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Challenges Ahead in China's Reform of State-Owned Enterprises

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EXECUTIVE SUMMARY

This essay analyzes three challenges ahead in reforming China's centrally owned companies, known as *yangqi*: determining how and when to give market forces a greater role, aligning mismatched executive incentives, and overcoming complicating factors within firms.

MAIN ARGUMENT

The Xi Jinping administration has identified the reform of state-owned enterprises (SOE) as an essential step in the structural transformation of China's economy. In September 2015, Beijing released long-delayed guiding opinions for reforming state firms, to be followed by a series of policy documents. Three key challenges, however, block the path ahead: deciding when and how to grant market forces a greater role, especially after stock market turmoil; aligning managerial incentives with firm performance and corporate governance priorities; and overcoming company-level obstacles. Continuing to restrict competition in protected sectors while merging centrally owned firms will increase their market share at the risk of long-term competitiveness and efficiency gains. Yet such performance concerns are a lesser priority for SOEs in strategic industries, where political rather than market logic remains paramount. Second, while the Chinese Communist Party under Xi is actively exercising its authority to appoint and remove the top leaders of yangqi, shuffling executives cannot eliminate their multiple and often conflicting incentives. Finally, the size, complexity, and organizational culture of centrally owned firms will complicate reform implementation.

POLICY IMPLICATIONS

- To establish realistic expectations for the next phase of China's reform of SOEs, policymakers and business leaders must understand the major challenges ahead in carrying out new reforms.
- The Chinese government has long maintained protected industries and reformed yangqi by merging underperforming and smaller state firms into other centrally owned companies. Yet boosting competition and enabling market exit for the worst performers, particularly in nonstrategic sectors, may be the best approach to improve efficiency and service quality in the long term.
- New reforms will not succeed without targeted policies at the firm level to align executive incentives, strengthen internal oversight, and overhaul enduring cadre culture.

The reform of state-owned enterprises (SOE) is an urgent priority for the Xi Jinping administration. Economically, Beijing aims to decrease the drag on domestic growth and increase the overseas competitiveness of its largest firms known as *yangqi*, long plagued by declining performance, rising debt, and serious corruption.[1] Politically, the Chinese Communist Party wants to reinforce state ownership as a pillar of domestic stability at home and increased influence abroad. To achieve these ends, Beijing released the long-delayed "Guiding Opinions of the Communist Party of China Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises" in September 2015, to be followed by a series of detailed policy documents.[2] This roadmap calls for regrouping state firms by function; further consolidating their assets, while simultaneously developing "mixed ownership"; and loosening state authority over executive management, especially for those in nonstrategic sectors.[3]

Categorizing SOEs into a public class (*gongyilei*) and a commercial class (*shangyelei*) is a transformative move at the heart of the new reforms. Firms will be divided by function into those dedicated to public welfare and those seeking profit. Future reforms will be carried out separately for these two groups in a dual-track approach: distinct strategic objectives will be set for each, and their performance will be evaluated by different metrics. While Beijing seeks to improve all SOEs' operational efficiency, service quality, and ability to innovate, profitability will always be a secondary priority for those charged with public welfare or national security functions. Specifically, the new guidelines stipulate that firms designated as public will be assessed by their ability to control costs, the quality of their goods and services, and the stability and efficiency of their operations.[4] Political rather than market logic will therefore remain the paramount driver of changes to state firms in the public class. In contrast, boosting market competitiveness and delivering gains in financial performance will be a top priority for SOEs classified as commercial, to be assessed by

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1 This essay focuses on China's central state-owned enterprises (*zhongyang guoyou qiye*), specifically the 106 nonfinancial firms administered by the State-Owned Assets Supervision and Administration Commission (SASAC).

2 *Zhonggong zhongyang, guowuyuan guanyu shenhua guoyou qiye gaige de zhidao yijian* [Guiding Opinions of the Communist Party of China Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises], Communist Party of China Central Committee and State Council of the People's Republic of China (PRC) (Beijing, September 13, 2015).

3 In 2006, the State Council identified seven "strategic industries" where the state will keep "absolute control" (defense, electricity, petroleum, telecommunications, coal, aviation, and shipping) as well as "pillar industries" where the state will maintain "strong influence" (machinery, electronics, information technology, automobiles, steel, nonferrous metals, chemicals, and construction).

