The Resurgence of State-Owned Enterprise in China Under Xi Jinping

By: MacAllister Hogan

Editor: Daniel Covert

I. Introduction

How can state-owned enterprise reform factor into China's current and future plans for economic development under the leadership of Xi Jinping? President Xi has tightened state control over strategic industries; maintaining the CCP's authority over the Chinese economy has been a top priority since he took office. The Xi administration represents a dramatic reversal in market reforms that China has undergone over the last forty years. State-owned enterprise in China was fundamental to the Chinese economy during the Mao era. Since the end of the central planning era, both the scope and extent to which the Chinese Communist Party controls the economy have decreased to make way for a growing private sector. The changing role of SOEs has been a prominent part of China's gradual shift toward a market economy. SOEs first began gaining a significant level of autonomy in the 1980s under a new system designed to increase their productivity and profitability. The system gave enterprises more freedom in decisions about production planning, marketing, and workforce adjustments and even allowed them to keep a share of the total profits as long as the state-mandated output quotas were met. Only in 1992 did ownership reform take place which involved privatizing smaller SOEs. Performance increased under this restructuring but continued to lag behind private enterprise, so in 2003 the State-owned Assets Supervision and Administration Commission (SASAC) was established in order to supervise the largest SOEs and maintain control over strategic industries such as defense, power, telecommunications, steel, construction, etc. Through a variety of goal-oriented policy measures, the size and value of SOEs actually increased. SOE reform has led to improvements, but the sector's overall performance continues to lag behind the private sector.

As China faces slowing economic growth, SOEs present an obvious opportunity to shed economic deadweight and maintain the pace of growth. Although they operate with much more autonomy and are subject to greater market discipline and competition from private enterprise, there is still room to modernize the position of SOEs in the Chinese economy. An obvious source of productivity gain is improving the allocation of resources and capital. The state sector has always benefitted from favorable policies such as low taxes, preferential access to credit, and subsidies. Without these protections, the real profitability of SOEs is much lower than it appears. Unfortunately, due to the inherent inefficiencies of SOEs, they would cease to remain profitable if these protections were to disappear. The favorable conditions under which SOEs operate limit the growth of more profitable private enterprises by forcing competition between two types of entities which play by two different sets of rules. By increasing privatization of SOEs and slowly subjecting them to greater market forces, they can incorporate a higher level of fiscal responsibility into their production and workforce models. This progress in turn should decrease instances of sunk resource and capital investment in relatively inefficient enterprises, allowing those resources to be allocated more efficiently to the sectors which need it most. The issue with SOE reform is the influence SOEs wield in shaping policy priorities coupled with their understandable interest in protecting the current role they play in the economy. Moving forward, the large and influential SOE interests in Chinese policymaking may result in the government's taking on a larger role in controlling the economy. SOEs have been used in the past to stabilize market forces and have allowed the Chinese government to achieve economic goals largely through policy rather than typical loosening of economic controls. SOE interests will certainly attempt to steer policymaking in this direction. The government could maneuver this obstacle by providing more support for private enterprise and increasing competition in the marketplace by reducing barriers to entering industries dominated by SOE. Decreasing regulations around SOEs to encourage growth outside the SOEs could force them to become more competitive. I argue that further reform of SOEs is necessary to maintain healthy economic growth and that this reform must be a gradual evolution similar to the broader economic shift China has undertaken for the past 40 years.

II. The State-Owned Enterprise System in Maoist China

1. Primary Functions and Benefits of SOEs

While the SOE system came with many drawbacks, there were concrete benefits for China concerning the overarching goals of the planned economy, as well as for a group of people who were rewarded by the advantageous position that SOEs held in Chinese society. Under Mao Zedong, SOEs played a major role in the Chinese economy. SOEs were the main economic units in industrial enterprise under the central planning system. They were used primarily to fulfill the government's production and distribution objectives, which were heavily invested in the growth and development of heavy industry.[1] All large factories, transportation, and communication enterprises were owned by the government and were assigned production targets to be met and the outputs sold at set prices. Despite product prices being virtually meaningless in guiding production decisions for SOEs, they could be used by the government to channel resources between economic sectors effectively.[2] These price controls were important in allocating maximum resources to industry in order to achieve the Big Push Industrialization plans set forward by Mao. The SOE system played an important role in developing the command economy system as well as reinforcing the CCP's control over that system. SOEs, as government agents, were also responsible for providing welfare for employees and their families. SOE employees enjoyed a comprehensive social safety net, which included housing, health care, education, and retirement.[3] Urban residents employed by state-owned firms were directly included in the formal party hierarchy and thus had a relatively high level of access to national resources and support compared to rural residents.

