SOE Reform in China: Performance and Prospects

LEE Sang-hun

Ph.D., Research Fellow, China's Regional and Provincial Research Team
Korea Institute for International Economic Policy

China has rapidly grown since 1978, and its economy has leaped to a status on par with the U.S. as it continues this growth. In the process of China's growth, state-owned enterprises (SOEs) played an important role in various sectors and areas of the economy, contributing to growth. Also since the 2000s, SOEs have also made quantitative progress through restructuring and initial public offering.

As of 2016, SOEs account for 35.7% of fixed-asset investment in China and 50% of overseas direct investment, and their total assets amount to 177% of the nation's GDP. Moreover, 295 of the top 500 Chinese enterprises are SOEs (59.0%), accounting for 75.9% of operating profits and 76.8% of profits. In 2016, Fortune Global 500 enterprises included 90 SOEs.

However, as the Chinese economy enters a period of the so-called "New Normal" era, where growth is slowing and the growth engine and economic structure are changing, structural problems that have been stalling high-speed growth have recently emerged. In particular, the excessive supply and inefficiency of SOEs, caused by over-investment and dismal management, have been pointed out as the most critical problems.

www.kiep.go.kr

The business performance of SOEs is deteriorating, as seen by an increase in the proportion of deficit enterprises and a slowdown in the gross profit growth rate. The proportion of SOEs recording losses in the industrial sector was the lowest at 22.2% in 2011 and then increased to 28.1% in 2016. This is three times higher than that of private enterprises. In addition, the gross profit growth rate of SOEs has been negative for four consecutive years since 2013, showing that their business performance is continuously deteriorating.

The inefficiency of SOEs is also confirmed by return on assets (ROA) and total capital turnover. In the industrial sector, the ROA of SOEs has been steadily declining since 2013, indicating that the inefficiency of asset operation is gradually expanding. At the same time, total capital turnover, which is an indicator of how efficiently a company uses its assets, has continued to fall in SOEs since 2011, indicating that their scale of investment and equipment is excessive compared to revenue.

The Chinese government is aware of the problem of chronic deficits and inefficiency in the operation of SOEs and has continued to carry out reforming measures since 1978 to solve these problems. The Chinese government has implemented a profit-sharing system (*'Rangli'*) that allows internal reserves for profits earned by SOEs, as well as a contract management responsibility system that grants management rights to professional managers. In the late 1990s, large-scale restructuring was implemented to privatize or integrate small and medium enterprises while maintaining large enterprises. Also, the management system was unified by establishing the State-owned Assets Supervision and Administration Commission (SASAC) to correct the negative problems caused by the lack of clarity in responsibility and rights concerning the management of SOEs between the central and local governments. Through these reforms, various policies such as the improvement of the stock system, the liquidation of insolvent corporations, and financing through stock market listing were newly implemented.

Despite these efforts to reform policy, however, the management efficiency and competitiveness of SOEs have not improved significantly. Accordingly, the Xi Jinping government launched in 2013 presented the reform of SOEs as its first priority policy. The main goal of the reform is to enhance the innovation ability of SOEs and strengthen their global competitiveness. To this end, the government is pursuing detailed policies such as the classification of SOEs, implementation of modern enterprise systems, strengthening of the management system for state-owned assets and development of a mixed-ownership system. As the reform of SOEs has been promoted in a relatively consistent manner, it has achieved certain results in areas such as corporate integration, governance, and management systems.

First, China has continued to promote mergers and acquisitions (M&A) between SOEs since the late 1990s, thereby strengthening the global competitiveness of SOEs through the elimination of excessive production, liquidation of insolvent enterprises, and corporate integration. In particular, together with reform on the supply side, M&A and liquidation of SOEs have been actively carried out in industries such as steel, coal, shipbuilding and cement. Second, the government is promoting the efficiency of SOEs by accelerating measures to improve corporate governance. The introduction of a mixed-ownership system and asset securitization policy are the most representative policies. Management efficiency is improved by reducing the ownership percentage of the state and securing private capital. These policies are currently being promoted mainly in the electric power, petroleum, natural gas, railroad, civil aviation, telecommunication and other key industries. Third, the contract management responsibility system was reinforced to reduce excessive influence by the government, and in particular, the right to appoint managers was transferred to the board of directors, which is granted the authority to supervise management as well.

Recent reforms of SOEs have been actively pursued through M&A among central SOEs. In particular, unlike how in the past large corporations acquired small and medium enterprises, very large global companies are created by merging large corporations. This expansion of M&As can be attributed to accelerated reform of SOEs by the Chinese government, and the necessity to strengthen global competitiveness of SOEs and restructure the industry to keep up with supply-side reform. With the Chinese government planning to reduce the number of central SOEs to 100 within the short term and to 40 - 50 in the mid to long term, it is expected that M&As will be promoted even more actively in the future.

While the Xi Jinping government has emphasized and actively promoted the reform of SOEs since its inception, these policies can be described more accurately as "fine-tuning" measures than "reform", as most of them were already being promoted by the prior government. In particular, there is a lack of concrete measures to eliminate SOEs with poor management performance from the market. Also, by stating that it will promote mutual investment between the private sector and public sector to develop the mixed-ownership system, there is actually a possibility that the influence of SOEs will increase. However, as the Chinese government clearly states that the goal of its SOE reform is to strengthen market competitiveness and global influence, we can expect the rise of very large SOEs to continue in the world market for the time being. KIEP