NAVAL POSTGRADUATE SCHOOL

MONTEREY, CALIFORNIA

THESIS

THE ECONOMIC AND POLITICAL LOGICS OF CHINESE STATE-OWNED ENTERPRISE REFORM SINCE THE 2013 THIRD PLENUM

by

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December 2021

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REPORT DOCUMENTATION PAGE	*Form Approved OMB No. 0704-0188*

1. AGENCY USE ONLY *(Leave blank)*	2. REPORT DATE December 2021	3. REPORT TYPE AND DATES COVERED Master's thesis

4. TITLE AND SUBTITLE
THE ECONOMIC AND POLITICAL LOGICS OF CHINESE STATE-OWNED ENTERPRISE REFORM SINCE THE 2013 THIRD PLENUM

5. FUNDING NUMBERS

6. AUTHOR(S) Kristin E. Van Boxtel

7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)
Naval Postgraduate School
Monterey, CA 93943-5000

8. PERFORMING ORGANIZATION REPORT NUMBER

9. SPONSORING / MONITORING AGENCY NAME(S) AND ADDRESS(ES)
N/A

10. SPONSORING / MONITORING AGENCY REPORT NUMBER

11. SUPPLEMENTARY NOTES The views expressed in this thesis are those of the author and do not reflect the official policy or position of the Department of Defense or the U.S. Government.

12a. DISTRIBUTION / AVAILABILITY STATEMENT	12b. DISTRIBUTION CODE
Approved for public release. Distribution is unlimited.	A

13. ABSTRACT (maximum 200 words)

In the 2013 Third Plenum of the Eighteenth Chinese Communist Party (CCP) Central Committee, China introduced plans to implement economic reforms to encourage market forces to play a more "decisive" role in China's economy. The government's actions following these announcements have lacked follow-through, and state-owned enterprises (SOEs) have instead been consolidated and strengthened. What explains the state of SOE reform implementation in China since 2013? This thesis examines whether economic and political logics better explain SOE reform measures under Xi Jinping's leadership. The findings reveal that the economic logics behind avoiding meaningful reform of China's SOEs are mixed. SOE contributions to China's GDP are substantial, but they create a negative impact on economic growth. However, SOE leverage on global markets and their ability to supply material for the Belt and Road Initiative provides stronger evidence. Evidence in support of political logics reveals that SOE contributions to employment curb a potential resurgence of social discontent and preserve a bastion of the socialist market economy that justifies the CCP's dominance. Furthermore, SOEs have been leveraged to alleviate market shocks and act on behalf of the CCP in domestic and global theaters, providing a more persuasive explanation behind the state of SOE reform.

14. SUBJECT TERMS
China, political economy, Chinese economy, Xi Jinping, economic reform, Chinese Communist Party, CCP, CPC, state-owned enterprise, SOE, state sector, SASAC, NDRC, Belt and Road Initiative, BRI, overcapacity, National People's Congress, national champion

15. NUMBER OF PAGES
131

16. PRICE CODE

17. SECURITY CLASSIFICATION OF REPORT	18. SECURITY CLASSIFICATION OF THIS PAGE	19. SECURITY CLASSIFICATION OF ABSTRACT	20. LIMITATION OF ABSTRACT
Unclassified	Unclassified	Unclassified	UU

NSN 7540-01-280-5500

Standard Form 298 (Rev. 2-89)
Prescribed by ANSI Std. 239-18

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THE ECONOMIC AND POLITICAL LOGICS OF CHINESE STATE-OWNED ENTERPRISE REFORM SINCE THE 2013 THIRD PLENUM

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Submitted in partial fulfillment of the
requirements for the degree of

MASTER OF ARTS IN SECURITY STUDIES
(FAR EAST, SOUTHEAST ASIA, THE PACIFIC)

from the

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ABSTRACT

In the 2013 Third Plenum of the Eighteenth Chinese Communist Party (CCP) Central Committee, China introduced plans to implement economic reforms to encourage market forces to play a more "decisive" role in China's economy. The government's actions following these announcements have lacked follow-through, and state-owned enterprises (SOEs) have instead been consolidated and strengthened. What explains the state of SOE reform implementation in China since 2013? This thesis examines whether economic and political logics better explain SOE reform measures under Xi Jinping's leadership. The findings reveal that the economic logics behind avoiding meaningful reform of China's SOEs are mixed. SOE contributions to China's GDP are substantial, but they create a negative impact on economic growth. However, SOE leverage on global markets and their ability to supply material for the Belt and Road Initiative provides stronger evidence. Evidence in support of political logics reveals that SOE contributions to employment curb a potential resurgence of social discontent and preserve a bastion of the socialist market economy that justifies the CCP's dominance. Furthermore, SOEs have been leveraged to alleviate market shocks and act on behalf of the CCP in domestic and global theaters, providing a more persuasive explanation behind the state of SOE reform.

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TABLE OF CONTENTS

LIST OF FIGURES

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LIST OF ACRONYMS AND ABBREVIATIONS

AFC	Asian Financial Crisis
AMC	asset management company
BRI	Belt and Road Initiative (Formerly “One Belt, One Road”)
CCP	Chinese Communist Party
EU	European Union
FDI	foreign direct investment
FYP	Five Year Plan
GDP	gross domestic product
GFC	Global Financial Crisis
MOFCOM	Ministry of Commerce
NDRC	National Development and Reform Commission
NPC	National People’s Congress
NPL	non-performing loans
PRC	People’s Republic of China
SASAC	State-Owned Asset Supervision and Administration Commission
SME	small- and medium-sized enterprise
SOE	state-owned enterprise
VCP	Vietnamese Communist Party
WTO	World Trade Organization

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ACKNOWLEDGMENTS

For my parents who gave me the opportunity. For my family and friends who gave me the encouragement. And for my grandmothers, Elizabeth Ann Croatt Van Boxtel, Maria Estrella Stockton, and Grace Elizabeth Curlee, who exemplified strength and made me demand more from myself.

This project could not be conceived or executed without the exceptional guidance from Dr. Glosny and Dr. Barma. Thank you for your commitment to excellence in education and academia.

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I. INTRODUCTION

A. MAJOR RESEARCH QUESTION AND MAIN FINDINGS

In the 2013 Third Plenum of the Chinese Communist Party (CCP) 18th Central Committee, the People's Republic of China (PRC) introduced a plan to implement new economic reforms to encourage market forces to play a "decisive" role in China's economy by allocating resources and determining outcomes.[1] The Third Plenum Communiqué referenced the importance of a "mixed economy" consisting of both public and private ownership, and pledged to "push forward economic development that is more efficient, more equitable, and more sustainable."[2] The government's actions following the ambiguous pronouncements in 2013 to increase efficiency and sustainability have lacked follow-through. SOEs continue to dominate access to capital, land, and energy and are offered better rates to receive loans that they often aren't able to pay off. Reform has only deepened the role of the CCP and the state in SOEs and "limited opportunities for efficiency gains through privatization, competition, and bankruptcy."[3]

Eight years later, SOE reform implementation has lacked substantive pro-market progress and SOEs continue to receive government funding and precedence while they remain operationally inefficient. What explains this policy reform implementation record? This thesis will examine the economic and political logics as explanations for the China's policy direction. Chapters III and IV will present evidence from three arguments for each of the economic and political poles. The economic arguments examine SOEs' contributions to GDP and growth, the utilization of SOEs' excess capacity for China's primary foreign

[1] Arthur R. Kroeber, "Xi Jinping's Ambitious Agenda for Economic Reform in China," The Brookings Institution, November 17, 2013, https://www.brookings.edu/opinions/xi-jinpings-ambitious-agenda-for-economic-reform-in-china/.

[2] Nargiza Salidjanova and Iacob Koch-Weser, "Third Plenum Economic Reform Proposals: A Scorecard," Staff Research Backgrounder (Washington, D.C.: U.S.-China Economic and Security Review Commission, November 19, 2013), 9, https://www.uscc.gov/sites/default/files/Research/Backgrounder_Third%20Plenum%20Economic%20Reform%20Proposals--A%20Scorecard%20(2).pdf.

[3] Elizabeth C. Economy, *The Third Revolution: Xi Jinping and the New Chinese State* (Oxford University Press, 2018), 106, 118; Arthur R. Kroeber, *China's Economy: What Everyone Needs to Know*, 1 edition (Oxford University Press, 2016), 89.

economic policy, the Belt and Road Initiative (BRI), and the CCP's use of SOEs to influence and control global markets. The political arguments examine SOEs' contributions to China's employment, the CCP's ability to leverage SOEs in order to stabilize its domestic economy during periods of market volatility, and the CCP's use of SOEs to implement domestic and foreign policy and diplomacy.

