China’s Unfinished Ownership Reform: Privatization and a Fair and Competitive Environment Remain to be Achieved

Chi Hung KWAN
Senior Fellow, Nomura Institute of Capital Markets Research

Abstract

The major objective of ownership reform in China is to enable different types of enterprises to realize their capabilities to the maximum by creating a fair and competitive environment and strengthening the corporate governance of state-owned enterprises. To that end, it is necessary to shift the center of gravity of the economy from state-owned enterprises to private enterprises by privatizing the former and promoting the growth of the latter, as well as to separate the government from business through restraining the involvement of the government in the management of state-owned enterprises. However, China has been retreating rather than making progress on both of these initiatives in recent years.

Under the Xi Jinping administration, instead of privatization, mixed-ownership reform is being promoted in the form of injecting private capital into state-owned enterprises. However, in most cases, control by state-owned capital has been maintained, so that corporate governance, and by extension, the efficiency of the enterprises concerned, is unlikely to improve.

Since China adopted the reform and opening-up policy in the late 1970s, private enterprises that started from scratch have ridden the tide of transition to a market economy and grown to surpass state-owned enterprises in terms of revenue and employment. However, the business performance of private enterprises has turned sluggish recently, thanks to the changing economic environment.

Fundamental reform of state-owned enterprises requires privatization. However, if it is politically difficult to achieve, as the second-best option, China should create a fair and competitive environment by minimizing the government’s interventions in business activities. Doing so is also necessary to promote the development of private enterprises.

Keywords: China, reform of state-owned enterprises, mixed-ownership reform, private enterprises, competitive neutrality

JEL Classification: P31

I. Introduction

For China, which aims for transition from a planned economy to a market economy, shifting from public ownership centered on state-owned enterprises (SOEs) to private ownership centered on private enterprises and other non-state-owned enterprises (non-SOEs) is a path that cannot be avoided. Generally speaking, this is achieved through the privatization
of SOEs and the growth of private enterprises.

However, four decades after the launch of the reform and opening-up initiative in the late 1970s, SOEs still maintain a monopoly position in many sectors while continuing to receive governmental support. On the other hand, private enterprises are at a disadvantage in market competition, as they continue to suffer various discriminatory treatments. In recent years, the government’s policy of “fostering large and internationally competitive SOEs” has added to this problem, and the trend toward “the advance of the state and retreat of the private sector” (increasing the share of SOEs and decreasing the share of private enterprises) has emerged.

Under the Xi Jinping administration which was inaugurated in 2012, instead of privatization, “mixed-ownership reform” is being promoted in the form of introducing private capital into SOEs. The primary aim is to improve the efficiency of SOEs by establishing a fair and competitive environment and strengthening corporate governance. However, it is questionable whether the mixed-ownership reform is the most effective means. On one hand, if the purpose is to curb the monopolistic power of SOEs in some industries, the best way is to ensure that enterprises under different types of ownership, private enterprises in particular, can compete fairly under the same conditions as SOEs. On the other hand, if the purpose is to improve corporate governance by changing the shareholder structure, the government should stop controlling SOEs as owners and let them be privatized.

If SOEs are to be fundamentally reformed, privatization is desirable. If this is politically difficult, the second-best option is minimizing governmental market intervention and creating a fair and competitive market environment. When doing that, the principle of competitive neutrality advocated by the OECD will serve as a useful reference. In order to thoroughly pursue the principle of competitive neutrality, the government’s intervention in the activities of enterprises and the market must be minimized.

II. Challenges of ownership reform

The main aim of ownership reform is to enable enterprises under different types of ownership to fully realize their capability by establishing a fair and competitive environment and strengthening the corporate governance of SOEs. For this purpose, “the advance of the private sector and retreat of the state” (decreasing the share of SOEs and increasing the share of private enterprises) through the privatization of SOEs and the development of private enterprises, and “separation of government and business” to reduce the interference of the government in the business management are required. However, in recent years, instead of making progress in this direction, China has rather receded, as symbolized by “the advance of the state and retreat of the private sector” and the strengthening of party committees in SOEs.
II-1. Conspicuous inequality remains between different types of ownership

In a market economy, all enterprises, both state-owned and non-state-owned, should stand at the same start line. However, under the policy of “fostering large and internationally competitive SOEs,” state-owned enterprises enjoy preferential treatment such as subsidies from the government, which are not available to non-state-owned enterprises. This harms the market mechanism and leads to a misallocation of resources.

According to Zheng Siping, a former Deputy Mayor of Shenzhen, the main cause of the inequality between enterprises operating under different types of ownership is that the government maintains control over the bulk of the country’s resources, most of which it allocates to SOEs (Table 1). Those resources include (1) resources liable to lead to monopoly because of a strong network effect, (2) land and other natural resources, (3) special permits for businesses requiring a market entry license, (4) investment-related resources, (5) resources related to industrial funds and investment funds, (6) price-setting rights, and (7) directly or indirectly controlled state-owned property.

The allocation of resources by the government has led to a market monopolized by SOEs and an unfair competitive environment. SOEs generate excess production capacity by expanding business with no regard for profitability on the back of their special status and the benefits of governmental policies, and their business activities also squeeze the activities of private enterprises. This situation lowers the efficiency of resources utilization, thereby bringing huge losses to the Chinese economy. Furthermore, the profits earned and assets acquired by SOEs as a result of the preferential resource allocation by the government have covered up problems, such as the enterprises’ low level of efficiency. This caused delays in the reform of SOEs.

The government not only owns SOEs on behalf of the state but also has the authority to supervise and manage all enterprises and the whole of society. The authority includes the power to supervise and manage private and foreign-invested enterprises that compete with SOEs, to approve their business licenses, and to levy various taxes on them. If SOEs can strengthen their own competitive advantage on the back of the state authority, fair competition cannot be realized.

Indeed, in China, SOEs are often given precedence over private enterprises in terms of law enforcement (Liu and Wang, 2016). To be more specific, private enterprises’ property rights and legitimate interests do not receive effective protection, so they face institutional and invisible obstacles to market entry and economic activity. In particular, at the time of a

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1 Between 2001 and 2013, the average return on equity (ROE) for state-owned and state-holding industrial enterprises was 9.1%, lower than the average ROE of 15.7% for non-state-owned industrial enterprises (China Statistical Yearbook for the relevant years). In addition, SOEs not only receive subsidies from the government but also enjoy other benefits, such as the reduction or exemption of fund-raising cost, land usage fees and the resource tax, so their ROE does not reflect their actual business performance. According to an estimate by the Unirule Institute of Economics, if it is assumed that the profits obtained by SOEs through the government’s preferential policy measures have to be earned by them at their own cost, their average ROE would be minus 3.7% (Unirule Institute of Economics, 2016).
Table 1. Resources Controlled by the Chinese Government

