



MACRO  
POLO

Decoding China's Economic Arrival

DEC  
2017

Houze Song

# STATE-OWNED ENTERPRISE REFORMS

Untangling ownership, control, and corporate governance





## EXECUTIVE SUMMARY

The reform of China's gargantuan state sector was a key pillar of the economic agenda released at the Chinese Communist Party's (CCP) Third Plenum in November 2013. This was widely welcomed because such reforms had effectively been halted since early 2005, when state-owned enterprise (SOE) performance began to improve and the state began to consolidate its control over SOEs.

Although Beijing intended to revive SOE reforms when it announced this new agenda in 2013, progress has since advanced much slower than anticipated. Indeed, when assessed against the stated objectives of the 2013 reform program, namely restructuring corporate governance, SOE reforms have probably performed worse than any other area in terms of the scope and depth of change. The focus on corporate governance rests on the fact that it is the cornerstone of necessary SOE reforms and is directly related to the effectiveness of another key effort: the so-called "mixed ownership" reform.

That's because China's SOEs have historically been controlled by management and have little external supervision. As is common in every economy, however, without such independent oversight, a company's management tends to pursue its own interest at the expense of shareholders. In China, too, the lack of external scrutiny over top executives has led to problems ranging from imprudent decisions that are not actually in the interest of the SOEs to management's corrupt behaviors such as stripping state assets for personal gain.

Therefore, progress in these two areas—corporate governance and mixed ownership—is a key measure of whether and how much China is actually reforming its SOEs. The following analysis, then, first provides context for SOE corporate governance reform, as well as its relevance to the mixed ownership agenda. The second section assesses the progress of SOE corporate governance reform over the past five years. A third and final section discusses the implications of Beijing's recent effort to strengthen Party committee control within SOEs.

“SOE reforms have probably performed worse than any other area in terms of the scope and depth of change.”

## KEY TAKEAWAYS

- Despite Beijing's intent to push corporate governance change in SOEs, the central issue of imposing external supervision on SOE management has not been solved;
- The China Unicom case may offer an example of how mixed ownership reform will proceed, but it may not be sufficient to improve corporate governance;
- Delegating authority to SOE boards has proceeded slowly, however, with trial reforms taking place in only three central SOEs so far and no plans to expand;
- Private investors aren't likely to gain control of SOEs, but they could potentially get more seats on the board to effect modest internal change;
- The latest push to revive Party committees as the ultimate authority within SOEs marks a regressive step that, if fully enforced, will offset the already limited progress made on empowering boards and incentivizing private investment.

## TWO SIDES OF A COIN

In some sense, mixed ownership reform—the pooling of public and private capital, as private investors are given small stakes in SOEs—and corporate governance reform are two sides of the same coin. That is because the latter is a precondition for the former to work effectively. Ultimately, corporate governance reforms are needed to provide private investors with sufficient assurances that their investments will be protected. In practice, mixed ownership likely means that private investors can only obtain a minority stake in, rather than majority ownership of, SOEs.

There are two major reasons why private investors will continue to be primarily minority shareholders in Chinese SOEs: (1) The SOE sector is simply so large that practically speaking, it is not possible to privatize a significant portion of SOEs within a realistic timeframe; (2) Beijing will not want to cede control of state firms to private interests.

China's Ministry of Finance currently estimates the total book value of non-financial SOEs' net assets at around [50 trillion yuan](#) (\$7.5 trillion). If private investors seek to control just 40% of the SOEs in China (i.e. own at least 51% of their shares), then the price tag for doing so will be 10 trillion yuan (\$1.5 trillion). To put this sum in perspective: since the creation of the Chinese stock market, the total amount of money Chinese public companies have *ever* raised domestically is less than [7 trillion yuan](#) (\$1.2 trillion).



Even with the hefty price tag, private investors in practice are likely to purchase stakes in SOEs at valuations *higher* than book value, which will further reduce the amount of shares private investors will be able to purchase. Part of the reason for the inflated asset prices is the revelation that during the previous round of SOE reforms, corrupt officials and SOE managers were frequently selling off state assets at bargain basement prices and pocketing the gains. As such, the selling of state assets became a sensitive issue and a major source of public discontent, leading Beijing to become more reticent about off-loading state assets cheaply.

This official attitude has meant that, in practice, the state has been basically unwilling to sell any assets below book value, even if many such assets are likely worth less. In the past few years, except during the liquidation or restructuring of insolvent SOEs, there has not been a single case, to my knowledge, of SOE assets being sold at below book value.