4 *Zhonggong zhongyang, guowuyuan guanyu shenhua guoyou qiye gaige de zhidao yijian*, part 1, section 6.

indicators such as economic value added.[5] However, these firms will still serve political goals, including fostering indigenous innovation, supporting social stability and crisis response in China, and advancing economic initiatives abroad such as "One Belt, One Road."

This essay analyzes three challenges confronting this reform agenda: determining how and when to grant market forces a greater role, especially for state firms designated as commercial; aligning mismatched managerial interests and incentives; and overcoming complicating factors within companies. First, continuing government-directed mergers while restricting competition in protected sectors will boost state firms' market share at the risk of deepening their financial and operational weaknesses in the long term. Second, while the Xi administration is actively exercising personnel control, defined as the authority to appoint and remove top company leaders, shuffling executives cannot eliminate their mismatched incentives.[6] Finally, the size, complexity, and cadre culture of SOEs will complicate reform implementation. Whether these difficulties can be surmounted will ultimately determine the success of Xi's reform agenda and China's economic transformation.

CENTRAL STATE-OWNED ENTERPRISES

China's state-owned economy remains significant today. State firms' exact contribution to industrial output is debated but has been estimated at between 25% and 30%.[7] State firms continue to enjoy advantages in obtaining bank loans and regulatory approvals, even if their privileged capital access has gradually declined. The central government currently owns 106 companies, out of which 47 firms ranked in the 2014 Fortune Global 500.[8] These centrally owned firms, or yangqi, controlled more than $5.6 trillion in assets at the end of 2013, including more than $690 billion abroad.[9] Concentrated in strategic industries like defense, petroleum,

5 *Zhonggong zhongyang, guowuyuan guanyu shenhua guoyou qiye gaige de zhidao yijian*, part 1, section 5.

6 Top executives refers to individuals holding one or more of the following positions: general manager (*zongjingli*), party secretary (*dangwei shuji*), or chair of the board of directors (*dongshizhang*), if one exists.

7 Nicholas R. Lardy, *Markets Over Mao: The Rise of Private Business in China* (Washington, D.C.: Peterson Institute for International Economics, 2014).

8 "47 jia zhongyang qiye ruwei 2014 nian shijie 500 qiang" [47 Central State-Owned Enterprises Enter 2014 Fortune Global 500], SASAC, July 8, 2014 ~ http://www.sasac.gov.cn/n1180/n1226/n2410/n314259/n315134/15951889.html.

9 "Guoziwei 'modi' zhongyang jingwai zichan" [SASAC "Feels Bottom" on Central State-Owned Enterprises' Overseas Assets], Xinhua, March 18, 2015.

and electricity, yangqi also operate in competitive sectors ranging from automobiles to shipping. Centrally owned firms have long been integral to China's industrial policy at home. Today, they also play a leading role in its economic statecraft abroad, such as the Xi administration's "One Belt, One Road" initiative to promote infrastructure development and economic integration in Eurasia. SOEs have historically been controlled by government ministries and other state organizations, but in 2003 Chinese leaders centralized their administration under the newly created State-Owned Assets Supervision and Administration Commission (SASAC).

Yangqi are officially divided into two groups based on their strategic importance and size. The first is a core group of 53 firms known as "important backbone state-owned enterprises" (*zhongyao gugan guoyou qiye*). This group includes many of China's largest and best-known companies, such as Sinopec, China Mobile, and State Grid. The second group comprises the remaining firms—a varied mix of global industry players such as Sinosteel, lesser-known companies like the China National Salt Industry Corporation, and state-run research institutes like the General Research Institute for Nonferrous Metals.

Due to their varying strategic importance and size, these two groups of yangqi possess different administrative ranks. The core 53 state firms are ranked at the vice-ministerial level (*fubuji*). This gives their top executives official standing equivalent to political elites of the same administrative rank (for example, vice provincial party secretaries or governors).[10] The remaining centrally owned firms have department-level (*zhengtingji*) rank. Administrative rank confers important political privileges that can enhance executives' ability to advocate for benefits to their companies, such as licenses, or oppose economic policies disadvantageous to their industries. Specifically, these political privileges include access to documents of varying grades of classification, invitations to meetings for officials of a certain rank, and the opportunity to participate in study groups and further training at the Central Party School of the Chinese Communist Party. While SASAC states that administrative rank does not matter for how yangqi are managed and assessed, in practice it is critical to the political influence of both these firms and their leaders.