<table>
<thead>
<tr>
<th>Type</th>
<th>Typical example</th>
<th>Method of allocation by the government</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Resources liable to lead to monopoly because of a strong network effect</td>
<td>Waterworks networks, Electricity grids, Pipeline networks, Information networks, Radio frequency bands</td>
<td>In most cases, the government has provided these networks to SOEs for free through administrative means, and the SOEs have earned monopoly profits. The SOEs have formed larger monopoly groups by exploiting their monopoly position to connect relevant industries in the upstream to the downstream of the industrial chain.</td>
</tr>
<tr>
<td>(2) Land and other natural resources</td>
<td>Land, Oil, Natural gas, Water resources</td>
<td>For some land resources related to real estate development and industrial development, the market auction method has been adopted, but most state-owned land resources have been given to SOEs through administrative allocation or negotiated transfer. Most of these resources have been given by the government to SOEs through administrative means, and SOEs involved in the development of the resources can use them for free over the long term.</td>
</tr>
<tr>
<td>(3) Special permits for businesses requiring a market entry license</td>
<td>Business permits for some special industries (banking, insurance, securities, and telecommunications), Certification for participation in infrastructure and public works projects, Various administrative permits, including certification for participation</td>
<td>Most of these permits have been granted to SOEs for free at relevant government levels.</td>
</tr>
<tr>
<td>(4) Investment-related resources</td>
<td>Full direct investment, Agency for investment projects, Public-private partnership (PPP) investment</td>
<td>Funds for SOEs' investment projects and fixed investments are injected directly into SOEs. SOEs implement construction and management as agencies for the government. Although investments are made and assets are owned nominally by the government, SOEs are actual users and operators. In most cases, this type of investment is made by SOEs in contravention of the policy of incorporating private enterprises' investments and management expertise.</td>
</tr>
<tr>
<td>(5) Resources related to industrial and investment funds</td>
<td>Investment funds and industrial development funds</td>
<td>These resources are operated directly by the government's fiscal division, or through state-owned holding companies, or asset management companies. The authority over resource allocation is controlled by bureaucrats at relevant government levels, and the final decision-making authority and review authority rest with the government sector. Most of the funds are allocated, directly or indirectly, to SOEs.</td>
</tr>
<tr>
<td>(6) Price-setting rights</td>
<td>Price setting, Subsidy to cover the price difference</td>
<td>Product prices are set mainly by SOEs. Because of such factors as information asymmetry and a lack of negotiating skills, prices set by the government are higher than the sum of companies’ reasonable cost and average profit. In addition to subsidies given by the government for public projects directly and explicitly, the provision of land, exemption of land usage fees, fiscal assistance and bank loans on preferential terms for SOEs are included in this type of subsidy.</td>
</tr>
</tbody>
</table>
personnel change at a government agency, the reversal of the predecessor’s commitments by the newcomer lowers private enterprises’ motivation for investment. In addition, cases of abuse of judicial power by security and prosecution organizations to illegally seize private enterprises’ assets are frequently observed.

II-2. Privatization stagnates while “the advance of the state and retreat of the private sector” gathers pace

Despite receiving various types of preferential treatment from the government, SOEs are less efficient than private enterprises because of their weak corporate governance. In order to solve this problem, privatization is necessary (See Box 1). However, in China, although the policy of privatization was introduced in the middle of 1990s, it was soon reversed.

Privatization was first promoted under the policy of “grasping the big ones and letting the small ones go” which was followed by that of “strategic realignment of the state-owned economy.” Under the policy of “grasping the big ones and letting the small ones go,” only small and medium-size SOEs were targeted for privatization. Under the policy of “strategic realignment of the state-owned economy” adopted at the 15th National Congress of the Communist Party of China (CPC) in September 1997, however, SOEs, including large ones, should withdraw from all areas in which they compete with privately-owned enterprises, with state ownership maintained only in sectors providing public goods.

Following the policy set forth at the 15th CPC National Congress, the Fourth Plenum of the 15th Central Committee of the CPC in September 1999 adopted “The Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning the Reform and Development of State-Owned Enterprises” to clarify the concrete content of the realignment policy. According to the Decision, SOEs should only be maintained in the following four areas, while those in all other areas should be allowed to be privatized.

(1) Sectors related to national security, which include defense industries such as arms manufacturing, the minting of money, and industries crucial to the nation’s strategic stockpiling system (including food and energy);

(2) Sectors subject to natural monopoly and oligopoly, which include the postal, telecommunications, electricity generation, railway, and airline industries;
(3) Sectors that provide important public goods and services, which include public utilities - such as water, gas, and public transportation services - in urban areas, the management of infrastructure such as ports, airports, irrigation, and other water-related facilities, and the development of crucial protection forests; and

(4) Core enterprises in sectors that constitute the backbone of the economy including oil, mining, steel, automobiles, and part of the electronics industry that uses the latest technology.

However, since the establishment of the State-owned Assets Supervision and Administration Commission of the State Council in 2003, the policy of “strategic realignment of the state-owned economy” has come to be replaced by that of “fostering large and internationally competitive SOEs.” Subsequently, large SOEs have been excluded from the object of privatization, while the merger of large SOEs has been advanced. As a result, the number of “central enterprises” under the jurisdiction of the State-owned Assets Supervision and Administration Commission decreased from 196 at the beginning to 97 as of April 2019. Furthermore, as the government has strengthened its stance of supporting SOEs, private enterprises have become increasingly disadvantaged in market competition. Some of them have been absorbed or merged by SOEs, aggravating the trend toward “the advance of the state and retreat of the private sector.”

The advance of the state-owned sector could limit the growth of the overall economy in the long run for the following reasons.

First, through lobbying activities, large SOEs seek to raise barriers to market entry to maintain their monopoly profits. This hinders the introduction of market-oriented reforms and further market opening.

In addition, as monopoly enterprises can generate profits readily, they have no incentive to improve efficiency, and so cannot achieve competitiveness in international markets. In fact, even though China is called the workshop of the world, this is largely attributable to foreign-invested enterprises. Those Chinese SOEs that are ranked in the Fortune Global 500 announced each year by Fortune magazine of the United States contribute little to exports.

Moreover, most of the profits of SOEs are not paid to the government and are retained internally. The SOEs subject to the budget for the operation of central state-owned capital made a total net profit of 1,428.1 billion yuan (after tax) in 2018, but they paid only 137.9 billion yuan, equivalent to 9.7% of that amount, to the national treasury, a large part of which is returned to the SOEs under the pretext of capital injection, etc. (Ministry of Finance, 2019). The internal circulation of funds in the state-owned enterprise sector encourages wasteful investment.

II-3. The trend toward “separation of government and business” has been reversed

If the option of privatization is ruled out, how to strengthen corporate governance will be the most important issue in the reform of SOEs. As a step in this direction, in the Third Plenum of the 14th Central Committee of the CPC held in 1993, the realization of “separa-
tion of government and business” through the establishment of the modern enterprise system was set as a goal of state-owned enterprise reform. The modern enterprise system is characterized by (1) separation of ownership by the state and the right of management by the enterprises, (2) clearly defined rights and obligations of investors and accountability of enterprises for their own profits and losses, (3) non-intervention of the government in production and management of enterprises, and (4) “scientific” organization and management systems. In particular, in the case of large enterprises, the modern enterprise system takes the form of the shareholding system, with a shareholders’ meeting, a board of directors and a board of auditors established to supervise the management team. However, what has been occurring at SOEs in recent years is an increase in intervention by the Communist Party of China and the government, rather than “the separation of government and business” (Zhang, 2018a).

