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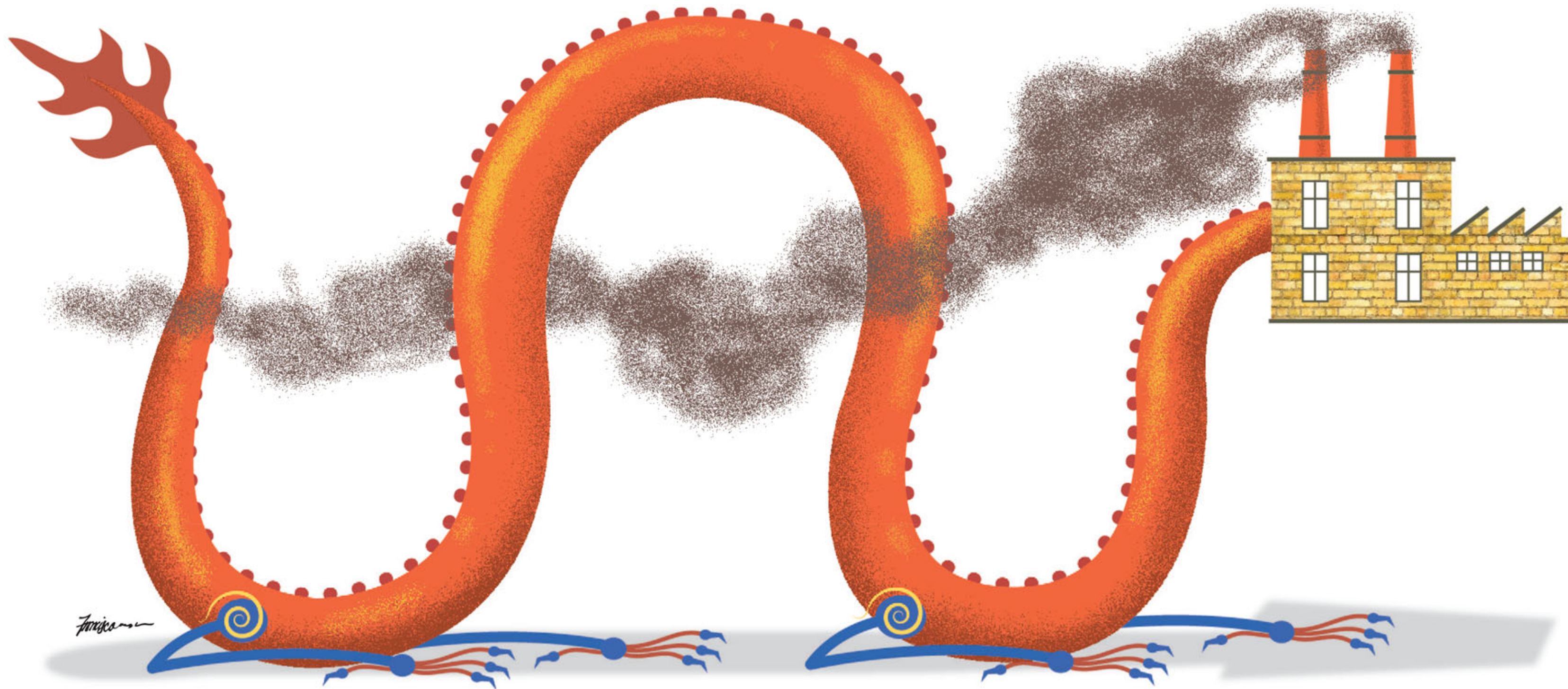

ByInvitation

The remaking of China's state-owned enterprises

While not the fangs and claws of the Chinese leviathan in the Western imagination, they need to be revamped for a rebalancing of China's economy

Zheng Yongnian

For The Straits Times

"Structural reforms" has become a buzzword in recent decades, usually at a time of crisis. Amid the Sino-United States trade war, this broad term has resurfaced and is frequently mentioned as one of America's key demands in its negotiations with China.

While we need to wait until a new trade agreement is unveiled for a precise definition of this vague term, the Trump administration will almost certainly include market-oriented reform of China's state-owned enterprises (SOEs) in its wish list.

On the Chinese side, one thing that's certain is that its negotiators will not easily make concessions on SOEs, especially the large business groups directly administered by Beijing, known as the centrally-managed SOEs.

Routinely listed at the top of the Fortune 500 list, these centrally-managed SOEs control large chunks of China's domestic markets and contribute a significant share of the central government's revenue, while many of their chief executives are members of the People's Congress and the Party's Central Committee.

Politically well-connected and financially well-endowed, they are easily imagined by outsiders as a threat to a market-based economic order. As a result, politicians and decision-makers in the West tend to exaggerate the role of China's state sector and regard Chinese "state capitalism" as a threat.

Such a conceptualisation, however, is too simple, and does not truly reflect the reality of China's economy. The non-state sector has grown very fast since the late Deng Xiaoping's reform and open-door policy, and it now generates more than 50 per cent of China's total tax revenue, 60 per cent of gross domestic product (GDP), 70 per cent of innovation, 80 per cent of urban employment, and 90 per cent of the total number of enterprises. China is now truly a mixed economy.

FIERCE DEBATES IN CHINA

That said, the state sector remains a strategically important part of China's political economy. It is unimaginable that Beijing will give in to American demands for a fundamental transformation of the SOEs. From China's perspective, such a demand is a form of "economic" war, aimed directly at a vital part of its system.