Another factor militating against mixed ownership reform is that Beijing wants to keep majority ownership of most SOEs for commercial *and* political reasons. The fiscal burden of supporting money-losing SOEs forced Beijing to privatize a large number of SOEs during the late 1990s to early 2000s. Yet despite the fact that many SOEs are currently in financial distress, the state sector as a whole is still very profitable. In both 2015 and 2016, for example, China's state sector took in [more than 6 trillion yuan](#) (~\$1 trillion) in pre-tax profits, and SOE profits have increased by more than 20% as of October 2017. Since SOEs receive implicit subsidies via cheap financing and free land, these figures likely inflate the profitability of SOEs. But it is clear that, at least in the near term, Beijing still sees no urgency to sell off large stakes in SOEs.

So the current reality is that private investors are unlikely to gain control of any SOE in which they invest. To incentivize private investment, therefore, will require that some mechanism is put into place to give investors confidence that their investment, at a minimum, will not be squandered and that they will be able to at least earn a reasonable return.

The most obvious mechanism for doing so would be to give private investors seats on the SOE boards in exchange for their capital. That way, private investors would at least have influence over strategic and operational decisions of a firm—and they could try to ensure that the firm takes a profit maximization approach that gives private shareholders decent returns.

And yet in the majority of SOEs, especially those that are not publicly listed, corporate boards currently have a very limited role in corporate governance. One of the reasons these boards play such a limited role is that many of their usual functions are currently under the aegis of the State-owned Assets Supervision and Administration Commission (SASAC)—the central government agency, and its local-level equivalents, that oversees SOEs. For instance, SASAC still evaluates SOE management performance and determines executive compensation. In Western corporate counterparts, those functions would normally fall under the authority of the board, not a government agency.

In addition, the composition of the SOE boards is also problematic, since they are still largely populated by corporate management, or “insiders.” This has created a misalignment of interests because board members typically represent the interests of shareholders while management often has different incentives. For example, senior SOE management may be more interested in creating internal fiefdoms or even engage in illegal activities such as stripping assets. These behaviors of course undermine shareholder interest in profit maximization. And this is why a board largely composed of “outsiders” would normally be created to supervise management performance and defend shareholder interests.

In short, a board dominated by senior management, as is currently the case in a typical Chinese state firm, renders the board largely ineffective at serving its core purpose—representing shareholder interests. In a more fundamental overhaul, Beijing will want to gradually change the composition of the board and make it more independent of SOE management. In fact, SASAC *has* begun appointing external directors to SOE boards. But the next test will be whether mixed ownership reform gains momentum and, as a direct consequence, private investors will be permitted to fill board seats to represent their interests.

Beijing has initially focused on addressing the corporate governance problem by both empowering the boards and mandating the creation of new ones in those state firms that do not currently have one. This approach has required many central SOEs to be restructured into either a limited liability or joint stock company, with one of the key features being the creation of a board that oversees all major corporate decisions.

Of course, this is not to say that the prospective reform process will be smooth or easy. Challenges such as dealing with taxation and accounting for SOE assets,

“

*The composition of the SOE boards is also problematic, since they are still largely populated by “insiders.”*



such as the free land they previously received, could hinder the restructuring process. These issues, while unresolved, will matter greatly because they can affect the valuation of the state firm down the line. Dealing with these problems will be a prerequisite if Beijing seriously wants to attract private capital in these SOEs as part of its mixed ownership program.

## ASSESSING PAST PROGRESS

In assessing progress against the key objectives of Beijing's SOE reform program—how both mixed ownership and corporate governance changes have actually fared—it becomes clear that the past four years have seen very little progress in achieving stated goals.

It was not until April 2017 that Beijing finally began to reduce the scope of SASAC authority and [experiment with delegating more authority to SOE boards](#), including a role for boards in evaluating management and determining executive compensation. This reform is currently being tried at fewer than 10 central SOEs or their subsidiaries. So far, there is no clear timetable on when and whether this reform will be expanded to the nearly 100 central SOEs.

Along with this modest reform, Beijing has now also mandated that [all central SOEs must "corporatize"](#) by the end of 2017—meaning that all SOEs and any subsidiaries that currently lack a board will need to create one by 2020. Currently, more than [two-thirds of central SOEs](#) have not gone through this restructuring, and more than 3,000 of their subsidiaries have not done so either.



So far, none of these approaches has actually made much progress. But at the very least, reform of SOE boards has taken *some* steps in the right direction by allowing better representation of shareholder interests and creating a bit more independence from SOE management. Still, since these efforts began only earlier this year, it is too soon to tell whether they will prove successful or can be scaled up nationwide. It is not so surprising, then, that progress on mixed ownership has also moved at a snail's pace, given how the current SOE corporate structure offers little protection to minority shareholders and disincentivizes private capital.