The findings reveal that the economic logics behind avoiding meaningful reform of China's SOEs based on the evidence examined are mixed overall. Although SOEs still represent between 21 and 28 percent of China's GDP, SOEs' impact China's economic growth is negative. The leverage gained by China when utilizing its SOEs to influence global markets and resources while furthering national economic objectives provides stronger evidence in support of economic logics as these objectives could not be accomplished if they were not centrally controlled. Finally, the evidence of SOEs' impact on ameliorating excess capacity while supplying material for the BRI is more convincing and provides a stronger explanation but does not eliminate excess capacity that derives from SOEs. Utilizing political logics, the findings reveal that SOE contributions to employment are negligible on a numeric and efficiency scale, but their retention deters a potential resurgence of social discontent while preserving a bastion of the socialist market economy that justifies the CCP's dominance. The CCP's use of SOEs to alleviate economic slowdown and mitigate global crises also acts to preserve socio-economic stability, which strengthens the argument. Finally, the way SOEs have been leveraged to act on behalf of the CCP to acquire diplomatic opportunities that strengthen China's position globally and the CCP's reputation domestically also offer compelling evidence in support of political logics. Overall, the evidence behind the three arguments presented for both economic and political logics is more persuasive in favor of political logics driving the state of SOE reform in China than those of economic logics.

B. SIGNIFICANCE OF THE RESEARCH QUESTION

The CCP's stability is widely viewed to be legitimized by China's continued economic growth. Since the Third Plenum, the state sector has continued to be prioritized and given preferential access to state resources that would otherwise be given to private companies which produce the largest share of economic production and return. Careful examination of the political and economic logics that have driven the policy decisions to strengthen SOEs can provide valuable insight into future economic decisions made by Xi Jinping, the CCP, and the state. Maintaining social stability by balancing economic policy decisions and maintaining socialism pillars creates an obvious challenge for the CCP and the incentives to retain and strengthen inefficient Chinese SOEs can provide clarity to the CCP's political motivations and societal concerns in future policy decisions.

There is a consensus among many China watchers that its economic performance is not only averaging between six and seven percent of GDP growth annually since 2012, but also that its economic performance is continuing to weaken.[4] If this is true, it is important to analyze if this relatively slower growth is a result of China's emergence into an advanced economy or a result of the structural inefficiencies within China's economy. Analyzing the PRC's focus and priorities derived from these reforms can assist in assessing if privatized and marketized developments within China's state sector can compensate for its inefficiencies and maintain or increase growth rates in the near future.

Additionally, identifying points of failure in financial policies that favor the state sector along with characterizing the banking sector's resiliency and financial prudence can support analysis in evaluating the long-term survivability and risk management of China and other states with high debt-to-GDP ratios.

C. LITERATURE REVIEW

1. The Third Plenum and Economic Reform Implementation

This thesis examines China's economic reforms since 2013 as the dependent variable and analyzes the economic and political logic of their implementation. A communiqué and comprehensive blueprint released by state media after the Third Plenum

[4] Derek Scissors, "How to Evaluate China's Economy," *American Enterprise Institute* (blog), 3 January 2019, https://www.aei.org/research-products/report/how-to-evaluate-chinas-economy/; Nicholas R. Lardy, *The State Strikes Back: The End of Economic Reform in China?* (Washington, DC: Peterson Institute for International Economics, 2019), 119–20; "GDP Growth (Annual %) - China;" "China Economic Update - December 2019," World Bank, accessed January 28, 2020, https://www.worldbank.org/en/country/china/publication/china-economic-update-december-2019.

revealed a range of reforms and policies highlighting five new roles for the government: "macroeconomic management, market regulation, public service delivery, supervision of society, and environmental protection."[5] Some of the reforms issued by these policy statements included 'relaxed housing registration system requirements, liberalization of the financial sector and interest rates, improving property rights, diversifying mixed ownership, modernizing corporate systems of state-owned enterprises (SOEs), and granting private sector businesses access to protected sectors dominated by SOEs.'[6]

Out of the range of reforms released from policy statements following the Third Plenum and implementation that has occurred since, this thesis will focus on SOEs. Literature from the Chinese government, the CCP, China analysts, and political economists will provide the necessary perspectives and information to understand political and economic drivers of China's economic policy formation in regard to SOEs. The literature review will examine the economic and political logics for SOE reforms under Xi Jinping by using existing literature to briefly examine the Third Plenum policy proclamations, identify themes in reform assessments, characterize broader political and economic logics, and apply them to China's SOE reform.

2. SOE Reforms Announced in the Third Plenum

In the months following Xi Jinping's ascension to General Secretary of the CCP in 2012, he launched a campaign to unite the Chinese populace by collectively achieving the "Chinese dream."[7] This ambiguous term serves a wide application of definitions to reach the heart of every citizen from the Politburo Standing Committee to the peasants in rural provinces. The general consensus suggests that this term equates to sustained economic growth, social welfare, widespread wealth distribution, and leadership in innovative

[5] Kroeber, "Xi Jinping's Ambitious Agenda for Economic Reform in China."

[6] Xi Jinping, "Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform" (USC U.S.-China Institute, November 12, 2013), https://china.usc.edu/decision-central-committee-communist-party-china-some-major-issues-concerning-comprehensively. Christopher K. Johnson, "China Announces Sweeping Reform Agenda at Plenum," Center for Strategic and International Studies, November 15, 2013, https://www.csis.org/analysis/china-announces-sweeping-reform-agenda-plenum.

[7] "Xi Jinping Pledges 'Great Renewal of Chinese Nation,'" *Xinhua*, November 30, 2012, http://www.china.org.cn/china/2012-11/30/content_27269821_3.htm.

technological sectors to create "a moderately well-off society by 2020."[8] Xi's plan for accomplishing this was economic liberalization with social insulation and political autocracy, or what Elizabeth Economy termed, "reform without opening up."[9] He then announced priorities that would help accomplish the Chinese Dream: weeding out corrupt officials,[10] increasing domestic consumption, improving the efficiency of the public sector, promoting emerging high-tech industries, and regulating industrial policy in order to achieve environmental sustainability.[11] Much of his roadmap derived from the economic goals announced in the Twelfth Five-Year Plan in 2011 but Xi made it his own at the Third Plenary Session (Third Plenum) of the Eighteenth Party Congress in 2013.

Xi's released statement, the "Decision On Some Major Issues Concerning Comprehensively Deepening The Reform" (henceforth "Decision"), announced his initiative for making markets play a "decisive" role in allocating resources to all forms of Chinese businesses including the private sector.[12] Allowing markets to possess this power removes a key function of the government.[13] There are some contradictions in the Decision: allowing markets to play a more "decisive" role in resource allocation would diminish the government's macroeconomic management capacity and its ability to protect inefficient SOEs. The proposed reforms for SOEs would give them "a leading role in China's economic growth," though SOE output and contributions to China's GDP have continued to decrease since the mid-2000s and state sector growth has paled in comparison

[8] William A. Callahan, *China Dreams: 20 Visions of the Future* (Oxford; Oxford University Press, 2013), 69. The CCP released a Third Plenum Communiqué following the meeting at the 18th Party Congress in November of 2013. The communiqué outlined goals of market-oriented reforms with the expected completion by 2020 that would be implemented by the newly established Central Leading Group. Three days after, the Party released the "Decision on Certain Major Issues Concerning the Comprehensive Deepening of Reform" to supplement the communiqué with clarification on specific reform initiatives. Salidjanova and Koch-Weser, "Third Plenum Economic Reform Proposals: A Scorecard," 2.

[9] Economy, *The Third Revolution*, 5.

[10] Xi Jinping, "Full Text of Xi's Address to the Media," *China Daily*, November 16, 2012, http://www.chinadaily.com.cn/china/2012cpc/2012-11/16/content_15934514.htm.

[11] Xi Jinping, "Decision."

[12] Dwight H. Perkins, "The Complex Task of Evaluating China's Economic Reforms," in *China's 40 Years of Reform and Development: 1978-2018*, ed. Ross Garnaut and Cai Fang (Canberra, AUS: ANU Press, 2018), 139, https://www.jstor.org/stable/j.ctv5cgbnk.16.

[13] Kroeber, "Xi Jinping's Ambitious Agenda for Economic Reform in China."

to that of the private sector.[14] If markets were given complete control of resource allocation, the effects "over time [would] undermine the importance of state-ownership all together" and dismantle "an economy with public ownership at its core."[15]

The Decision stated that a focus should be made on separating the state from SOE management, state asset management, operational management, and "decontrol competitive businesses based on the characteristics of different industries."[16] Additionally,

> [SOEs] must adapt to new trends of marketization and internationalization, and further deepen their reform by aiming the focus at regular decision making over operation, maintaining and appreciating the value of state assets, participation in competition on an equal footing, raising production efficiency, strengthening enterprise vitality, and bearing due social obligations.[17]

Additionally, the Decision stated that the government would professionalize SOE management and "continue to break up all forms of administrative monopoly" that exists within SOEs.[18]

Xi stated the difficulty of balancing the role of the government with the role of the market must be in allowing "the market [to] play the decisive role in allocating resources" and "address the problems of market imperfection, too much government interference and poor oversight."[19] He also provided a procedural new role for the Chinese government.

