State-owned Enterprise

The Story So Far

Reforming state-owned enterprises (SOEs) is critical to improve the competitive environment within China's economy and in overseas markets where Chinese firms are engaged in trade and investment. Unlike other commercial entities, SOEs are tasked with economic and political objectives. The crux of SOE reform is delineating and separating these commercial and political activities.

During the 1990s, Beijing tried to reform the state sector by consolidating state control over large SOEs while withdrawing from small ones, which contributed to private sector prosperity and a decade of strong economic growth. In the 2000s, Beijing redefined SOE "reform" as concentrating state control over key and pillar industries with strategic linkages to China's economic development and national security.

In 2013, the Third Plenum further clarified SOE reform as transforming SOEs into modern corporations, with the state exercising influence in the same fashion as other shareholders. The Third Plenum also envisioned that the state would reduce control of commercial SOEs while pushing SOEs in strategic industries to focus on their "core" business areas.

- Starting in 2014, Beijing tried to improve SOEs' competitiveness using ad hoc measures, such as mergers and mixed ownership programs (similar to those used in the 1990s) involving the sale of minority shares to private firms. These piecemeal efforts continue today. However, none of these measures has been sufficient to reshape SOEs' incentives in line with market principles or redefine their role within the economy.

- In September 2015, the State Council published a new set of "guiding principles" for SOE reform. The document was more conservative than expected. Rather than allowing the market to decide the future of SOEs, the State Council proposed utilizing market mechanisms to make SOEs bigger, stronger, and more efficient, while maintaining control by the government.

- The 2015 guiding principles reiterated a 2013 Third Plenum goal to transform the government's role in managing SOEs from "managing assets" to "managing capital." The plan was to allocate state capital toward strategic industries and reduce direct intervention within SOEs' day-to-day operations, thereby improving efficiency. The government also stated that it would strengthen SOE corporate governance but made clear that it viewed Communist Party supervision as critically important.

- Since 2017, the government has pushed to "corporatize" SOEs, including establishing boards of directors to replicate the structures of other commercial entities. But it also required all SOEs to institutionalize the role of Communist Party committees into their articles of association and give the Party oversight for all strategic decisions. As a result, boards of directors still lack de facto authority to manage SOE operations.

Methodology

We use China's own classification scheme to assess SOE reform progress. When information is available for listed companies, we gauge SOE revenue relative to all revenue in three clusters: (1) key industries (defense, electricity, oil & gas, telecom, coal, shipping, aviation, and rail); (2) pillar industries (autos, chemicals, construction, electronics, equipment manufacturing, nonferrous metals, prospecting, steel, and technology); and (3) normal industries (tourism, real estate, general manufacturing, agriculture, pharmaceuticals, investment, professional services, and general trade). As SOE reforms are implemented, the state firms' share of revenue should at a minimum decline in normal industries – those that Beijing has identified as suitable to market competition as the decisive factor. To supplement this primary indicator, we look at the share of all industrial assets held by SOEs, leverage ratios at state versus private firms, SOE versus private returns on assets, SOE versus private ability to cover interest payments, and the SOE share of urban employment.

Quarterly Assessment and Outlook

- We downgrade our assessment of SOE reform in this quarter, as state investment continued to outpace private investment, and policies encouraged a more expansive state sector.

- SOEs continued to underperform private firms but invested more based on top-down instructions from the state. In the first eight months of 2020, SOE investment grew by 3.2% year-on-year (yoy) while private investment fell by 3.8%.

- Beijing is doubling down on existing policies to increase SOE competitiveness and innovation capacity while trying to extend its influence into the private sector.

This Quarter's Numbers

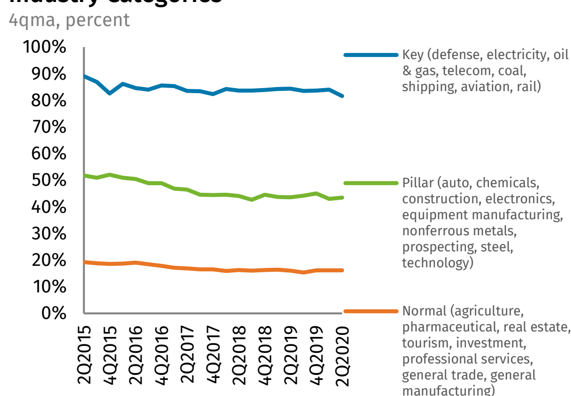
SOE reform did not progress in 2Q2020. Among listed firms, the SOE revenue share in "normal" commercial industries—where Beijing promised to withdraw state influence—remained about the same as 1Q2020. It increased in "pillar" industries, which Beijing considers strategic to China's economic development, to 43.5% from 43% in the first quarter. In other words, SOEs maintained their presence in commercial sectors where Beijing had committed to letting the market play a bigger role.

