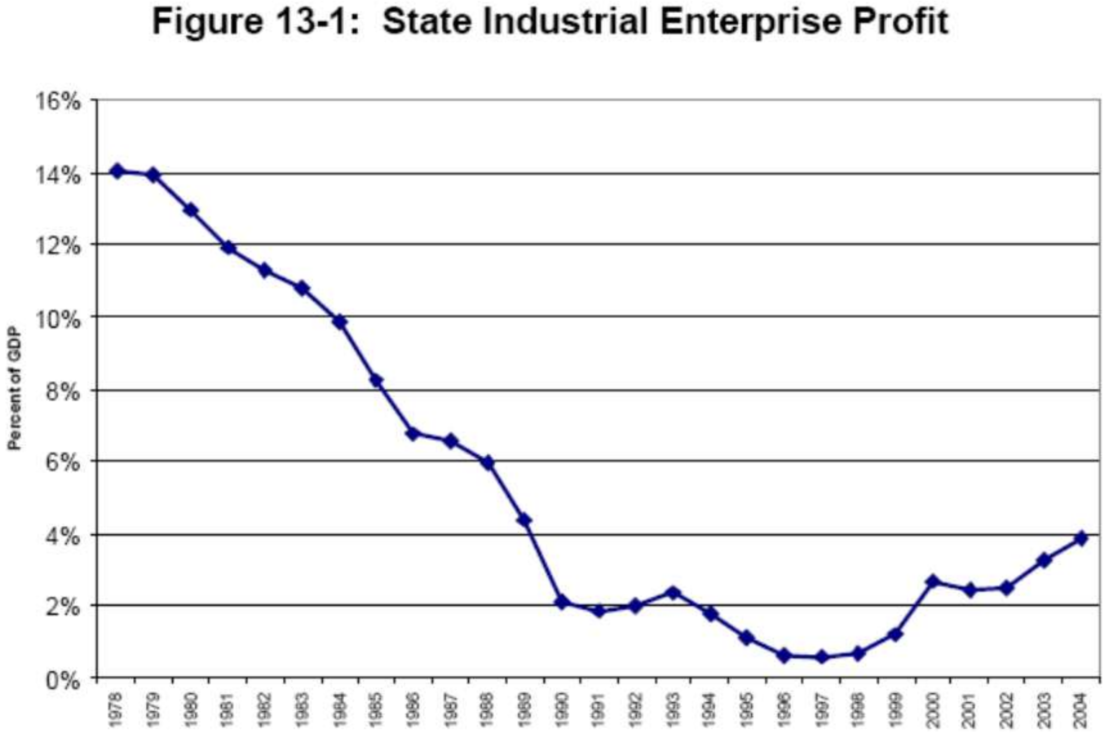


Figure 5. State Industrial Enterprise Profit



Naughton (2007) p. 305