

The Role of State-Owned Enterprises' Reform and Development in the Construction of Modern Economic System

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The modern economic system is an important concept in the new plan covering new provisions related to the prospects of China's economic development in a new era. The concept was proposed in the report of the 19th National Congress of the Communist Party of China (CPC). The so-called economic system refers to the entire economy, and the modernized economic system refers to a system that can fully reflect the main features of the present era. State-owned enterprises (SOEs) are an important micro-foundation of the socialist market economy with Chinese characteristics. The reform and development of SOEs would play an important role in the construction of a modern economic system in China.

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The function, task, and key work of SOEs

The functional orientation of SOEs

In November 2013, The Decision on Major Issues Concerning Comprehensively Deepening Reforms in brief of the Central Committee of the CPC clearly stated, for the first time, the functional orientation of SOEs. It considered that SOEs are important forces to advance modernization and safeguard people's common interests. Further, SOEs have generally integrated in the market economy. In August 2015, the Central Committee of the CPC and the State Council again defined the functional orientation of SOEs in the Guiding Opinions on Deepening the Reform of State-Owned Enterprises: State-owned enterprises are an important force in advancing modernization and safeguarding the common interests of the people. They are important material basis and political basis for the development of the Party and the state...State-owned enterprises shoulder a major historical mission and responsibility in maintaining medium-high speed growth of China's economy; developing and perfecting the socialist system with Chinese characteristics; and realizing the Chinese nation's great rejuvenation of the Chinese dream. Thus, it is clear that the central government sees a clear link between the functions of SOEs and stable economic growth, promotion of industrial transformation, and protection and upgrading of the common interests of the people, especially for the promotion of the national modernization that is happening for the first time. SOEs are regarded as an important force in the construction of China's modern economic system.

The main task of reform and development of SOEs

The reform and development of the state-run economy and SOEs have always been a focus area and key aspect of China's economy since its reform and opening up. Although the state-run economy and SOEs have had some remarkable achievements in the past 40 years, the task of reforming and developing SOEs is always a work in progress because it is based on a step-by-step approach. The report of the 19th National Congress of the CPC made a clear statement on the main tasks related to SOEs in the future: "We will improve the systems for managing different types of state assets, and reform the system of authorized operation of state capital. In the state-owned sector, we will step up improved distribution, structural adjustment, and strategic reorganization. We will work to see that state assets maintain and increase their value; we will support state capital in becoming stronger, doing better, and growing bigger, and take effective measures to prevent the loss of state assets. We will further reform of state-owned enterprises, develop mixed-ownership economic entities, and turn Chinese enterprises into world-class, globally competitive firms." The CPC's definition of the reform and development tasks related to SOEs can be summarized as three main initiatives that the state has been striving to promote for a long time: improving the state property management system, strategic restructuring of the state-run economy, and reform of property rights system of SOEs. The state-run economy is an important part and a micro-foundation of China's basic economic system. If the state-run economy fails to function well and SOEs lack

competitiveness, efforts to construct a modern economic system will lose an important driving force. It would also be difficult to obtain effective micro-level support. Therefore, the reform and development of SOEs based on the three main initiatives is essentially the endogenous requirement for the construction of a modern economic system.

The main areas of reform and development of SOEs

In recent years, the following have been the main areas of reform and development of SOEs in the context of supply-side structural reforms. First, the government should promote the reform of the state-owned assets supervision system based on the management of capital. Second, it should continue to cut overcapacity and carry out de-stocking and deleverage. In accordance with the requirements of giving full play to the influence and control of the state-run economy and making SOEs stronger, better, and larger, the focus has been on promoting the strategic industrial restructuring of the state-run economy and reorganization of assets at the enterprise level. Third, the reform of enterprise ownership has focused on the reform of mixed ownership by clarifying and diversifying property rights; the aim is to further clarify the dominant role of SOEs in the market competition, and improve the developing force and competitiveness of enterprises. Fourth, China should promote the reform of the corporate system for SOEs and establishing a new type of modern enterprise system. Fifth, it should integrate the CPC's leadership with the corporate governance structure and mechanism, and give full play to the CPC's role in taking political calls on major decisions related to SOEs. Obviously,

the above-mentioned aspects are the priorities after the SOEs step into the “deep-water zone” of reform, and also the “hurdles” that must be overcome in the construction of modern economic system.