10 A small number of executives come to their companies with a higher administrative rank by virtue of their previous positions. For example, Wang Yupu, appointed as party secretary and board chairman of Sinopec in April 2015, gained full ministerial rank (*zhengbuji*) by serving previously as the vice party secretary of the Chinese Academy of Engineering starting in 2013.

GIVING MARKET FORCES A GREATER ROLE

The Enduring Appeal of Consolidation

Consolidating central SOEs has long been China's preferred method of reform. SASAC administered 189 nonfinancial SOEs at its establishment in 2003. Of the 83 firms that disappeared over the past thirteen years, the vast majority were merged into existing central SOEs, while a handful were combined to create new conglomerates or returned to ministerial control. For instance, the Yangtze Estuary Waterway Construction Company was returned to the Ministry of Transportation in 2006 to become the Yangtze Estuary Waterway Administration Bureau. China Communications Construction Company Group and China Energy Engineering Group are examples of such newly created conglomerates. During these processes of consolidation and restructuring, however, the core 53 firms have remained largely unchanged.[11]

Beijing's consolidation of yangqi is motivated by both economic and political factors. In theory, merging these companies combines complementary capacities and increases resources—employees, capital, and client networks. It aims to promote Chinese state firms' international competitiveness in a given sector by eliminating price wars among them overseas. In addition, consolidation is politically appealing for two reasons. First, it avoids the sensitive issues of selling state firms, which prompts corruption concerns, or closing them and dismissing their employees, which raises the specter of social instability. Second, it fits Beijing's win-win vision for reforming SOEs, especially those classified as commercial—market competitiveness with party control. This aspiration is embodied most clearly in China's "national champions" strategy: a long-term government initiative to build large, globally competitive state firms. The privatization of SOEs is not the end goal for new reforms and never has been.

The new guiding opinions call for ongoing government-directed consolidation of state-owned firms, which has been Beijing's stated goal for years. In a 2007 speech, for example, inaugural SASAC director Li Rongrong identified the development of 30–50 globally competitive companies as the "clear goal" for central SOE reform. Impending reforms, however, may step up the pace. Multiple mergers have been officially confirmed, while others

11 Exceptions are the 2008 merger of China Aviation Industry Corporation I and China Aviation Industry Corporation II to form China Aviation Industry Corporation, the 2008 merger of China Netcom into China Unicom, and the 2013 reorganization and merger of China National Erzhong Group into China National Machinery Industry Corporation (Sinomach).

remain rumored.[12] Two changes already stand out in the latest round of consolidation. First, China's core 53 state firms—not only smaller or poorly performing centrally owned firms—are now among those under consideration for mergers. Second, because of this fact, and since the size of yangqi overall has increased dramatically over the past decade, newly created conglomerates may dwarf both their domestic and international competitors.

New Risks of an Old Approach

Creating even larger SOEs is likely to exacerbate their already daunting financial and organizational ills. The average return on assets for nonfinancial state firms nationwide was 3.1% in 2012, falling well below the cost of capital.[13] A number of yangqi that year posted a return on assets below this average, including several companies operating in nonstrategic sectors.[14] Efforts to boost performance by merging huge state firms without downsizing them risk running aground on SOEs' well-known organizational ills—inefficient operations, communication gaps, and weak oversight. Mergers can also create a host of other problems, such as redundant staff and departments or dueling executive teams.

While many of these challenges are typical for mergers involving multinational firms, they are amplified for Chinese SOEs. Many yangqi operate in administrative monopolies created by government actions to limit competition in certain industries or grant monopoly status to specific enterprises. These administrative monopolies create little external pressure

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12 Confirmed mergers include China Merchant Group and SINOTRANS & CSC Holdings Corporation; Minmetals and China Metallurgical Group Corporation; China Ocean Shipping Group (COSCO) and China Shipping Group; China CNR Corporation Limited and CSR Corporation Limited; Nam Kwong Group Corporation Limited and Zhuhai Zhenrong Company; and China Power Investment Corporation and State Nuclear Power Technology Corporation. Rumored mergers include Air China and China Southern Airlines; China State Shipbuilding Corporation and China Shipbuilding Industry Corporation Limited; China Railway Construction Corporation and China Railway Engineering Corporation; Sinopec and PetroChina; Baosteel and Wuhan Iron and Steel Company (WISCO); and Dongfeng Motors and First Auto Works.

13 Average interest rates on loans of one to three years have exceeded 7% since 2011, according to statistics from the People's Bank of China, as cited in Andrew Batson, "Fixing China's State Sector," Paulson Institute, Paulson Policy Memorandum, January 2014, 8–9.