> The main responsibility and role of the government is to maintain the stability of the macro-economy, strengthen and improve public services, safeguard fair competition, strengthen oversight of the market, maintain

[14] Nicholas R. Lardy, "Third Plenum: Transformation of State Firms' Role Likely to Accelerate," PIIE, November 16, 2013, https://www.piie.com/blogs/china-economic-watch/third-plenum-transformation-state-firms-role-likely-accelerate.

[15] Ryan Rutkowski, "The Third Plenum and State-Owned Enterprises: A Step Backward or Forward?," PIIE, November 14, 2013, https://www.piie.com/blogs/china-economic-watch/third-plenum-and-state-owned-enterprises-step-backward-or-forward. "Communiqué of the Third Plenary Session of the 18th Central Committee of the Communist Party of China," China.org.cn, January 15, 2014, http://www.china.org.cn/china/third_plenary_session/2014-01/15/content_31203056.htm.

[16] Xi Jinping, "Decision."

[17] Ibid.

[18] Ibid.

[19] Ibid.

market order, promote sustainable development and common prosperity, and intervene in situations where market failure occurs.[20]

Since the Third Plenum, continued economic growth has remained the major focus for Xi because the Party has enjoyed political stability from rising per capita GDP over the past few decades. Increasing the efficiency of SOEs, expanding the role of markets in pricing, progressive private sector deregulation, encouraging domestic innovation, and sponsoring high-tech manufacturing has become Xi's focus for sustaining that growth. In 2019, China's estimated GDP growth increased by only 6.1 percent and is projected to decrease in the following years due to "declining returns to public investment, growing debt and rapid aging."[21] These economic lags are largely produced by SOEs but this is not a new problem for China.

3. Implementation of SOEs Reforms

The government began the massive undertaking of reforming China's deeply entrenched SOEs in 1995 with the adoption of a comprehensive reform program under the slogan "grasp the big, release the small." This meant that most of the state-owned small- and medium-sized enterprises (SMEs) were allowed to become privatized or go bankrupt. The largest SOEs or those that were referred to as the "commanding heights" sectors which included aviation, telecommunications, energy, railways, automobiles, infrastructure and production materials, defense equipment, and heavy machinery for production, would be preserved under state ownership and strengthened.[22] As a result, many of the non-performing loans that were accumulating debt were eliminated from government balance sheets and the retained SOEs were divided into smaller enterprises to generate competition between each other. This also created negative consequences within society as the

[20] Ibid.

[21] "China Economic Update - December 2019," World Bank, 19 December 2019, https://www.worldbank.org/en/country/china/publication/china-economic-update-december-2019.

[22] Kroeber, *China's Economy*, 93-4.

surrender of over 73 percent of non-financial SOEs also eliminated 33 million public sector jobs.[23]

Other reform efforts included corporatizing SOEs by selling no more than 20 percent of shares on overseas stock markets, which exposed them to some performance demands from shareholders and generated international funding to support expansion efforts. Lastly, the government established a regulatory body, the State-Owned Assets Supervision and Administration Commission (SASAC) of the State Council in 2003 to "act as the government shareholder" and 'keeping appointed managers accountable to meeting financial targets.'[24] Many SOEs have merged to remove redundancy and other state-owned competitors, leaving only 108 SOEs under the SASAC's supervision, though many of these entities are still extremely powerful and influential with multiple subsidiaries and branches. Furthermore, the role of SASAC today "places control of the national champion SOEs that dominate all key sectors of the economy directly in the hands of top Party bosses who deploy them to boost the economy and buttress the Party's monopoly on political power."[25]

Existing literature argues that the reforms initiated from the Third Plenum to develop greater competition between SOEs and private enterprises was flawed initially because SOEs have not been incentivized to become strong competitors due to state subsidies enabling and augmenting inefficiencies through the decades. Market competition naturally leaves certain businesses behind as others thrive, making business that do survive more resilient, efficient, and successful. In China's case, the consolidated mega SOEs that continue to provide the state with essential materials—electricity, petrochemicals, defense, and hard infrastructure resources such as concrete and steel—would be sacrificed in order for the successful, more efficient, more innovative, and more competitive businesses to absorb the consumers of failing firms and allow them to grow.

[23] Nicholas Lardy, *Markets Over Mao: The Rise of Private Business in China* (Washington, DC: Peterson Institute for International Economics, 2014), 45; Economy, *The Third Revolution*, 105.

[24] Ibid., 48–55; Kroeber, *China's Economy*, 94–95; Economy, *The Third Revolution*, 105.

[25] James McGregor, *No Ancient Wisdom, No Followers: The Challenges of Chinese Authoritarian Capitalism* (Westport, CT: Prospecta Press, 2012), vii.

In Xi's National Party Congress work report at the Nineteenth Party Congress in 2017, he reemphasized his desire for SOEs to 'improve distribution, make structural adjustment, and enact strategic reorganization.'[26] In the same address, he reiterates the problem stemming from monopolies—a problem that derived from state-sponsored SOE mergers that have eliminated competition between each other.[27] He called to "deepen reforms in the business sector, break administrative monopolies, preclude the forming of market monopolies, speed up the reform of market-based pricing of factors of production, relax control over market access in the service sector, and improve market oversight mechanisms."[28]

Instead of allowing markets to determine which SOEs thrive or fail, inefficient SOEs are protected by the government, surviving from subsidies, mergers, or acquisitions, and have largely avoided international competition variables such as price wars.[29] Partial privatization has continued to convert many SOEs to hybrid firms that maintain jobs and production quotas but have failed to meet the hybrid-ownership objectives of incentivizing competition and inspiring higher performance and productivity levels.

4. Assessments on China's Economic Reform Implementation

There are two schools of thought within the existing literature regarding the progress and effectiveness of Xi's deepening reforms and the overall impact on economic growth. These schools follow the Keynes-Hayek state versus market debate that started nearly a century ago. As this debate relates to China in the midst of its showing GDP growth and massive growing debt, some view China's targeted industry promotion as a risky

[26] Xi Jinping, "Full Text of Xi Jinping's Report at 19th CPC National Congress," *China Daily*, November 4, 2017, https://www.chinadaily.com.cn/china/19thcpcnationalcongress/2017-11/04/content_34115212.htm.

[27] Kroeber, "Xi Jinping's Ambitious Agenda for Economic Reform in China;" Chris Buckley and Keith Bradsher, "Xi Jinping's Marathon Speech: Five Takeaways," *New York Times*, October 18, 2017, https://nyti.ms/2zjJTUe.

[28] Xi Jinping, "Full Text of Xi Jinping's Report at 19th CPC National Congress."

[29] Economy, *The Third Revolution*, 108–9; Wendy Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," *Asia Policy* 21, no. 1 (2016): 88, https://doi.org/10.1353/asp.2016.0013.

gamble while others insist "promoting industries that play to their comparative advantages" will produce the greatest growth.[30]

In the broader sense, this debate questions the causal factors of China's growth through the last four decades. The Hayekian view argues that the effects of markets and actions of private firms have been the primary causal factors in China's economic expansion and growth since its initial opening in 1978, not the command-driven economic policies and retention of state ownership. Thus, greater privatization and market integration of domestic Chinese firms will be the solution for social stability from job creation, labor mobility, and increased per capita growth as well as improved efficiency, market durability, industrial modernization, increased FDI, and the like.[31] This method provides reliable material gain and fosters a collective effort to avoid financial disaster.

Supporters of Keynesian theory assert that economic growth is the result of the Party's hybrid and gradual approach toward marketization. Simultaneously, China's gradual approach stifles the market pressures that create income inequality between the companies that exhibit "effort, anticipation, innovation, and luck" and those that lack the motivation.[32] As it relates to China's economy, the continued bailouts and stimulus packages provided to SOEs during international market turmoil offer Chinese firms protection and the ability to sustain normal operations.

There is a wide-reaching consensus among China analysts that China's SOEs continue to fall short of productivity goals and lack efficiency gains because there is an absence of incentive for reaching such goals among managers and workers. This is due to SOE managers' inexperience with market competition and public-sector employment assurances disincentivize workers from contributing any extra effort. Furthermore, there is a consensus that effective and necessary SOE reform has not occurred so far in order to dissolve the drag they place on China's economic growth. As Leutert aptly observes,

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[30] "Plan v Market," *The Economist*, November 5, 2016, https://www.economist.com/finance-and-economics/2016/11/05/plan-v-market.