The status quo of reform and development of SOEs

The mixed-ownership reform

Since reform and opening up, the focus of the reform of SOEs has remained at the level of management and administrative rights. In November 2013, the Third Plenary Session of the 18th Central Committee of the CPC approved the Decision on Major Issues Concerning Comprehensively Deepening Reforms, thereby officially deciding that mixed ownership is an important model for deepening reforms of SOEs. At present, the reform of SOEs with mixed ownership as a breakthrough is being actively promoted. According to the State-Owned Assets Supervision and Administration Commission (SASAC) of the State Council, China has selected, since 2016, 50 SOEs in electric power, oil, natural gas, railway, civil aviation, telecommunications, military, and other key industries to carry out mixed ownership reform trials; among these, 28 are central enterprises and 22 are local SOEs. At the same time, the employee stock ownership plan under mixed ownership has also been officially launched; the plan has witnessed the participation of nearly 200 pilot enterprises nationwide. In the first half of 2018, the SASAC of the State Council decided to select 100 subsidiaries of central enterprises and hundreds of local

key SOEs to implement the “Double-Hundred Actions” for SOEs’ reform between 2018 and 2020, and continue to promote the mixed ownership reform. At the same time, efforts to clarify and improve the ownership system of SOEs, strengthen the management of state-owned assets, and further shape an “owner” who is responsible for state-owned assets are also witnessing orderly progress.

Strategic restructuring of state-run economy and SOEs

A strategic restructuring of the state-run economy was proposed in the mid-1990s. However, even after more than 20 years, the industrial distribution of SOEs is still not satisfactory. In fact, the industrial distribution and asset structure of SOEs are still lopsided; besides suffering from overcapacity, many are middle- and low-end enterprises in their industries and industrial chains. This affects not only the efficiency of SOEs, but also the transformation and upgrading of China’s industrial structure. The profitability of SOEs has also risen and fallen in a wavelike manner. In this context, the central government proposed the acceleration of supply-side structural reforms to make further adjustments in the industrial layout of SOEs and reduce excess capacity; this has yielded some results. Since the 18th National Congress of the CPC, the central enterprises have completed 38 enterprises’ reorganizations, and the number of central enterprises supervised by the SASAC has been reduced to 96 from 116. In the first half of 2018, enterprises in the state-owned assets supervision system realized an operating income of RMB25.7 trillion and a profit of RMB1.65 trillion, heralding a year-on-year increase of 10.6% and 22.6%,

respectively. The revenue of the central enterprises increased “double-fast,” and the monthly profit crossed the RMB200 billion marks. By the end of June 2018, the central enterprises had reduced the number of legal persons by 11,261—a decrease of 21.58%. The central government has completed the task of resolving overcapacity in iron & steel, and decreasing 3.4 million tons coal in the first half of the year. At the end of July 2018, the asset-liability ratio of SOEs was 59.4%, down 1.3% year-on-year, and at the lowest level since 2016.

Improvement of the governance structure of SOEs

Along with the corporate system reform of SOEs and the establishment of a modern enterprise system, another main line of reform is the improvement of the corporate governance structure of SOEs in accordance with Company Law. However, because of the “absence of owners,” the “insider control” problem of SOEs has not been satisfactorily resolved. In September 2015, the General Office of the Central Committee of the CPC issued the Several Opinions on Adhering to Party Leadership and Strengthening Party Building in Deepening the Reform of State-Owned Enterprises. According to the survey, most SOEs have already completed arrangements for governance by leading the Party committee for major decisions, and a new governance model for SOEs is gradually taking shape.

Innovation and competitiveness of SOEs

For a long time, SOEs have not acquired a significant improvement in their overall competitiveness owing to a neglect of their core competitiveness, inadequate learning and accumulation of knowledge and skills, insufficient

investment in R&D, and an imperfect innovation mechanism. In recent years, guided by the new development concept of focusing on innovation and aiming at creating world-class large enterprises, SOEs have continuously increased their investment in innovation. For example, the R&D funds of the central enterprises accounted for one fourth of the national R&D funds by the end of 2016; further, the scale of innovation guidance funds established has reached RMB150 billion, driving more than 200 innovation funds that had a total scale of over RMB600 billion. Central enterprises have set up 518 “mass entrepreneurship and innovation” platforms, 170 physical incubators, and 86 science and technology industry parks; these have not only enhanced the innovation capability of SOEs, but also effectively driven innovation in the entire economic system.

Promoting comprehensive reform and development of SOEs by taking the construction of modern economic system as the standard

The important thought of building a modernized economic system, proposed in the report of the 19th National Congress of the CPC, sets higher requirements for the reform and development of SOEs and points the way forward. The key implication of the policy is that the reform and development of SOEs should consider not only benefits, but also social effects.