14 Among the top 53 companies, firms reporting a return on assets in 2012 below this average include China Telecom, China Unicom, China First Heavy Industries, China National Erzhong Group (now Sinomach), Chinalco, Baogang, WISCO, China Shipping Group, and the Commercial Aircraft Corporation of China. Yearbook data for the 2012 return on assets was not reported for the following: China National Nuclear Corporation, China Aerospace Science and Industry Corporation, China State Shipbuilding Corporation, Sinopec, China National Offshore Oil Corporation (CNOOC), Huadian, Dongfeng Motors, Anshan Iron and Steel Corporation, COSCO, China Minmetals Corporation, and China National Travel Service Corporation. *Zhongguo guoyou zichan jiandu guanli nianjian* [State-Owned Assets Supervision and Management Yearbook], SASAC (Beijing, 2013).

for yangqi to improve the quality of goods and services or boost operational efficiency, such as by streamlining internal departments and reducing staff. As mergers simultaneously produce larger SOEs and shrink the number of players operating in still-protected sectors, these problems will become more acute. Those looking to China's anti-monopoly law to address the concerns about competitiveness raised by mergers among SOEs will be disappointed. Enforcement authority is fragmented among three government agencies—the National Development and Reform Commission, the Ministry of Commerce, and the State Administration for Industry and Commerce—with limited resources and little authority to rule against mergers mandated by higher levels of government.

Tough Choices about Marketization Remain

Beijing's latest reform push is running headlong into concerns about economic and political stability, leaving the timing and process of future marketization unclear. The guiding opinions for SOE reform never mention the "decisive role" for the market pledged at the Third Plenum in November 2013. In 2015, Chinese stock market turmoil solidified conservative political elites' conviction that party-controlled yangqi are an essential part of the government's toolkit for averting financial crisis. Beijing is also extremely concerned about the security implications of foreign investment and technology, as demonstrated by the National Security Law and banking technology regulations. Tough choices lie ahead about which market-oriented reforms the government should adopt, which agencies will be responsible for carrying them out, and when, where, and in what order reforms will be implemented.

The first approach under consideration is gradual expansion of mixed ownership between centrally owned firms and other state-owned and private investors through instruments including share subscriptions, equity stake purchases, and convertible bonds. But many private investors have remained skittish despite rosy coverage by official media and efforts by the State Council to clarify the permissible forms and scope of investment.[15] An alternative approach involves authorizing the holding companies of state-owned business groups, presumably those classified as commercial, to augment their role in state capital management. In effect, this would shift SASAC's function

15 "Guowuyuan guanyu guoyou qiye fazhan hunhe suoyouzhi jingji de yijian" [Opinions of the State Council on State-Owned Enterprises Developing Mixed Ownership Economy], State Council (PRC), Document No. 54, September 24, 2015.

away from asset management toward a regulatory role. Although SASAC set up pilots in 2014 to explore these two options, the guiding opinions call for additional experimentation, making it unclear which of these tactics, if any, will be implemented on a wider scale.[16]

Others advocate rolling back administrative monopolies and boosting competition—both between state and private firms and within the state-owned sector—as the best approach to improve efficiency and service quality in the long run.[17] Most if not all of the nonstrategic sectors still protected by the Chinese government as "pillar industries"—electronics, machinery, information technology, automobiles, steel, nonferrous metals, chemicals, and construction—are inherently competitive, if capital intensive. Lowering levels of state ownership while making administrative interventions more limited and predictable will boost the efficiency of resource allocation and encourage the participation of smaller private firms.[18] The State Council's pledge in October 2015 to phase out price controls in nonstrategic sectors by 2017, limiting government-set prices to sectors like electricity and water supply, is an important step toward creating more competitive markets. However, this move is unlikely to seriously affect yangqi domination of these industries in the near term.

ALIGNING MISMATCHED MANAGERIAL INCENTIVES

Personnel Control versus Personal Power

A second obstacle to carrying out new reforms arises from SOE leaders and the party's system of personnel control. The Central Organization Department, the powerful party organ charged with management of elite cadres, appoints top executives for the core 53 SOEs. Leaders of the remaining central state-owned firms are appointed by SASAC in coordination with the Central Organization Department. In theory, the party exercises influence over SOEs through its authority to appoint, transfer, and remove their top leaders. This control is thought to align officials' career incentives with party priorities. According to

16 "Guoziwei qidong si xiang gaige shidian" [SASAC Starts Four Reform Pilots], Xinhua, July 14, 2014.