Interestingly, SOE revenue share in "key" industries including defense, utilities, and aviation, where Beijing hoped to bolster state control, declined sharply this quarter, falling to 81.6% from 84% in 1Q2020. The lower SOE presence in key industries resulted from the revenue collapse in the airline industry, which is dominated by SOEs, due to COVID-related lockdown measures rather than privatizations. SOEs' revenue weight in these key industries is likely to rebound in 3Q2020 as China's domestic air traffic recovers.

SOEs continued to underperform private firms even as Beijing vowed to improve their efficiency and private firms were more vulnerable during the pandemic. In the industrial sector, SOE revenue barely grew in 2Q2020, while private firm revenue was 6% higher than in 2019, as they benefited more from China's export recovery. Nonetheless, Beijing pushed SOEs to expand investment to stabilize the economy. State investment increased by 3.2% yoy in the first eight months of 2020, compared with a 3.8% yoy drop in private investment.

Primary Indicator: Share of SOE Revenues in Different Industry Categories

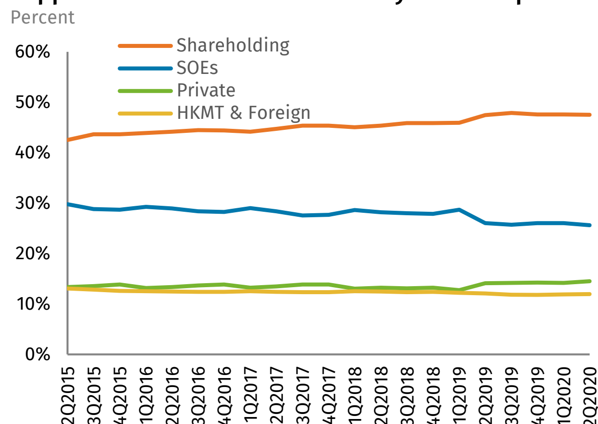
4qma, percent



Source: Bloomberg, Rhodium Group.

Supplemental 1: Industrial Assets by Ownership

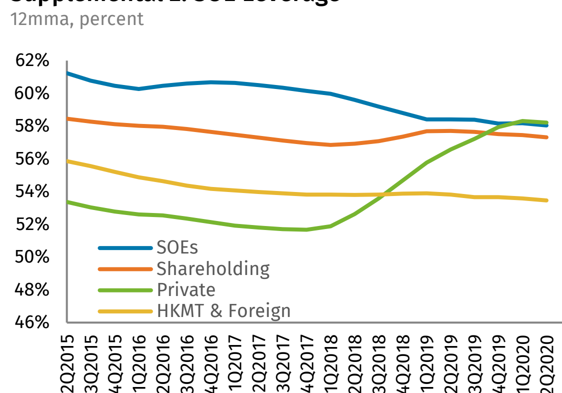
Percent



Source: Source: National Bureau of Statistics, Rhodium Group.

Supplemental 2: SOE Leverage

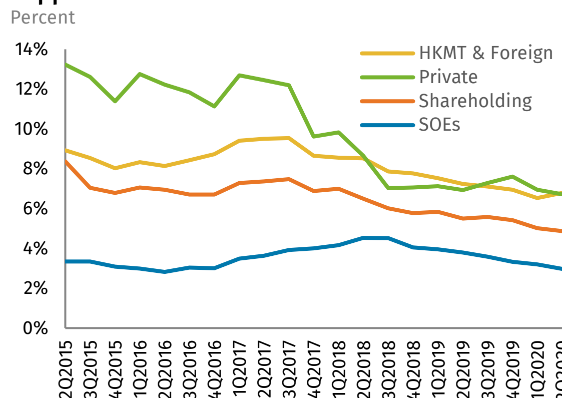
12mma, percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Return on Assets

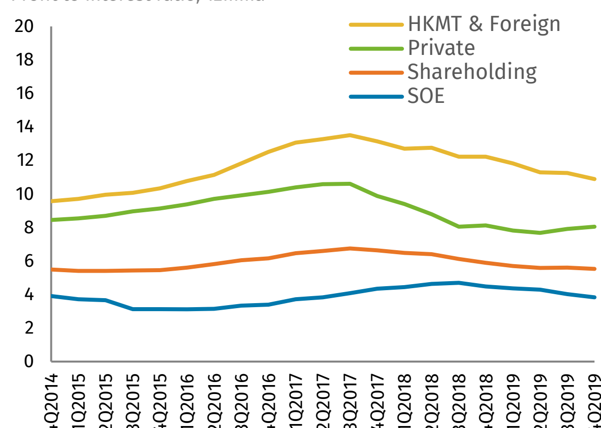
Percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 4: SOE Interest Coverage Ratio