Firstly, there is a need to take a rational division between the modern state-run economy and the non-state-run economy, and give full play to the influence and control force of

the state-run economy as the way to clarify the strategic positioning of the state-run economy and implement its strategic restructuring, as well as that of SOEs. This would involve the following three steps. First, the existing state-run economy and SOEs should be classified according to their function, that is, SOEs should be subdivided into completely public welfare, intermediate, and competitive enterprises. In accordance with the requirements of building a modern economic system, the state-run economy and SOEs should implement the strategic restructuring of industries and assets, thereby providing greater development space for the non-state-run economy and the large number of non-SOEs. Public welfare SOEs belong to the category of “public legal person” and mainly undertake the function of maximizing social public welfare. Intermediate SOEs belong to the category of “special legal person” and should have their special functions clarified. They can regulate their behaviors by formulating “laws of special legal person” and clarify how policies should support. Competitive SOEs belong to the category of “commercial law” and market regulation, and should be given full management autonomy according to the principle of “competitive neutrality,” so that they can compete with other entities operating in the market. Second, the reorganization of enterprises with high asset specificity and significant synergetic effect should be given priority. Olive E. Williamson, an American economist, once pointed out that enterprises with high asset specificity can reduce transaction costs between enterprises through integration; this should be an important principle in the restructuring

of SOEs. Thus, the ongoing merger and reorganization of enterprises in the coal, electricity, and iron & steel industries, which have severe overcapacity, should be actively promoted to realize capacity utilization and reduction with lower transaction costs. In addition, it is also necessary to actively promote the integrated reorganization of enterprises with significant synergetic effects, and invigorate the assets of vulnerable enterprises through the organizational capital output of dominant enterprises. Third, there is a need to focus on the re-integration of enterprise internal resources. While the reorganization among SOEs is important, the redistribution of resources within enterprises, especially those that are a part of large enterprise groups, should not be neglected. Innovative allocation of assets and organizations should be carried out in accordance with the organic relationship between business chain and technology chain; the focus should be on solving problems, such as the internal business overlaps and multi-level legal person system that have long troubled enterprises. Fourth, it is necessary to adopt a positive and cautious attitude toward joint venture restructuring and cross-border mergers and acquisitions (M&As) of SOEs. After fully assessing the various risks of overseas M&A, enterprises with low risk and considerable returns can be encouraged to carry out M&As.

Secondly, the implementation of mixed-ownership reform for SOEs should be based on a flexible and diversified modern property rights structure. As a first step, by following the classification reform principle, the purely public welfare-oriented SOEs should gradually divest their non-

public welfare businesses through restructuring, and their competitive business should be completely shut down. These SOEs do not need to implement mixed ownership. Intermediate SOEs should be the focus of mixed ownership reform to clarify their special functions. The strategy of capitalization and privatization should be combined to urge these SOEs to change the property rights structure at the group level and implement diversified or mixed ownership. SOEs that are too large to reform at the group level can choose to start with the diversification of the property rights structure of low-level companies within the group, and expand the scope of mixed ownership by means of reverse merger, that is, the lower-level companies can acquire the equity of higher-level companies. In some new projects, the public-private partnership mode of corporate cooperation can be encouraged. Next, the financial sector and capital market should be encouraged to treat SOEs and non-SOEs equally in terms of offering credit and market listing; there are various reasons why SOEs are preferred; this, in turn, has made them reluctant to implement the mixed ownership reform. Therefore, the government should force banks to adopt a less discriminatory credit structure and strictly implement it when making credit plans to ensure that SOEs are fair to other non-state-owned enterprises when obtaining loans. In corporate listing, the securities regulatory authority should treat all companies equally. If the external financing environment can be truly improved, SOEs will be more proactive in absorbing non-state-owned capital when they are financing, and the mixed ownership reform of SOEs will

have more endogenous power.

Thirdly, the governance structure of SOEs should be improved, with the implementation of scientific decision making as the standard. The following are the main measures that can be taken: (1) It should start with the reform of the board of directors by introducing more independent directors and reducing the proportion of government officials on the board, thereby ensuring that the board has broader social representation and independence; (2) the recruitment of the management staff should rely more on the market; (3) it should strengthen the role of the Party in the corporate governance structure by handing over major decision-making rights of enterprises to the Party committee. There should be an active exploration of effective integration mechanisms between the Party committee and the board of shareholders, as well as the board of directors and the board of supervisors, in the corporate system.

Fourthly, the modernization of innovation capabilities should continue to be promoted as a way to enhance the competitiveness of SOEs. To some extent, the competition among enterprises is a competition for technology. SOEs should improve the technological innovation with the enterprise itself functioning as the main body, strengthen R&D investment, make technological breakthroughs and build technical reserves, foster core technological innovation capabilities, and form technical competitive advantages in some areas.