To be sure, the lack of progress has been a source of concern and frustration, even for top policymakers in Beijing. Perhaps in a sign of impatience with the pace of progress, Liu He, who is President Xi Jinping's key economic advisor and is tipped to become Vice Premier overseeing finance, reportedly [personally orchestrated](#) the high-profile private investment into China Unicom, the weakest of China's three national telecommunication companies. Since telecom has been deemed a "strategic" industry, it had hitherto been closed to private investment. But Liu seems to want to use the Unicom case to demonstrate that Beijing remains determined to pursue its mixed ownership agenda.

With total investment of more than 78 billion yuan (\$12 billion), more than half of the investors in Unicom were private and included all major players in China's burgeoning tech sector. The Unicom investment, in fact, offers a good illustration of how complicated mixed ownership reform can be.

For instance, on the one hand, the Unicom investment set precedents that could potentially be emulated in other mixed ownership efforts going forward. One example is that, as part of the investment, Unicom was allowed to give its employees stock options, a sensitive issue for SOEs. That sensitivity arises from the fact that a sizeable portion of SOE profits are essentially monopoly rents by another name, because they often depend on policy support. This, in turn, raises the question of how precisely to reward employees since SOEs' profits may have little to do with employee performance. But if designed properly, stock options can help to mitigate problems currently rampant in SOEs, such as the pursuit of market share expansion at the expense of profitability. It is likely that stock options for SOE employees will be introduced in mixed ownership reform packages nationwide.

On the other hand, since the Unicom investment was largely state driven and not a market outcome, it is unclear whether more Unicom-like investments will take place

“*The lack of progress has been a source of concern and frustration, even for top policymakers in Beijing.*”

in the near term unless Beijing first fixes larger corporate governance problems. Another potential flaw in the Unicom case is that although private investors now collectively own about 20% of this state telco, each investor only owns about 3% since there are eight total investors. In other words, private investors may now have some skin in the game, but it is still too little skin. Such a small stake may not offer sufficient incentive for private investors to meaningfully devote their time and effort to improve Unicom's performance and help it pursue higher returns. Moreover, private investors can only intervene in corporate operations through a board that is not, at this point, fully functional. That makes it even less likely that private investment can bring fundamental change to the state telco.

## A PEEK INTO THE FUTURE

Despite the modest steps taken to shake up SOE corporate governance since the beginning of 2017, the prospects for enduring corporate governance reform in China appear gloomier than ever. This is in large part because of Beijing's latest bid to strengthen the Party committees in SOEs to assure that they can exert more control.

Strengthening CCP control over SOEs is an agenda that has preoccupied Chinese policymakers for at least the last five years. And it is an initiative that will, in practical terms, reverse the longstanding approach of transforming SOEs into more commercially oriented operations. Since Beijing values its control over SOEs above anything else, from the Chinese government's vantage point, strengthening CCP control is a necessary precondition for SOE reform, especially if Beijing is to tolerate private investment pouring into SOEs. But this presumption, which is driven by political considerations, makes no sense economically: consolidating CCP control over SOEs will actually make reforms much more difficult to implement.

China's current SOE structure most obviously deviates from a standard Western corporation in the existence of these Party committees. Other differences include weak boards and their strength vis-à-vis senior management.<sup>1</sup> The complicated and tangled relationship between the Party committee and the board has been an especially enduring challenge to corporate governance reform in China. Reform has long been predicated on balancing between the need for granting authority to the corporate board and the realities of the Party committee's control. Until

recently, the compromise solution was to appoint Party committee members as board directors to give the committee influence through the board without marginalizing the authority of the board itself.

But this approach appears to have been abandoned by Beijing. Instead, decision-makers now favor putting the Party committee atop the board as the ultimate authority in an SOE. If this effort is fully implemented and enforced, then more independent boards will never really become a reality of China's corporate landscape.

### “Three Significantants and One Large”

This effort to reassert CCP control within SOEs began quietly in 2010, when the CCP Central Committee published an obscure [document](#) called “Three Significantants and One Large.” The policy at the core of this document simply called for better delineating SOE internal management decision-making. That is, all major decisions related to the company's operations, personnel, and investment (the “three significantants”) and big-ticket spending (the “one large”) needed to be conducted under a collective decision-making process that involved the three main stakeholders: the Party committee, the board, and the management (see Table 1).

In addition to reinforcing the Party committee's longstanding authority to appoint SOE management, this policy signaled that the Party committee now also had *broader* discretion over a larger swath of corporate activities that previously had not been under its purview. But the emphasis on the pivotal role of the SOE Party committee grew gradually. In fact, the policy's official formalization occurred only recently at the 19th Party Congress, when the emphasis on Party committees was incorporated into the CCP Constitution.

