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Reforming China's State-owned Enterprises

Agatha Kratz

Translator: Peter Brown



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China Analysis
Les Nouvelles de Chine

Reforming China's State-owned Enterprises

Analysis by Agatha Kratz based on:

- Lin Yongsheng,⁽¹⁾ "Working out once again the efficiency of SOEs," *Xin shiji*, 13 August 2012.
- Zhang Wenkui⁽²⁾ interviewed by Wang Xiaobing, "Reforming state-owned enterprises represents the next opportunity for growth," *Xin shiji*, 20 July 2012 (interview conducted in June, before the publication of July's economic figures).
- Sheng Hong⁽³⁾ interviewed by Chen Cai, "Public shareholding has lost its halo of virtue," *Licaiyi zhoubao*, 27 November 2011.
- Sheng Hong interviewed by Wang Daojun, "Private enterprises have the right of access to all markets," *Dongfang zaobao*, 15 May 2012.

On the eve of the 18th Congress of the Chinese Communist Party (CCP), the Chinese press was publishing an increasing array of articles setting out details of the reforms to be undertaken by the new leadership. A number of these discussions focused on state-owned enterprises (SOEs).⁽⁴⁾ Among these contributions are those of Lin Yongsheng and Zhang Wenkui, both of whom are advocates of root-and-branch reform of the system of state-owned enterprises. In addition to these two noticeably critical contributions, we offer two interviews with Sheng Hong, a highly controversial figure in the overall debate on SOEs.⁽⁵⁾ These four contributions give us insight into the state of play with the issues around these enterprises, which are, quite literally, "exceptional."

A significant contribution of SOEs to the Chinese economy

Sheng Hong begins his piece by recalling that in 2011 the gross aggregate income of Chinese public companies reached 30,3 billion *yuan*, that is, 64 percent of China's GDP for the year.⁽⁶⁾ Hence, these companies, whose capital is largely if not wholly under state control, represent a considerable portion of China's economy. Lin explains that although the weight of these companies has gradually been reduced within the economy, ever since the reforms of the 1970s, they still account for 30 percent of all Chinese companies.⁽⁷⁾ This spread is very uneven, however, since in some sectors, such as everyday consumer items, these companies represent "only" 50 percent of invested capital, whereas in certain "strategic" sectors – such as industries to do with the military, telecommunications, energy, etc. – they represent nearly 90 percent of capital invested.

Sheng Hong points out that not all SOEs are comparable. Some are veritable industrial monsters, while others operate on quite a limited scale. This differentiation is reflected in their levels of profit. Some of these companies are perfectly viable, while others are experiencing financial difficulties.

It is on this subject of the profitability of SOEs that Sheng Hong made his name. He reminds us that in 2011, his research centre, the Unirule (Tianze)

Institute of Economics, published a damning report highlighting the economic inefficiency of these companies. Indeed, this report established that over the period 2001-2009, Chinese SOEs recorded an average annual rate of return of 8.16 percent. However, when the enormous state subsidies that these companies received were factored into the equation, their average annual rate of return fell spectacularly, to minus 6.29 percent. This figure shows the extent to which these companies are not economically viable, as well as the extent to which they are assisted by the government through various kinds of subsidies.

Ongoing support to public companies within the political and academic arenas

In spite of these very poor figures, there are still many in favour of maintaining SOEs for a variety of reasons. Zhang explains that many people highlight the sustained growth of SOEs in the past, and their rather significant contribution to the country's development. But Zhang rejects this point of view, arguing that this contribution was in terms of volume and not return on investment. Lin notes that others are keen to preserve the state's capacity for action in certain key industries related to "national well-being" (*guoji*)

1. Deputy-Director of the Centre for Market Economy Research, Beijing Normal University.
2. Deputy-Director of the "Business" wing, Development Research Centre of the State Council (*guowuyuan fazhan yanjiu zhongxin*). He was in charge of implementing the reform programme of the State-owned Assets Supervision and Administration Commission (SASAC). He also contributed to the World Bank's "China 2030" report, published in 2012, and has taken part in the reform and restructuring of many public companies, particularly in the civil aviation sector.
3. Director of the Unirule (Tianze) Institute of Economics, Beijing, and Professor at the Economic Research Institute of the Shandong University.
4. Defined as companies with majority, if not wholly, public shareholding.
5. Indeed, the second interview, dating from 15 May 2012, is, according to some the reason behind the dismissal of *Dongfang zaobao's* deputy-chief editor. See <http://chinadigitaltimes.net/2012/09/is-winter-coming-for-the-chinese-news-media> (consulted on 10 January 2013).
6. Source: International Monetary Fund – October 2012 World Economic Outlook Database.
7. "Report on the Development of the Market Economy in China," Centre for Market Economy Research, Beijing Normal University, 2010.