First, managers at SOEs are increasingly becoming civil servants, as the civil servant status is being applied to them again. “The Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning the Reform and Development of State-Owned Enterprises” at the Fourth Plenum of the 15th Central Committee of the CPC in 1999 prescribed that the civil servant status of managers at SOEs should be abolished. However, in recent years, the central and local organization departments of the Communist Party have been applying the civil servant status to managers at SOEs again, and have regained the personnel appointment authority concerning senior officials from the government agencies responsible for management of state-owned assets and the boards of directors of SOEs. This has opened a channel whereby senior party officials and the government move into top management posts at SOEs, making it possible for senior party and government officials with no experience in business management to become chairmen or CEOs at SOEs. As a result, public recruitment for senior executives at SOEs has been discontinued, and SOEs have become similar to the party and the government in terms of the selection of leaders, performance management, and the appointment system but also the remuneration system. In particular, because the remuneration level for senior party and government officials is lower than for managers at non-state-owned enterprises, competent personnel are unlikely to be attracted by SOEs even if public recruitment is used.

Moreover, party committees have acquired control over decision-making at SOEs. The role of party committees in SOEs has extended beyond the traditional scope, which was limited to the supervision of enterprises, to decision-making. As a result, the authority of the board of directors has weakened, while shareholders have lost some legal rights prescribed by the company law, including the rights to make important decisions and to elect managers, which they previously exercised in accordance with the size of their shareholdings. In particular, however much a private enterprise is investing in an SOE, it has to follow decision-making by the party committee there.

Unless these problems are resolved, it will be difficult to establish corporate governance at SOEs in China.
III. Limitations of SOE reform without privatization

Reform of SOEs is the most important issue of ownership reform in China. In this process, the privatization of small and medium-sized SOEs has advanced, but the privatization of large SOEs has stagnated. This situation has not changed since the inauguration of the Xi Jinping administration in 2012. Although mixed-ownership reform is being promoted by introducing private capital into SOEs, in most cases control by state-owned capital has been maintained. It is, therefore, unlikely that the corporate governance, and by extension, the efficiency of the target enterprises would improve as a result.

III-1. SOE reform proposals presented in the Third Plenum of the 18th Central Committee of the CPC

“The Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning the Comprehensive Deepening of Reform” (hereafter referred to as the “Decision”) adopted at the Third Plenum of the 18th Central Committee of the CPC (the “Third Plenum”) held in November 2013 presented reform proposals centering on three areas: the promotion of a mixed-ownership economy, the development of a modern corporate system, and the improvement of the supervision and administration of state-owned assets.

These policies were embodied in the “Guiding Opinions for Deepening Reform of State-owned Enterprises” (Hereinafter, “Guiding Opinions”) published on September 13, 2015. The “Guiding Opinions” stipulate that “By 2020, China should establish a state-owned asset management system, a modern enterprise system, and a market-based management mechanism that meet the requirements of China’s basic economic system and the development of a socialist market economy, make the allocation of state-owned capital more rational, nurture skilled managers and major SOEs that are innovative and competitiveness in international markets, and constantly improve the vitality, control, influence, and risk response capabilities of the state-owned economy.” In order to achieve this, the following six tasks must be firmly addressed.

(1) Reform SOEs by type. SOEs are to be divided into “for-profit enterprises” and “public welfare enterprises.” The fusion of SOEs with market economies and the fusion of economic and social contributions of SOEs should be promoted.

(2) Establish a modern corporate system. Reform of the corporate shareholding system, improvement of corporate governance, establishment of management systems for business managers by field and level, implementation of a salary distribution system for enterprises in line with China’s socialist market economy, and reform of the personnel system should be pursued.

(3) Establish a system for managing state-owned assets. With a focus on changing the function of the state-owned assets supervision and management organizations from “managing SOEs” to “managing state-owned capital,” reform of the authorized man-
agement system of state-owned capital will be promoted, resource allocation will be optimized through enhancing the mobility of state-owned capital, and management and supervision of state-owned assets for profit should be centralized.

(4) Develop a mixed-ownership economy (in which state-owned and private enterprises coexist). The participation of non-state-owned capital in the state-owned enterprise reform and equity participation of state-owned capital in non-state-owned enterprises are encouraged. The feasibility of introducing employee shareholding systems in mixed-ownership enterprises (comprising both state-owned capital and non-state-owned capital) should be explored.

(5) Prevent the loss of state-owned assets by strengthening supervision. Strengthen internal supervision of enterprises and establish an efficient coordination mechanism with external supervision. Strengthen social supervision through information disclosure. Misconduct should be punished.

(6) Strengthen and improve the leadership of the party toward SOEs. Uphold party discipline. Party committees should play a central role in politics. Efforts should be made to strengthen management, develop human resources, and eradicate corruption. However, it is feared that the implementation of such policies will reverse China’s transition to a market economy rather than promote privatization.

First, the monopoly power of SOEs may be strengthened. China aims at the market economy, and the Decision of the Third Plenum specifies that the market should play a decisive role in resource allocation. To this end, the monopoly power of SOEs should be curbed as part of the construction of a fair market environment, but unfortunately, if the “Guiding Opinions” are followed, it may actually be strengthened. In particular, the government supports the international expansion of SOEs, as well as mergers and acquisitions between SOEs or between state-owned and non-SOEs in order to speed up the process of building world class multinationals. As a typical example, in order to strengthen the export of China’s high-speed railway technologies and related products, CRRC was created in June 2015 by merging China South Railway and China North Railway, China’s top two railway rolling stock manufacturers.

In addition, “the advance of the state and retreat of the private sector” may be encouraged. In the “Guiding Opinions,” besides the strengthening of SOEs, the promotion of “a mixed-ownership economy” is mentioned as a policy of future reform. Specifically, the government will encourage non-state-owned capital to participate in the reform of SOEs through investment, the restructuring of SOEs, capital injection into state-owned listed enterprises, and participation in the management of SOEs. On the other hand, the government will encourage the investment of state-owned capital into non-SOEs in various forms. The former is expected to promote “the advance of the private sector and retreat of the state” and eventually privatization, while the latter means “the advance of the state and retreat of the private sector.”

Furthermore, establishing corporate governance will become increasingly difficult. The “Guiding Opinions” stipulate that the guidance of the SOEs by the Communist Party should
be strengthened and improved. Because of this stipulation, the management of SOEs must not only fulfill their responsibilities to the representative directors, the board of directors, the board of auditors as required by corporate governance, but also follow the guidance of the Communist Party. If there is a conflict between the two, party leadership will take precedence over corporate governance. It must be said that this runs counter to the government’s policy of “separation of government and business.”