17 World Bank and the Development Research Center of the State Council (PRC), *China 2030: Building a Modern, Harmonious, and Creative Society* (Washington, D.C.: World Bank, 2013).

18 Ibid., 110.

this view, cadres loyal to the party compete to become top performers, motivated by possible promotion to a higher-ranked political position.[19]

A disconnect in career incentives, however, means the mechanism of personnel control may not always function as intended. One way of assessing this is to examine executives' career backgrounds and next positions. During the Hu Jintao era, most heads of the top 53 state firms were veterans of state-owned industry, often of the very companies they later led. The majority entered retirement directly from their company leadership positions. With no prospect of political promotion due to China's mandatory retirement age—60 for officials at the vice-ministerial and department levels—such individuals may have more incentive to coast to a comfortable retirement than to engage in the hard work of reform.[20]

Yet state firm executives are far from passive pawns in a centralized personnel management system. They derive personal power vis-à-vis the center from multiple sources. A small number of executives hold ministerial rank from their previous positions, equaling that of the government agencies charged with monitoring them. Internal checks on top leaders' authority are weak, as the board of directors often overlaps substantially with the party committee and independent directors remain scarce. Executives who built their careers within a single sector or company operate from a position of deep personal networks within their industries and firms. A fortunate few even possess professional or family ties to top leaders. Finally, individual executives' influence has also been boosted by the growing size and profits of central SOEs during the past decade.

Greater attention should be given to departmentalism (*benwei zhuyi*) in SOE management as a potential impediment to reform. Studies of China's bureaucratic politics have documented the impact of this phenomenon, in which long-serving individuals in specialized bureaucracies come to evaluate national policy priorities from the perspective and interests of their own bureaucratic unit.[21] Departmentalism is thought to be more likely to occur if tenure in a given functional bureaucratic system is lengthy—in this case, if an executive has spent his or her entire career working in a state-owned industry or a single state firm.

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19 For further discussion of the system of local official competition and political incentives in China, see Hongbin Li and Li-An Zhou "Political Turnover and Economic Performance: The Incentive Role of Personnel Control in China," *Journal of Public Economics* 89, no. 9–10 (2005): 1743–62.

20 Barry Naughton, "Leadership Transition and the 'Top-Level Design' of Economic Reform," Hoover Institution, China Leadership Monitor, no. 37, Spring 2012.

21 See, for example, Kenneth Lieberthal and Michel Oksenberg, *Policy Making in China: Leaders, Structures, and Processes* (Princeton: Princeton University Press, 1988), 404.

The majority of yangqi executives built their careers in the state-owned economy, and numerous individuals worked for decades in the same firms they later led. Many served longer than 5 years in top leadership positions, and some served over 10 years or even all the way to retirement. One example of a long-serving executive who entered retirement directly is Liu Fuchun, who worked for 32 years at China National Cereals, Oils and Foodstuffs Corporation (COFCO) before serving as its general manager (2000–2007). In part, long company service and leadership tenures in SOEs may result naturally from China's former system of lifetime state employment as well as from the time required to gain industry-specific technical expertise. However, recent moves by the Xi administration suggest that the government has recognized departmentalism in yangqi as one hindrance to reform.

Beijing Shuffles Executives, but Mismatched Incentives Remain

To consolidate control over central SOEs, the Xi administration has stepped up the rotation of executives. During the Hu Jintao era (2002–12), fourteen top-level executive transfers were made among the 53 core state firms. In the past three years, the Xi administration has already made approximately half this number of transfers within the same group of companies.[22] Reassignment of executives from one yangqi to another serves two purposes. First, it shakes up established groups of leaders and creates potential organizational learning by bringing in individuals with successful experiences running other state firms. Second, it may function as a prelude to further consolidation of SOEs in a given sector.

