China's Unfinished State-Owned Enterprise Reforms

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The changing role and position of State-Owned Enterprises (SOEs) in China's economy provides an insight into China's market oriented reforms since the initial opening up of the late 1970s. While past reforms to the SOE sector were a catalyst for China's rapid economic rise over recent decades, SOEs now lag well behind the non-state sector in terms of their productivity performance, contribution to economic growth and their role in China's broader economic development. However, China's state sector remains powerful; it continues to dominate many key areas of the economy, commanding a disproportionate share of the country's financial resources through its privileged position in the political system. Further market oriented reforms to the SOE sector will therefore be crucial if China is to achieve ongoing gains in productivity and to maintain a swift pace of economic development. Looking ahead, the government is expected to pursue further corporatisation and public listing of SOEs, better public asset management, while broader economic reforms to China's financial markets and government administration is likely to subject SOEs to an increasingly competitive operating environment.

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Introduction

China's State-Owned Enterprises (SOEs) have been on a long and yet-to-be accomplished journey since the late 1970s; from affiliates to China's previous command economy, to independent commercial entities. The market-oriented reforms introduced to the SOE sector over the past two decades have seen the government loosen its control over SOEs, the shedding of a large number of loss-making enterprises, and significant restructuring of remaining enterprises, including by public listing. SOEs are now subject to greater market discipline, enjoy more autonomy, and are more accountable for their performance. However, these achievements still fall short of making SOEs 'modern enterprises', an explicit goal set by the Government in 1992 for SOEs to become fully capable of making business decisions free of administrative interference. So far, the Government retains considerable influence over SOEs, through the exercise of its owner's rights as well as multiple regulatory channels.[2] SOEs have also become a strong vested interest in a system that treats them favourably.

Undertaking further market-oriented SOE reforms has again become an important policy task, as China faces a structural slowdown associated with a declining working age population and the fading benefits of past economic reforms. China's new leaders agree that growth has to increasingly come from productivity gains driven by improved resource allocation (rather than through simply agglomerating large amounts of capital and labour). Nowhere is reform more important than in the allocation of capital, which is dominated by the state sector. Reform will also be hard to accomplish without the government redefining its own role to be the provider of public services while refraining from interfering in the economy through SOEs.

This article discusses China's approach to SOE reform as part of the effort to grow the economy out of its centrally planned origins. Reform of SOEs has been evolutionary, not revolutionary; the non-state sector has been allowed to grow faster than the state sector. However, this model will face difficulties in the future as China's overall economic growth slows and the need to make efficiency gains across all sectors of the economy becomes more acute. The article discusses China's future SOE reform options and the challenges in carrying them out.

An incremental reform approach

China's economic reform policies since the late-1970s have balanced the dual objectives of enhancing economic efficiency and strengthening the position of the ruling

2 The Chinese Communist Party is China's ruling party and, as such, discussions in this paper on SOE issues treat the Party's role in, and relationship with, SOEs as those of the government.

Communist Party. SOE reforms, which began thirty years ago, are case in point. While these reforms were designed to tackle the obvious inefficiencies inherent in state enterprises, they needed to be done slowly in order to preserve China's political and social stability.

The important role for SOEs was a worldwide phenomenon during the post-war period. Their presence in national economies was justified on various grounds, including: the necessity to provide public goods; regulating (or benefiting from) natural monopolies; acting as 'national champions'; and being the fundamental production unit in the case of centrally planned economies as in China from the 1950s until the economic reforms of the 1980s.

It is widely recognised that SOEs generally operate less efficiently than private firms, for a range of reasons: governments provide 'softer budget constraints' than markets[3] (Kornai 1980, 1986; Kornai, Maskin, and Roland 2003), the policy burden from achieving various costly social goals (Lin and Li 2008);[4] agency issues; and/or a lack of competition.

In undertaking SOE reforms, policy makers face at least three options: changing ownership (mainly through privatisation) (Shirley 1997, 1999, Zhang 1999), introducing competition (Cook and Kirkpatrick 1998, 1995, 2000, Lin *et al* 2003; Carlin et al 2001), or managerial and institutional reforms (Stiglitz 1994, Farazmand 2001, Qian 2000; Hassard 2005). Privatisation involves selling off inefficient, unprofitable, or loss-making SOEs to non-state owners. Greater exposure to competition requires market-oriented reforms that expand the reach of the market economy, through breaking up state monopolies, removing barriers to entry for non-state players and exposing SOEs to market-determined input prices. Corporatisation and corporate governance reforms include the setting up of internal governance structures (decision making procedures and standards) so that management will have incentives to pursue profit and be accountable for their business decisions.

In reality, these options are not mutually exclusive, with different countries trialling different combinations. Although privatisation often seems the first-best option for enhancing efficiency, non-economic considerations have often led policy makers to

3 Under a soft-budget constraint, state-owned enterprises did not have to worry about survival, and therefore were subject to various moral hazard problems, being lax about firm costs, sales, revenues, and ultimately profits.

4 Because the SOEs are owned by the state, both in theory and in reality, the government may be able to require the SOE to deviate from the goal of profit maximization so as to fulfil policy goals of the state, such as employment and social services. There is another reason to have SOEs, which is that provision of social services through SOEs may be more efficient than other delivery channels despite that SOEs are less profitable than private firms.

avoid a comprehensive programme of privatisation. In China, while the overhaul of the SOE sector from the mid-1990s occurred with a large scale sell-off of loss-making SOEs,[5] only partial privatisation was pursued, as the government kept the majority stakes in large SOEs. Fears of falling tax revenue, social and political instability have all been cited as reasons for avoiding an all-out privatisation programme (Li and Liu 2004). In the meantime, the Government pushed remaining SOEs towards corporate governance reforms and greater exposure to competition.