III-2. Mixed-ownership reform as the centerpiece

The centerpiece of SOE reform proposed in the Decision of the Third Plenum is mixed-ownership reform. The emphasis is placed on participation in the reform of SOEs by non-state-owned capital through investment. In the “Guiding Opinions,” SOEs are categorized into “for-profit enterprises” and “public welfare enterprises.” The “for-profit enterprises” are further categorized into “competitive enterprises” (for-profit Class I) and “specific-purpose enterprises” (for-profit Class II). These categories have different reform policies.

More specifically, “for-profit Class I enterprises” primarily engaged in sectors with sufficient market competition, such as consumer goods, should diversify their share ownership structure by introducing other state-owned capital and non-state-owned capital through such means as listing of the entire group (including the primary business). This category of enterprises may not necessarily be controlled by state-owned capital.

Meanwhile, in the case of “for-profit Class II enterprises” primarily engaged in business which is important for the nation’s security and economy, such as telecommunications, transportation, hydraulic power generation, petroleum, natural gas, electricity grid, nuclear power generation, and the defense industry, investment by non-state-owned capital should be encouraged, but state-owned capital should remain dominant.

In the case of SOEs categorized as “public welfare enterprises” (e.g., utilities, public transportation, and public facilities), participation in business management by non-state-owned entities shall be encouraged by such means as service procurement, concession, and outsourcing. In principle, enterprises belonging to this category should be 100% owned by state-owned capital; however, diversification of investors (investment by non-state-owned capital) should also be allowed subject to certain conditions.

The process of the mixed-ownership reform of SOEs can be broadly divided into the

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2 “Mixed ownership economy” is not a new concept. “The Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning the Reform and Development of State-Owned Enterprises” adopted at the Fourth Plenum of the 15th Central Committee of the CPC in 1999 stipulated that “State-owned capital can attract and organize social capital through the shareholding system, expand the function of state-owned capital and increase the control, influence, and driving power of the state-owned economy. State-owned large and medium enterprises, particularly those which have an advantage, are suited for the implementation of the shareholding system, and we will change them to shareholding companies and develop the mixed ownership economy in forms such as listing according to rules, joint ventures with foreign companies, and mutual investment. In the case of important enterprises, the state will be the controlling shareholder.” “The Decision of the Central Committee of the Communist Party of China on Several Issues Concerning the Development of the Socialist Market Economy” adopted at the Third Plenum of the 16th Central Committee of the CPC in 2003 also states: “We will greatly advance the mixed ownership economy in which state-owned capital, collective capital, and non-publicly-owned capital are jointly invested and make the shareholding system the main form to realize the public ownership system.”
following three categories:

1. Dilution of state-owned capital: Reduce the shareholding ratio of state-owned holding companies by means of receiving investments from non-state-owned strategic investors.

2. Separation of ancillary business from the main business: Separate an ancillary business division from the main business as a new company, and then invite private capital to invest in the new company.

3. Joint market development: Incorporate a joint venture partly funded by non-state-owned capital to enter a new market.

Generally speaking, dilution of state-owned capital is expected to lead to larger-scale reform and turn out to be more effective than the other two processes, as this involves reform of the primary business of SOEs.

III-3. *China Unicom as a model case for mixed-ownership reform*

When China pursues an economic reform, it often launches a pilot program covering only limited enterprises (or regions) to verify its effects before full-fledged implementation. This is also the case with the current mixed-ownership reform. By April 2019, 50 SOEs covering seven industry sectors, namely, electricity, petroleum, natural gas, railway, aircraft, telecommunications, and defense had been selected in three rounds of pilot tests. One of the companies participating in the pilot tests was China Unicom, the third-largest state-owned telecommunications operator after China Mobile and China Telecom.\(^3\) China Unicom is one of the “central enterprises” under the supervision of the State-owned Assets Supervision and Administration Commission of the State Council and is listed on the Shanghai “A-Share” market.

China Unicom’s mixed-ownership reform focused on dilution of state-owned capital, targeting the primary business, which was the first attempt among central enterprises. China Unicom’s mixed-ownership reform plan, announced on August 20, 2017, set the following basic policy: “Under the comprehensive plan, proactively solicit domestic investors, reduce the state-owned share ratio and transfer a portion of shares to other state-owned shareholders and non-state-owned shareholders, so as to advance full-fledged mixed-ownership reform. Create a market-oriented corporate system and corporate governance structure, focus on both the company’s primary business and new business models, develop both the basic and innovative businesses, and enhance the efficiency and competitiveness throughout the company. Achieve the company’s strategic goals and contribute to the diffusion of IT in the nation’s economy and society, structural reform of the supplier side, and shifting to a new growth engine.”

According to this plan, China Unicom was set to procure funds in the aggregate amount

\(^3\) According to the Fortune Global 500 published in 2017 by *Fortune*, China Mobile ranked 47th, China Telecom 133rd, and China Unicom 241st in terms of revenue.
of about RMB78 billion (about $12 billion) through the following three avenues.

1. Third-party allocation of shares: issue new shares at RMB6.83 per share, with a maximum of around 9.037 billion shares, and allocate them to specific strategic investors, so as to raise about RMB61.725 billion at a maximum.

2. Share transfer: based on an agreement, transfer about 1.9 billion shares worth about RMB12.975 billion to the National Fund for Structural Adjustment of State-owned Enterprises from China Unicom Group, the holding company of China Unicom, for RMB6.83 per share.

3. Creation of an employee stock ownership plan: grant an option to key employees to acquire newly-issued shares for RMB3.79 per share, with a maximum of around 848 million shares (2.7% of the total number of shares after the mixed-ownership reform), so as to raise about RMB3.213 billion at a maximum.

As a result of the mixed-ownership reform, strategic investors together would acquire 35.19% of China Unicom’s total shares. On the other hand, the shareholding ratio of China

Table 2. Change in Shareholding of China Unicom Due to Mixed-ownership Reform

<table>
<thead>
<tr>
<th>Category</th>
<th>Shareholder</th>
<th>Before reform</th>
<th>After reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>Largest shareholder</td>
<td>China Unicom Group</td>
<td>62.7</td>
<td>36.67</td>
</tr>
<tr>
<td>Financial group</td>
<td>China Life Insurance Company</td>
<td>-</td>
<td>10.22</td>
</tr>
<tr>
<td>Internet service operators</td>
<td>Tencent</td>
<td>-</td>
<td>5.18</td>
</tr>
<tr>
<td></td>
<td>Baidu</td>
<td>-</td>
<td>3.30</td>
</tr>
<tr>
<td></td>
<td>J D.com</td>
<td>-</td>
<td>2.36</td>
</tr>
<tr>
<td></td>
<td>Alibaba</td>
<td>-</td>
<td>2.04</td>
</tr>
<tr>
<td>Companies serving vertical markets</td>
<td>Suning Commerce Group</td>
<td>-</td>
<td>1.88</td>
</tr>
<tr>
<td></td>
<td>Kuang-Chi</td>
<td>-</td>
<td>1.88</td>
</tr>
<tr>
<td></td>
<td>Huaihai Ark</td>
<td>-</td>
<td>1.88</td>
</tr>
<tr>
<td>Industrial funds</td>
<td>National Fund for Structural</td>
<td>-</td>
<td>6.11</td>
</tr>
<tr>
<td></td>
<td>Adjustment of SOEs</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Aegon-Industrial Fund</td>
<td>-</td>
<td>0.33</td>
</tr>
<tr>
<td>Employee stock ownership plan</td>
<td>-</td>
<td>-</td>
<td>2.70</td>
</tr>
<tr>
<td>Public shareholders</td>
<td>37.3</td>
<td>25.40</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.00</td>
<td></td>
</tr>
</tbody>
</table>

Note 1: Some strategic investors invest through their subsidiaries instead of directly.

