The Costs of Reform

China Shakes Up Its State-Owned Enterprises

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In 2015, Chinese factories produced more than 800 million metric tons of steel—nearly eight times as much as the United States produced in the same year and more than the entire world produced in 1995. By all accounts, that figure reflects an overcapacity problem: China's big steel firms are increasingly turning to foreign markets to absorb their excess output, but because of lower prices and reduced domestic demand, they are still struggling to make money, losing nearly $10 billion in 2015.

It’s not just China's steel sector that suffers from an overcapacity problem. The country is pumping out too much of other industrial products, too, including coal, aluminum, and copper wire.

To its credit, the Chinese government has recognized the need to make cuts to the country's industrial sector. In January, Beijing pledged to trim steel production by between 100 million and 150 million metric tons per year, and in February, it announced plans to cut around 500,000 jobs from the sector. Cuts to production and employment levels in the coal industry will be even steeper.

Beijing's main tool for reducing excess industrial capacity is the reform of China's giant state-owned enterprises (SOEs), something it has been trying to do since the late 1970s. In the 1980s, Beijing sought to make individual state-owned factories responsible for their financial performance by, for example, moving their accounts out of the state budget and onto separate income statements. In the 1990s, Chinese officials attempted to turn legacy communist production units into modern corporations. And in the first decade of this century, Beijing consolidated its oversight of SOEs by creating so-called state asset management committees, with the State-owned Assets Supervision and Administration Commission at the top of the pyramid.

Throughout the course of these reforms, the Chinese state, and the Communist Party in particular, has kept a firm grip on the top management of SOEs. The government uses SOEs to support official policy, even appointing government bureaucrats as company executives (usually with massive increases in pay relative to their previous government salaries). But recently, as SOEs in many sectors have suffered big losses, such control has been less rewarding. In the past, Beijing has sought to address this problem by privatizing or shuttering smaller SOEs and maintaining control over the country's larger, more profitable ones—a practice that the government of Chinese President Jiang Zemin introduced in the 1990s under the slogan of "grasping the large and letting go of the small."

Today, Beijing is considering relaxing government control through further privatizations, at least in loss-making sectors such as mining, manufacturing, and other heavy industries. In theory, privatized companies will get professional managers and independent boards. In practice, no one knows exactly what to expect, perhaps not even the Chinese government itself.

What is more certain is that the wave of reform will result in the firing of many workers in the industrial sector—1.8 million of them in the coal and steel industries alone. Beijing has pledged to spend $15 billion a year to mitigate the impact on workers, largely by retraining them and relocating them to areas where job opportunities are growing, and provincial governments will spend a similar amount. Those funds will be desperately needed to cushion the impact of restructuring. But it is just
as likely that the money will be siphoned off as a sweetener to entice private sector companies to take over, and eventually close down, loss-making SOEs.

THE MANCHURIAN MODEL

The model for the latest wave of SOE reforms may be the harsh transformation of China's industrial northeast over the past decade. Heilongjiang, Jilin, and Liaoning Provinces, which form an emerging rust belt in the region historically known as Manchuria, were long shielded from major market reforms, but since the early years of this century, they have been ground zero for China's industrial restructuring. Hundreds of mines and factories have been closed, thousands of workers have been laid off, and companies have been closed so that their land could be turned over to real estate developers. Plant closures have failed to boost growth in the region, but they have at least reduced the state's expenses by eliminating government subsidies for unprofitable SOEs. As China faces increasingly constrained budgets, officials in Beijing may see that as good enough—so China's leadership may be ready to roll out a similar reform model nationwide.

Beijing's recent attempts to downsize the northeast's SOEs date to at least 2004. That year, Wang Min became the governor of Jilin Province, where he would later serve as the provincial party secretary. By the end of 2005, Wang had overseen the sale of more than 800 SOEs, many of them apparently given away to private owners. Most of these privatizations flew below the radar of the international media—until 2009, when workers at a steel plant in the city of Tonghua rioted against its privatization and killed a factory manager who had been sent in to enforce job cuts. (The privatization went ahead anyway, and the episode didn't seem to hurt Wang's career: later that year, he was appointed party chief of the much larger Liaoning Province, presumably with instructions to continue the downsizing.)

Wang, a one-time protégé of Jiang's and a member of Jiang's "Shanghai clique," appears to have fallen out of favor under the rule of Chinese President Xi Jinping: he was investigated for corruption and removed from office earlier this month. But in China's northeast, the privatizations will continue. The downsizing at Longmay Group, northeastern China's largest coal company, is illustrative. Facing public protests over plans to lay off 100,000 workers at the state-owned company, Lu Hao, the governor of Heilongjiang Province, has admitted that the firm had failed to pay its miners for months. But he has been unapologetic about its end goal—which will require the firing of some 40 percent of the company's workers.

In short, it seems that the Chinese government is determined to shed excess industrial capacity at its loss-making SOEs, no matter the political or human cost. China's northeastern provinces aren't the only ones to have faced these restructurings, which have since targeted other relatively poor provinces with large industrial sectors, such as Shandong and Shanxi Provinces. We'll know that Beijing is serious about putting SOEs on a market footing—and not simply cutting its losses in oversupplied sectors—if it starts privatizing profitable firms in richer provinces and cities, such as Guangdong and Shanghai.

KEEP THEM CLOSE

There is no official figure for the cumulative size of China's SOEs, but by most accounts, state-owned firms make up somewhere between one-third and one-half of China's economy. Not all of these companies are heavy industrial dinosaurs, and many of them are making money. Although profits in the SOE sector fell in 2015, they still amounted to some $350 billion, and some of China's SOEs are among the largest companies in the world.
The Communist Party has no intention of letting go of China's profitable SOEs. In fact, the guidelines for reform released by the central government in September suggest that the party will be directly involved in the appointment of SOE managers, that party personnel will serve rotations in key corporate roles, and that each company's party secretary will chair its board of directors. Of course, this calls into question just how independent and professional the management of the reformed companies will be: to foreign observers, such plans might seem more like a Russian-style attempt to privatize China's economy by giving it away to the party nomenklatura than like real reform.

But China's leadership clearly does not want to repeat the mistakes that Russia made during the 1990s. It has a cleaner model of crony capitalism in mind: Singapore, which was ranked fifth in the world on a "crony capitalism index" published by The Economist in 2014 but whose state-owned firms are still widely admired and generally profitable. China's economy and population are orders of magnitude larger than Singapore's, however, and the revenues of some of its largest SOEs are higher than Singapore's entire GDP. It seems unlikely that China will be able to emulate Singapore's success.

More likely is that Beijing's SOE reforms will advance the model it has already tested in China's industrial northeast. Loss-making enterprises will be sold off and closed, and profitable ones will be kept close to the party state. Company directors and CEOs who find themselves on the right side of the political divide will gain fabulous wealth, and those on the wrong side of the political divide will be charged with corruption and removed. Post-reform China may look a lot like pre-reform China, but with better managed companies and more than a few new billionaires.