According to the [official translation](#) of the language on SOE Party committees appended to the [latest version of the CCP Constitution](#):

“The leading Party member groups or Party committees of state-owned enterprises shall play a *leadership* role, set the right direction, keep in mind the big picture, ensure the implementation of Party policies and principles, and discuss and *decide* on major issues of their enterprise in accordance with regulation.”

“  
Decision-  
makers now  
favor putting  
the Party  
committee  
atop the  
board.”

Prior to this recent revision, the Party committee was defined in the [18th Party Congress Constitution](#) as simply the “political core (*zhengzhi hexin*)” of the SOE. Such language indicated that the authority of the Party committee was largely confined to political affairs. But as is evident from the above, the Party committee’s role was changed at the 19th Party Congress to “leadership,”—in other words, it now also has authority over other corporate affairs, including the ability to “decide” on major issues.

This development, if it continues to move forward, will disrupt the modest improvements in SOE corporate governance in two ways.

**TABLE 1. MAKING SENSE OF LINES OF AUTHORITY WITHIN SOES**

Type of Decision	Type of Activities	Decision body	CCP involvement
<b>Operation</b>	Implementing Party orders and national strategy; medium-term planning; restructuring and mergers and acquisitions; transfer of state assets; issuing stocks or bonds; Party building; and all decisions that require a meeting of shareholders, the board, or Party committee, as stipulated by relevant corporate law or SOE regulations.	Board, shareholders, and Party committee.	Party committee’s role is to ensure properly implementing the Party-state’s orders. But the scope of the Party committee’s mandate can be far-reaching and varies from SOE to SOE.  For all other matters, Party committee participates in decision making.
<b>Personnel</b>	Appointment and promotion of senior and mid-level executives, as well as board directors and management at the SOE’s subsidiaries.	Board and Party committee	Party committee makes the ultimate decision.
<b>Investment</b>	Drafting and revising of annual investment plans; investments in futures and derivatives; any investment large enough to have significant impact on the company’s bottom line.	Management	Party committee participates in decision making.
<b>Spending</b>	Any expenditure above a predetermined level	Board and management	Party committee participates in decision making.

First, and the most straightforward, is that corporate boards will be further marginalized as Party committees assume the highest executive roles within an SOE. The effect could further dissuade private investors from investing in SOEs because, as minority shareholders, they will have even less ability to become involved in corporate governance in the context of a further weakened board. In short, this change has the potential to lead to the unintended consequence of undermining the Chinese leadership's own mixed ownership objective.

