

### **Role of State-owned enterprises in China's economic development**

State-owned enterprises (SOEs) have played an important role in the Chinese economy and in the international markets. The reform of Chinese state-owned enterprises has taken place for almost four decades since 1978 and China's SOE sector has grown significantly since China's launch of the marketization reform. Chinese state-owned enterprises contribute to around one-third of the country's GDP which shows that Chinese SOEs are a significant feature of China's economy that the central government used as a tool to pursue national policy objectives. A state-owned enterprise in China refers to state-owned enterprises and state-holding corporations that are controlled by the government. There are two types of SOEs which are central SOEs and local SOEs. Central state-owned enterprises are companies that are owned by the central government while local SOEs are companies owned by the government at the provincial level. Both sectors account for approximately 40 percent of the total number of enterprises. Central and local State-owned enterprises are the main targets of SOE reform, especially in the electricity, oil and gas, and railway industries. Moreover, state-owned enterprises in China can be divided into four groups based on their regulator which is central industrial supervised by the Central SASAC, local industrial SOEs supervised by local SASAC, financial institution controlled by Central Huijin Investment Co. Ltd., and entities supervised by the Ministry of Finance (MOF). In addition, the number of central state-owned enterprises are managed by the State-Owned Assets Supervision and Administration Commission or SASAC, a special commission directly under the State Council. In this paper, I will discuss the role of state-owned enterprises, the reform history, impact, and disadvantages of state-owned enterprises in Chinese economic development which will show why SOEs are important for the Chinese economy. SOEs obtain financing through the financial sector, the banking sector, and alternative financing channels controlled by the government, therefore, SOEs are able to obtain long-term loans with low creditworthiness requirements. The other financing channels also include the state budget, foreign investment, internal funds, corporate bonds, and trade credits.

Before the opening reform in 1978, the government experienced disadvantages of state owned enterprises system that could not help the government to overcome the economic distress. Before China's state owned enterprises had been reformed, the state held the ownership and the operation rights of SOEs, and strategic decisions such as personnel and sales were made by the government. Production plans are developed by national planning agencies and state owned enterprises can only execute these plans. SOEs planned their production according to plans that were issued by the government, without considering about product price and the demand of the market. Moreover, the state provided funds to SOEs sectors in which all profit from state owned enterprises were remitted to the state only which under this system managers and laborers had little incentive to promote production resulting in lower operational efficiency. Therefore, the Chinese government have to implement state owned enterprises reform in 1978, which became a vital component of the national reform process. The reform of SOEs has been divided into four stages. The first phase of reform was between 1978 and 1984, the government aimed to the modernized management system and motivate supervisory authority bodies by encouraging the entry of new firms and creating business competition for state owned enterprises. In addition, the government also wants to improve state owned enterprises performance and increase enthusiasm for production. Therefore, individuals were allowed to operate businesses and production rather than the state's mandatory plans. State-owned enterprises were granted more flexibility in operations and management. A taxation system was introduced. Instead of transferring all profits to the state, SOEs were allowed to pay tax at the rate of 55%. SOE managers became residual claimants which greatly improved enthusiasm for production. However, central planning still dominated during this period. The second phase was between 1985 and 1993, the Central Committee of the Communist Party of China (CPC) started to reform the urban economic system and separate ownership and operation right in SOEs which the policy implemented with the Contract Responsibility System or CRS which is a system them mangers were given the operating right from the government which was considered to have improved the operating performance of the SOEs. Initially, the intention of the CRS was to motivate managers by giving residual profits, but they obtained more benefits by extracting resources from SOEs that cause significant erosion of stated-owned assets. Furthermore, the provincial government of certain regions became involved in business leading to regionalized economic development strategies. The third phase of reform was from 1994 to 2002, the CRS was seeming successful but SOEs were lack of market-supporting institutions to facilitate the separation