minsheng 国计民生). According to them, SOEs have a strong “sense of social responsibility” (*shehui zerengan* 社会责任感). Thus, in strategic areas such as energy or the military, their monopoly must be maintained. Lin also attacks this argument by explaining that whilst there are natural monopolies – and strategic SOEs – throughout the world, in developed countries these sectors are at least partially liberalised and open to competition. Sheng Hong, for his part, describes with an ironical tone the argument stating that SOEs are fundamental for guaranteeing “economic security” (*jingji anquan* 经济安全). He cites the example of the United States, whose main economic resource is oil, but whose oil companies are for the most part privately owned, and explains that “patriotism” (*aiguo* 爱国) is not about holding shares.

Finally, Sheng Hong criticises Wu Jinglian, an economist who claims that listing certain SOEs on the stock market has turned them into normal and responsible companies. For Sheng, “these are only small reforms, of little consequence” (*zheshi xiaoda xiaonao, xiaogai xiaoge* 只是小打小闹、小改小革), which have in no way dealt with the major problems posed by SOEs, namely distortion in the allocation of economic resources, favouritism toward SOEs to the detriment of private companies, as well as politicisation, conflicts of interest, and the rent-seeking behaviour to which they give rise.⁸

Important problems posed by the SOEs

“Exceptional” companies

Chinese SOEs are indeed far from being regular companies. Sheng Hong describes the ease with which they have access to many more significant sources of financing than other companies, which enables them to set up considerable investment projects. Moreover, as their status is more flexible than that of private companies, they have less to worry about in the event of incurring financial loss, since, as Sheng ironically puts it, they act “for the public good” (*minsheng* 民生). Further, unlike private companies, the principal shareholder of an SOE, the Chinese State, does not claim its right to a dividend. Thus, the totality of the profits made by these companies is automatically reinvested internally, creating liquidity reserves and a significant capacity for self-financing of future projects. This distorts economic signals, since private companies, whose shareholders do demand access to their company's profits, cannot compete in terms of investment capacity. This is all the more the case in that, according to Sheng, SOEs have favoured access to credit via the Chinese financial system, which is also publicly-owned.

Economic distortions

These companies benefit not only from their special status; by dint of their size and their monopoly situation, they cause major distortions in China's economic sphere, particularly in terms of available “resource allocation” (*ziyuan peizhi niuqu* 资源配置扭曲). In order to limit these distortions, and to improve the efficiency of the Chinese economy, reforms are therefore needed. Zheng explains that although “beautiful” (*piaoliang* 漂亮), these companies contribute to high market costs. Increased competition would thus enable a downward price adjustment to market level. Lin agrees with Sheng and Zhang in affirming that SOEs are a form of market failure. In addition to generating losses, they distort the decisions of economic agents, who cannot rely on market signals to make decisions about production or

investment. These monopolies also block the access of private companies, which are nonetheless more competitive and potentially more profitable, to some markets. Public companies have the means to set up important barriers in these markets, and take advantage of political support to maintain their advantages.

Lin there recommends that the SOE be reformed as quickly as possible, beginning with companies whose economic performance is poor, but that are nevertheless surviving thanks to the financial and political support of the Chinese state. He explains that allowing these under-performing companies to carry on under the pretext of “economic security” would effectively jeopardise the country's economy by wasting resources that could be better invested.

Politicisation, conflicts of interest, and rent-seeking

Sheng Hong illustrates the politicisation of Chinese companies by citing the conclusions of a report by the Unirule (Tianze) Institute of Economics. Among 183 upper-echelon employees (deputy-minister and above) in 19 Ministries and Commissions, 56 have had experience in managing a state-owned enterprise. Zhang confirms this trend, and notes that this politicisation necessarily removes SOEs from the principles of market economy and competition.

This situation thereby creates potential conflicts of interest. Many politicians are named on a rotating basis to head an SOE or a ministry, and can therefore use their connections to ensure that their company, on whose performance they are assessed, benefits from favourable treatment by certain public bodies. These conflicts of interest create situations where the state is led to formulate certain policies that are costly for the population at large but advantageous to certain SOEs.