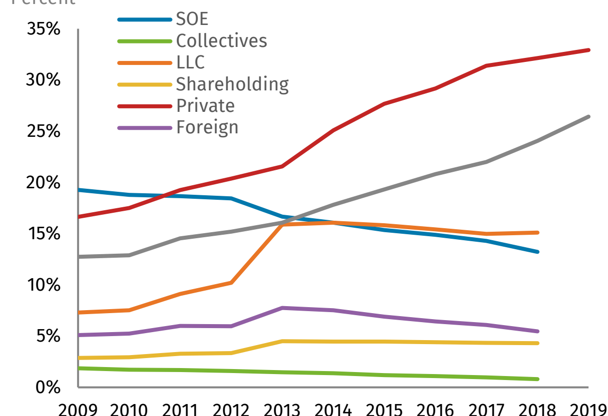
Profit to interest ratio, 12mma



Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment

Percent



Source: Ministry of Human Resources and Social Security, Rhodium Group.

Policy Analysis

This quarter saw more of the same on SOE reform. Policies aimed to improve SOE efficiency while increasing market influence, yet with firm Party control. The Party is now trying to extend its influence to private firms, further blurring the line between the state and the private sector in China. We are highly skeptical that this mix of efficiency and Party control is a viable aspiration.

On October 12, the State-Owned Asset Supervision and Advisory Commission (SASAC) held a press conference on the three-year outlook for SOE reform. It named eight priorities, including continuing mixed-ownership reform, focusing on state management of capital instead of assets, and strengthening the role of the Party. These are all *existing* policies being implemented. A new development is that technological innovation has moved to the forefront of SOE reform. SASAC is urging key SOEs to increase their R&D expenses as a share of revenue to 5% by 2022, compared with only around 2% today.

SASAC's assessment of SOE reform over the past five years is at odds with our findings. It declared "mixed ownership" reform—a mechanism expected to lead to some partial SOE privatization—a success. Mixed ownership reform has attracted more than RMB 1.5 trillion ($220 billion) in private capital to central SOEs. However, our primary indicator shows no meaningful shift toward private control among listed firms. (Our primary indicator sets a 20% state ownership threshold for SOEs. While there have been several instances of changing classifications from SOE to private firms and vice versa, in aggregate they are not significant enough to shift our indicator.) Today, SASAC encourages more mergers and acquisitions between SOEs and private firms, arguing that this can improve competitiveness. It certainly will not improve competition inside China.

Final Dashboard Assessment

SOE reform has been redefined from the 2013 vision. Seven years ago, Chinese leaders made three pledges on state firms: (1) SOEs would be concentrated in key and pillar industries, leaving normal commercial industries to the market; (2) SOEs would be restructured to operate more efficiently; and (3) SOEs would help increase social safety net spending.

Beijing remains far from realizing these goals. It "corporatized" SOEs in 2017 (see **Fall 2017 Edition**), diluted the state's shareholding in giant telecom SOE Unicom (see **Winter 2018 Edition**) and many smaller SOEs (see **Summer 2020 Edition**), ordered SOEs to reduce their financial leverage (see **Spring 2018 Edition**), linked SOE employee salaries to productivity (see **Summer 2018 Edition**), and forced SOEs to transfer 10% of state equity to social security funds (see **Fall 2019 Edition**). However, the presence of SOEs across industries has barely changed, their efficiency has not improved, and more than 70% of dividends paid were *reinvested back into SOEs* themselves, not used for social spending (see **Spring 2019 Edition**). These reforms have failed because SOEs lack incentives to exit commercial industries (leaving them to more competitive private firms) to politically dominated key and pillar industries where security and strategic considerations justify state presence. Stronger Party supervision has made it harder for SOEs to act on commercial incentives. These contradictions have intensified in recent years, meaning that serious reform is less likely going forward.

The Party is also enhancing its influence over the private sector. On September 15, the Party and the State Council issued an opinion on strengthening "United Front Work" in the private sector (informal, nonregulatory institutional

interactions to augment Party influence). While Party interference in the private sector is not new, this campaign reflects a major reimposition of ideology on private business. The policy calls for ensuring a team of private businesspeople that is "dependable and usable in key moments." It asks private firms to align themselves politically with the Party and envisions recruiting more Party members from the private sector. At the same time, it promises to improve market access for private firms in strategic sectors and allow private entrepreneurs to participate in policymaking, which sounds to many like a threat to deny those privileges to firms that do not consent to Party influence. The dividing line between the state and private sector is more blurred than in years and is likely to get even more so.