But rotating company leaders does not solve the mismatched incentives inherent in the personnel control system, a problem that will persist as long as these individuals are both bureaucrats and executives. The average age of SOE executives has decreased over the past decade, but because of mandatory retirement ages, many know already that their current leadership position is likely to be their last. For such individuals, it cannot be assumed that the prospect of political promotion will motivate performance or deter corruption. Even for younger officials, the current system creates serious risks. As SASAC itself acknowledges, evaluation on economic performance for

22 These statistics understate actual management rotation because they refer only to transfers of top executives in the core 53 state firms directly to another such position in this group of companies; they do not include transfers of lower-level executives. They also do not count those individuals who served in two or more top leadership positions in the core 53 state firms, but who held positions outside state-owned industry in the interim.

political promotion can lead executives to make risky short-term investments as they seek fast returns to get promoted.[23]

Nor are financial incentives being deployed to help align executives' and the government's interests in improved company performance. Amid the ongoing anticorruption campaign, Chinese leaders have worried about how to address the issue of one set of bureaucrats getting rich while others of the same administrative rank do not. In response, they unveiled plans in 2015 to reduce SOE executives' pay by up to 50%.[24] SASAC officials argue that widespread attrition is unlikely because yangqi executives enjoy nonmaterial benefits that substitute for salary, such as career stability and the opportunity for professional development at leading industry firms.[25] Such rewards, however, do not incentivize individual performance gains; moreover, slashing salaries may serve as an impetus for corrupt behavior.

One path forward is to combine increased external recruitment of executives with expanded market-based compensation schemes (including bonuses and stock options), especially for the leaders of state firms designated as commercial. A prominent Chinese expert has forecast that SOE leaders at the level of general manager and below will all be recruited from the market by 2020, instead of being appointed by party or government organs.[26] In October 2015, Xinxing Cathay International Group became the first yangqi to have its general manager selected by the board of directors. However, the problem of wage disparity persists, because managers recruited from the market are likely to outearn state-appointed executives. Indeed, new reform guidelines indicate that SOEs should develop separate compensation schemes for external market hires and executives appointed by the Central Organization Department and the State Council.[27]

23 *Tansuo yu yanjiu: guoyou zichan jiandu guanli he guoyou qiye gaige yanjiu baogao* [Exploration and Research: State-Owned Assets Supervision and Management and State-Owned Enterprise Reform Research Report] (Beijing: Jingji chubanshe, 2012), 351.

24 See *Zhongyang guanli qiye fuzeren xinchou zhidu gaige fangan* [State-Owned Enterprise Executive Compensation Reform Plan], January 1, 2015. The plan was dubbed the "pay ceiling order."

25 Bai Tianliang, "Yangqi gaoguan, xinchou zenme guan" [Central State-Owned Enterprise Executives: How to Manage Compensation], *Renmin ribao*, September 29, 2014.

26 See Chai Hua, "Yangqi shouci xingshi zongjingli xuanpinquan" [Yangqi Exercise Right to Select General Manager for the First Time], *Zhongguangwang*, October 18, 2015. In addition, Chinese Academy of Social Sciences expert Zhang Zhuoyuan commented on this issue in "Guoqi gaige liang da fangan jiang chulu, guoziwei zhineng jiang shengbian" [Two Major State-Owned Company Reforms to Be Released, SASAC's Role Will Change], *Jingji guancha bao*, May 10, 2015.

27 *Zhonggong zhongyang, guowuyuan guanyu shenhua guoyou qiye gaige de zhidao yijian*, part 1, section 10.

Untangling Managerial and Party Roles

Joint appointments for top managerial and party positions in yangqi remain widespread but entail conflicting economic and political priorities.[28] Joint appointments refer to when a single person serves simultaneously in one, two, or even three of the following roles: party secretary, general manager, and board chairman. They occur in a variety of configurations, with the combination of board chairman and party secretary being by far the most common among the core 53 state firms. When boards of directors were established at the holding company level of these SOEs, the new board chairman was nearly always the existing party secretary or concurrently appointed to serve as party secretary. Overall, the incidence of joint appointments has been highest in the strategic industries where party control is paramount: defense, power, and petroleum.

Separating managerial and party roles is important for strengthening corporate governance, which is a stated priority for yangqi designated as commercial and now seeking greater external investment. In particular, the widespread joint appointment of board chairman and party secretary undermines outside investors' confidence in boards of directors. Specifically, it implies that the board's independent decision-making authority may be subject to influence by the party committee, suggests the possibility of political priorities trumping profit maximization, and underscores the state's predominant authority to shareholders already wary about protection of their interests. Although dividing managerial and party roles cannot resolve deeper tension between firm autonomy and party control, it would be a critical step for yangqi pursuing mixed ownership reforms.