2. Drawbacks of SOEs

These positive externalities were dwarfed by the production

1 Ligang Song, "State-owned Enterprise Reform in China: Past, Present and Prospects," China's 40 Years of Reform and Development: 1978–2018 (2018): 346.
2 Ligang Song, "State-owned Enterprise Reform in China: Past, Present and Prospects," China's 40 Years of Reform and Development: 1978–2018 (2018): 346.
3 Ibid., 346.

inefficiencies and wasted capital that became a feature of the SOE system. SOEs were given very little autonomy in determining what to produce, how much to produce, or how to use surpluses. Planners made commercial and employment decisions, and any profits made had to be handed over to the state.[4] The lack of market-based incentives and poor organization and management of SOEs led to their low efficiency as production units. Inefficiencies in SOEs contributed to several issues during the planned economy period under Mao. Low output and shortages were typical during the Mao years. SOEs also never had to compete with each other or other enterprises in a state-controlled market for inputs and outputs.[5] Without having to adhere to competitive market forces, coupled with their extreme reliance on government funding, subsidies, and tax exemptions, SOEs were very prone to losses, mismanagement, and poor performance.

In a broader sense, the adverse effects of SOEs infected many facets of the Chinese financial system. The Chinese government used the financial system to channel low-cost funds from households to SOEs, while households were restricted in their ability to purchase financial assets other than bank deposits.[6] Financial repression led to the misallocation of investment, increased volatility in asset markets, and depressed household consumption. Under Mao and the command economy, the Chinese financial system was very shallow. Government-run banks provided trade credit and payment services to facilitate the exchange of goods, but no long-term lending for investment projects. Decisions about investments were made by planners and financed from the government budget rather than being based on financial considerations.[7] The key economic and societal role that SOEs played under Mao before 1978 made reform a slow and complicated process. Due to the blatant deficiencies of extensive state intervention in the economy, however, it was clear to reformers that the role of the state had to be mitigated in order to transition from the command economy to a market economy.

4 Dong Zhang and Owen Freestone, " China's Unfinished State-owned Enterprise Reforms," Economic Roundup 2 (November 2013): 79-102.

5 Ligang Song, "State-owned Enterprise Reform in China: Past, Present and Prospects," China's 40 Years of Reform and Development: 1978–2018 (2018): 346.

6 Barry Naughton, The Chinese Economy: Adaptation and Growth (Massachusetts: MIT Press, 2018), 481.

7 Ibid., 487

III.Post-Mao SOE Reform

1. Deng Xiaoping, 1978-1992: Increasing Autonomy and Introducing Market Forces

China's transition from a command to a market economy is marked by different periods of economic reform in response to macroeconomic patterns, which began with facing harsh realities in the direct aftermath of Mao's rule.[8] Transforming the command economy into a market economy involved reforming many of the institutional structures which had been in place for over two decades. At the time of initial reform in 1978, there were virtually no market forces or private businesses. Most significant urban enterprises were state-owned, and farmers were organized into rural collectives. Deng Xiaoping was handed an economy that was completely insulated from world markets, where individual prices and profits were meaningless and material incentives of all kinds were abolished and frowned upon.[9] The initial steps of the early reform process included reducing the power of planners, lowering entry barriers, and giving ordinary people some decision-making authority. Reformers aimed to gradually change the rules under which all economic actors, including SOEs, operated in order to maintain the CCP's control and limit the scope of disruptive change.[10] In the wake of some of Mao's more disastrous economic policies, the most obvious area in need of immediate attention and reform was agriculture. At the end of the 1978 Third Plenum, China's leaders decided to reduce the constant pressure under which farmers had operated. For the previous 30 years, China's farmers were a resource that the government extracted cheap grain from in order to fuel industrialization, resulting in slowing grain production and a dissatisfied rural population. Procurement targets were reduced, procurement prices were raised, and prices for production above the procurement target were raised dramatically.[11] The fundamental institutions in place remained, but the parameters under which they operated were adjusted. The collectives remained, but they were

8 Barry Naughton, The Chinese Economy: Adaptation and Growth (Massachusetts: MIT Press, 2018), 109.
9 Ibid., 96.
10 Ibid., 98
11 Barry Naughton, The Chinese Economy: Adaptation and Growth (Massachusetts: MIT Press, 2018), 101.

allowed more latitude in how they organized themselves. Ultimately the collectives gravitated towards the solution of contracting specific parcels of land to individual households, essentially reverting collectives to the role of landlords.[12] With more autonomy and drastically reduced quotas, rural residents were allowed to sell the surplus food they grew above the planned output in the free market. The increased independence also led to the establishment of township and village enterprises (TVEs), which were permitted to produce goods in response to market demand once agricultural output quotas had been met.