[31] Lardy, *Markets Over Mao*, 2, 123-4, 152.

[32] Thomas G. Rawski, "Reforming China's Economy: What Have We Learned?," *The China Journal*, no. 41 (1999): 143, https://doi.org/10.2307/2667590.

"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."[33] Therefore, a general consensus among the existing literature favors marketization and privatization for the existing SOEs in order to allow debt to stabilize and growth to increase overall.[34]

Existing literature also describes the CCP's lack of trust solely in market forces to achieve Xi's prospects of "China's dream."[35] Although efforts have been made to enable competition, develop efficient methods of production, and allow gradual market forces to "serve as a disciplining agent,"[36] the CCP uses caution in allowing Chinese businesses to be exposed to market forces on its own and potentially lose to reputable international competitors. Thus, applying Keynesian economic policy to strengthen Chinese firm competition appears as a safer solution to safeguarding Chinese firms than absolute market exposure. This view asserts that Xi's vision of rejuvenating and restoring China's role in the world would not be accomplished by playing by the market rules, but instead by parenting China's domestic sectors into high-production, high-efficiency, and high-quality before introducing them to ruthless market competition. Additionally, incorporating more marketization to the point where Chinese firms are competing against each other in global markets will likely increase income inequality which can easily perpetuate political instability.[37]

5. Assessments on SOE Reform Implementation

Government regulations on markets along with industry targets are not uncommon in developing economies. However, at a certain point, many developing economies

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[33] Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," 84.

[34] Lardy, *Markets Over Mao*; David Shambaugh, *China's Future*, 1 edition (Cambridge, UK ; Malden, MA: Polity, 2016), 41–43; Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," 89.

[35] Minxin Pei, "CLM Insights: Interview with Elizabeth Economy," China Leadership Monitor, December 1, 2018, https://www.prcleader.org/interview-with-elizabeth.

[36] Economy, *The Third Revolution*, 151.

[37] Richard Mcgregor and Yu Sun, "Challenging Change: Why an Ever Fiercer Battle Hinders China's March to the Market," *The Financial Times*, 2006; Lardy, *Markets Over Mao*, 147.

released their grip on guiding domestic industry and allowed market supply and demand forces to determine the survival of businesses, largely due to the World Trade Organization's encouragement to liberalize economies in order to better integrate into the global economy.[38] Many economists and China analysts believe that the time of China's governmental guidance of its domestic firms is over and the time for markets to determine winners and losers has arrived—a sentiment found within the highest levels of China's leadership as well.[39]

Analysts assess the declining efficiency of SOEs will become a driver in China's inevitable transition to increased privatization and marketization.[40] Kroeber asserts that "the worsening performance by SOEs is both a reflection and a cause of China's recent economic slowdown" and suggests that the concept of mixed ownership will only be effective if those firms transition to absolute privatization.[41] Leutert views the CCP's protection of centrally controlled large-scale SOEs as harmful for future market integration, contending that "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."[42] The continued bailouts of SOEs are viewed by Zheng as the result of the government's unwillingness to create microeconomic regulations specifically in its fiscal policy in order for productivity to

[38] "Global Trade Liberalization and the Developing Countries," *International Monetary Fund*, November 2001, https://www.imf.org/external/np/exr/ib/2001/110801.htm.

[39] Victor Shih, "Cracks in Statist Consensus," *China Leadership Monitor*, December 1, 2018, https://www.prcleader.org/cracks-in-statist-consensus; Minxin Pei, "Ideological Indoctrination Under Xi Jinping," *China Leadership Monitor* (blog), December 1, 2019, https://3c8314d6-0996-4a21-9f8a-a63a59b09269.filesusr.com/ugd/10535f_973ed89773a94a03abad4e70fd5a1612.pdf; Lingling Wei and Jeremy Page, "Discord Between China's Top Two Leaders Spills Into the Open," *Wall Street Journal*, July 22, 2016, https://www.wsj.com/articles/discord-between-chinas-top-two-leaders-spills-into-the-open-1469134110; Lardy, *Markets Over Mao*, 145.

[40] Kroeber, *China's Economy*, 108–10; Economy, *The Third Revolution*, 117; Qinglian He, "China's SOE Reform: Privatization or Taking over the Private Sector?," China Change, October 1, 2015, https://chinachange.org/2015/09/30/chinas-soe-reform-privatization-or-taking-over-the-private-sector/; Xin Liu, "China's State-Owned Enterprises Reform: Will It Work?," *China Business Knowledge @ CUHK* (blog), January 5, 2016, https://cbkcuhk.wordpress.com/2016/01/05/china-state-owned-enterprises-reform-will-this-time-work/.

[41] Kroeber, *China's Economy*, 2016, 109.

[42] Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," 86.

increase, industrialization to modernize, and resources to be allocated appropriately.[43] Zheng asserts, "SOEs cannot make their own management decisions and take full responsibility for their profits and losses until they are no longer reliant on the government."[44] Meanwhile, SOEs continue to incur massive government debt and rob private enterprises of valuable opportunities essential for expansion such as favorable interest rates on bank loans and access to land sales.[45]

Xi's government clearly espouses the value of SOEs and uses the media as a propaganda mechanism to promote them as an important pillar in "socialism with Chinese characteristics."[46] One announcement claimed 'upholding and improving the basic economic system and developing and expanding the state-owned economy are the consistent principles of the central government and the country's strong will.'[47] On *Xinhua's* SOE memorandum homepage, the Party's ideology on SOEs is bluntly expressed: 'It is necessary to correctly understand the role of state-owned enterprises in the national economic and political strategy—the role it plays in improving overall social welfare in reducing the gap between the rich and the poor.'[48] The role of the public sector does provide job security and many welfare needs (though many of these needs have been transferred to the private sector), but especially true is the role the public sector plays in sustaining income equality of its employees. Unabated market competition does raise wage disparity—something Xi wants to avoid. But SOE employment accounts for less than 48

[43] Xinli Zheng, *China's 40 Years of Economic Reform and Development: How the Miracle Was Created* (Beijing: The Commercial Press, Ltd., 2018), 29–30, 183–89.

[44] Ibid., 189.

[45] Economy, *The Third Revolution*, 104–20; Kroeber, *China's Economy*, 2016, 106–8.

[46] Hu Yu, "Hu Yu: Challenges in the Image Dissemination of State-Owned Enterprises," *Xinhua*, September 4, 2017, https://www.guancha.cn/huyu/2017_09_04_425574.shtml; Yang Ruilong, "Yang Ruilong: The Logic, Dilemma, and Future Reform of State-Owned Enterprises," *Xinhua*, July 10, 2019, https://www.guancha.cn/yangruilong/2019_07_10_508841.shtml.

[47] "Xinhua News Agency: We Must Unequivocally Opposed the Erroneous Viewpoint of Privatization," *Xinhua*, September 17, 2015, https://www.guancha.cn/economy/2015_09_17_334684.shtml.

[48] "State-Owned Enterprise Memorandum," accessed February 14, 2020, https://www.guancha.cn/GuoQiBeiWangLu.

million jobs among the 1.4 billion Chinese populace.[49] This appears to deduce the purpose of the centrally controlled large-scale SOEs as the sole socialist vestige in China's economy and one of the few remaining justifications for centralized economic planning.

6. Financial Sector Reform and the Effects on SOEs

In the past decade, the financial market was given its own dual-track system of formal and informal financial institutions. The subsidies favoring SOEs from China's four major banks were not only increasing debt but excluding SMEs, private firms, and low-income households from loan opportunities. This gave rise to shadow banking, digital finance, and informal markets to augment the lack of opportunity from formal institutions. Though these transactions occurred outside of the financial repression imposed by the state, the Government Bank Regulatory Commission continued to allow them to occur because they "contribute to the diversification and restructuring of the economy that policy-makers would like to see."[50] While these shadow institutions and transactions coexist with and within formal Chinese banks, they lack the breadth and regulatory stability to solve the financial imbalances created by SOEs throughout China.[51]

Following the Asian Financial Crisis (AFC), China developed a safety net for China's major banks that functioned in the same way as secondary markets: creating asset management companies (AMCs) to buy non-performing loans (NPLs) from the four big banks dedicated to SOE lending in exchange for bonds or stocks.[52] Existing literature argues the scapegoat of AMCs continues to enable banks to lend to insolvent or hazardous businesses unable to pay back loans without threatening the bank's capital. This has

[49] Barry Naughton, "The Current Wave of State Enterprise Reform in China: A Preliminary Appraisal," *Asian Economic Policy Review* 12, no. 2 (July 2017): 285, https://doi.org/10.1111/aepr.12185.

[50] Barry J. Naughton, *The Chinese Economy*, second edition (Cambridge, Massachusetts: MIT Press, 2018), 505.