China's mixed approach to SOE reform also reflects that markets and the broader non-state sector were almost non-existent when China began its reform process. This is in contrast to Australia and other western market economies prior to the programme of de-regulation and privatisation of the 1980s, where vibrant markets and market-oriented private firms already co-existed with state-owned companies. Instead, the authorities recognised that China needed time to develop markets, market-friendly institutions, and market-compatible norms, ideas, practice, and enforcement.[6]

China's approach towards SOE reform also reflects its broader incremental strategy in reforming the centrally planned economy. This contrasts with the more radical and wholesale approach in the former Soviet Union and East European countries following the collapse of the communist regimes (Wu 2012; Lin et al 1998:307-337, Nolan 1995). In introducing economic reforms, the Chinese Communist Party (CCP) has been careful to make policies that strengthen, rather than undermine, its political rule (Zhang 1998). Relying on existing political and administrative institutions to carry out reform policies also means that the government was more likely to push change through in areas where institutional resistance was the weakest (Shirk 1993). China's leaders carefully crafted reform measures and implemented them through trial-and-error to ensure desirable outcomes, broad-based support, and minimum risks from taking on powerful groups.

Market forces were first introduced into areas where economic problems were most acute, vested interests supporting the status quo were weak;[7] and tangible benefits

5 While privatisation in China in the late 1990s was conducted in many quasi forms and in a quiet fashion, it was arguably the largest ever in scale in human history (Guo *et al* 2008).

6 One example is the spread of modern economics in China when pre-reform was dominated by Marxist political economy theories. Through the thirty years of reforms and opening up, modern economics (as opposed to the pre-reform Marxist political economy) has now become the dominant paradigm and policy framework among China's economists and economic policy makers (Wu 2012a).

7 This explains why market-oriented reforms were first introduced in the rural sector where, pre-reform, the commune system was broke, farmers' incentives to work was sapped, and growth also stalled. Compared with numerous powerful industrial ministries, only the ministry of agriculture looked after rural issues, and it was a weak one in the late 1970s and early 1980s.

were immediately achievable.[8] Reforms to China's industrial sector progressed more slowly than other reforms (for example, in agriculture) because of its political importance as a stronghold of the socialist system and the complexity of the sector, with progress in this sector contingent upon success in other areas. Indeed, the government only began serious SOE reform in the 1990s, when widespread loss-making among SOEs could lead to an economic crisis. Even then, resistance to SOE reform was assuaged by the Government's commitment to a continued important role for SOEs, rather than complete privatisation.

However, this approach also means that the transition from a centrally-planned to market economy has become protracted. While the economy has gradually become more market-based, the government retains considerable economic power. The Chinese economy nowadays is a hybrid, with growing market-oriented sectors co-existing with a shrinking, yet still powerful, state sector. This dual track system initially helped to break the economy free from the iron grip of the central planners, and could eventually help it to evolve into a fully-fledged market economy (Naughton 1995). However, the powerful and entrenched interests that remain in the state sector are likely to provide stubborn resistance to further market-oriented reforms, which could risk de-railing the completion of China's economic transition.

SOE reforms: an overview

China's SOE reforms have been a mixed experiment of quasi-privatisation, corporate governance reform, and greater exposure to competition, resulting in a significant change in SOEs' role and position in the economy.

Thirty years ago when China was a centrally planned economy, the government directly ran SOEs, set their annual output targets, and left SOEs with little autonomy in making commercial decisions, including what to produce, where to invest, who to sell to, how to price, and where to get finance. SOEs had no right to hire and fire, and any profits they made had to be handed over to the government. Each SOE acted as a mini-society in providing life-time employment — the so-called 'iron rice bowl' — and some basic social services (clinics, schools, age pension equivalent) for its employees and their families. As a result, pre-reform SOEs were highly inefficient.

Reform policies in the 1980s focused on loosening government control, particularly by giving SOEs more decision making autonomy and incentives through profit sharing. These efforts did not succeed, as SOEs, plagued by soft-budget constraints and agency issues, had every incentive to maximise their own gains while letting the government take the losses.

8 One could point to the opening up to foreign trade and investment as such a case.

By the early to mid-1990s, the SOE sector was in crisis — SOEs were bleeding financially, the sector as a whole was on the verge of loss making. Due to the rigid internal management structures, SOEs were uncompetitive against more nimble, market-oriented non-state firms. In the mid-1990s the government undertook more radical reforms. By redefining the reforms as market-oriented, the government undertook a large-scale de facto privatisation program of loss making or less strategically important businesses[9] and withdrew SOEs from more labour-intensive sectors. At the same time, the government encouraged rapid expansion of the non-state sector — an ideological breakthrough that accorded private enterprises equal political status with the state sector — to help absorb tens of millions of workers laid off from the privatisation of small and medium SOEs.

From the mid-1990s, Chinese leaders increasingly realised that the state sector did not need to be involved in every sector of the economy. However, the Government decided to keep the majority of large SOEs in its ownership, reflecting its fear that full privatisation might lead the Government to lose its overall control over the economy.[10] Instead, the government pushed large SOEs for consolidation through mergers and restructuring and into 'strategic and pillar' industries and industries with a natural monopolistic nature. Official slogans capturing the gist of these policies were 'grasping the big and letting go of the small' (SOEs) and the state sector 'advancing (in some areas) while retreating (from other areas)'.