Note 2: Due to rounding, the shareholding ratios may not add up to 100.

Source: Compiled by the author based on China Unicom (2017)

The National Fund for Structural Adjustment of State-owned Enterprises was established through contributions from central and local SOEs and financial institutions including China Chengtong Holdings Group, Ltd. (principal initiator), CCB Financial Asset Investment Co., Ltd., China Merchants Jinkui, China North Industries Group Corporation, China Petroleum and Chemical Corporation, Shenhua Group, China Mobile, China Communications Construction, CRRC Capital and Beijing Financial Street Investment Group Co., Ltd. As the main business, the fund provides services for the development of central enterprises, industrial sector-wide integration and reorganization, adjustment of production capabilities, and cross-border M&A.
Unicom Group would decrease from 62.7% to 36.67% (Table 2). The shareholding ratios of these strategic investors estimated based on the cap on the number of shares issued would be as follows: China Life Insurance Company, 10.22%; Tencent, 5.18%; Baidu, 3.30%; JD.com, 2.36%; Alibaba, 2.04%; Suning Commerce Group, 1.88%; Kuang-Chi, 1.88%; Huaihai Ark, 1.88%; Aegon-Industrial Fund, 0.33%; and the National Fund for Structural Adjustment of State-owned Enterprises, 6.11%.

As China Unicom is a “for-profit Class II” category enterprise, it has to remain under the control of state-owned capital. In fact, China Unicom Group continues to be the largest shareholder of China Unicom even after the mixed-ownership reform. When the shares held by China Unicom Group are combined with those held by the National Fund for Structural Adjustment of State-owned Enterprises and China Life Insurance Company, state-owned capital still accounts for over 50% of China Unicom’s shares. As minority shareholders, non-state-owned strategic investors have little influence over important decision making.

III-4. Challenges to be overcome in mixed-ownership reform

As is also the case with China Unicom, in general, the mixed-ownership reform is expected to generate the following positive effects.

First, it helps improve the business performance of the SOEs concerned. Introduction of non-state-owned capital is useful for the enhancement of productivity and profitability of an enterprise due to improved corporate governance.

Second, it helps curb the monopoly power of SOEs by lifting the barriers hindering the entry of non-state-owned capital and entities. It has been very difficult for non-state-owned capital and entities to enter into the seven priority sectors for the mixed-ownership reform. The mixed-ownership reform paved the way for market entry into these sectors.

Third, it allows SOEs to procure funds for investment through the use of non-state-owned capital. This is expected to curb SOEs’ dependence on debt issuance.

However, in order to achieve these effects, the following issues need to be solved (Liu, 2016):

The first issue is the delay in the reform of institutions and mechanisms. The mixed-ownership reform of listed enterprises is only ending up in diversifying shareholders, falling short of establishing effective corporate governance structure of mixed-ownership enterprises. For mixed-ownership enterprises whose control is retained by state-owned shareholders, non-state-owned shareholders are often put into a disadvantageous position where their interests are impaired.

The second issue is that sectors which are attractive for private entities are dominated by SOEs and are not open for market entry, whereas most of the sectors where market access is permitted are not profitable and are unattractive to private entities.

The third issue is that the state-owned asset supervising and managing authorities are still reluctant to transfer state-owned shares to private entities, due to the perception that private capital still poses a threat to state-owned capital and gives rise to economic instability.
The fourth issue is that, in the process of mixed-ownership reform, state-owned assets are often disposed of inappropriately, due to insufficient development of effective supervising mechanisms and the lack of laws and prescribed procedures regulating transfer of state-owned shares to private entities.

The fifth issue is that, while the government is trying to improve corporate governance and business results of SOEs through the mixed-ownership reform, in reality, most SOEs are taking this opportunity to pass their non-performing business segments to private entities.

Finally, there is no mechanism for private entities to exit from mixed-ownership enterprises. In addition, exiting private entities may be criticized for stripping state-owned assets.

The most important goals of the mixed-ownership reform are the development of a competitive market environment and the improvement of corporate governance in SOEs. However, it is doubtful whether the mixed-ownership reform is the most effective way to achieve these goals (Zuo, 2014).

If the goal is to eliminate monopoly of state-owned capital in certain industrial sectors through the introduction of non-state-owned capital, the most effective way would be to lower the barriers for market entry and to allow private enterprises to compete on an equal footing with SOEs. The market competition that results would motivate SOEs to improve their corporate governance, productivity, and competitiveness.

If the goal is to change the management structure of SOEs, including corporate governance, the state as represented by the government would need to abandon its dominant position in the shareholding structure by way of privatization. As long as the government remains the dominant stakeholder, business management of SOEs is unlikely to change drastically.

IV. Development of private enterprises in China entering a difficult phase

In addition to reform of SOEs, promoting development of private enterprises is another pillar of ownership reform. Since China started its reform and opening up policies, private enterprises that started from scratch have ridden the wave of the shift to a market economy, and the private sector comprised of those enterprises has outgrown SOEs in terms of revenue and employment (Figure 1). However, recently, the sluggishness of the business performance of private enterprises has become conspicuous, raising concerns over the trend toward “the advance of the state and retreat of the private sector,” which runs counter to the shift to a market economy that has been promoted by the Chinese government. In response, the government has introduced a series of measures to support private enterprises, mainly through financial assistance.

IV-1. Private enterprises having a hard time

Private enterprises are at a disadvantage in market competition as they are discriminated
against because they operate under a different ownership system from SOEs. As the recent deterioration in the economic environment has added to this disadvantage, many private enterprises are having a hard time.

First, in line with a rise in prices of producer goods, such as raw materials, production costs are rising. Since 2016, as a result of structural reforms on the supply side, mainly
through the reduction of excess capacity, prices of products in upstream and midstream industries (producer goods), such as coal and steel, have been rising. However, enterprises have been unable to pass the additional cost on to downstream products (consumer goods) amid the weakening of final demand due to the economic slowdown (Figure 2). One notable feature of the industrial structure in China is that the share of SOEs is larger in upstream and midstream industries, and the share of private enterprises is larger in downstream industries (See Box 2). As a result, while revenues and other indicators of SOEs’ business performance are improving in response to the rising prices of producer goods, the business performance of private enterprises is deteriorating because of growing production costs.

Figure 2. Changes in PPI in China – Producer goods vs. Consumer goods –

![Graph showing changes in PPI in China](image)

Source: Compiled by the author based on the CEIC database (raw data from the National Bureau of Statistics of China).

Next, as a result of the initiative to resolve excess capacity and meet environmental protection regulations, many private enterprises have been forced to scale down production or even to go bankrupt due to their failure to meet new standards.