[51] Yiping Huang and Xun Wang, "'Strong on Quantity, Weak on Quality': China's Financial Reform Between 1978 and 2018," in *China's 40 Years of Reform and Development: 1978–2018*, ed. Ross Garnaut, Ligang Song, and Cai Fang (Canberra, Australia: ANU Press, 2018), 299, https://www.jstor.org/stable/j.ctv5cgbnk.

[52] Victor Shih, "Partial Reform Equilibrium, Chinese Style: Political Incentives and Reform Stagnation in Chinese Financial Policies," *Comparative Political Studies* 40, no. 10 (2007): 1250–51, https://doi.org/10.1177/0010414006290107.

compounded on China's aggregate nonfinancial debt which has soared from 179 percent of GDP in 2012 to over 255 percent of GDP in 2017, raising questions about sustainable risk management and the potential for China to cause a financial crisis.[53]

Xi's response to managing corporate debt and NPLs to "deleverage the economy by firmly taking a prudent monetary policy and prioritizing reducing leverage in state-owned enterprises" is well intentioned but leaves little room for continuity of SOE survivability and high employment rates in the event of economic shocks.[54] The liberalization of interest rates along with the elimination of deposit interest rate ceilings was a milestone in China's financial reform, however, the major banks have been slow to raise their rates. Since 2013, interest rate fluctuations and the emergence of innovative and nontraditional financial institutions has created serious challenges for the five large state-owned banks and the government's financial repression tactics.[55]

7. General Economic and Political Logics of Economic Policy Formation

Though China's economic development strategy has been unique, it is not the only economy to transition from a strictly state-owned socialist economy to one that opened to privatization and international markets, nor has it been the only country facing structural issues and inefficiencies in its economy while balancing political and economic priorities. This section will use examples from socialist, post-socialist, and liberal democratic economies in order to develop a series of broad political and economic logics for economic policy formation and reform. It will use examples from Vietnam, Poland, Russia, and former Soviet republics and their economic policy choices made in response to crises and market forces in order to develop evidence supporting the political and economic drivers behind economic reform implementation.

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[53] Naughton, *The Chinese Economy*, 508-9; "Does China Face a Looming Debt Crisis?," CSIS: ChinaPower Project, September 7, 2017, https://chinapower.csis.org/china-face-looming-debt-crisis/.

[54] "Does China Face a Looming Debt Crisis?" Kroeber, *China's Economy*, 133-8.

[55] Naughton, *The Chinese Economy*, 506-7; Kroeber, *China's Economy*, 2016, 140–41.

a. Tensions between the Public and Private Sector and the Logics Behind Economic Transition

Since China is a hybrid economy, incorporating capitalist logic can be just as useful as socialist logic especially when analyzing a state's welfare expenditures. The existing literature among political sociologists contend that the tension of prioritization between the State and capital is that "capitalist states are torn between the conflicting imperatives of legitimation and accumulation."[56] The school of theorists on the left reject the Keynesian view of a mixed economy because "efforts to improve social welfare through government action interfere with either the logic of the market or the imperatives of accumulation."[57]

Theorists who argue for free-market activity assert, in the most basic sense, that the innate human desire to trade drives a society to develop around that desire and to interrupt this autonomous process would only hinder the society's capacity for trade.[58] Polanyi challenged this view in the mid-twentieth century with an alternative argument crediting government intervention as the cause for national and international markets to form, capitalism to spread, and impose essential legal limits to bind businesses from exploiting capitalism.[59] Moreover, he argues that social welfare policies are central in developing the labor market and that "the economy is not an autonomous entity but that it has always been profoundly shaped by state action."[60]

This can be best recognized by the contrasting strategies of market reform between Russia and China. Existing literature argues that the economic logic behind rapid privatization is to eliminate institutional arrangements that distort markets. Analysts who favor the alternative approach of gradualism argue that it is essential to consider the cultural, social, and political forces within a society that have been developed out of centralized resource allocation and allow the state to continue to be a key facilitator of

[56] Fred Block, "Political Choice and the Multiple 'Logics' of Capital," in *Structures of Capital: The Social Organization of the Economy*, ed. Sharon Zukin and Paul DiMaggio (Cambridge, England: Cambridge University Press, 1990), 293.

[57] Ibid., 295.

[58] Adam Smith, *The Wealth of Nations* (New York: P.F. Collier & Son, 1776).

[59] Karl Polanyi, *The Great Transformation* (Boston, MA: Beacon Press, 1957), 63–67.

[60] Block, "Political Choice and the Multiple 'Logics' of Capital," 296.

resource allocation for a smooth market transition.[61] The latter characterizes the logic of economics as closely associated, if not synonymous, with the logic of politics and asserts that "economic processes are fundamentally political processes."[62] Contrasting these two logics will be useful in understanding why the pace of restructuring and reform in China occurred the way it did.

b. Structural Reform of International State-Owned Assets

Like China, Vietnam's SOEs were unprofitable and received financial preference while inhibiting private sector developments. Similarly, SOEs in Vietnam also contribute to the legitimacy of the Vietnamese Communist Party (VCP) and "reducing the employment in the sector would have a direct impact on vested political interests."[63] Existing literature asserts that Vietnamese SOE reform is central to its overall economic reform process because poorly performing SOEs have developed a vulnerability within the VCP's power due to heavy debts and corruption.[64] Other views contend that SOE reform has been revolutionary in its growth prospects and the government would do better to focus on financial reform.[65]

In the early 1980s, SOEs were given more liberty to act in their best interest in terms of trade, production, and financial management but this prompted debate within the VCP to hand over state control to SOEs more so because "the state violated objective economic laws by maintaining tight controls over production and trade" as well as appeasing the influential individuals largely benefiting through arbitrage and rent

[61] Doug Guthrie, *China and Globalization: The Social, Economic, and Political Transformation of Chinese Society*, 3rd ed. (New York, N.Y.: Routledge, 2012), 9–10.

[62] Ibid., 10.

[63] Duncan McCargo, *Rethinking Vietnam*, Rethinking Southeast Asia (London; RoutledgeCurzon, 2004), 6.

[64] Gabriel Kolko, *Vietnam: Anatomy of a Peace* (London: Routledge, 1997), 58; Ari Kokko and Fredrik Sjöholm, "Some Alternative Scenarios for the Role of the State in Vietnam," *Pacific Review* 13, no. 2 (2000): 258–59, https://doi.org/10.1080/095127400363587.

[65] Keith Griffin, ed., *Economic Reform in Vietnam* (New York, N.Y.: StMartin's Press, 1998), 42–44, https://doi.org/10.1007/978-0-333-99521-1.

seeking.[66] Eventually, the reformists pushed forward comprehensive SOE reform in the late-1980s, decreasing the number of SOEs from 12 thousand to six thousand and cutting one third of public jobs by 1992.[67] Through the 1990s, many of the remaining SOEs were privatized, merged, or closed, leaving the remainder to undergo a drastic "equitization" conversion of eliminating reliance on direct subsidies, raising competition incentives, and becoming joint stock companies.[68] Political interests have slowed the process of overall reform throughout the twenty-first century but what progress had been made was reflecting positive results.[69]

In the last five years, the nearly five hundred Vietnamese SOEs have contributed anywhere from 30 to 60 percent of Vietnam's annual GDP.[70] Due to the conditions of the 11-nation Trans-Pacific Partnership agreement, the government has attempted to reduce the number of SOEs by more than 82 percent between 2016 and 2020—a target they were positioned to miss by a long shot.[71] The economic logic of gradually privatizing most of Vietnam's remaining SOEs is to promote increased competition, market-driven efficiency, and investor incentives. Political logics for retaining the slated 103 SOEs argue that they

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[66] Gerard Clarke, "The Social Challenges of Reform: Restructuring the State-Owned Enterprises in Vietnam," in *Rethinking Vietnam*, ed. Duncan McCargo, Rethinking Southeast Asia (London: RoutledgeCurzon, 2004), 93; Melanie Beresford, *Vietnam: Politics, Economics and Society* (New York: Pinter Publications, 1988), 163; Gareth Porter, *Vietnam: The Politics of Bureaucratic Socialism*, Politics and International Relations of Southeast Asia (Ithaca, N.Y: Cornell University Press, 1993), 140.

[67] World Bank, "Preparing to Take-off? How Can Vietnam Participate Fully in the East Asian Recovery" (The World Bank, December 31, 1999), 36, http://documents.worldbank.org/curated/en/270441468761711236/Viet-Nam-preparing-to-take-off-How-can-Viet-Nam-participate-fully-in-the-East-Asian-recovery?

[68] Griffin, *Economic Reform in Vietnam*, 42; Clarke, "The Social Challenges of Reform: Restructuring the State-Owned Enterprises in Vietnam," 93–94.

[69] Clarke, 95.