This politicisation also creates “rent-seeking” opportunities (*xunzu* 寻租) that the government must absolutely strive to assess strictly and punish, according to Zhang. Sheng Hong highlights the opportunities for corruption generated by the SOE system, citing the example of the Chinese Railways Ministry. This sector has in the past undertaken huge projects with equally grandiose financial backing but doubtful economic feasibility. Furthermore, Sheng Hong affirms that this sector has had no qualms about “using the left-over money to invest in so-called investments in the services sector” (*tamen nazhe shengyu de qian, yonglai zuoweide disan chanye touzi* 他们拿着剩余的钱，用来做所谓的第三产业投资). In this kind of situation, it is difficult to know the real rate of return for each of the projects undertaken, and to hold the SOE genuinely accountable.

Sheng Hong concludes by deploring this behaviour, which he says tarnishes the government's reputation and compromises its legitimacy and authority. That is why the government, which he believes is largely in favour of the reforms, absolutely must embark on a restructuring of the SOE.

Important hurdles in the path of reforms

Sheng Hong reminds us that these companies – and notably their managers – have over the years set themselves up as powerful interest groups. Their financial and political means have allowed them to gain significant influence over public policy and within government circles.

8. Rent-seeking behaviour happens when an economic agent seeks to obtain an economic rent, either for himself or for those close to him, by manipulating the social or political environment in which he operates rather than by creating new wealth.

He notes that historically it has been easier for the Chinese government to reform the least coveted areas, where opposition is weak. This is not the case for the sectors of the SOEs, where stakes are very high and the markets and potential profits (or rents) enormous, and where powerful and well-organised interest groups are involved.

Sheng also points out that reforming the system of public companies amounts to recognising the poor management of these entities in the past, and opening up the path to challenging and questioning the government's legitimacy.

Finally, many people are concerned about the imbalances that could result from such liberalisation. Indeed, as Lin reminds us, public companies are some of China's main taxpayers, and have become so well engrained into the economy that their disappearance could cause major economic fallout in terms of fiscal revenues, employment, and production, at least in the short term.

Reforms: A new growth opportunity for China?

Given these hurdles, Sheng states that the present situation (change of leadership, lower growth figures, disappointing economic indicators, etc.) presents an opportunity for reform. Just as the reforms to state companies in the early 2000s were motivated by the bankruptcies of the late 1990s, so the next wave of reforms could be driven by the disappointing economic situation in 2012.

Zhang goes even further in suggesting that this reform could represent the new growth opportunity for China. He shows that the last two waves of reform – of state-owned enterprises in the early years of this century and China's entry into the WTO – served as growth "dividends" (*hongli* 红利), and that in order to keep on growing, China "must find a new reform dividend" (*women xuyao chuangzao xinde gaige hongli* 我们需要创造新的改革红利), which could well lie in the reform of SOEs.

Zhang follows the same line of reasoning: after 30 years of continuous growth, he says, China is entering a very delicate phase in its economic history. It can no longer rely on political or cyclical levers of growth, but has to readjust its economic model if it wants to avoid a hard landing. Reforming the SOEs could therefore provide China with its "next opportunity for growth" (*xiayige zengzhang jihui* 下一个增长机会).

Which reforms?

The task ahead is therefore to reorganise, merge, close, reduce, and even sell certain activities or some branches of these companies. To do this, SOEs have to be judged on their performance by means of objective criteria, and only SOEs that are making a profit (without subsidies) should be left on the market, according to Sheng. Once this first wave of reforms has been achieved, and once the privileges of the SOEs have been abolished, they will slowly but surely all have to be eliminated.

Zhang sets out the goal for the Chinese economy to have less than 15 percent public participation by 2030 – against 30 percent today – and if possible, even to reach a public capitalisation of under 10 percent. Indeed, this drop in the weight of the SOEs is not only a possibility, but also a necessity. Without it, economic distortions will not be corrected and China's growth might be destined to decline even more sharply.

Finally, Sheng Hong concludes more generally by explaining that if SOEs are really the people's enterprises, and if, despite repeated calls for their reform, they remain in place in the years ahead, their governance at least must be reformed. As the property of the people – whose taxes pay for their creation and capitalisation as well as for the many subsidies they enjoy – these companies must be "governed" by the people. Thus, the National People's Congress and not the Executive – via the government – must be given the power and legitimacy to manage the SOEs. The upper echelons of power must therefore undertake a process of reform at a "constitutional level" (*xianzheng cengmian* 宪政层面), and the management of the SOE must revert, *in fine*, to the people. We should note that this plea most certainly extends beyond the sphere of public companies.

All the writers therefore give clear encouragement to getting reform of public companies underway. While some offer more forceful criticisms and recommendations than others, all agree that this subject not only has to be broached but also debated exhaustively, and that the process of reform should begin following the 18th Congress.

■ Translated by Peter Brown.