OPINION

Ownership Is Key to Fixing China's SOEs

By Eswar Prasad

China's state-owned enterprises remain one of the biggest challenges facing Beijing today. SOEs play an outsize role in the country's economy, even though they are a major source of corruption and inefficiency. So it was encouraging when the Communist Party's Third Plenum in late 2013 announced new reform plans.

Increasing competition and private ownership would help spur the changes needed to reform the country's state-owned enterprises.

But Beijing has been going about things the wrong way. Instead of forcing SOEs to operate as commercial entities free of political interference, Beijing is increasing state control. Recent reforms with Chinese characteristics do more to impede rather than promote the changes that are needed.

Consider some steps the government has taken. Beijing has increased SOE oversight by Party committees, which play critical roles on the ostensibly independent boards of SOEs. Among other things, this is meant to prevent asset-stripping by unscrupulous managers.

But Party officials themselves are often well-connected and have little relevant managerial or technical expertise. They are hardly the buffers needed against political interference and have little interest in promoting competition.

The government has also cut the salaries of top bosses. The CEOs of major SOEs now make about one-third of their previous salary, equivalent to less than $100,000 a year. Those in the U.S. who support government-mandated egalitarianism would salivate at the prospect of cutting CEO pay to such levels. But there is a cost. Pay compression has led competent middle- and senior-level managers to decamp to the private sector. And pay cuts have hardly improved the incentives facing CEOs.

Beijing has tightened SOE budgets by reducing direct government subsidies, but this is not a viable reform strategy by itself. In the mid-2000s, this led to millions of workers being laid off. The process was then left incomplete, and the surge of bank-financed investment during the global recession of 2009 and 2010 effectively rolled back the changes.

China's reluctance to reform SOEs is in part related to concerns about social stability. Laying off even tens of thousands of workers, a fraction of the necessary retrenchment, without a strong social safety net and at a time when other employment opportunities are limited could lead to social upheaval.

REUTERS

China's biggest mining enterprise, Longmay Group, plans to lay off 100,000 workers this year.

China should target spending toward a better safety net, one that could provide a buffer for laid-off workers. SOEs aren't the venue for subsidizing employment and social services such as education and health care.

But Beijing has been reluctant to do this. Instead, it emphasizes fiscal restraint, which makes the government's fiscal position look stronger than it actually is but has some undesirable side effects.

One consequence is that fiscal costs are diverted through the financial system in the form of cheap and abundant credit, perpetuating inefficiencies. The International Monetary Fund estimates that the traditional SOE sector accounts for about 20% of China's employment and output but soaks up more than 50% of bank loans. This leaves the more dynamic, employment-generating parts of the economy, such as small- and medium-size firms and service-sector firms, starved of bank credit.

It also distorts the market. Many SOEs are state-sanctioned monopolies and receive subsidized energy and land from provincial governments eager to boost investment. These are the state firms that are most likely to show a profit.

Beijing needs to reduce both its explicit and implicit subsidies to SOEs and open them up to a greater share of private ownership. Opening up protected sectors to more domestic and foreign competition would also spur change.

The financial sector, too, needs reforms. Reducing the incentives for banks to lend to SOEs, including those already technically insolvent, and making corporations more reliant on equity and bond markets, would over time drive them to improve their corporate governance and adopt better auditing and accounting practices.

Allowing corporate defaults would bring discipline to both SOEs and bond markets. But fear of financial-market turmoil appears to be holding back Beijing. In fact, such defaults could force both firms and financial markets to more carefully scrutinize the balance sheets and financial operations of both SOEs and banks.

China's government has said all the right things about the necessity and urgency of SOE reforms. Now it must act. If these reforms don't take hold, the country's financial liberalization and opening of its capital account could end badly.

Mr. Prasad is a professor in the Dyson School at Cornell University, a senior fellow at the Brookings Institution and author of "The Dollar Trap" (Princeton, 2015).