[70] Nguyen Thanh Hai, "Strategic Management in Vietnam State-Owned Enterprises (SOE)," *International Journal of Business and Management* 11, no. 2 (January 25, 2016): 197, https://doi.org/10.5539/ijbm.v11n2p197; *Nikkei*, "Vietnam Privatizations Hit Wall as TPP Arrives," *Nikkei Asian Review*, January 7, 2019, https://asia.nikkei.com/Economy/Vietnam-privatizations-hit-wall-as-TPP-arrives.

[71] *Nikkei*, "Vietnam Privatizations Hit Wall as TPP Arrives."

not only serve as flag-bearers for the socialist economy but also safeguard national security as the eleven sectors encompass energy and key infrastructure services.[72]

Following the collapse of the Soviet Union, Russia, the former Soviet republics, and other socialist states' transition from centrally planned resource allocation to full privatization was rapid, destabilizing, and traumatic for employment rates. Production declined and inflation soared. "Financial markets and banking practices were largely unknown, there was no legal framework for private economic relations or corporate governance, and initial property rights were ambiguous," providing a ripe opportunity for oligarchy to take over.[73] In countries that practiced capitalism prior to their Soviet occupation or socialist conversion experienced a transition that was considerably more stable with legal frameworks to fall back on following the collapse.[74]

The transition of the state sector was equally volatile within the majority of these states. For example, Poland employed the Balcerowicz Plan in 1990 to liberalize its economy and restructure its SOEs. The state sector which accounted for 80 percent of Poland's overall employment in 1989 was mostly made up of large industrial sector businesses. Two structural problems were identified in Poland's state sector based on the trends of other Organization for Economic Co-operation and Development (OECD) countries: it needed to diversify by developing its service and production sectors and it needed to downsize, splinter, or close large enterprises to grow small businesses.[75]

Ideally, in order to prepare these SOEs for free market competition and privatization, "they will have to reduce operating costs, trim bloated labor forces, focus

[72] Additionally, these retained SOEs maintain a 90-94 percent rate of efficiency and total factor productivity has averaged around 5.1 percent. Kunmin Kim and Nguyen Anh Tru, "Reform of State-Owned Enterprises in Viet Nam to Increase Performance and Profit," ADBI Working Paper Series (Manila: Asian Development Bank Institute, September 2019), 3, https://www.adb.org/sites/default/files/publication/524106/adbi-wp999.pdf; *Nikkei*, "Vietnam Privatizations Hit Wall as TPP Arrives."

[73] Paul R. Krugman, Maurice Obstfeld, and Marc J. Melitz, *International Economics: Theory & Policy*, 9th edition (Boston, MA: Addison-Wesley, 2012), 642.

[74] These states include Hungary, Poland, and the Czech Republic and were helped with their ease of access to European Union markets and institutions. Krugman, Obstfeld, and Melitz, 642–43.

[75] Simon Johnson and Gary Loveman, *Starting over in Eastern Europe: Entrepreneurship and Economic Renewal*, 1st edition (Boston, Mass: Harvard Business Review Press, 1995), 19–24.

their product portfolios, increase productivity, and reschedule extensive debt" that wouldn't be payable on normal terms.[76] Some SOEs were slated to be privatized because of their production potential. Continuing to use Poland as an example, select SOEs were publicized by the government as the first to attempt privatization and received substantial positive support from the international community because of the pro-capitalistic publicity, providing them offers for lines of credit, initial public offerings, and foreign direct investment. With the positive exposure came incentives for leadership change with market-oriented managers replacing the legacy communist-oriented executives. Years later, many of these selected SOEs that privatized dominated the market with top quality products and lower prices.[77] This process carried with it economic and political logics that grew the economy while staving off political vulnerability during Poland's market transition.

The majority of SOEs that were not selected for the spotlight in Poland and other transitioning economies attempted full privatization, received partial privatization, or went bankrupt because their liabilities and structural inefficiencies disincentivized investors. The collapse of the Soviet Union removed much of the demand from the Eastern bloc which the SOEs were supplying, free market reforms dismantled monopolies requiring SOEs to market themselves, and the financial security once offered by the state was cut, leaving SOEs with massive debt and bad credit to acquire new loans to expand or pay off lenders.[78] Additionally, long-term efficiencies fostered low-quality production and output, lacked innovative attitudes to modernize, and did nothing to develop effective supply and demand practices. Overcapacity, poor productivity, and an inefficient use of funds drove most SOEs bankrupt in the new economic environment. Economic logics behind the swift transition allowed government debt to immediately stop growing but at the expense of high inflation rates, recession, and complete economic restructuring. Often, these types of

[76] Ibid., 36.

[77] Ibid., 47–66; Irina Boeva and Tatiana Dolgopiatova, "State Enterprise During Transition: Forming Strategies for Survival," in *Economic Transformation in Russia*, ed. Anders Åslund (New York: StMartin's Press, 1994), 114.

[78] Boeva and Dolgopiatova, "State Enterprise During Transition: Forming Strategies for Survival," 116–19; Johnson and Loveman, *Starting Over in Eastern Europe*, 36–39.

transitions occur after political collapse, therefore, reasonable political logics would be to shed or dismantle state-dependent liabilities.

8. Economic and Political Logic of China's SOE Reform Implementation

The existing literature suggests the logic of economics is evolving and adapting because of "social structures of accumulation," which are social and institutional arrangements influenced by the state, market, and society.[79] The effectiveness of the established social structures are time-limited because of a variety of factors that have been observed over time—dissatisfaction of workers' rights, movements challenging the status quo, an increase in energy prices, and the like—to make the existing social structures systemically dysfunctional. Thus, states should naturally adapt economic policies to match the historical changes in order to foster continued economic advancement and efficiency gains while satisfying domestic political and social concerns. Taking this perspective into consideration will be a necessary contextual factor in analyzing the political and economic logics of reform implementation in their specific time, place, and the conditions of crises.

According to Huang and Wang, "the initial rationale for protecting SOEs is both political (SOEs are cornerstones of the socialist economy) and economic (to maintain employment levels)."[80] The existing literature continues to identify employment retention as a major priority of the CCP, especially within the state sector, which continues to carry disproportionately high social and political influence when compared to its economic value. When a law was passed to allow SOEs to become corporatized, which opened many of the state-owned SMEs to become privatized through the 1990s and into the 2000s, many of the SMEs were given to local governments to become privatized or have mixed ownership. This shift in prioritizing efficiency within newly converted private enterprises allowed many of them to go bankrupt and eliminated around 33 million public sector jobs by the early 2000s—a blow to the central government's socialist capability which promised state employees jobs for life.[81] The surviving SMEs and centrally controlled large-scale

[79] Block, "Political Choice and the Multiple 'Logics' of Capital," 299–300.

[80] Yiping Huang and Xun Wang, "'Strong on Quantity, Weak on Quality,'" 296.

[81] Economy, *The Third Revolution*, 105–6, 109.

SOEs have since not provided the government a return on its investments but continue to hold influence on social stability and political legitimacy over the socialist-capitalist economy. While economic logics may be less visible in the survival of SOEs, political logics are clearly guiding SOE reform due to the influence that SOEs have on the CCP's political stability overall.

9. Conclusion

The existing literature suggests less developed economies with newly established institutions and fewer fiscal securities may benefit from financial repression by guiding resource allocation and investments while providing greater insulation from market forces.[82] However, as economies mature through large-scale development over several decades, existing literature contends that financial repression can tip the scale and have negative consequences overall on an economy's annual GDP growth. Liberalized economies outgrow heavy state intervention in financial decision making when capital allocation is being forced to support unsustainable enterprises instead of being applied to fund low-risk investments or innovative firms seeking loans.[83] Based on a study by Huang and Wang in 2011, their findings suggest China had reached a threshold of economic maturity by the end of the 1990s and it no longer benefits from financial repression.[84] This may indicate that financial reform is driven by political logics more so than by economic logics based on the crucial role banks play in preserving unsustainable SOEs.

Current analysis also views China's recapitalization of nonperforming SOEs to have negative long-term effects on GDP growth while they continue to foster "a serious level of moral hazard" among businesses in China.[85] Existing literature asserts that these bailouts also stall the larger macroeconomic structural reforms needed for China to start on

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[82] Joseph E. Stiglitz, "Capital Market Liberalization, Economic Growth, and Instability," *World Development* 28, no. 6 (2000): 1082, https://doi.org/10.1016/S0305-750X(00)00006-1.

[83] Ronald I. McKinnon, *Money and Capital in Economic Development* (Washington, DC: The Brookings Institution, 1973); Edward S. Shaw, *Financial Deepening in Economic Development*, Economic Development Series (New York: Oxford University Press., 1973).

[84] Yiping Huang and Xun Wang, "'Strong on Quantity, Weak on Quality,'" 299–301.