The success of the household responsibility system and TVEs in the rural reform experiment showed that improved market incentives could dramatically increase output, and the improved quality of life for farmers gave further reform popular support.[13] In 1984, based on this success, an enterprise responsibility system was implemented with the goal of increasing SOE productivity, output, and profitability. After fulfilling the state-mandated production quotas, firms were allowed to keep a share of the total profits and make decisions regarding production plans, purchases of inputs, and employee management.[14] It granted SOEs much more autonomy in decision making, increased competition, and encouraged the development of nonstate enterprises. State ownership of SOEs remained intact due to the perception of the need for continued state control of most critical means of production, but the contract responsibility system gradually introduced industrial product markets and inter-SOE competition.

This first period of accelerated reform and transition is characterized by a slow and cautious decentralizing approach, which involved shifting power and resources from the hands of central planners to local actors while protecting core state interests. This approach would come to be known as the dual-track system because, instead of dismantling the plan, reformers introduced markets while maintaining a continuous role for the plan in order to keep the macroeconomy on track.[15] The dual-track system opened protected industries to new entrants, allowed state-owned firms to use

12 Ibid.
13 Ibid., 102.
14 Ligang Song, "State-owned Enterprise Reform in China: Past, Present and Prospects," China's 40 Years of Reform and Development: 1978–2018 (2018): 349.
15 Barry Naughton, The Chinese Economy: Adaptation and Growth (Massachusetts: MIT Press, 2018), 104.

additional capacity for the production of market goods above their planned output, and increased managerial incentives and performance monitoring for the purpose of profitability rather than plan fulfillment. It also ultimately committed to freezing the central government's materials-allocation plan in absolute terms, which would gradually increase the share of non-plan, market transactions in the economy, as well as incentivizing individual enterprises to make decisions based on market prices. The system led to enhanced competition and induced the government, as owner of the firms, to become more concerned with profitability.[16]

However, with price decontrol and firms and local governments wielding the power to make new investments, suppressed inflation surged. Policymakers reacted to these adverse developments by suspending reforms and attempting to stabilize the macroeconomy, effectively marking the end of the first period of accelerated reform.[17] From 1989-1991, China entered a period of conservative ascendancy in response to the economic crisis and successive political crisis culminating in the Tiananmen Square incident. After this brief, failed period of economic retrenchment and reform rollbacks, Deng Xiaoping visited and endorsed the SEZs and reemphasized the need for accelerated reform. After Deng's "Southern Tour" in 1992 and the October 1992 CCP Congress' endorsement of a "socialist market economy," reform was back on the agenda, and the next period of accelerated transition could begin.[18]

2. Zhu Rongji, 1992-2013: Privatization, Ownership Reform, and Streamlining the SOEs

The accelerated transition period in the 1990s involved improving the legal and regulatory environment in order to create a more level playing field as the economy "grew out of" the plan. The banking system underwent fundamental restructuring, and the central bank was given an active role in determining and implementing monetary policy. By 2003, the China Bank Regulatory Commission was established to more closely supervise and manage nonperforming

16 Barry Naughton, The Chinese Economy: Adaptation and Growth (Massachusetts: MIT Press, 2018), 104-107.
17 Ibid., 109.
18 Ibid., 110.

loans. State-run commercial banks then faced harder budget constraints due to curtailed access to easy government money leading to tougher standards being imposed on clients in state-owned enterprises.[19] SOE reform in the 1990s and early 2000s under Zhu Rongji focused on transforming ownership and led to the privatization of many SOEs. Ownership transformation allowed small firms to be gradually released from the explicit and direct control of the state while the larger, more important firms were retained. The gaizhi ownership transformation process is characterized by this policy of zhuada fangxiao or "grasping the large, letting go of the small."[20] The reasoning behind zhuada fangxiao was that large firms performed much better and had much greater importance in the economy compared to smaller firms, and the policy was formally approved at the fifteenth National Congress in 1997. Between 500 and 1,000 large SOEs were retained, while all other enterprises were restructured through sale or lease.[21] The ownership transformation reduced the number of SOEs in the economy and began transferring state production assets to the private sector. The financial burden of poorly performing SOEs on government spending was reduced while more the more productive private firms were able to benefit from absorbing the resources and labor released from the state sector.

The most significant difference between the two periods of reform and transition in the 1980s and 1990s is the evolution from "reform without losers" to "reform with losers." During the 1990s, public firms faced increased product-market competition and pressure, as well as reduced access to funding from government banks.[22] The benefits of reform in the 1980s were widely shared, and almost no major social group had suffered significant economic losses.[23]

Conversely, reform after 1993 clearly imposed significant losses on substantial social groups. Most directly affected were SOE workers who were laid off by the millions, and further, millions were forced to abandon failing firms. Those who had once been members

19 Barry Naughton, The Chinese Economy: Adaptation and Growth (Massachusetts: MIT Press, 2018), 114.
20 Ligang Song, "State-owned Enterprise Reform in China: Past, Present and Prospects," China's 40 Years of Reform and Development: 1978–2018 (2018): 352.
21 Ibid.
22 Barry Naughton, The Chinese Economy: Adaptation and Growth (Massachusetts: MIT Press, 2018), 115.
23 Ibid., 110.