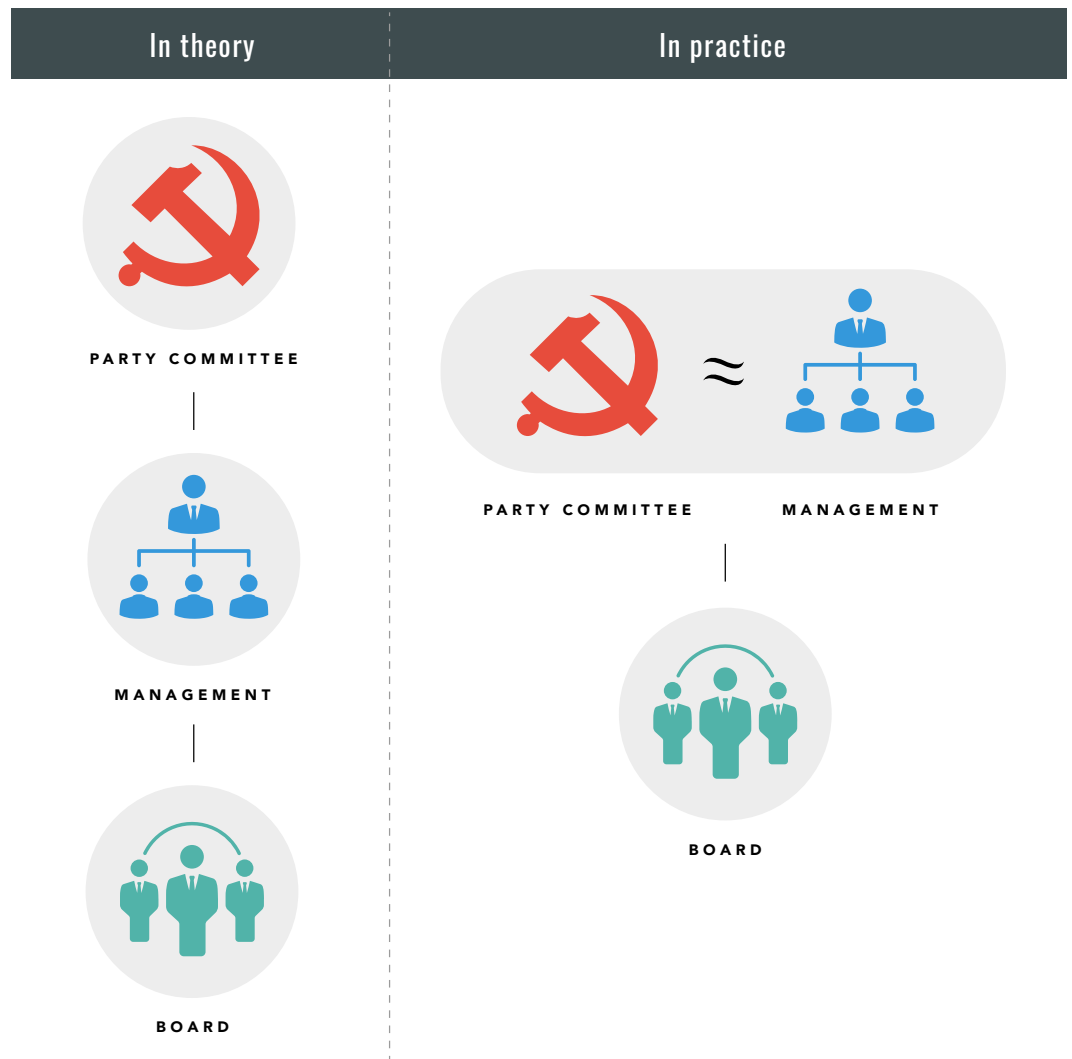
Second, and a less appreciated factor, is that empowering the Party committee in corporate affairs is tantamount to empowering SOE senior executives themselves, which will reduce independent supervision of SOE management and further stymie the effort to improve corporate governance.

This is because SOE senior managers, or corporate "insiders," wear dual hats as Party committee members and company executives (see Figure 1). The structure of the SOE Party committee parallels that of the CCP hierarchy, including a standing committee that is composed of the Party Secretary at the top (who is also simultaneously the SOE chief executive officer), all senior management, a deputy Party Secretary, and the head of the SOE discipline inspection group. This means that senior SOE executives and the Party committee are essentially one and the same, with no checks and balances and no supervision.

To illustrate what this problem would mean in practice, let's assume a hypothetical situation that involves a common corporate decision: executive compensation. If the board members voted to cut management compensation because they were unsatisfied with the SOE's performance, the senior managers who also control the Party committee could simply retaliate by overruling the board or even make life difficult for board members. Put another way, with the Party committee now in the SOE driver's seat, tension between "outsiders" and "insiders" could well reinforce internal deadlock in decision-making.<sup>2</sup>

Such a shift in the internal power balance within an SOE may not have any immediate or notable consequences, since most boards are already populated by insiders. And how far any given Party committee will go in asserting its authority is uncertain at the moment. But over the long term, this will likely hinder the longstanding effort to turn SOEs into more commercial enterprises.

FIGURE 1. POWER DISTRIBUTION WITHIN AN SOE, IN THEORY VS. IN PRACTICE



One possibility for the future is a “halfway house” scenario—one in which Party committees remain powerful but the SOE managers who tend to serve on these committees eventually relinquish their majority on the board to make way for more “outsider” seats. At that point, it might become possible for the board and the Party committee (which is composed of SOE managers) to have debates over different strategies, corporate governance issues, and major decisions.

Given the primacy of the Party committee, SOE management will likely continue to “win” in major decisions under this scenario, but it would at least allow for internal dissension and perhaps some accommodation of alternative views held by non-executive board members.

This sort of comity and new equilibrium in corporate governance, while possible, remains improbable in the near term, making the prospects for SOE reform seem dimmer than they were just a year ago.



## ENDNOTES

<sup>1</sup> There is a fourth SOE corporate governance body, the supervision committee, whose job is to prevent fraud. However, the supervision committee has historically played a very limited role in SOEs, and there is no sign that its role will be strengthened in the future. As such, the supervision committee is excluded from the discussion.

<sup>2</sup> In theory, granting SOE management stock options can help to align the interests of management and owner since SOE managers care more about profitability, they are less likely to abuse the power of Party committee. However, it seems SOE management will not receive sufficient stock options to incentive them to maximize firm value. Under the current policy on SOE executive compensation, executive bonuses are capped at no more than eight times the average salary of an SOE employee.