[85] Perkins, 146–47; Economy, *The Third Revolution*, 106–8.

a new growth path that synchronizes with global market mechanisms.[86] It is essential to glean from existing literature on what constitutes as effective non-financial SOE reform that offers China's economy the greatest return without accumulating debt. According to Derek Scissors, the state sector must diminish its size and influence on the Chinese economy. He concludes, "the only solution is a return to market-driven, politically difficult reform."[87] He adds that "there are only two fundamental types of pro-market change: greater ownership rights and greater competition."[88]

The existing literature also provides a stark contrast between the potential for a financial crisis to derive from China with the causal factors that were observed prior to the AFC and Global Financial Crisis (GFC). Although the similarities of China's ever-increasing debt and excessive construction of urban housing give rise to concerns of a housing bubble, the securities of mortgage lending and government capital are far stronger than that of the United States pre-GFC, Thailand, or Malaysia.[89] Down payments for a house in China are between 20 to 30 percent vice the five percent typical in the U.S., and coupled with the increasing incomes and high savings of domestic households, lending is less risky.[90] The corporate financial and non-financial debt situation in China is far more fluid as banking liberalization continues to be stalled by market shocks. Luckily for China, its foreign reserves continue to insulate its ability to recapitalize in troubled times. China's minimal reliance on foreign barrowings (ten percent of GDP) has diminished external pressures to repay foreign lenders by selling domestic currency in times of financial duress as South America, Thailand, Russia, and Greece were forced to do. China's continued flow

[86] David Shambaugh, *China's Future*, 1 edition (Cambridge, UK; Malden, MA: Polity, 2016), 7.

[87] Derek Scissors, "Shrink the State or Stagnate," *American Enterprise Institute*, March 2, 2016, https://www.aei.org/articles/shrink-the-state-or-stagnate/.

[88] Derek Scissors, "China's Economic Reform Plan Will Probably Fail," American Enterprise Institute, February 11, 2014, 2, https://www.aei.org/research-products/report/chinas-economic-reform-plan-will-probably-fail/.

[89] T. J. Pempel and Keiichi Tsunekawa, eds., *Two Crises, Different Outcomes: East Asia and Global Finance* (Cornell University Press, 2015), 225.

[90] Kroeber, *China's Economy*, 2016, 134.

of income provides it the ability to pay off foreign debts without sacrificing other domestic assets.[91]

D. EXPLANATIONS AND HYPOTHESES

The literature review revealed that there are potentially multiple drivers incorporated in a state's economic policy formation that derive from politicians in the CCP and technocrats in the State Council. This thesis will explore two potential explanations for what was driving the direction of China's economic policy formation: economic logics and political logics. Furthermore, it is useful to understand the interests of those benefiting from SOEs' survival to include the CCP and Chinese bureaucracies responsible for implementing reform that gain legitimacy from maintaining a socialist market economy with a strong public sector. Xi and the bodies of authority overseeing economic reforms such as the Central Comprehensively Deepening Reforms Commission and the SASAC continue to guide and wield authority to avoid class conflict from income inequality, and societal instability that could evolve into a proletariat revolt that overthrows the government. Additionally, there are other vested interests from SOE managers and local officials whose influence and societal position rely on the important role of SOEs in China's economy. Thus, maintaining a harmonious state is a top priority and a key propaganda slogan for the government.

Economic logics would suggest that SOEs have not been effectively reformed because they provide their employees greater wealth distribution, lifetime employment assurances, and substantial welfare services for their workers (in some cases).[92] Additionally, state control of core sectors provides a measure of security for China as the "commanding heights" SOEs provide products and resources essential to domestic and foreign firms, markets, and investments. Many of these SOEs also dominate within their sectors, which make them strategically important to insulate and preserve by the CCP as they have a hand in China's geopolitical and economic position in the world order. As

[91] Ibid., 134–35.

[92] As mentioned previously, many of the social welfare services have been privatized. Economy, *The Third Revolution*, 106.

Chapter III will examine, 93 of China's commanding heights SOEs were listed in the 2020 Fortune Global 500 ranking of the largest corporations in the world, an accomplishment that could only be achieved because of state sponsorship. SOEs contributed between 23.1 and 27.5 percent of China's GDP in 2017, however, they only account for between 35 and 91 million jobs (between 4.5 and 16.3 percent of China's total employment) that same year.[93] While SOEs' GDP contribution is relatively moderate, the Chinese government's claim of the sector's significance in the employment realm appears to be a weak argument. However, as discussed in Section C, SOEs carry a disproportional influence on the Chinese society's trust in the socialist-market economy.

Political logics would suggest that SOEs have not been marketized or privatized because they continue to offer greater political leverage over the economy and society that outweighs their financial burden. Kroeber observes that SOEs "are often used as instruments of macroeconomic policy and industry regulation in place of relatively weak formal policy and regulatory instruments."[94] Chinese reformists—even the most liberal of those that have led China's economy—have supported state management of the economy and have made attempts to strengthen the state's methods and institutions for this purpose. Kroeber adds that these leaders "believed that [the state's] role had to be exercised, in part, through the direct ownership of assets, rather than merely through regulatory control of the distribution of resources, as was the case in Japan."[95] Therefore, SOEs have been strengthened both to act as agents of the state in domestic and international arenas and to protect the PRC from political and social instability deriving from economic inequality.[96] Additionally, state control of core sectors supports foreign policy projects and supplies materials for international investments like those under the Belt and Road initiative to secure the expansion of Chinese influence globally.

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[93] Chunlin Zhang, "How Much Do State-Owned Enterprises Contribute to China's GDP and Employment?" (The World Bank, July 15, 2019), 3, 7–8, http://documents.worldbank.org/curated/en/449701565248091726/How-Much-Do-State-Owned-Enterprises-Contribute-to-China-s-GDP-and-Employment.

[94] Kroeber, *China's Economy*, 2016, 89.

[95] Ibid., 91.

[96] Economy, *The Third Revolution*, 108–10.

E. RESEARCH DESIGN

The study examines and assesses the relative strength of economic and political logics of SOE reform as explanations for the continued state control and financial support of inefficient SOEs. These two logics are analyzed in order to explain China's SOE policy development and reform implementation.

This thesis examines the policy statements derived from the CCP's leadership since 2013 and compares them with how reform implementation has rolled out, providing assessments from existing literature and data on the progress. Primary sources derive from the Chinese Party and State Council's official statements, speeches, and publications as well as state-sponsored media coverage to evaluate both the intentions and outcomes of SOE reform. Analysis of the reform statements and implementation derive from academic literature to provide insight and context to the official statements.

This thesis characterizes the economic logics of China's economic policy formation by using data from the People's Bank of China Annual Report and the National Bureau of Statistics publications. This literature was used to identify the economic contributions and burdens of Chinese SOEs to provide evidence for the economic incentives or deterrents behind SOE retention. Additional data and analysis will derive from academic literature and international organizations such as the World Bank to provide empirical analysis of the economic performance of Chinese SOEs.

The political logics have been examined to determine the social and political order that SOEs maintain within China. The study will also incorporate academic literature to generate a deeper understanding of the internal incentives and motivations of the Chinese leadership and other interest groups that benefit from SOEs' paramount importance in China's economy.

F. THESIS OVERVIEW

This thesis assesses the economic and political logics of China's SOE reform implementation by examining each logic's ability to explain the PRC leadership's incentives to retain and strengthen its inefficient state sector. Chapter II will describe China's SOE reforms before Xi came to power and the reforms that occurred under his leadership to understand the state sector's evolution and transition over the last several decades. Chapter III will examine the economic logics, identifying the economic context and incentives behind China's state sector and its reforms. Chapter IV will analyze the political logics, examining the incentives from the Party, the state, and other interest groups to retain and strengthen SOEs. In Chapter V, the conclusion will incorporate the two logics and develop an explanation of why SOEs remain at the core of China's economy with subsequent policy recommendations.

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II. CHINA'S STATE-OWNED ENTERPRISE REFORMS

At the Third Plenum in 2013, President Xi Jinping introduced a plan to implement reforms to Chinese state-owned enterprises (SOEs) that would allow market forces to play a more "decisive" role in allocating resources and determining outcomes.[97] Since 2013, however, the implementation of these ambitions have fallen short and SOEs continue to have priority over private business when accessing capital, land, and energy. Xi's statements regarding China's SOEs at the Third Plenum instilled optimism among pro-market reformists, though they also presented ambiguity and contradicting statements that led to convoluted policy approaches and marginal implementation. Ultimately, the state of Xi's SOE reform achievements eight years later lack substantive pro-market progress and SOEs continue to operate inefficiently backed by government subsidies. The findings of this chapter demonstrate the Chinese Communist Party (CCP) and State Council's desire to avoid large-scale restructuring and allow smaller-scale, less socially and politically invasive reforms to occur in order to boast minor achievements while maintaining political and economic stability.