In China, as elsewhere, SOE reforms were foremost a political decision. Chinese leaders faced the difficult choice of balancing the short-term political cost of reform against the longer-term prospect of slower growth without reform. At the same time, China's leaders cautiously traversed this path amid a challenging domestic and international environment, including the unfolding Asian financial crisis in the late 1990s that hit China's export and economic growth, and preparation for China's entry into the WTO in 2001 which required necessary market-oriented reforms. There were other constraining factors at the time, including China's (largely absent) macroeconomic policy framework and financial markets. Businesses' limited access to capital from under-developed financial markets may have been one reason why SOE investment remained important for economic growth through this time (Musacchio 2012).

9 During the mid-1990s and the mid-2000s, the state sold around two-thirds of SOEs and state assets to non-state owned firms. From 1998 to 2004, six in ten SOE employees — totalling tens of millions of workers — were laid off (Liu, March 2005).

10 However, not all large SOEs were safe. During 1998 and 2003, there were about 5000 loss-making large and medium SOEs went bankrupt, involving nearly 10 million workers (RBRB 2013).

It is not surprising then that SOE reform slowed from the early 2000s, or may even have reversed during the global financial crisis (GFC) (Wu 2012b). By then, a large number of small and medium SOEs had already been sold and non-profitable large SOEs restructured. There was also a public backlash against privatisation given a myriad of scandals of asset stripping and rising unemployment. In response, China’s State Council established the State-owned Assets Supervision and Administration Commission (SASAC) in 2003, with the mandate of SOE reforms, growing state assets, and optimising their sectoral allocation. SASAC has taken measures to strengthen its supervision of SOEs, such as streamlining SOEs’ reporting structures (Box 1), and has pushed for corporate governance reforms and diversification of ownership structure for SOEs. SOE consolidation has continued through merger and acquisition. However, in reality, SASAC put more emphasis on its mandate of growing and supervising state assets, rather than on reforming and restructuring SOEs (Wu 2012a).

Box 1: Overview of SOEs' Reporting Structures

SOEs are nowadays no longer attached to, or directly run by, state ministries, as was the case under China's centrally planned economy. SOEs report to the state owners who are various government agencies at the central, provincial, or local level.

SOEs fall into three groups. The first group contains industrial SOEs and, at the end of 2011, there were 144,700 such enterprises with total assets of RMB 85.37 trillion (US$13.55 trillion), revenue of RMB 39.25 trillion, and profits of RMB 2.58 trillion, in turn accounting for 35 per cent of total industrial and business revenues and 43 per cent of the total profits (Xinhua 2012).

All these SOEs, except a very few, report to provincial and local governments. These very few (currently at 113) are under the direct supervision of the State-owned Assets Supervision and Administration Commission (SASAC), set up by the State Council in 2003 to represent the state through its rights and responsibilities as a major or sole shareholder, with the objective of allocating state assets into the 'right' sectors and growing their value. The central SOEs are all conglomerates, clustered around China's 'strategic', 'emerging' and 'pillar' industries, and are also the largest overseas investors.

Provincial and local SOEs are typically much smaller in size, scale, and business operations. While association with different state agencies at local levels makes LSOEs more likely to operate locally, they also extend their operations into other jurisdictions. As a result, they compete fiercely among themselves, and with private companies in China's domestic market.

The second group consists of banking and financial companies, including China's major state-owned commercial banks, which are governed by banking, securities and insurance regulators. The third group consists of media, publications, culture, and entertainment companies, run by various government agencies.

A key SOE reform objective has been to establish a 'modern enterprise system'. The modern enterprise system, as sanctioned in 1993, consists of four pillars: clarification of property rights; clarification of rights and responsibilities; separation between government administration and corporate business; and 'scientific' management. Over time, a growing number of SOEs have adopted modern corporate structures with boards of directors responsible to shareholders and for supervising the management of business operations. This has led to the administrative functions being stripped off from SOEs' business operations. SOEs' corporate governance has also been strengthened through shareholding reforms, with a growing number of SOEs being publicly listed. SOEs' ownership structure has become more diversified, involving the participation of non-state (private and foreign) firms as majority or minority shareholders. These reforms have moved SOEs away from being direct affiliates to the central planning system, with the government no longer involved in most SOEs' day-to-day operations.

By the end of 2010, about half of the large SOEs have undergone various kinds of shareholding reforms, resulting in a more diversified ownership structure across the sector (Table 1). Large SOEs are no longer purely state-owned, with non-state investors taking partial ownership through joint ventures, joint partnership, joint business operations, or public listing. The head of SASAC was quoted in late 2012 as saying that 90 per cent of CSOEs under its supervision had become corporations and some of them had undergone shareholding reforms (Xinhua 2012). Publicly listed SOEs now account for over 60 per cent of SOEs' total revenues and over 80 per cent of SOEs' total profits.