of ownership and operations and also suffered from the agency problem. The stage also establish a modern enterprise system or corporatization which focused on the reform of ownership rights and SOEs gained benefit from the corporatization reform. The enterprise reform results in an improvement in their operational efficiency. There was also the involved increase in privatization and witnesses of selloff and transfer of SOEs ownership in the country. Preferential policies were supported to retain larger SOEs, while the majority of smaller SOEs converted their ownership from government to non-state entities that result in the sale of large businesses of SOEs to private investors. The data from the China institute shown that the number of smaller SOEs in 1995 fell from 118,000 to 24,961 in 2004. The fourth phase of the reform began in 2003 which is the reform of the stated-owned asset management system. The reform aimed to solve the problem of undefined property rights. The government needed to establish a state-owned assets management system, in which the central and local governments assume as the responsibilities of shareholders on behalf of the state in terms of rights, interests, duties and obligations. The most important reform of this phase was the government establishing the State-owned Assets Supervision and Administration Commission or SASAC to fulfill the role of shareholder on behalf of the central government. SASAC also monitors SOEs operations and advises the management team. Furthermore, it also promotes mergers and acquisitions among large state owned enterprises. However, the reform led to a decreasing number of SOEs. SOEs are increasingly concentrated in sectors related to the national security of the national economy. In 2006, the Chinese government divided industries into three categories and readjusted the allocation of state assets since the government believed that stated-owned assets should maintain absolute control over key industries that are crucial to national security and the national economy, maintain strong control over in pillar industries and maintain the necessary influence in normal industries. There are three categories. First, key industries which include defense, electricity, telecom, coal, oil and gas, rail, and aviation. Second, pillar industries which are auto, chemicals, electronics, construction, equipment manufacturing, nonferrous metal, prospecting, steel, and technology. Lastly, normal industries include agriculture, pharmaceutical, tourism, investment, professional services, general trade, and manufacturing.

State owned enterprises play a crucial role in the economic growth of China in domestic markets. In this section, I will discuss evidence that state owned enterprises have a positive impact on long-run GDP growth and its advantages to the Chinese economy. There are three main points of state owned

enterprises that it can promote economic growth. First, SOEs investment in China has been more stable than private investment, for instance, it stabilizes growth in economic downturns by carrying out massive investment which has played a crucial role in maintaining aggregate demand, preventing economic recessions, and reducing uncertainty for investors. The State owned Assets Supervision and Administration Commission or SASAC has control over the role of economic stabilizer which comes from the order of the central government to control over state owned enterprise investment decisions. The Central Committee of the Chinese Communist Party and the presidents of the board and party secretary have control of almost fifty most important of the central enterprise. Therefore, with these strong influential institutions, the central government can command state owned enterprises to carry out massive investments. State owned enterprises not only followed the government instruction but State owned enterprises also sometimes have made their own investment decision that is institutionalized in the ways to remain a stable relationship with the government. Furthermore, the central government wants SOEs to meet macro targets, therefore, the central government provides policy and financial support to support state owned enterprises to remain in stable macro conditions and to motivate state owned enterprises to fulfill the central government's command. Thus as state owned enterprises get support from the government, state owned enterprises also benefit from a stable relationship with financial institutions. For instance, during a recession or economic downturn, the financial institution will maintain or increases funds to state owned enterprise. The stabilizing role has both short-term and long-term effects on economic growth. In the short run, SOEs' investments can reduce the severity impact of economic recession. An economic downturn may result in a permanent effect on long-term growth, therefore, state owned enterprises can contribute to long-term growth by offsetting the adverse effect of economic downturns in the short run. On the other hand, the long-term effect of SOEs depends on the profitability and efficiency of SOEs investment. State owned enterprises may induce overcapacity in the long run which imposes an extra burden on the long-term growth when the central government has loose central control over the areas of state owned enterprises investment. According to the role of SOEs in the economic stabilizer implies that there might be simultaneous causality between economic growth and the shares of SOEs in the economy. Second, state owned enterprises promote technical progress by carrying out investments in the riskier technical area. The role of SOEs in promoting technical progress by considering the opportunity cost of research and development activities. The State Science and Technology Progress Award is the progress to provide award for the only major innovations which are one the most important state prizes for science and technology that given to Chinese citizens or organizations that have made a creative contribution to technological development, innovations, and

research which help to promote the industrialization of new technologies. The reward project of the State Science and Technology Progress represents the most influential technical advances in China that provide an opportunity to see how SOEs have contributed to expanding the technological frontier of the country. Thus, most of the awards go to several organizations of SOEs which results in SOEs having played the main role among enterprises leading major technical progress. The projects that have won the award were both economically important and scientifically important. For example, the Beijing-Shanghai High-Speed Railway project in which aimed to reduce transportation costs, the ultra-deepwater submersible semi-drilling platform which ensured energy supply, and the two-line hybrid rice aimed to enhance productivity and increase output. SOEs able to lead contributed accounted for 63.6 percent while non-SOEs accounted for only 3.8 percent. The percentage shows the importance of state owned enterprises in conducting major innovations that create a positive externality through numerous sectors. Although, some may argue that if non-SOE spent the same amount of money on research and development they might gain better results. However, private enterprises are reluctant to invest in innovation because that is a highly risky investment. The reason behind the success of innovation results from a less intensified competitive environment and stable relations with shareholders which make SOEs more likely to meet the requirement than non-SOEs. Support for innovation enhances national competitiveness and brings benefits to the country. Another component that helps to improve innovation performance is the high wage strategy of state owned enterprises which bring a positive effect on innovation performance since the high wage of state owned enterprises put pressure on SOE's employee to enhance productivity and technology in order to survive in the market competition against low-wage of non-SOEs. Lastly, SOEs use a high road approach in the treatment of employees. Working days for SOEs employees are shorter than in private enterprises. Furthermore, SOEs pay a significantly higher salary than non-SOEs as in 2015, the average salary was 65 percent higher in SOEs than in private enterprises. The reason that private enterprises are unable to pay wages as high as SOEs is that the profit of private enterprises would become negative if they were required to pay wages according to China's Labor Law (Li et al 2015). Most SOEs employees also have access to social security. The high road approach can promote economic growth by increasing labor productivity which would also result in an increased profit for SOEs and would also enhance employees' loyalty and morale as well; they are good to improving working skills and stimulating innovation. Moreover, a high road approach also results in sustainable economic growth which requires a sustainable reproduction of labor power in which employees must be able to pay the living wage, if they fail to do so, it would be an obstacle to economic growth. Poor working conditions and long working time would bring intensified capital-labor conflicts and undetermined social stability. The low wage would result in