Meanwhile, in order to prevent a financial crisis and curb the already high level of debt owed by enterprises, the government has adopted a tight monetary policy and is strengthening regulations on shadow banking. Small and medium-size private enterprises with low creditworthiness have been the first to feel the impact of those measures, finding it more and more difficult to raise funds.

Consequently, SOEs have overtaken private enterprises in terms of the growth rate of value added and the share of profits in the industrial sectors, aggravating the trend toward “the advance of the state and retreat of the private sector” (Figure 3).

Under these circumstances, comments about the situation of private enterprises made by
two individuals who happen to have the given name “Xiaoping” have created a buzz.

On September 11, 2018, Wu Xiaoping, who claims to be a financial expert, issued a commentary saying that in China, as the private sector has fulfilled its role of assisting the state-owned economy in achieving development, it should gradually retreat (on the website Toutiao). In the commentary, Mr. Wu insisted that the private sector should not blindly ex-

![Figure 3. SOEs Surpassing Private Enterprises in Terms of Value Added Growth and Share of Profits in the Industrial Sector](image)

Note 1: State-owned enterprises refer to state-holding industrial enterprises with state shareholding greater than non-state shareholders.

Source: Compiled by the author based on the CEIC database (raw data from the National Bureau of Statistics of China).
pand and should merge with the state-owned sector to form a huge state-private mixed-ownership sector that will play the leading role socially and economically in the future.

On the same day, Qiu Xiaoping, Vice-Minister at the Ministry of Human Resources and Social Security, speaking at a meeting on the democratic management of private enterprises nationwide hosted by a private company called Transfar Group, emphasized that private enterprises should let employees play a more active role and involve them in corporate management, thereby allowing them to enjoy the benefits of corporate development, and that in order to realize that goal, it is necessary to strengthen the Communist Party’s guiding role (Ministry of Human Resources and Social Security, 2018). His comments were taken by some people as a message signaling the government’s intention to intervene in the management of private enterprises and revive the state-private joint management initiative that marked the first step toward nationalization of private enterprises in the 1950s.

Now that nurturing large and strong SOEs has become a national policy as the ongoing U.S.-China trade war is putting downward pressure on the Chinese economy, the commentaries by the “two Xiaopings” have attracted intense attention as arguments supporting the trend toward “the advance of the state and retreat of the private sector,” which runs counter to the market economy reform that was launched by Deng Xiaoping who is regarded as the mastermind behind China’s reform and opening-up initiative.

IV-2. Policies launched in the “Symposium on Private Enterprises”

Government leaders, as well as government-affiliated media organizations, are trying hard to downplay the intensifying arguments erupting over the retreat of private enterprises. The prime example of this effort is a speech made by Secretary General Xi Jinping at the “Symposium on Private Enterprises” on November 1, 2018 that was presided over by himself (Xi, 2018). In the speech, Xi paid high compliments to the importance and role of the private-sector economy in China and pointed out difficulties faced by the private-sector economy on the path of development. Having done that, he presented a policy package supporting the private-sector economy.

Xi highly praised the private-sector economy, which had previously been small and weak but has grown large and strong over the four decades since the launch of the reform and opening-up initiative, as an indispensable force in promoting China’s development, citing the following points. First, he pointed out the private-sector economy’s various contributions to the overall economy in quantitative terms: it contributes more than 50% of tax revenue; it accounts for more than 60% of gross domestic product (GDP); it accounts for more than 70% of the technological innovations achieved in China; and it supports more than 80% of the employment of urban-area workers; it accounts for more than 90% of the total number of enterprises. Moreover, the private-sector economy plays an important role in the development of the socialist market economy, the transition of the government’s systems, the absorption of surplus rural workers and the penetration of international markets, as it has come to perform the main role in business start-ups and employment and to serve as
an important player in technological innovation and as an important source of tax revenue. In reference to the recent debate over the private-sector economy, Xi expressed his opinion as follows. For some time, in certain quarters of society, there have been attempts to write off or cast doubt on the private-sector economy. For example, some people have argued that the private-sector economy should retreat from the stage of history on the ground that it has already fulfilled its mission. Others have misrepresented the ongoing reform toward a state-private mixed-ownership system as a new form of state-private joint management. Still others have argued that the strengthening of party construction and labor union activity at enterprises is intended to exert control over private enterprises. These arguments are completely wrong and are inconsistent with the party’s broad policy line, according to Xi. He argues that China’s private-sector economy should grow larger and stronger, not weaker—and that it should play a role on a wider stage.

Xi expressed his intention to assist reform and development by creating a better environment for the private-sector economy and supporting the resolution of difficulties through the implementation of the following six measures (Table 3). (1) Reduction of the tax and cost burdens on enterprises; (2) resolution of problems such as the difficulty for private enterprises to raise funds and high fundraising costs; (3) creation of a fair and competitive environment; (4) improvement of policy implementation methods; (5) development of a new type of government-company relationship that is clean and friendly; (6) strengthening protection of the personal and property rights of entrepreneurs.

In order to resolve the difficulties faced by private enterprises, the Chinese monetary authorities have already launched a three-pronged initiative featuring (1) support for securing credit, (2) support for fundraising through corporate bonds, and (3) support for fundraising through stocks (Xinhuanet, 2018). To be more specific, regarding support for securing credit, the People’s Bank of China adopted the expansion of credit for private enterprises as a new assessment item under the Macro-Prudential Assessment system (MPA) that is applied to commercial banks and also expanded its relending and rediscount quotas for financial institutions. On support for fund-raising through corporate bonds, the Standing Committee of the State Council decided at a meeting on October 22, 2018 to introduce a scheme to support fundraising by private enterprises through bonds, such as CDS (credit default swaps). In addition, on support for fund-raising through stocks, the People’s Bank of China will support the establishment of private placement funds and venture capital funds by securities companies and asset management companies affiliated with banks.

However, these measures are nothing more than quick fixes that address the symptoms, and treating the cause requires creating a fair and competitive environment through institutional reforms.