Table 1: A more diversified state ownership structures

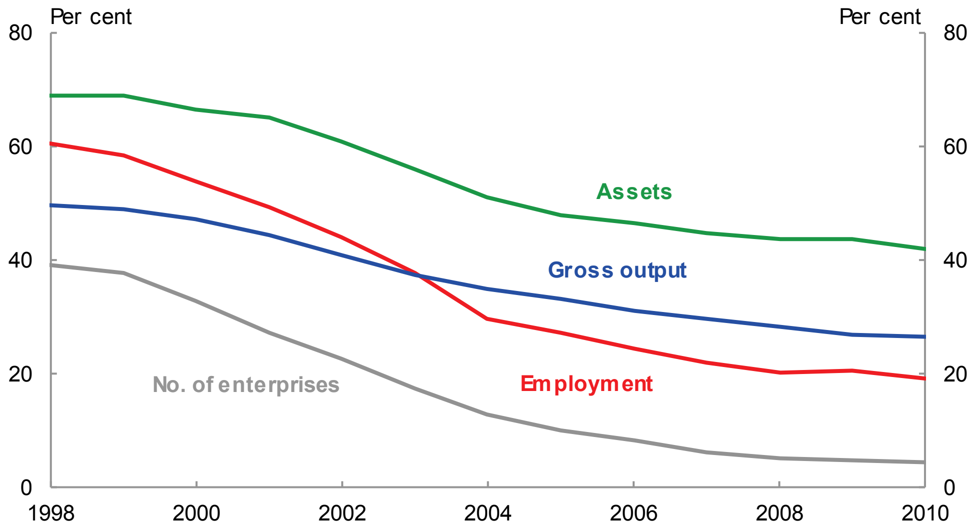
State-ownership types	Share of state enterprises (per cent)
State-owned Enterprise (SOE)	43
State Sole Funded Corporations	7
State Joint Ownership Enterprises	1
Total state-controlled SOEs	***51***
Joint State-collective Enterprises	1
Unspecified	48
Total state holding enterprises	***49***
SOE and State-holding Enterprise (SHE)	**100**

Source: National Bureau of Statistics of China.

SOEs: no longer as important but still powerful

SOEs nowadays are significantly different from what they were 15 years ago when serious reforms began, let alone 30 years ago when reforms were first introduced. In particular, SOEs' importance in the economy has been in a constant decline since the mid-1990s, which can be seen across a range of metrics (Chart 1).

Chart 1: State enterprises — declining importance in the economy

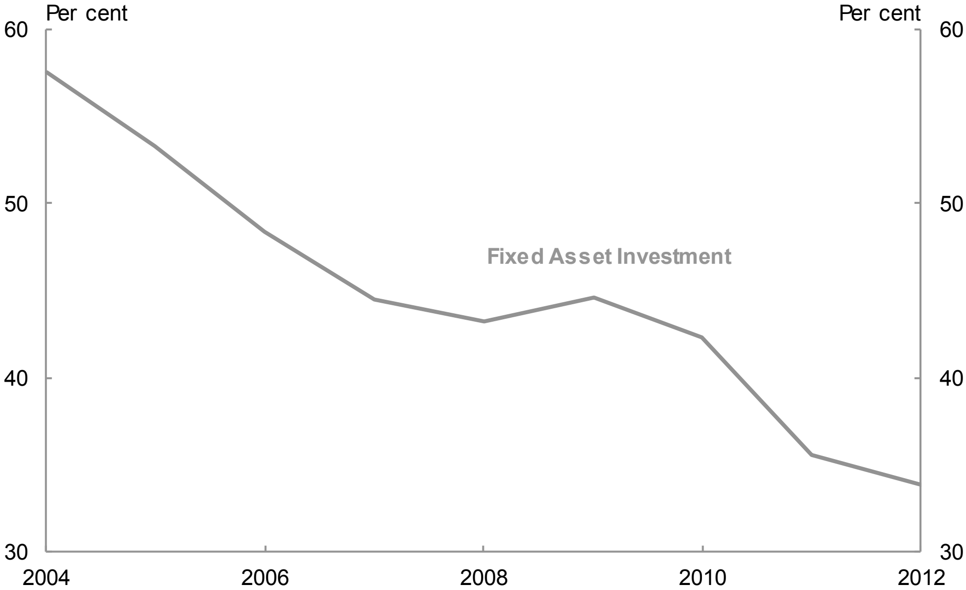


Sources: CEIC China Database and Treasury.

First and foremost, SOEs' share of gross output — which measures their combined contribution to China's economic output — almost halved between 1998 and 2010, to be only slightly more than a quarter. Mirroring this, in 2010, SOEs accounted for only slightly over a quarter of the industrial sector's total profits. While the state sector's *share* of the economy has fallen over time, it is worth noting that its absolute size has continued to rise in terms of gross output and total assets. Indeed, the relative decline of SOEs in China's economy simply reflects that the non-state sector has grown at a much faster rate, and has been the true drivers of China's industrial production and profit growth.

Second, SOEs' share of fixed asset investment (FAI) — which is often touted as a sign of China's state-led growth — has continued a long-term decline, from 58 per cent in 2004, to below 45 per cent in 2009, to below 35 per cent in 2012 (Chart 2). Again, this does not mean that FAI by SOEs did not grow during the period of time. It simply means that FAI undertaken by the non-state sector outpaced that of the state sector. According to the National Development and Reform Commission, private investment grew by 32.5 per cent in 2010, 34.3 per cent in 2011, and 24.8 per cent in 2012. Its growth rates were 8.7, 10.5, and 4.2 percentage points higher than the growth rates in total FAI during these three years. The private sector's share of FAI also increased, from 55.9 per cent in 2010, to 61.4 per cent in 2012. In the first half of 2013, private investment grew by 23.4 per cent to reach RMB 11.6 trillion, with its share rising further to 63.7 per cent (The People's Daily 2013). Interestingly, despite evidence of an SOE revival following the global financial crisis (GFC), the investment data suggest any rise was merely temporary. Moreover, any success in moving away from investment-led growth and towards the more efficient use of capital would be likely to reinforce this downward trend.

Chart 2: State enterprises — declining share in total fixed asset investment



Source: CEIC China Database and Treasury.