of one of the more privileged groups in the economy were deprived of job security for the first time since the establishment of the PRC. The benefits of the 1990s transition were spread much more unequally than had been the case in the 1980s.[24] The losers of reform in the 1990s exposed a vastly inadequate social safety net. In 2003, the new Hu Jintao-Wen Jiabao administration had new policy priorities, which marked a significant drop in the commitment towards introducing and implementing market-oriented reforms. Instead, priority was given to policies geared towards rebuilding social services like health insurance, bolstering agriculture by cutting taxes and providing protection, developing robust industrial policies, and initiating steps to reverse increasing environmental degradation.[25] The reform period under Zhu Rongji would be the last big push for SOE reform in China.

3. Hu Jintao-Wen Jiabao, 2003-2013: Stagnating Reform and SOE Restructuring

Market-oriented reform stagnated under the Hu Jintao-Wen Jiabao administration due to new policy priorities, which focused more heavily on addressing China's inadequate social safety net. Despite priority being given to policies geared towards rebuilding social services, boosting agriculture, and reversing increasing environmental degradation, SOEs were not ignored. The State-owned Assets Supervision and Administration Commission (SASAC) was established to supervise the central SOEs directly.[26] The SASAC was initially charged with improving the performance of 196 of China's largest nonfinancial state firms in sectors such as oil, telecommunications, electric power generation, coal production, steel production, and the airline industry.[27] The focus of SASAC and the Chinese government was to increase the size and state control of SOEs in key and strategic industries. The SASAC's goal was to turn these large firms into "national champions," cementing the decision-making role of the state-party apparatus in the market. The Chinese government asserted its control over high technology, nonrenewable

24 Ibid. 116.
25 Barry Naughton, The Chinese Economy: Adaptation and Growth (Massachusetts: MIT Press, 2018), 120.
26 Ligang Song, "State-owned Enterprise Reform in China: Past, Present and Prospects," China's 40 Years of Reform and Development: 1978–2018 (2018): 356.
27 Nicholas R. Lardy, Markets over Mao: The Rise of Private Business in China (Washington DC: Peterson Institute for International Economics, 2014), 50.

natural resources, public utilities, infrastructure services, and national security through industrial policy measures designed to allocate resources to SOEs in these industries.[28] Government and SASAC support for SOEs to pursue international M&As, as well as the public listing of SOEs on domestic and international stock exchanges, increased the average size of SOEs despite a decrease in number. The number of state firms continued to decline as it had in previous years, but the remaining ones became much larger and wielded greater market power.[29]

The importance of state-owned firms was reinforced further under the Hu-Wen administration by a set of aggressive industrial policies and initiatives. These aggressive industrial policies appeared to promote state-owned firms, often at the expense of foreign and indigenous private firms. The State Council launched the Strategic Emerging Industries policy in October 2010. This initiative identified seven next generation technologies that the government believed would become "the backbone of China's next phase of industrial modernization and technological development," and these industries would then be promoted through tax rebates and financial incentives at the detriment to other non-state firms.[30] Furthermore, the Hu-Wen administration did not respond to the Global Financial Crisis (GFC), and the subsequent weak performance of state-owned companies, with market-oriented reform. Instead, the administration opted for a massive credit-financed stimulus program to keep the important state sector afloat.[31] The 2009 stimulus program routed most funds through the SOEs themselves.[32] The establishment of the SASAC and the flood of stimulus capital in response to the GFC strengthened the position of SOEs in the economy and increased the role of the state in these important firms. The first decade of China's WTO membership was dampened by accusations that unfair buttressing of the state sector by the government provided evidence that China is not a real market economy.

28 Ligang Song, "State-owned Enterprise Reform in China: Past, Present and Prospects," China's 40 Years of Reform and Development: 1978–2018 (2018): 357.
29 Nicholas R. Lardy, Markets over Mao: The Rise of Private Business in China (Washington DC: Peterson Institute for International Economics, 2014), 48.
30 Ibid., 54-55.
31 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 17.
32 Elizabeth Economy, Third Revolution: Xi Jinping and The New Chinese State (New York: Oxford University Press, 2019), 105.