OVERCOMING COMPLICATING FACTORS WITHIN STATE FIRMS

Sprawling, Hybrid Organizations

New reforms also confront complicating factors at the company level: SOEs' byzantine structures, partial marketization, and growing global scope. Nearly all yangqi are huge, multi-tiered, partially marketized business groups. At the top is a state holding corporation wholly owned by SASAC. Below this

28 In addition to enhancing party influence, joint appointments for executives are intended as an internal bridging mechanism between the vertically oriented "new three committees" (*xin san hui*)—shareholders meeting, board of directors, and supervisory board—and the horizontally oriented "old three committees" (*lao san hui*)—party committee, workers representative assembly, and workers union.

administrative entity is an opaque constellation often comprising one hundred to over two hundred member companies, including joint venture firms, research institutes, and other bodies. These member companies range widely in size, financial performance, operational scope, and geographic location. To complicate matters further, each member company may itself have subsidiary firms or hold ownership stakes in multiple other enterprises.[29] Such complex corporate organizations are a typical feature of many large and multinational firms. What makes yangqi stand out is their partial marketization and extremely rapid increase in size and complexity, due to both domestic restructuring and overseas expansion.

Yangqi are partially marketized entities. Some of their member companies and subsidiaries may be publicly listed on Chinese or overseas stock exchanges, but typically the majority are not.[30] The proportion of publicly listed assets varies widely across centrally owned firms, with full public listing still a distant goal for most. In some cases, this hybrid nature creates conflict between the commercially oriented viewpoint of publicly listed entities and the often more conservative outlook and emphasis on political priorities of holding companies.

Ongoing mergers of central SOEs, together with their rapid international expansion, have greatly increased these firms' size and geographic spread. The average number of subsidiaries of centrally owned enterprises more than doubled from 82 in 2003 to 191 in 2010.[31] For more than a decade, Beijing's explicit policy goal has been to consolidate yangqi and make them bigger. At the same time, government support, together with growing domestic competition and surplus capacity, impelled a surge of overseas investments and joint ventures. According to state media, centrally owned firms hold more than $690 billion of assets abroad, and this figure is expected to grow.[32]

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29 See, for example, the visual depiction of China Datang Group's 143 member companies and their holdings in Li-Wen Lin and Curtis J. Milhaupt, "We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Stanford Law Review* 65, no. 4 (2013): 733.

30 Comprehensive and reliable data on the proportion of Chinese centrally owned firms' assets that are publicly listed is scarce. According to official media, centrally owned companies controlled a total of 277 entities listed on the Shanghai and Shenzhen stock exchanges as of April 2015. Yang Ye, "Chongzu chaoyong, yangqi hui suozhi 40 jia" [Wave of Restructuring, Central State-Owned Enterprises to Shrink to 40], *Jingji cankao bao*, April 27, 2015.

31 Chang-Tai Hsieh and Michael Song Zheng, "Grasp the Large, Let Go of the Small: The Transformation of the State Sector in China," Brookings Institution, Brookings Papers on Economic Activity, February 2015.

32 "Guoziwei 'modi' zhongyang jingwai zichan."

Intra-firm Obstacles to Reform

The size, global spread, and complex, hybrid structure of yangqi create additional stumbling blocks for reform. First, these factors create serious communication problems, a common challenge for multinational companies regardless of nationality. Yet inside China's SOEs, communication problems are often compounded by a lack of information-sharing mechanisms across departments, and even within them. SASAC has sought to increase reporting requirements, particularly about state firms' overseas investments, but yangqi themselves often struggle to collect accurate information from their subsidiaries.[33] Underreporting of losses is endemic and damaging for the state as well as other shareholders.

These communication problems exacerbate a second issue: weak oversight. Auditing capacity at all levels is limited and often inadequate for effective reporting among the holding company, member firms, and their subsidiaries, as well as external auditors. Internal monitoring is also bogged down by bureaucratic paperwork. Forms requiring approval by multiple superiors are ubiquitous for both large and small issues. Intended as an operational cross-check, the result is instead an enormous paperwork backlog that negatively affects both oversight and efficiency. As anticorruption investigations have revealed, corruption thrived in this environment of weak internal and external scrutiny.