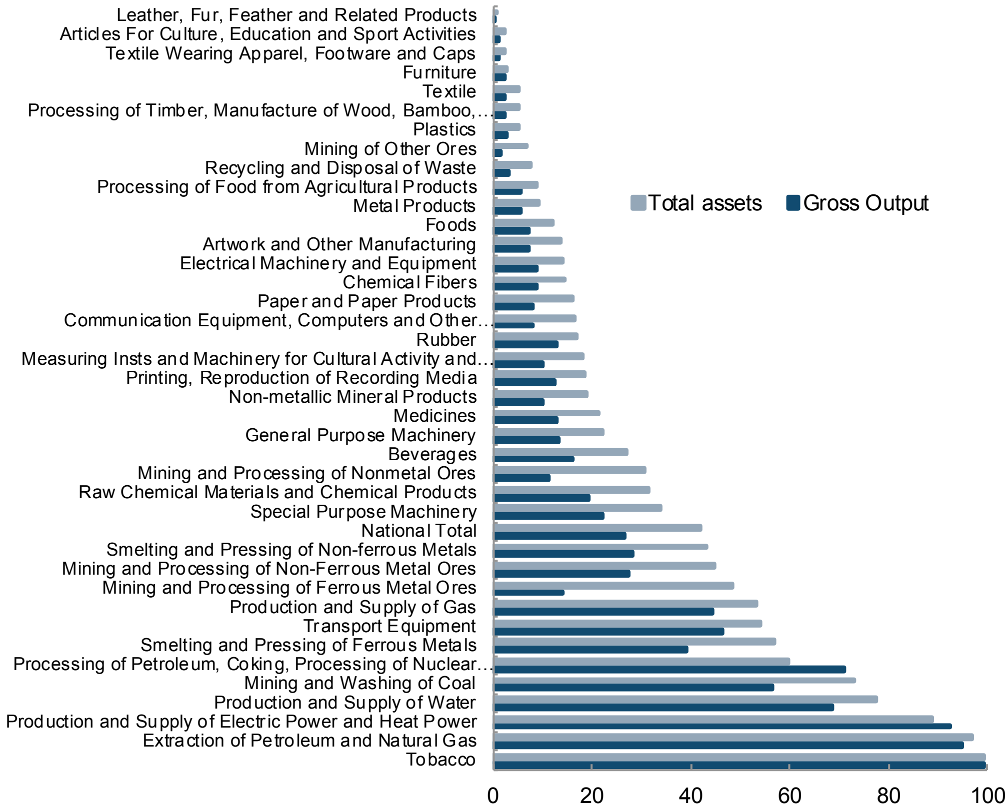
Other measures are equally telling. SOEs accounted for 20 per cent of total industrial employment in 2010, falling from around 60 per cent in 1998. After shedding tens of millions of workers while undergoing various reforms, SOEs are no longer China's major employer. The share of workers employed by SOEs have more than halved between 1998 and 2010. The non-state sector is, and will continue to be, the main source of employment.

A majority of firms in China are already non-state owned, with SOEs accounting for less than 5 per cent of the number of industrial firms, dropping from slightly below 40 per cent in 1998. This should be read together with SOEs' share of assets, which, while falling from about 70 per cent in 1998, still hovered above 40 per cent in 2010.

Taken together, these metrics suggest that SOEs tend to be much larger and more capital-intensive than non-state firms. In 2010 on average, a SOE had five times more workers, produced nearly eight times more output value, and used 15 times more asset than a firm in the non-state sector. As previously discussed, larger-scale and more capital-intensive SOEs are direct policy outcomes of the government pursuance of SOE reform since the mid-1990s.

Indeed, some SOEs have become industrial behemoths on a global scale. In 2012, 54 of the largest SOEs entered into the Fortune 500, with the largest reaching the 5th place. In the mid-1990s, by contrast, the total combined revenue from China's top 500 SOEs was less than that of General Motors.

Chart 3: State enterprises — sectoral distribution (share of total assets and gross output)



Source: National Bureau of Statistics: Statistical Yearbook of China, 2011.

The sectoral distribution of SOEs has also changed markedly since the reforms began. SOEs have almost completely abandoned labour-intensive industries such as textile and footwear. They are now heavily concentrated in the production and distribution of natural resources, materials, and energy, with a large presence in transport equipment and machinery production — industries earmarked as 'strategic and pillar' (Chart 3). State-owned companies continue to dominate key utility and infrastructure sectors, such as electricity, aviation, telecommunications, banking, railway and shipping.

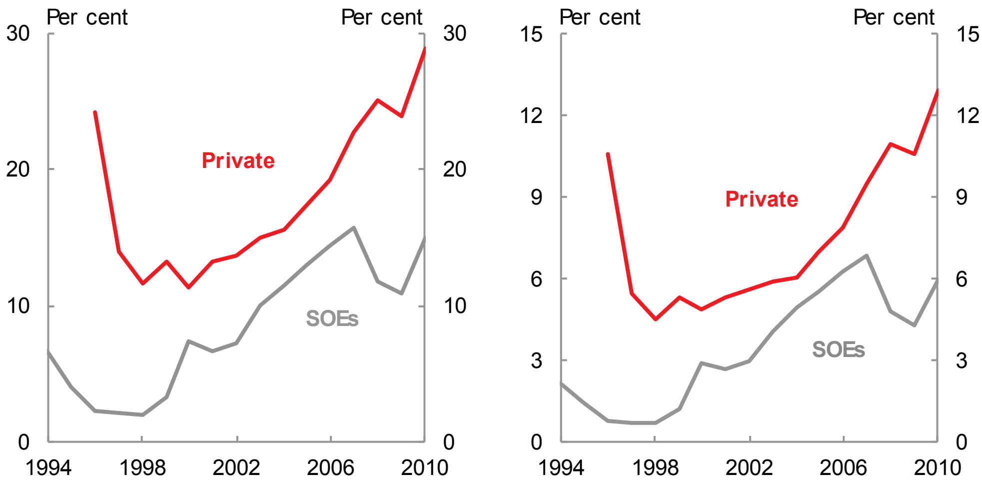
In a sense, this represents a clear success for the government in realising their policy objective of 'seizing the big and letting go of the small', with SOEs making a retreat from the more competitive sectors to the more strategic sectors. However, what constitutes a 'strategic' industry is an evolving concept, and the 12th Five Year Plan for 2011-15 lists seven strategic industries: new-generation information technology, energy-saving and environment protection, new energy, biology, high-end equipment manufacturing, new materials and new-energy cars.