IV. The Reversal of SOE Reform Under Xi Jinping

1. Xi Jinping, 2013 to Present: Promoting Mixed Ownership and Tightening State Control

SOE reform under the Hu Jintao and Xi Jinping administrations is highlighted by the consistent promotion of mergers and mixed ownership in the hope of improving financial performance, corporate governance, and return on assets of state firms. The SASAC has orchestrated mergers among the largest state-owned companies, reducing the number of central firms under their control from 196 to fewer than 100 by 2017.[33] By merging large state firms in individual industries, the SASAC has become arguably one of the world's largest and most powerful holding companies. While the initial role of the SASAC was meant to be limited to that of a financial holding company, the commission has assumed direct management of most of its holdings and subsidiaries instead of leaving them in the hands of professional management.[34] These central state firms have not only failed to improve their financial performance. According to the SASAC's own data, firm performance has deteriorated parallel to their consolidation through mergers under the SASAC. Returns on assets of central SASAC enterprises have dropped from 4.7 percent in 2010 to 2.4 percent in 2016.[35] Mixed ownership has been promoted for decades by reformers and was formally endorsed by the CCP at the Third Plenum of the 18th

Central Committee in 2013. By 2017, over two-thirds of all central state firms and over half of their subsidiaries had introduced mixed ownership. This method was meant to rejuvenate state firms with fresh private capital while reducing the burden on the state banks that typically support them.[36] However, most firms that adopt mixed ownership remain firmly under state control. The Organization Department of the Chinese Communist Party continues to nominate

33 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 86.
34 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 87.
35 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 89.
36 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 91.

candidates for top management positions, and there are no known cases where the board of a state-controlled mixed-ownership company has failed to confirm one of these nominees.[37] The merger program of the SASAC and the push for mixed ownership have failed to accomplish their given missions of either positively impacting the financial performance of state forms or improving their corporate governance structure and transparency.

Initially, Xi Jinping seemed committed to reforming the economy, reducing the role of government stimulus, and allowing the market to play a more decisive role.[38] However, in the vital SOE arena of economic reform, efforts have been mostly underwhelming. The Chinese government has pulled back considerably from purely market-oriented reform with regard to SOEs and is instead opting to assert absolute control over final decisionmaking in enterprises engaged in strategic industries. SOEs are now divided into public and commercial categories, and firms in each category are evaluated with different standards. While competitive sectors have been encouraged to steadily promote mixed ownership of SOEs, the strategic sectors have remained tightly under the control of the Chinese government.[39] They receive government subsidies, preferential interest rates when they borrow money, lower tax rates, and privileged access to resources. Even with the sturdy crutch of the Chinese government aiding them, SOEs are consistently outperformed by private firms in profit margin, cash flow, and return on assets.[40] The SOE system is a major source of inefficiency, waste, and overcapacity, but Xi Jinping has opted to strengthen its role in strategic industries. There has been a renewed sense of commitment to SOEs, and their role as agents of the Chinese state has expanded as a result. The central role of both the CCP in managing SOEs and SOEs in core economic sectors has expanded.[41] This commitment is indicative of a larger goal of Xi Jinping to ensure that the state holds ultimate control over all important aspects of the economy.

37 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 97.
38 Elizabeth Economy, Third Revolution: Xi Jinping and The New Chinese State (New York: Oxford University Press, 2019), 97.
39 Ligang Song, "State-owned Enterprise Reform in China: Past, Present and Prospects," China's 40 Years of Reform and Development: 1978–2018 (2018): 362.
40 Elizabeth Economy, Third Revolution: Xi Jinping and The New Chinese State (New York: Oxford University Press, 2019), 106.
41 Ibid., 120.

In addition to strengthening the Party's commitment to SOEs as a key player in the economic and political realm, the Xi administration has also tightened the Party's administrative control over these centrally-owned companies. The global expansion and financial dominance of SOEs under the Hu-Wen administration was matched with significant gains in political influence and autonomy from the central government. The rapid growth of SOEs in the 2000s left the SASAC outmatched in most attempts to effectively monitor, discipline, and govern its holdings.[42] Xi Jinping took immediate action through existing government mechanisms and techniques to reaffirm Party authority over the operations and personnel in strategic industries. Central leading small groups are "supra-ministerial, extra-constitutional organizations that bring together high-ranking officials from the government's agencies, Party organs, and/or the military who are involved in decision-making for particular policy areas."[43] Under the early Xi administration, central leading small groups were employed as an added tool for the purpose of advancing policy while simultaneously mitigating the influence from SOE actors who could potentially benefit from maintaining the status quo which allowed them to become so influential while operating under a weak SASAC. The regime created, and Xi himself chaired, the Central Leading Group for Comprehensively Deepening Reforms. This group served as the de facto headquarters for Xi to personally liaise with relevant SOE actors with regard to his roadmap for wider SOE reform.[44] Xi has altered traditional power bases before in attempts to consolidate power. In 2016, the President split up the four powerful general departments of the People's Liberation Army (PLA) into fifteen functional departments and appointed himself as head of the most prominent one.[45]

President Xi also utilizes joint appointments to leadership roles in SOEs as a means of solidifying Party control through co-optation. The top three executives for core central SOEs are appointed by the Central Organization Department by direction from higher ranking

42 Wendy Leutert, "Firm Control: Governing the State-owned Economy Under Xi Jinping," China Perspectives 113, no. 1-2 (2018): 28-29.
43 Wendy Leutert, "Firm Control: Governing the State-owned Economy Under Xi Jinping," China Perspectives 113, no. 1-2 (2018): 29.
44 Ibid., 29.
45 Elizabeth Economy, Third Revolution: Xi Jinping and The New Chinese State (New York: Oxford University Press, 2019), 26.