A third obstacle for implementing reforms is the frequently overlooked politics within yangqi themselves. Much analysis has focused on state firms' efforts to influence central government policies or on power struggles between party leaders and specific individuals linked with state firms. Insufficient consideration has been given to the competitive and even conflictual relationships among a company's top executives, between the holding company and member companies, among member companies, and between member companies and their subsidiaries in China or overseas. Mergers often cause the most acute internal clashes, because they transform existing networks and hierarchies and create clear winners and losers, especially at

33 For details on SASAC's efforts to take stock of centrally owned companies' overseas assets and establish a reporting system for their assets abroad, see "Guanyu jiaqiang zhongyang qiye jingwai guoyou zichan guanli youguan gongzuo de tongzhi" [Announcement on Strengthening Central State-Owned Enterprises' Overseas State Asset Management Related Work], SASAC, October 14, 2011 ⁓ http://www.sasac.gov.cn/n1180/n1566/n258222/n259188/13863071.html; and "Zhongyang qiye jingwai guoyou chanquan guanli zanxing banfa" [Interim Measures for the Administration of Overseas State-Owned Property Rights of Central Enterprises], SASAC, June 27, 2011 ⁓ http://www.sasac.gov.cn/n1180/n1566/n11183/n11244/13624758.html. In addition, starting in 2015, SASAC has taken the further step of sending its own inspectors to yangqi for multi-month investigations into the status of overseas assets.

higher levels of management. They can also result in redundant departments and staff, leading to turf battles and further inefficiency.

The final obstacle that new reforms must confront is SOEs' enduring cadre culture. The organizational culture of state firms still reflects their origins in a system of socialist and traditional values—where authority and benefits are disproportionally allocated to those who are older, longer serving, loyal, and male.[34] De facto lifetime employment remains common, and it is extremely difficult to lay off workers. Personal connections and family background are still influential factors in hiring and promotion, despite concerted efforts to standardize human resource management. Career progression is still based on a bureaucratic system of grades linked with years of service, and individual sacrifice for the company's long-term good is encouraged over personal ambition.

New reforms to yangqi will not succeed without targeted policies to address these obstacles. Centralized reporting and document-management systems should be strengthened to boost the timeliness and accuracy of information reporting throughout SOEs, especially from member companies and subsidiaries operating overseas. Oversight can be improved by streamlining internal approvals, increasing the numbers and professionalization of company staff responsible for audits, and establishing mechanisms to improve their communication with one another and external auditors. When merging state-owned firms, greater consideration must be given to the challenges of integrating executive teams and downsizing redundant departments and personnel. Overhauling existing cadre culture will require concerted effort toward achieving ambitious aims: implementing standardized hiring and dismissal procedures, promoting employees based on their qualifications and competence rather than seniority or gender, and building organizational cultures oriented toward improving efficiency and individual integrity.

CONCLUSION

Beijing's planned overhaul of SOEs confronts major obstacles: determining how and when to give market forces a greater role, aligning mismatched executive incentives, and overcoming complicating factors within firms. Beyond these three challenges discussed in this essay, other factors are also likely to bedevil reform of SOEs.

34 John Child, *Management in China during the Age of Reform* (Cambridge: Cambridge University Press, 1996), 190.

Bureaucratic contestation among the various actors engaged in implementing reforms will be a major stumbling block. New leading small groups at the central level, within the State Council, and inside SASAC were a critical mechanism for the Xi administration to overcome bureaucratic gridlock and formulate the long-delayed 2015 guiding opinions. But implementing the policy documents within this framework must again contend with the divergent interests of multiple government, party, and company actors—many of whom view new reforms as threatening a status quo from which they have long profited.

Ultimately, the success of SOE reforms will be linked inextricably with progress in broader financial and legal reforms. Boards of directors in yangqi still lack independent directors, autonomy from party committee influence, and greater oversight and authority over managerial decision-making. Increased marketization of state firms under a mixed ownership system must first overcome private sector skepticism. Both of these goals—empowering boards of directors and expanding yangqi marketization—will require improved legal regulations to protect minority shareholders and greater transparency in accounting procedures. A further obstacle is that despite considerable progress in financial reforms, Beijing is still struggling to get commercial state-owned banks to extend more credit to private firms instead of SOEs.

Articulating different objectives for SOEs operating in strategic and competitive sectors is a pivotal step and will be the foundation for future reforms. For yangqi classified as public, political priorities will continue to predominate. For those designated as commercial, it remains to be seen whether government-directed reforms can improve firm performance if mixed ownership and market influence on company restructuring, operations, and management stay minimal. Ending administrative monopolies in industries where the state lacks an overriding strategic interest will face fierce resistance. Yet competition—not consolidation—may be the best way to increase yangqi efficiency and service quality while promoting long-term economic growth. Whether new SOE reforms can overcome the challenges ahead will be a critical test for both Xi's reform agenda and the transformation of China's economy. ◈