The debate over SOEs goes back decades, ever since China's economic reforms started. For a long time, a fierce debate raged in Chinese academic and policy circles, not so much about whether China should have an SOE sector but over how it should be reformed. In 2013, China's top official think-tank, the Development Research Centre of the State Council, along with the World Bank, argued for the phase-out of the majority of SOEs in favour of market mechanisms.

This official position represents a midpoint between the market and the statist views.

The market school, whether its radical or gradualist wings, argues for the elimination of inefficient, market-distorting SOEs. In contrast, the statist school champions a slimmer but stronger state sector as the engine for economic growth and a bulwark against economic crisis.

The mixed results of China's SOE reforms are a product of policies arising from both schools. The economic reforms of the mid-1990s led to the steady decline of the SOE's share in GDP and employment figures. The global crisis of 2008 helped the largest SOEs to accumulate assets from China's credit-driven stimulus programme, contributing to a structural imbalance. But despite this windfall, the share of the SOEs in employment has declined steadily from 2008 to last year.

China's state sector is indeed in need of market-oriented reform, but the undertaking should be done with care and a proper understanding of its history and features.

For one thing, SOEs are part and parcel of the Chinese political economy. Their roots are to be found in a long political and intellectual tradition that stretches back to China's first empires. It would be wrong to see them from the perspective of Eurocentric theories of political economy and seek to change them based on Western models.

For another, China's SOEs hardly constitute a fundamental challenge to global economic order.

FALSE ANALOGY

Their oft-quoted global prowess derives from a false analogy between the biggest multinational firms and China's centrally-managed SOEs. Far from the fangs and claws of the Chinese leviathan, they are too much embedded in a state-dominated domestic order to be reckoned as effective multinational enterprises. In fact, they are often a headache for the central government when they become too big and inefficient.

A key milestone in China's efforts to reform its economy came in the late 1990s when the then Prime Minister Zhu Rongji took an axe to what was then a bloated and wasteful state sector. It was brutal, costing 30 million workers their jobs but it helped energise the economy, freeing up manpower and resources for more nimble private enterprises. Now 80 per cent of all urban Chinese workers are employed in the private sector.

The Zhu reforms had another characteristic – it transformed the largest state-owned enterprises into vehicles for the newly minted Chinese-style state capitalism. By 2003, these enterprises were consolidated into centrally-managed SOEs and locally-managed SOEs.

The centrally-managed SOEs were usually corporatised former ministries and bureaus of the planned economy and inherited their control over nationwide infrastructure and sometimes even seats on powerful central political bodies like the Party's Central Committee and National People's Congress. These Janus-faced political and economic actors have become immensely powerful, throwing their weight around as provincial and local leaders seek their support for investment opportunities. In effect, the large SOEs have become economic barons whose interests lie in maintaining their grip on the economy.

In order to understand why reforming the big SOEs is not an easy matter, one must consider the historic role of the state sector. The SOE's function was neither purely economic nor political. Unlike the public sector in the West and Japan, China's largest state enterprises were cash cows for the government, though they reserved much of the profits for their own expansion.

Unlike the national champions of South Korea and government-linked companies in Singapore, the big Chinese SOEs are not all that globally competitive and have often made rash investments abroad.

PROPOSED CHANGES

One question now is how to improve their performance in order to provide goods and services efficiently and equitably.

The emerging consensus seems to be to split SOEs into two broad categories, those that are considered strategic (broadly speaking those with implications for national security such as energy and aerospace) and those that are commercial enterprises.

For commercial enterprises, such as the telecommunication giant China Mobile, further reform would entail introducing private capital and creating a more diversified ownership structure.

Even though China is not a city-state, Singapore's Temasek model could serve as a reference, if not a road map, if future SOE reform is to follow a market-oriented direction; in other words, even though the government can hold the state investor accountable for its performance, it maintains an "arms-length relationship" and does not interfere in its operational decisions, leaving them to professional managers.

Other factors to consider in China's SOE reforms:

- A more level playing field for state and non-state sectors
- A rebalancing of the state-owned enterprises' power with primary responsibilities.

In this regard, more attention should be paid to the public's interest, rather than focusing on profit-making and expansion, particularly abroad. Should the SOEs generate profits, these should go first towards shoring up public finance and contributing to the National Pension Fund. Any attempt at strengthening the state sector without also highlighting their primary duty to the people risks further erosion of public trust.

Ironically, the trade war's focus on China's state sector as being emblematic of unfair trade practices comes at a time when China's economy is undergoing structural changes that favour non-state actors.

The expansion of the state sector has been stalled and their attraction has diminished. Today, the star performers are no longer Sinopec or State Grid but the Alibaba Group, BYD, Xiaomi and Huawei. These private-sector firms offer high-paying jobs, better career paths, and a more outward-looking business culture. They attract the best and brightest candidates and they are competitive globally, especially in Asia, Africa and Latin America, even though their main market is still domestic. Simply put, they are not really different from other East Asian multinational companies.

Given the broader economic changes at home and abroad, the current model of state capitalism will become less and less viable over time. A product of Chinese history, SOEs must continue to reinvent themselves if they are to keep up with the times and better fulfil their primary mission to the people.

A better way forward for China's economy would entail an improved relationship between the commercial SOEs and their partners in the private sector, making the most of the synergies involved while reining in the former's ability to take unfair advantage of their political clout. At the same time, more should be done to strengthen the rule of law in order to protect the interests of private enterprises, the true engines of China's phenomenal growth.

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