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.

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For The Straits Times

"Structural reforms" has become a buzzword in recent decades, usually at a time of crisis. Amidst 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 businesses directly administered by Beijing, known as the centrally-managed SOEs.

Road-tested 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 state government’s revenue, while many of their chief executives are members of the People’s Congress and the Party’s Central Committee.

Politically-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 market analysts in the West tend to exaggerate the role of China’s state sector and regard Chinese “capitalism” as a threat. Such stereotyping, 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 now generates more than 60 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.

FEARLESS DEBATE 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, even 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 state views.

The market school, whether its radical or gradual wings, argues for the elimination of inefficient, market-distorting SOEs. In contrast, the state school champions a smaller 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 state’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, SOEs are part and parcel of the Chinese political economy. Their roots are in the mid-19th century, when the Chinese were in a long political and intellectual tradition that sought back to China’s first empires. It would be wrong to see them from the perspective of a Eurocentric theory 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 ANTAGONY

The oft-quoted global progress derived 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 economy 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.

For commercial enterprises, such as the telecommunications giant China Mobile, further reforms would entail introducing state capital and creating a more diversified ownership structure. Even though China is not a one-party-state, Singapore’s Temasek model could serve as a reference; if not a roadmap, if future SOE reform is to follow a market-oriented direction, in other words, even though the state 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 paths of reform 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 focus on profit-making expansion, particularly abroad. Should the SOE generate profits, these should go first towards shielding up public finance and contributing to the National Pension Fund.

Any attempt at strengthening the state sectors without also enriching their primary duty to the people risks further erosion of public trust. Ironically, the trade war stress on China’s state sector as being emblematic of unfair trade practices comes at a time when China’s economy is actually in the midst of structural changes that favour non-state enterprises.

The expansion of the state sector has become a distraction that has stunted China’s economic attraction has diminished. Today, the star performers are no longer competitors of the Alibaba Group, BYD, Xiaomi and Huawei. These private-sector firms offer high-paying jobs, better career paths, and a more forward-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 China and the West, there are not really different from other East Asians.

Given the broader economic changes at home and abroad, the current model of state capitalism will become less viable and less attractive over time. A product of Chinese history, SOE is likely to continue to evolve into something less and less like itself to keep up with the times and better meet the needs of 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 renting 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 ensure the interests of private enterprises, the true engine of China’s phenomenal growth.