Favourable policies towards SOEs

But has the financial performance of SOEs improved? Normally this would be an important indicator of whether the reforms have also succeeded in making SOEs more productive.

On the surface, SOEs have made a turnaround in financial performance since the late 1990s, when the sector was on the verge of loss-making. The return on equity (ROE) of SOEs rose from below 2 per cent in 1998 to above 15 per cent in 2007. After a two-year fall following the onset of the GFC, the ROE in 2010 recovered to just below the pre-GFC level. While this apparent reversal in fortunes has been hailed by the government as a success in SOE reforms, policy favouritism, rather than their economic performance, has played an important role (Chart 4).

Chart 4: State enterprises — improving profitability but still lagging behind non-state firms (left panel: return on equity and right panel: return on asset)



Source: CEIC China Database and Treasury.

Indeed, the remarkable change of financial fortune for SOEs has been significantly aided by policies and regulations to help SOEs take the 'strategic heights' of the economy. SOEs continue to enjoy a privileged status in natural monopolistic sectors such as utilities. Further, the government has effectively created administrative monopolies that restrict entry and competition from non-state firms in a wide range of activity in services and other industries that it regards as strategically important (World Bank 2012). Moreover, a disproportionate share of SOE profits come from a few state monopolies that earn artificially high rates of return. For example, SOEs in the resource and energy industries accounted for around 55 per cent of SOEs' total profit.

In addition to protection from competition, SOEs continue to receive explicit and implicit government subsidies, including low effective tax rates, low dividend payouts, and little or no royalties on resource extraction. Compared to non-state firms, SOEs are in a much better position to benefit from under-pricing on key inputs such as energy, water, land, and capital derived from China's distorted factor markets (Huang 2010). SOEs are also in a more favoured position than non-state firms in accessing credit from banks because of the implicit backing they have from the government.

These protections, subsidies, and preferential treatments have artificially propped up SOEs' profitability. Based on the costs of doing businesses faced by non-state firms, SOEs' profitability would be much lower or even negative. Unirule (2011), an independent Chinese think tank, estimates the average real ROE of SOEs from 2001 to 2009 to be -6.29 per cent, rather than the 8.16 per cent reported. The figure is derived from stripping the benefits of various preferential policies and fiscal subsidies from SOEs' reported profits, and adding back the real cost of financing, land and resource rent to their expenses.

An important source of economic distortions

Understandably, these favourable policies mean that SOEs remain a source of economic distortion, which is manifested in different forms.

First, SOEs are run considerably less efficiently than non-state firms. Even using the inflated SOE profit figures, private firms were still more than twice as profitable as SOEs in terms of ROA in 2010. Resources keep pouring into SOEs, while non-state firms still face discriminations in access to finance, inputs, and entering certain industries. A report released on the 2013 *Boao Forum* said that based on its survey of 1000 small and medium enterprises (SMEs) across China, 62 per cent of them do not have bank loans (Zheng 2013, *China Daily*).

The majority of SOEs' profits have been retained for internal uses. Until 2007, SOEs were not required to distribute any dividends to their shareholders. While this is changing, the payout rates remain low. Moreover, most dividends that the government receives have been funnelled back into SOEs in the name of supporting their development. Of the anticipated RMB 108.3 billion that SOEs will pay the government in 2013, over 90 per cent is expected to be used to support SOEs, for the purpose of either their restructuring and research and development (RMB38 billion), major investment projects (RMB 37billion), industrial upgrading (RMB 17.7 billion), or foreign investment and economic cooperation (RMB 6.7 billion). Only 7 per cent (RMB 76 billion) is scheduled to be transferred either to the government budget or for social security purpose.[11] Therefore, raising dividend payout ratios alone does not guarantee that SOEs will ultimately provide a larger dividend to the government.

Excessive retained profits and access to cheap credit enable SOEs to keep investing in areas with non-economic returns. Because of their access to cheap capital, SOEs also tend to maintain a higher level of inventories, and are able to undertake long-term investment. This in turn exacerbates the issues of excess production capacity already confronting many industries.

Because they are in competition for factors of production, these distortions limit the growth of China's more efficient and profitable non-state firms. It is difficult to determine whether the distortions are worsening or not. The declining share of SOEs in the economy suggests that their distortions may also be declining. However, they are also concentrating in certain sectors and competing for increasingly scarce factors of production, which may be increasing their economic cost. Their constraining influence over the broader reform agenda may also have become more costly.