Party officials. By appointing individuals into joint leadership roles, decision making power is consolidated in the hands of only one or two executives who, due to the nature of their appointment, are brought into the political realm and become more intimately bonded with the goals of the Party.[46] The deliberate placement of officials with stronger Party ties into decision making roles simultaneously asserts the Party's own authority while weakening potential opponents of its broader reform and policy agendas. Furthermore, the higher frequency of leadership rotation of executives in state firms limits the opportunity for those executives to develop networks of influence and support. This practice inherently limits the influence and managerial autonomy of SOE executives and suggests that influence lost equates to authority vested by Xi and the CCP.

Lastly, the anti-corruption campaign he has championed (similar to the campaigns of bureaucratic and citizen mobilization characteristic of Mao's rule) implements fear as a tactic in his broader campaign to recentralize authority over SOEs. The cadre culture prevalent in SOE management disproportionately allocates authority and benefits to those with personal connections and preferable family backgrounds. Although the administration's allegations of corruption in central SOEs is a contentious issue, their weak oversight made top executives of these firms an early and easy target of the campaign. By the end of Xi's first term, twelve top executives of strategic SOE firms were charged with corruption.[47] The steps taken by the Xi administration have affirmed the Party's influence and authority over the critical sector of SOEs, but these actions appear to be contradictory to the administration's public strategy of promoting mixed ownership. It is difficult to measure how Xi's power consolidation could potentially undermine his own public agenda. However, institutionalizing the Party's leadership role in the mixed ownership scheme can be linked to real quantifiable economic costs which will be discussed shortly.

46 Wendy Leutert, "Firm Control: Governing the State-owned Economy Under Xi Jinping," China Perspectives 113, no. 1-2 (2018): 30.
47 Ibid., 32.

V. The Future of SOE Reform

1. The Context for Further Reform

China faces slowing growth and must search for new growth drivers and transition towards a more sustainable growth model. While the scope of SOEs has decreased over the last 40 years, many remaining SOEs, concentrated in strategically important industries, arguably play a more important role than ever before. China's rise to a high-income economy requires ever-increasing efficiency with regard to the returns from capital invested. A considerable amount of political and financial capital is funneled, both directly and indirectly, towards SOEs. The reliance on state-led economic growth following the GFC is a key contributor to China's slowdown in growth. The growing role of the state in resource allocation and the deteriorating performance of SOEs has occurred almost simultaneously with slowing growth and points to a clear opportunity for resuming SOE reform.[48] Before laying out the various possibilities, parameters, and implications of further SOE reform, the current approach to SOE reform must be considered critically.

2. The Potential for Resuming SOE Reform

SOEs in the PRC have always been far less efficient than private firms, but they have always commanded a much larger quantity of assets and resources. The difference in returns between private and state firms is at an all-time high. Between 2005 and 2016, the number of state firms reporting losses had declined slightly, but the absolute size of the losses increased sevenfold.[49]

Although fewer firms are posting losses, the loss-making firms are losing more money than ever. In this period, the return on assets of state companies fell by 2.3 percent. 1.2 percent of this decline was due to rising losses, and 1.1 percent was due to the declining profitability

48 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 16-17.
49 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 50.

of profitable state firms.[50] This large domestic disparity in performance represents a loss of potential economic growth.[51] If state firms could close the gap in efficiency with private firms, or if more productive private firms were allowed to acquire underperforming state assets, the resulting efficiency gain in the aggregate allocation of assets would bolster economic growth. In fact, the estimated efficiency gains from eliminating this gap would raise China's GDP by 5 percent.[52] Misallocation of capital, insufficient profit-maximizing behavior, and soft budget constraints have allowed poorly performing SOEs to survive and expand. It is becoming clear that SOEs have diminished economic growth, and the data suggest that the efficiency gap is continuing to widen despite efforts under the current reform approach.

There is a potentially feasible and effective approach to reform that might allow China to take advantage of this opportunity. One method would be promoting real, market-oriented mergers and acquisitions. Unlike the state-orchestrated mergers under the SASAC mentioned previously, individual firms can be enabled to participate in M&A activity.[53] By allowing private firms to acquire some underperforming state companies or assets, increased exposure to competition and profit-maximizing behaviors could remedy many of the flaws that caused those assets to perform poorly. Instead of using mergers to consolidate the inefficiencies of the SOE system, M&A can be used to offload financial burdens and let the market encourage innovation and financial performance. For example, on December 9th of last year, the three state-owned energy companies (CNPC, Sinopec Group, and CNOOC) merged to form the National Oil & Gas Pipeline Network Group. The merger will consolidate the pipeline networks of three major SASAC holdings totaling a combined US $71 billion in combined assets.[54] It's too early to tell if this move will increase efficiency by consolidating the transportation of oil and natural gas, or if this is yet another instance of the SASAC merging multiple large SOEs in order to create larger super-SOEs with the goal of artificially enhancing their ability to withstand increased global competition. Only