In a market economy, as fair competition is the prerequisite, SOEs must participate in market competition as independent business agents, as other enterprises, by enhancing their competitive advantage without relying on governmental support. This is also a pre-condition for the healthy growth of private enterprises. As to how SOEs should operate in a market economy, the principle of competitive neutrality advocated by the OECD, as summarized
Table 3. Measures to Support Private Enterprises Launched in the “Symposium on Private Enterprises”

<table>
<thead>
<tr>
<th>Measures to Support Private Enterprises</th>
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<tbody>
<tr>
<td>(1) Reduction of the tax and cost burdens on enterprises</td>
</tr>
<tr>
<td>The government must effectively reduce the burden on enterprises by fully implementing projects that will lower costs through supply-side structural reforms. It is necessary to increase the level to which company’s needs are met by reforms in a simple and clear manner, for example, by expanding applicable tax deduction or by promoting effective reduction of the value-added tax. Tax exemption measures should be adopted for small and micro businesses and high-tech start-up enterprises. Furthermore, the burden on enterprises of social security payments should be mitigated.</td>
</tr>
<tr>
<td>(2) Resolution of problems such as the difficulty for private enterprises to raise funds and high fundraising costs</td>
</tr>
<tr>
<td>It is necessary to resolve the credit squeeze problem by adopting support for the development of the private-sector economy as a business performance assessment item for banks. The government must expand the scope of fund suppliers for private enterprises by increasing financial market entries and must make private-sector banks, small-loan lenders, venture capital companies, and the stock and bond markets fulfill their role as fund suppliers. It is also necessary to avert the transfer of ownership of private enterprises to state-owned entities by implementing special support measures for private enterprises which have borrowed funds using stocks as collateral and are facing a difficult position due to falling stock prices. Moreover, the government must instruct local governments to provide necessary fiscal support to promising private enterprises that will be able to contribute to the optimization and sophistication of the economic structure.</td>
</tr>
<tr>
<td>(3) Creation of a fair and competitive environment</td>
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<td>Various obstacles standing in the way of private enterprises should be removed in order to create a fair and competitive environment for them in terms of market entry, review for approval, management, and auction. The government must also encourage private enterprises to participate in the reform of SOEs. In addition, it is necessary to shift from discriminatory and optional industrial policies to comprehensive and functional ones, review policies that run counter to market rules that ensure fairness, openness and transparency, and promote the enforcement of antimonopoly and anti-unfair competition laws.</td>
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<tr>
<td>(4) Improvement of policy implementation methods</td>
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<tr>
<td>The government must ensure that private enterprises’ needs are increasingly met in terms of policy implementation by strengthening policy coordination, designing and quantifying segmented policy measures and adopting relevant incidental measures and making sure that those measures are actually implemented down to the last detail. Regarding the resolution of excess production capacity and deleveraging, it is essential to apply the same standard to enterprises operating under different types of ownership. When implementing policies in such fields as safety supervision and environmental protection, it is important to take account of the respective circumstances of individual enterprises, rather than applying a one-size-fits-all approach.</td>
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<tr>
<td>(5) Development of a new type of government-company relationship that is clean and friendly</td>
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<tr>
<td>A new type of government-company relationship should be developed that is clean and friendly, and support for the development of private enterprises should be promoted as an important task. The government should devote more time and effort to the development of private enterprises and the growth of private-sector entrepreneurs, rather than merely making verbal commitments or promoting slogans. Senior officials of government ministries and agencies concerned and local governments must consistently listen to appeals from private enterprises, and when private enterprises are facing difficulties in particular, they must make active efforts to support the resolution of those problems. It is necessary to include support and guidance for efforts to overcome difficulties faced by SOEs and private enterprises, especially small and micro businesses, and to promote innovation among the assessment criteria of the performance of senior officials.</td>
</tr>
<tr>
<td>(6) Strengthening protection of the personal and property rights of entrepreneurs</td>
</tr>
<tr>
<td>When seeking cooperation from entrepreneurs to conduct investigations in the course of performing their duties, discipline inspection and oversight agencies must not only make the nature of the problem clear, but also protect the entrepreneurs’ legitimate personal and property rights and ensure that they can continue to lawfully conduct business. With respect to private enterprises that have committed illegal acts in the past, it is necessary to treat their cases based on legal principles and the supposition of innocence without proof to the contrary, liberating entrepreneurs from mental burdens and allowing them to move forward without hindrance.</td>
</tr>
</tbody>
</table>

Source: Compiled by the author based on Xi (2018).
below, serves as a useful reference (OECD, 2015).

(1) There should be a clear separation between the state’s ownership function and other state functions that may influence the conditions for SOEs, particularly with regard to market regulation.

(2) Stakeholders and other interested parties, including creditors and competitors, should have access to efficient redress through unbiased legal or arbitration processes when they consider that their rights have been violated.

(3) Where SOEs combine economic activities and public policy objectives, high standards of transparency and disclosure regarding their cost and revenue structures must be maintained, allowing for an attribution to main activity areas.

(4) Costs related to public policy objectives should be funded by the state and disclosed.

(5) As a guiding principle, SOEs undertaking economic activities should not be exempt from the application of general laws, tax codes, and regulations. Laws and regulations should not unduly discriminate between SOEs and their market competitors. SOEs’ legal form should allow creditors to press their claims and to initiate insolvency procedures.

(6) SOEs’ economic activities should face market-consistent conditions regarding access to debt and equity finance. In particular:

1. SOEs’ relations with all financial institutions, as well as non-financial SOEs, should be based on purely commercial grounds.

2. SOEs’ economic activities should not benefit from any indirect financial support that confers an advantage over private competitors, such as preferential financing, tax arrears or preferential trade credits from other SOEs. SOEs’ economic activities should not receive inputs (such as energy, water, or land) at prices or conditions more favorable than those available to private competitors.

3. SOEs’ economic activities should be required to earn rates of return that are, taking into account their operational conditions, consistent with those obtained by competing private enterprises.

(7) When SOEs engage in public procurement, whether as bidder or procurer, the procedures involved should be competitive, non-discriminatory and safeguarded by appropriate standards of transparency.

If the principle of competitive neutrality is to be followed, the government must maintain neutrality by providing equal treatment to enterprises operating under different types of ownership, including SOEs, private enterprises, and foreign-invested enterprises. This is consistent with China’s existing policy that the government protects the property rights and legitimate interests of enterprises under different systems of ownership, and ensures that they have equal access to factors of production, can participate in market competition publicly, equally and fairly, and receive equal protection under the law (“The Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning the Comprehensive Deepening of Reform” adopted at the Third Plenum of the 18th Central Committee of the CPC, November 12, 2013).
The Chinese government is also promoting the creation of a fair and competitive market environment as the objective of the market economy reform. To that end, the government issued “Opinions on Establishing a Fair Competition Review System in the Construction of Market System” (June 14, 2016), followed by the issuance of “Notice on Issuing the Fair Competition Review System Implementing Regulations (Interim)” (October 23, 2017). These documents prescribed that policy-making organizations, including administrative agencies, should conduct a fair competition review, evaluate the impact on market competition, and prevent the exclusion or limitation of market competition when they prepare regulations, normative documents, and policy measures related to matters concerning market players’ economic activities, such as market entry permission, industrial development, invitation for enterprises to locate business operations, injection of funds, invitation for bids, bidding, government procurement, code of management conduct, and qualification criteria.

Meanwhile, “Opinions of the Central Committee of the Communist Party of China and the State Council on Improving the Property Right Protection System and Providing Law-based Protection to Property Rights,” which was issued on November 4, 2016, stated that the government should accelerate the establishment of a property rights protection system and effectively protect the property of economic organizations under different types of ownership and citizens, and that interference in judicial activities, judicial disputes and specified cases by senior officials of the Communist Party and the government should be prohibited.

To dispel the concerns of private and foreign-invested enterprises, Governor Yi Gang of the People’s Bank of China, speaking at a G30 seminar on international banking on October 14, 2018, sounded a positive note on the possibility of the Chinese government embracing the principle of competitive neutrality, which was followed by similar comments by senior officials of the State-owned Assets Supervision and Administration Commission and related ministries.