The entrenched SOE-government nexus

Despite years of reforms to free SOEs from government interference, China's current institutional settings continue to provide the government with multiple channels to influence SOEs. SOEs are also in a strong position to influence the process of policy making. The SOE-government nexus has, in varying degrees, entrenched the economic distortions that favour SOEs.

The government can exert its influence on SOEs through the appointment of board directors and chief executives, which are the legitimate rights that any majority owner is able to exercise. The government has also appointed independent boards of directors on some occasions, which has reportedly played a positive role in improving the quality of corporate governance and management in such SOEs.

There are further policy channels through which the government can influence SOEs, including administrative guidance in implementing macroeconomic policies and industrial policy. The government also gains influence through compliance requirements for SOEs in regard to business regulations, licensing, and bank lending.

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11 According to China's Ministry of Finance, there are five different payout ratios applying to industries: 20 per cent for the tobacco industry, 15 per cent for industries with monopolistic nature, such as petroleum, petrochemical, electricity, telecommunications, and coal production, and 10 per cent for steel, transport, electronics, trade, and construction industries; 5 per cent for ministry enterprises, science research institutes, China Post, and 0 per cent for policy companies, including companies in engaged in food and cotton reserves (see http://yss.mof.gov.cn/2012zyczys/201303/t20130322_784806.html).

The role of local governments is particularly important. Decentralisation of economic power during the reform period has generally made local governments an important driver for growth. The performance assessments of local officials and therefore their promotions are closely linked to the performance of their local economy. This has given local officials every incentive to push local SOEs to implement a variety of goals — growth, employment, or social stability. Backed up by local governments, local SOEs have often been compelled into activities which would not be undertaken on a purely commercial basis, which has drawn the government into shouldering the associated cost and risks of such activities.

Their stake in the success of local SOEs means that local governments have an incentive towards industrial favouritism, rather than promoting the market economy through greater competition and enhanced consumer protection.[12] Central government agencies, particularly SASAC, have been making some progress in reining in these types of government interference through more centralised supervisions and coordination. However, progress is slow, often hampered by strong and differing local interests.

Influence goes both ways. SOEs shape government policy priorities, often advancing their own interests. Lack of effective supervision means that the balance of the relationship is often tipped in the favour of SOEs away from their state owners. With insider information and a strong interest in protecting SOEs' interests, senior managers in state enterprises are often in a much better position in dealing with officials from the supervisory agencies who may not have the same strong incentive to enact supervision.

SOEs can also derive influence from their ranking vis-à-vis the government. Despite SOEs no longer being part of the bureaucratic system, SOEs retain their state and party ranking, which often see the heads of major CSOEs ranked as equal to a minister or vice-minister, with a few heads also members or alternates of the Chinese Communist Party (CCP) Central Committee. This link is reinforced by the rotation between government and SOE positions, and a more common practice by the government of promoting heads of SOEs into key government positions. In this context, it is not surprising that SOEs are an integral part of the policy making process, routinely consulted throughout policy deliberations.

12 However, there are different views as to whether local governments have become more or less partial in promoting competition. Coarse and Wang (2013), for instance, argue that, due to strong inter-regional competition for business investment, local governments have increasingly become public service providers that contribute to the improvement of overall business environment and fairer competition.

As a beneficiary of the existing system, SOEs have strong interests in maintaining the status quo. Their strong voice in the system means that the government has to take into account their interests when undertaking future SOE reforms. SOEs' entrenched position in the policy making process has given rise to concerns that the government has even become a captive of SOEs (Yao 2010). This leads to the fundamental question of whether the government is able to push forward necessary economic reforms.

Renewal for market-oriented SOE reforms

Against this backdrop, there emerged a robust debate within China's policy circle on the need for further market-oriented reforms in the lead up to the CCP 18th National Congress in late 2012 and the 12th National People's Congress in March 2013.[13] The World Bank-Development Research Centre report, *China 2030*, jointly released by China's Finance Minister and the President of the World Bank in Beijing in March 2012, was another trigger of the debate.[14] The report contains in-depth analysis and practical recommendations for further market-oriented SOE reforms as a cornerstone to China's rise to a high income economy.

China's renewed push for broad-based reforms is occurring against a background of slowing growth and a search for new growth drivers. While the recent moderation in China's economic growth is partly a result of the withdrawal of government stimulus applied during the GFC and weak demand from developed countries, it also reflects ongoing structural shifts in the economy (Kong *et al* 2012). The benefits from previous reforms are dissipating, China is approaching closer to the technological frontier, and the working age population has peaked.

In policy circles, there has been a clear recognition of the limit to continuing to use credit and investment to drive growth. Many accept that there is an urgent need to transition towards a new growth model, driven mainly by productivity gains, innovation, and private sector participation (Lu 2013). The key to this transition, the government believes, is to liberalise the still-tightly controlled portions of the economy, including the SOE sector (World Bank 2012).

Almost immediately following the inauguration of the new administration, in which reform-minded officials have taken key policy making positions, market-based reform programs have begun rolling out (Naughton 2013a, 2013b). [Box 2: Major reform as announced by the State Council for 2013.]

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13 This debate is ongoing. While views defending SOEs' position are loud, calls for trimming their influence have gained some ascendency in the policymaking process.

14 The report involved an extensive collaboration between the World Bank and the Chinese Government, with its coordinator Liu He now sitting as the head of the Secretariat for the CCP's Leading Small Group for Finance and Economy.

Box 2: Major reform areas approved by the State Council for 2013

On 24 May 2013, China's State Council approved recommendations made by the National Development and Reform Commission (NDRC) on reforms in seven key areas: administrative system; fiscal system; financial system; investment system; resources and energy prices; social security; and urbanisation, as part of China's efforts to transition to a more sustainable growth model.