insufficient consumption demand which would make the economy vulnerable to overinvestment, external shocks from the global economy, and trade conflicts. Giving higher wages is easier for SOEs by following the high-road approach to treating SOEs' employees since it would increase workers' productivity which will help state owned enterprises move to a more sustainable growth model that requires steadily increasing wages and consumption in aggregate demand. Thus, SOEs can be one of the components that connect the Chinese economy toward a sustainable economic model. SOEs can be one of the ways to maintain social stability to function the economy properly. The government intervention can be a benefit to the Chinese economy since it maximizes resource mobility to create capital intensive industries that are necessary for the industries. Moreover, the government can use SOEs to maintain controlling a set of firms and outputs that are consistent with the government interest. China is the world's second-largest economy and has the largest number of state-owned enterprises in the world with over 150,000. The reason is that the government used the policy that called "Grasping the large and letting the small go" which indicates that the central government would maintain control of the large SOEs and shut down the smaller companies. SOEs are financed by the government, therefore, it backed up by government support which they do not have to consider about the financial return of the projects they do.

Even though China's economy has been relying on SOEs which has achieved outstanding an economic growth but it appears to have lower production efficiency resulting in multiple reasons. The reason that makes state owned enterprises have lower economic performance is that SOEs are public goods. SOEs are public goods that have excludability and non-diminish ability characteristics. Excludability resulted from undefined property rights since all parties are allowed to get access to and consume them which leads to overconsumption of assets by various parties such as managers, the state, and workers that lead in lower performance. Another characteristic is it is a non-diminish ability which indicates that overconsumption does not affect the ability of others to extract value from public goods but results in reducing the operation efficiency of SOEs. The excessive policy burdens and budget constraints also lead to lower performance because of the role in the economy such as maintaining social stability, high capital intensive, high finance costs, costs related to retirement pensions, social welfare, and salaries of abundant workers. Furthermore, the agency problems arise from the conflicting interest between managers and shareholders. In other words, the agency problems of SOEs context refer to the controlling shareholder or the government and the minority shareholders which the government wants to pursue multiple objectives rather than value maximization, for example, the government would like to maintain social stability by reducing unemployment. There is also the agency problem between the controlling shareholder and the firm managers. The SOEs problems are made by the state or local government which results in ineffective

mechanisms encouraging managers to pursue profitability. Information asymmetry also leads to ineffective of SOEs. SOEs are using a hierarchical structure in which the firms hinder information transfer between them and the government. SOEs may conceal information to obtain the benefit that generates costs for the state. The larger the distance between the SOE and the state, the costlier the information transmission and the less effective the decision making process.

In conclusion, since China's SOEs have been central to China's economic reform since 1978. In this paper, I address the classic question in China's context: what role did state-owned enterprises play in Chinese economic development?

Therefore I explained the process of SOE reform since 1978, how SOEs promote economic growth, and also obstacles that SOEs experience. There are five stages of reform which is well-developed SOEs that made China able to rely on SOEs till the current economy. As a result, the characteristics and practices of SOEs performance have shifted. The role of the State Owned Assets Supervision and Administration is to manage the central and local SOEs to follow the government's desire. Chinese SOEs will remain as a significant feature of the Chinese economy and important that tools that the central government uses to pursue national policy objectives. SOEs have played a crucial role in the pro-growth role of the Chinese economy in several ways such as SOEs play the role of an economic stabilizer which offsetting the adverse effect of economic downturn, SOEs also promote technical progress by carrying out investment in the technical area and the government also support the SOEs which help to ease economic problems by using the scientific method. The high road approach is also used to treat workers by providing higher wages to workers so they are able to pay the living wage to maintain standard living so they can perform effective work. It occurs to me that these strategies will help the Chinese economy to move toward sustainable economic growth.

## References

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