In his “Report on the Work of the Government” presented to the National People’s Congress in March 2019, Premier Li Keqiang clearly stated that “We will follow the principle of competitive neutrality, so that when it comes to access to factors of production, market access and licenses, business operations, government procurement, public biddings, and so on, enterprises under all forms of ownership will be treated on an equal footing.” In this way, pursuing the principle of competitive neutrality has become an official policy of China.5

In order to thoroughly pursue the principle of competitive neutrality, the government’s intervention in enterprises and the market must be minimized.

First, the government’s authority over resource allocation should be significantly reduced. The market should be allowed to play a decisive role in resource allocation, while the government’s role should be limited to providing public goods, responding to market failures, redistributing income through social security, and achieving economic stability through

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5 In international trade negotiations, such as those concerning the Trans-Pacific Partnership (TPP), the principle of competitive neutrality is regarded as important for the development of rules intended to realize fair trade and investment. For China, promoting the principle of competitive neutrality as a key concept in its market economy reform will be helpful not only for developing private companies but also for resolving the ongoing trade friction with the United States.
Box 1. Why is it difficult for SOEs to establish effective corporate governance?  
— Opinion of Professor Zhang Weiying of Peking University

In China, some argue that the focus of SOE reform should be corporate governance rather than ownership structure, and that by improving their corporate governance, SOEs would be able to achieve efficiency on par with private enterprises. However, Peking University Professor Zhang Weiying argues that it is impossible for SOEs to establish effective corporate governance based on the following observations (Zhang, 2014).

Corporate governance has two fundamental functions: one is to select talented entrepreneurs as top executives, and the other is to motivate, supervise, and manage the top executives.

In private enterprises, it is the “shareholders” who primarily play these two roles. Due to such factors as asymmetry of information, it is not easy to pick the right top executives and supervise and manage them properly. Shareholders (in particular, large shareholders) strive to perform these roles in a proactive way, because incompetent top executives unconcerned with corporate value will cause loss to their property. Corporate governance can be achieved through such means as shareholders meetings, board meetings, audit committees, stock options for executives, employees’ bonuses, stock market transactions, M&A, and the trust of stakeholders.

On the other hand, if one asks whether it is possible for SOEs to firmly establish effective corporate governance, the answer is “no,” because SOEs are owned by the state, not individuals. Politicians and bureaucrats entrusted with the management of SOEs have disproportionate powers relative to responsibilities, which means that they can exercise the same rights as shareholders of private entities in appointing and supervising top executives of SOEs, but they do not have to bear the consequences. Whether or not these enterprises are making money has little effect on their salaries. Unlike shareholders of private entities, they have no incentive to appoint talented entrepreneurs to become executives and to supervise them in the performance of their duties. Executives of SOEs also lack entrepreneurial spirit, and they only seek career success as bureaucrats. They may try to improve corporate profit in the short term, but they have little interest in technology development and innovation which require a long time to achieve results.

Professor Zhang’s conclusion that “it is impossible for SOEs to establish effective corporate governance” would also apply to mixed-ownership enterprises over which state-owned capital retains control.
Box 2. Segregation between SOEs and private enterprises by sector

By sector, China’s SOEs are concentrated in the upstream (raw materials) and midstream (intermediate goods, capital goods) of the supply chain, while private enterprises are concentrated downstream (consumer goods and services). This shows that, in the downstream sectors, a competitive market environment has already taken shape, whereas in the upstream and midstream sectors, the barriers to entry for private enterprises are still high, and the SOE monopoly structure has remained intact. Thus, SOEs and private enterprises do not compete in the same sectors. Rather, they are segregated into different parts of the supply chain. This “vertical structure” is a main feature of the Chinese economy and can be seen from the list of Chinese enterprises in the Fortune Global 500.

Specifically, while state-owned enterprises in China maintain an overwhelming share in the sectors of “capital goods and producer services,” “energy,” “financial services,” and “materials” in the 2018 edition of the Fortune Global 500, private enterprises have an advantage in the sectors of “consumer goods and services” and “real estate” (Table 4). In the field of “consumer goods and services,” seven Chinese private enterprises are listed in the ranking, of which three (JD.com, Alibaba, Tencent) are internet services and retail companies. In addition, five Chinese real estate companies are ranked in this Global 500 and three of them are private enterprises.


<table>
<thead>
<tr>
<th>Sector</th>
<th>SOEs</th>
<th>Private Enterprises</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Share (%)</td>
<td>Number</td>
</tr>
<tr>
<td>Capital Goods and Producer Services</td>
<td>26</td>
<td>89.7</td>
<td>3</td>
</tr>
<tr>
<td>Energy</td>
<td>18</td>
<td>100.0</td>
<td>0</td>
</tr>
<tr>
<td>Financial Services</td>
<td>14</td>
<td>77.8</td>
<td>4</td>
</tr>
<tr>
<td>Consumer Goods and Services</td>
<td>6</td>
<td>46.2</td>
<td>7</td>
</tr>
<tr>
<td>Materials</td>
<td>9</td>
<td>81.8</td>
<td>2</td>
</tr>
<tr>
<td>Information Technology</td>
<td>4</td>
<td>50.0</td>
<td>4</td>
</tr>
<tr>
<td>Real Estate</td>
<td>2</td>
<td>40.0</td>
<td>3</td>
</tr>
<tr>
<td>Utilities</td>
<td>3</td>
<td>100.0</td>
<td>0</td>
</tr>
<tr>
<td>Health Care</td>
<td>2</td>
<td>100.0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>84</td>
<td>78.5</td>
<td>23</td>
</tr>
</tbody>
</table>

Note: Industries included in each sector (as classified in the Fortune Global 500) are as follows.

- Capital Goods and Producer Services: industrial machinery; aerospace and defense; airlines; shipping; mail, package, and freight delivery; trading; wholesalers (diversified); engineering, construction
- Energy: energy; petroleum refining; mining, crude-oil production
- Financial Services: banks (commercial and savings); insurance (life and health); insurance (property and casualty); diversified financials
- Consumer Goods and Services: motor vehicles and parts; textiles; internet service and retailing; specialty retailers
- Materials: metals; chemicals; building materials, glass.
- Information Technology: telecommunications; network and other communications equipment; computers, office equipment; electronics, electrical equipment
- Real Estate: real estate
- Utilities: utilities
- Health Care: pharmaceuticals; medical facilities

Next, the government should sever its “parent-child” relationship with SOEs by maintaining the direction of the reform, which is moving toward “the separation of government and business.” SOEs must acquire the capability to compete in the market without governmental support.

It is also essential to accelerate the reform of monopoly industries. It is important to ease entry regulation in industries monopolized by SOEs, permit entry by enterprises under different types of ownership, including private and foreign-invested enterprises, and strengthen price control and the supervision of service quality by the government in sectors prone to natural monopoly.

However, while the government continues to own SOEs, it will be difficult to implement those policy measures. In the absence of privatization, ownership reform, and by extension, the transition from a planned economy to a market economy in China will remain unfinished.

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