asia policy, number 21 (january 2016), 83–99

~ http://asiapolicy.nbr.org ~

Challenges Ahead in China's Reform of State-Owned Enterprises

Wendy Leutert

wendy leutert *is a PhD Candidate in government at Cornell University and a Visiting Researcher at the Brookings Institution's John L. Thornton China Center (2014–15). She worked for the International Crisis Group in Beijing and holds an MA in government from Cornell and an MA in international relations from Tsinghua University. She can be reached at <wendy.leutert@cornell.edu>.*

note ~ *The author thanks the Brookings Institution's John L. Thornton China Center and the Brookings-Tsinghua Center for Public Policy and is also grateful for support from the U.S.-China Policy Exchange Fellowship funded by the Ford Foundation. All views expressed are those of the author.*

keywords: china; state-owned enterprises; yangqi; economy; reform

EXECUTIVE SUMMARY

This essay analyzes three challenges ahead in reforming China's centrally owned companies, known as *yangqi*: determining how and when to give market forces a greater role, aligning mismatched executive incentives, and overcoming complicating factors within firms.

MAIN ARGUMENT

The Xi Jinping administration has identified the reform of state-owned enterprises (SOE) as an essential step in the structural transformation of China's economy. In September 2015, Beijing released long-delayed guiding opinions for reforming state firms, to be followed by a series of policy documents. Three key challenges, however, block the path ahead: deciding when and how to grant market forces a greater role, especially after stock market turmoil; aligning managerial incentives with firm performance and corporate governance priorities; and overcoming company-level obstacles. Continuing to restrict competition in protected sectors while merging centrally owned firms will increase their market share at the risk of long-term competitiveness and efficiency gains. Yet such performance concerns are a lesser priority for SOEs in strategic industries, where political rather than market logic remains paramount. Second, while the Chinese Communist Party under Xi is actively exercising its authority to appoint and remove the top leaders of yangqi, shuffling executives cannot eliminate their multiple and often conflicting incentives. Finally, the size, complexity, and organizational culture of centrally owned firms will complicate reform implementation.

POLICY IMPLICATIONS

- To establish realistic expectations for the next phase of China's reform of SOEs, policymakers and business leaders must understand the major challenges ahead in carrying out new reforms.
- The Chinese government has long maintained protected industries and reformed yangqi by merging underperforming and smaller state firms into other centrally owned companies. Yet boosting competition and enabling market exit for the worst performers, particularly in nonstrategic sectors, may be the best approach to improve efficiency and service quality in the long term.
- New reforms will not succeed without targeted policies at the firm level to align executive incentives, strengthen internal oversight, and overhaul enduring cadre culture.

The reform of state-owned enterprises (SOE) is an urgent priority for the Xi Jinping administration. Economically, Beijing aims to decrease the drag on domestic growth and increase the overseas competitiveness of its largest firms known as *yangqi*, long plagued by declining performance, rising debt, and serious corruption.[1] Politically, the Chinese Communist Party wants to reinforce state ownership as a pillar of domestic stability at home and increased influence abroad. To achieve these ends, Beijing released the long-delayed "Guiding Opinions of the Communist Party of China Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises" in September 2015, to be followed by a series of detailed policy documents.[2] This roadmap calls for regrouping state firms by function; further consolidating their assets, while simultaneously developing "mixed ownership"; and loosening state authority over executive management, especially for those in nonstrategic sectors.[3]

Categorizing SOEs into a public class (*gongyilei*) and a commercial class (*shangyelei*) is a transformative move at the heart of the new reforms. Firms will be divided by function into those dedicated to public welfare and those seeking profit. Future reforms will be carried out separately for these two groups in a dual-track approach: distinct strategic objectives will be set for each, and their performance will be evaluated by different metrics. While Beijing seeks to improve all SOEs' operational efficiency, service quality, and ability to innovate, profitability will always be a secondary priority for those charged with public welfare or national security functions. Specifically, the new guidelines stipulate that firms designated as public will be assessed by their ability to control costs, the quality of their goods and services, and the stability and efficiency of their operations.[4] Political rather than market logic will therefore remain the paramount driver of changes to state firms in the public class. In contrast, boosting market competitiveness and delivering gains in financial performance will be a top priority for SOEs classified as commercial, to be assessed by

---

1 This essay focuses on China's central state-owned enterprises (*zhongyang guoyou qiye*), specifically the 106 nonfinancial firms administered by the State-Owned Assets Supervision and Administration Commission (SASAC).

2 *Zhonggong zhongyang, guowuyuan guanyu shenhua guoyou qiye gaige de zhidao yijian* [Guiding Opinions of the Communist Party of China Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises], Communist Party of China Central Committee and State Council of the People's Republic of China (PRC) (Beijing, September 13, 2015).

3 In 2006, the State Council identified seven "strategic industries" where the state will keep "absolute control" (defense, electricity, petroleum, telecommunications, coal, aviation, and shipping) as well as "pillar industries" where the state will maintain "strong influence" (machinery, electronics, information technology, automobiles, steel, nonferrous metals, chemicals, and construction).

4 *Zhonggong zhongyang, guowuyuan guanyu shenhua guoyou qiye gaige de zhidao yijian*, part 1, section 6.

indicators such as economic value added.[5] However, these firms will still serve political goals, including fostering indigenous innovation, supporting social stability and crisis response in China, and advancing economic initiatives abroad such as "One Belt, One Road."

This essay analyzes three challenges confronting this reform agenda: determining how and when to grant market forces a greater role, especially for state firms designated as commercial; aligning mismatched managerial interests and incentives; and overcoming complicating factors within companies. First, continuing government-directed mergers while restricting competition in protected sectors will boost state firms' market share at the risk of deepening their financial and operational weaknesses in the long term. Second, while the Xi administration is actively exercising personnel control, defined as the authority to appoint and remove top company leaders, shuffling executives cannot eliminate their mismatched incentives.[6] Finally, the size, complexity, and cadre culture of SOEs will complicate reform implementation. Whether these difficulties can be surmounted will ultimately determine the success of Xi's reform agenda and China's economic transformation.

5 *Zhonggong zhongyang, guowuyuan guanyu shenhua guoyou qiye gaige de zhidao yijian*, part 1, section 5.

6 Top executives refers to individuals holding one or more of the following positions: general manager (*zongjingli*), party secretary (*dangwei shuji*), or chair of the board of directors (*dongshizhang*), if one exists.