50 Ibid., 52.
51 Ibid., 46.
52 Ibid., 49.
53 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 102.
54 Louise Moon, "China Establishes 3-in-1 Oil Pipeline Operator to Enhance Efficiency," South China Morning Post, December 9, 2019.

time will tell, but it has the potential to be a step in the right direction. SOE reform can also be stimulated by increasing domestic competition on the supply-side. Providing more support for private firms and lowering entry barriers could serve a dual purpose of pushing SOEs to become more competitive while also reducing their costs.[55] It remains highly unlikely that existing state monopolies or oligopolies will be broken up in various strategic sectors in the near future. However, gradually allowing private participation in these sectors could be mutually beneficial for all parties. Private firms gain entry, and state firms can cut costs by outsourcing stages of the production or distribution process. A new wave of SOE reform with a renewed emphasis on increasing competition and reducing political interference could help address the inefficiencies that are holding China back from fulfilling its growth potential.

3. Obstacles to SOE Reform

Regardless of the apparent need or high potential for further market-oriented SOE reform, meaningful reform efforts will travel on the path of most resistance. Numerous obstacles stand in the way of implementing future economic reform. The most potentially problematic adversary for reform efforts is the top leadership of the CCP and their commitment to the SOE system. The leadership has operated under the assumption that SOEs are essential to maintaining the party's control and achieving strategic party objectives. Furthermore, they seem willing to tolerate the diminishing effect that SOEs have on economic growth as long as they continue to serve the interests of the party.[56] The prospective value that SOE reform could stand to supplement China's economy with has been outweighed by the fundamental value that Xi and the CCP place on the ability to command extensive economic and political authority. Xi's attachment to the SOE system is a fundamental obstacle to market-oriented reform. There cannot be market-oriented economic reform in China without reforming SOEs as well. This commitment to SOEs and the emphasis on state-party authority is indicative of what is possibly the CCP's greatest fear: instability.

55 Dong Zhang and Owen Freestone, "China's Unfinished State-owned Enterprise Reforms," Economic Roundup 2 (November 2013): 79-102.
56 Elizabeth Economy, Third Revolution: Xi Jinping and The New Chinese State (New York: Oxford University Press, 2019), 15.

Another significant obstacle facing far-reaching economic reform is the Chinese leadership's fear of social or economic instability. Reform would likely result in the downsizing of the state sector, significant job losses, and short-term growth slowdown and could exacerbate already-growing social unrest in China.[57] Private firms would not be able to immediately expand to fill the employment gap. Although some state firms may be taken over by private firms, a large number will likely be fully liquidated if they remain unprofitable even with better management or reduced state interference. Even those firms that are taken over by private interests will experience major downsizing. The Chinese leadership has made it known through official media outlets that avoiding the type of layoffs which occurred due to SOE reform in the 1990s would be a priority. Unemployment is not the only risk that would accompany an aggressive reform package. China's credit and debt problems could threaten financial stability. Although China has made some progress addressing the buildup in domestic debt since the GFC through deleveraging non-bank financing credit, reducing the liabilities of SOEs is much more challenging.[58] Many of the most heavily indebted state firms are those that have been borrowing to cover a long history of ongoing losses. Since these firms lack sufficient profits, reform could result in widespread loan defaults.[58] These defaults would put enormous pressure on those financial institutions that have lent large sums to SOEs for long periods of time.

The nature of the previous obstacle threatens to push reform efforts in the wrong direction towards further consolidation rather than meaningful progressive reforms. Since the establishment of the SASAC in 2003, consolidation has been the most appealing method of reform. On the surface, consolidating core and strategic state-controlled firms is an attractive option for would-be reformers. Merging the powerful yet inefficient firms in strategic industries aims to promote international competitiveness and increase the availability of labor, capital, and client networks for China's "national

57 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019),122-123.
58 Ibid., 124.
58 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 125.

champions" to wield in consultation with the Party leadership.[59] Further consolidation is a flawed method of reform because it represents a lateral move that not only fails to address the current issues with SOEs but also risks exacerbating those issues. Creating even larger SOE conglomerates out of China's massive core firms, without the necessary downsizing that the Party firmly opposes, is likely to create an even bigger source of redundancy, inefficiency, and waste. Furthermore, doing so would only exacerbate current concerns over domestic and international competitiveness. The last sentence of the previous section alluded to potential costs of institutionalized Party leadership in firms. Staying the course of consolidation through mergers, acquisition, and mixed ownership threatens the ability of Chinese firms to attract private investment.[60] Investors are already wary of the state's support and direction of SOEs to fulfill commercial and political objectives. Consolidating the increased Party authority over these firms risks scaring away the private sector and will draw more scrutiny over foreign investment made by SOEs.