The administrative system reforms aim to reduce government interference in the economy and transform it into a public service provider. The State Council announced that it reformed 133 administrative approval processes (107 were removed) in the government's first two months in office. Continued regulatory efficiencies are noted in this reform plan.

Fiscal system reforms aim to establish an open, transparent, standardised budget system. Tax reform is a key element, including expansion of the pilot value-added tax (VAT) into transportation, shipping, certain service sectors, coal and other heavy polluting products, and recommendations for improved management of dividends from state assets, and fiscal support for SMEs.

Financial system reforms include the pushes for more market-determined interest rates and exchange rates and progressing RMB convertibility under the capital account. The reforms will also allow for greater foreign investment in China — Premier Li told a German audience recently that the rest of the world has an 'enormous' opportunity in this reform package. Private sector firms will also gain from the removal of barriers to investment in hitherto protected sectors such as energy, railways and telecoms. Implementing deposit insurance is also recommended.

Other reforms include measures for more market-determined prices for commercial and residential use of electricity, coal, water and LNG; establishment of social security, food security, and environment protection; and pushing for further urbanisation, including reforms of the *hukou* system (household registration), which so far has disadvantaged urban migrant workers in access to government services.

More broadly, the State Council notes that this reform package supports ongoing reforms in state-owned-enterprises, economic opening up, and other social services.

The clear direction of the reform programs is to use market-based principles to reshape the economy, including pushing for de-regulations (cutting red tape) to encourage private sector-led growth, allowing the market to set prices for land, resources, energy, and capital (through interest rate and exchange rate liberalisation). While discussion of large-scale economic reforms by Chinese leaders is not new, the strength of rhetoric used by top leaders and official statements and the level of detail for implementation suggest this time may be different. If successfully implemented, these reforms will consequently change China's business environment and make SOE reforms easier to undertake.

Discussions by leading academics and officials indicate that the government is likely to continue pushing SOE reforms along the following three fronts. First, given the existence of so many inefficient and loss-making SOEs, there seems to be significant room to resume the process of privatisation, which has stalled since the early 2000s. By the end of 2012, one quarter of SOEs were loss-making and continued to be viable only through state support. While privatisation remains politically sensitive, it is likely that any further privatisation would proceed quietly and in a gradual manner away from the public limelight.

Second, the government is likely to stimulate SOE reforms by increasing domestic competition, through: providing support to private firms; lowering barriers to entry and exit; breaking up state monopolies or oligopolies in key industries (such as petroleum, chemicals, electricity distribution, telecommunications, and banking and financing areas); and promoting SMEs and increasing their access to finance. These reforms will help force SOEs to be efficient and competitive. Allowing private participation in the existing state monopoly sectors could also help lower production and distribution costs, and broaden the revenue bases for the government.

Third, there is much room for further corporatisation and corporate governance reforms. The government has clearly indicated that, wherever conditions are met, SOEs will be pushed for public listing in either domestic or international stock markets. The government hopes that public listing could facilitate the separation of ownership from management and the introduction of modern corporate governance practices. As a result, SOEs will be forced to face direct market disciplines, further diversify their ownership structure with broader private sector participation, and better allocate their assets.

These reforms would eventually help the government securitise its implicit equity in SOEs. For that purpose, it could consider establishing one or more state asset management companies (SAMCs) to represent the government as shareholder and professionally manage and trade these assets in financial markets where feasible. This would facilitate a portion of state assets being transferred to the national pension fund with the flow of returns being used to help fund future pension obligations. In the meantime, SASAC would confine itself to the role of policy making and oversight of state assets.

Concluding remarks

Our discussions so far do not suggest radical changes but point to a continuation and deepening of the reforms that started in the mid-1990s. While China's leadership appears determined to push forward market-oriented SOE reforms, the delivery of these reforms will continue to rely on the existing system, institutions, and policy making process, in which SOEs have a strong voice. Any reforms affecting SOEs' interests will likely be carried out through internal negotiations, with outcomes likely to reflect a compromise, possibly including compensation for potential losers. It is therefore likely that the outcomes may not be exactly what the leadership has planned for in its current roadmap for reform.

Moreover, SOE reforms cannot proceed alone, but are interdependent with other key major reforms, including those of the administrative and fiscal (particularly transfers) systems, and capital and other factor markets. Together, these reforms are the major steps that the government must take to withdraw from being a direct player in the economy. This will allow the market to play a much larger role in determining factor prices, for land, labour, capital, and energy, and thus provide a more level-playing field for firms to compete with one another, regardless of their ownership.

Of course, implementing these reforms involves great uncertainties and risks. These reforms are highly complex, interconnected, and their implementation entails 'top-level design' — a buzzword frequently used by China's leaders nowadays in referring to the need for a coherent reform strategy that coordinates reforms in each of these major policy areas. Acutely aware of these risks, the Chinese leadership will continue to pursue reforms gradually to minimise the chances of instability, be it economic or political.

The outcomes of these reforms, whatever they might be, will have profound implications for China's growth prospects, the shape of its economy, and for the international economy more broadly. For example, if market-oriented reforms are successfully implemented, growth in China is likely to become less resource and perhaps less energy intensive. Moreover, SOEs' share of investment, both domestically and internationally, is also likely to decline further, although at least some of this slack will be picked up by private sector investment. While the impact on China's aggregate investment may be unclear, there is little doubt that a larger role for private sector will be a critical step in driving China's transition to a higher income economy.

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