The third major obstacle standing in the way of SOE reform lies in the implicit complexity of the modern SOE system. The first component of this obstacle is characterized by the opposing vested interest group which currently benefits from the system as it exists now. The policy channels between SOEs and the Chinese government provide a strong position for SOEs to influence policy. Since SOE reform primarily focuses on continued and increased exposure to market forces, decreased subsidies and tax exemptions, and removing barriers for potential competitors, SOEs as an interest group have every motivation to slow future reform. Despite no longer being a formal part of the bureaucratic system, senior managers in state enterprises retain high-level state and party rankings, which places them in a strong position to influence deliberations on future reform.[61] Local government officials can also find themselves at odds with reform programs that might reduce local employment or fiscal revenues. Officials who expand fiscal revenues, meet growth targets and minimize local unrest are often rewarded with cash and increased

59 Wendy Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," Asia Policy 21 (2016): 88.
60 Wendy Leutert, "Firm Control: Governing the State-owned Economy Under Xi Jinping," China Perspectives 113, no. 1-2 (2018): 32.
61 Dong Zhang and Owen Freestone, "China's Unfinished State-owned Enterprise Reforms," Economic Roundup 2 (November 2013): 79-102.

chances of promotion.[62] As beneficiaries of the existing system, these vested interests may be highly motivated to maintain the status quo.

Another facet of SOEs is their complicated and often confusing organizational structure. The period of unprecedented SOE consolidation and growth over the last two decades has created sprawling networks of disjointed holdings across the globe. Member companies consist of different bodies of varying size, financial performance, geographic location, number of subsidiary firms, etc. Additionally, different member companies and their bodies have varying levels of partial marketization.[63] Their hybrid structure creates an assortment of intra-firm obstacles to further reform. Communication is a major issue in SOEs due to the lack of information-sharing mechanisms across departments, weak reporting requirements, and inaccurate information collection.[64] Communication and reporting shortfalls often point towards a lack of oversight, but in SOEs, it could also mean that internal or external audits are so bureaucratically intensive that they foster inefficiencies while still failing to effectively scrutinize firms and their subsidiaries. Finally, reformers must contend with the politics within the firms themselves. The relationships among the top executives, member companies, and subsidiaries are often competitive which makes each one a potential point of conflict.[65] Even if Xi Jinping and the CCP can get behind a progressive and comprehensive reform strategy, there are structural roadblocks within SOEs themselves that must be addressed.

VI. Conclusion

There is still significant room to resume the process of privatization gradually, and quietly, in order to cut certain loss-making enterprises that remain viable only through the financial and political support of the state. By implementing reforms that are mutually beneficial for both SOE and private interests, at least in the short

62 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 126.
63 Wendy Leutert, “Challenges Ahead in China’s Reform of State-Owned Enterprises,” Asia Policy 21 (2016): 96.
64 Wendy Leutert, “Challenges Ahead in China’s Reform of State-Owned Enterprises,” Asia Policy 21 (2016): 97.
65 Ibid., 97.

term, the threat of vested interests may be mitigated long enough for the changes to take hold. There are also contradictions with the fundamental challenge that Xi Jinping and the Chinese leadership have leveled against SOE reform by ostensibly confirming the SOE system's function as a lever of party control. "No issue is as central to the Chinese leadership's legitimacy as ensuring rising income levels."[66] We previously established that the domestic disparity in efficiency between state and private firms is a key characteristic of China's slowing growth. By committing to maintaining the present SOE system that perpetuates this disparity, the Chinese leadership weakens its ability to achieve this "central" goal. Furthermore, China's pursuit of state-driven growth is inconsistent with Xi Jinping's claimed goal to promote globalization and open the economy.[67] An ongoing concern about China's status in international relations is the significant involvement of the state in supposedly competitive enterprises. Many foreign observers are concerned that the unfair advantages the Chinese government bestows upon SOEs create an uneven playing field.[68] Xi Jinping and China's claim to "go global" and participate in free trade and open markets, while simultaneously advocating for the preferential status of state enterprise. Entry to Chinese markets is restricted, SOEs are protected, and outward-bound foreign direct investment actively targets leading firms in other countries.[69] The overinvolvement of the state in so many sectors of the economy has diminished China's status in the international community as well as its potential for economic growth.

66 Elizabeth Economy, Third Revolution: Xi Jinping and The New Chinese State (New York: Oxford University Press, 2019), 95.
67 Nicholas R. Lardy, The State Strikes Back: the End of Economic Reform in China? (Washington DC: Peterson Institute for International Economics, 2019), 128.
68 Elizabeth Economy, Third Revolution: Xi Jinping and The New Chinese State (New York: Oxford University Press, 2019), 211.
69 Ibid., 208.