This chapter examines the history behind China's SOEs, their evolution through various reform measures, and why SOEs remain so embedded within China's macroeconomic policy under Xi's leadership. The first section examines the roles that SOEs played in the decades before Xi's leadership under Mao Zedong and then Deng Xiaoping, initial reforms during China's economic opening, and the growth of SOE profits following China's entry into the World Trade Organization. The second section explains the reform proposals made by Xi and statements made by the CCP and State Council after 2013 regarding SOEs and economic reform. The third section analyzes the implementation of those proposals since 2013 and the fourth section explains the findings in a brief conclusion.

[97] Arthur R. Kroeber, "Xi Jinping's Ambitious Agenda for Economic Reform in China," The Brookings Institution, November 17, 2013, https://www.brookings.edu/opinions/xi-jinpings-ambitious-agenda-for-economic-reform-in-china/.

A. THE INHERITANCE: CHINESE SOEs AND THE REFORMS IMPLEMENTED BEFORE XI'S RISE

SOEs have been a crucial pillar in China's economy since the CCP's victory over the Nationalist party during the civil war. It is necessary to examine the role of SOEs in China's modern history in order to understand why reforming China's SOEs is so politically difficult. This section examines the socialist economy under Mao when SOEs dominated, their continued importance in the first decade of China's economic opening to global markets, the massive changes to SOEs from the mid-1990s to the mid-2000s, and the huge boost in infrastructure investment and subsidization in response to the Global Financial Crisis (GFC).

1. SOEs Under Mao Zedong

Following the Communist triumph in 1949, Mao Zedong established a planned economic strategy with centrally controlled SOEs carrying the majority of the economy. Mao's developmental strategy prioritized industrial expansion of heavy industry with an emphasis on capital intensive production.[98] "The new government expropriated all foreign businesses as well as those owned by the Nationalist government and turned them into state-owned enterprises."[99] Factories that were built in Manchuria during the Japanese occupation were also converted into SOEs.[100] SOEs were the engine of industrial development and dominated key sectors such as steel, machinery, transportation, communications, and military equipment, which were "strategic in the sense that they have the most linkages with other industries" up and down the value chain.[101]

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[98] Barry Naughton, *The Chinese Economy: Adaptation and Growth*, Second edition (Cambridge, Massachusetts: The MIT Press, 2018), 65.

[99] Private firms also existed, and "were allowed to operate on their own, but subject to strict price control." Ning Wang, "The Chinese Economic System Under Mao," *Man and the Economy; Berlin* 2, no. 2 (2015): 159, http://dx.doi.org.libproxy.nps.edu/10.1515/me-2015-6002.

[100] Naughton, *The Chinese Economy: Adaptation and Growth*, 75-76; Yun Chen and Ken Morita, "The Logic of the Mao Zedong Development System and Its Institutional Inefficiency," in *Transition and Development in China: Towards Shared Growth* (Abingdon, UK: Taylor & Francis Group, 2009), 47, http://ebookcentral.proquest.com/lib/ebook-nps/detail.action?docID=438588.

[101] Naughton, 66, 68, 70.

SOEs played a critical role in Mao's centralized planning strategy because they produced government revenue and were the facilitators of government-led initiatives. Government-controlled prices enabled SOEs to become profitable despite their inefficiencies (losses were subsidized by the state) and they were "the main source of government revenue," which "gave the Chinese government the fiscal capacity to mobilize resources for the Big Push industrialization and its other priorities."[102] Also, as Chen and Morita explain, SOEs became the implementors of government policy.

> A fundamental precondition in the traditional investment scheme in China was that enterprises (most of which were state-owned enterprises) were full "attachments" for central government. The management procedure was said simply to be the following. (1) First, central government decided on specific projects. (2) Investment was financed by central budget expenditure. (3) The administrative section arranged the plan and construction. (4) After the construction, the plant manager was appointed by the administrative section. The administrative section arranged for production and distribution, and paid all the profits (including depreciation) to the finance section. (5) Return to the first process, where central government decides specific projects.[103]

To enable the continuity of this cycle, the government allocated any material and manning resources and capital that SOEs needed.

2. SOEs in China's Economic Transition

Following Mao's death, Deng Xiaoping initiated China's high-growth economy in the late 1970s almost exclusively with state-owned assets and SOEs continued to provide stability through China's economic opening into international markets.[104] Deng sought to grow the economy without restructuring the entire system all at once. Instead, he initiated gradual reforms to avoid disruption to the CCP's political power and China's economic stability. These early reforms largely circumvented SOE reform directly. For instance, policies were aimed at promoting certain sectors that shift the majority of production from

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[102] Ibid., 71.

[103] Chen and Morita, "The Logic of the Mao Zedong Development System and Its Institutional Inefficiency," 44.

[104] Kroeber, *China's Economy*, 2016, 13.

"capital-intensive heavy industry to labor-intensive light industry," improve the incentives of SOEs to become more efficient, reshape the management of China's industrial sector through various decentralization reforms that preserve central control, and eventually introduce privatization and foreign direct investment (FDI). SOE superiority in China's economy was preserved while smaller-scale macroeconomic reforms created the foundation for later, more radical and marketized reforms. After much trial and error, many of these policy reforms were implemented and Chinese annual GDP growth was nearly 10 percent between 1978 and 1990.[105] Simultaneously, these efforts resulted in a decrease of state sector's industrial production by 24 percent, and SOEs accounted for only 54 percent of China's overall production in 1990 compared to 78 percent in 1978.[106]

Decentralization reforms were initiated in the late 1970s and 1980s which began to delegate SOE administration from the central government to local and municipal governments. These reforms augmented standard marketization reforms in order for the state to retain control of corporate affairs but delegate direct management to local and municipal governments to focus on efficiency and growth by stimulating competition.[107] The separation and reallocation of various property rights formally held by the centralized government enabled recipients of those rights—the local governments—to establish collusion with businesses from corporate management.[108] The state's implementation of the dual track pricing system of planned and market pricing along with raising consumer demand compounded the local governments' power. This fostered arbitrage among

[105] "GDP Growth (Annual %) – China," The World Bank, accessed October 26, 2020, https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=1990&locations=CN&start=1978.

[106] Kroeber, *China's Economy*, 2016, 48.

[107] "Administrative decentralization delegated decision-making authority to lower levels of government office – rather than to the market, which would result in liberalization, or to individuals, which would result in privatization." Xiaobo Hu, "The Future of SOEs: From Shortage Economics to 'Enron–Omics'?," in *China under Hu Jintao: Opportunities, Dangers, and Dilemmas*, ed. Tun-jen Cheng, Jacques Delisle, and Deborah A Brown (Singapore, SINGAPORE: World Scientific Publishing Co Pte Ltd, 2006), 170.

[108] Ibid., 167–68.

China's prominent officials and businessmen which created a culture of corruption and caused a considerable lag in China's overall economic growth.[109]

Further inefficiencies were developed during this period through the uncoordinated and indirect control of enterprises by the state that had the ability to override the decisions of producers and extract profits from their enterprises. Property rights claims from the aforementioned decentralization reforms remained secondary to state authority which could pull resources and reallocate them accordingly at any time.[110]

Employment benefits within the state sector were also altered in the 1980s. Previously, SOEs among other forms of state sector employment provided Chinese citizens with permanent employment and lifetime welfare service. This was known as the "iron rice bowl," which included "lifetime employment with full enterprise-based pension rights, the right to enterprise-built housing," lifetime healthcare, a guaranteed job for the worker's offspring, and other services.[111] In 1986, the CCP allowed SOEs to hire temporary contracted workers with reduced welfare benefits from those of permanent employees. Over the following decade, SOEs decreased the number of permanent workers that received the full-time benefits of the "iron rice bowl" from nearly 90 million in 1988 to 54 million in 1996.[112] This alleviated some of the fiscal burdens on SOEs and allow private companies to augment the services previously provided by the state.

3. SOE Reforms in the 1990s

A major effort in reforming SOEs began in the 1990s with large-scale privatization initiatives. Deng's southern tour and the reforms initiated following the Fourteenth Party

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[109] Broken or distorted feedback loops regarding SOEs' financial conditions prompted taxation increases to continually finance SOE inefficiencies. These loopholes were further exacerbated by the lack of an independent judiciary system, commercial laws, and a competent oversight regulatory body. Edward S. Steinfeld, *Forging Reform in China: The Fate of State-Owned Industry* (Cambridge, UK: Cambridge University Press, 1999), 46; Gabriella Montinola, Yingyi Qian, and Barry R. Weingast, "Federalism, Chinese Style: The Political Basis for Economic Success in China," *World Politics* 48, no. 1 (1995): 50.

[110] Steinfeld, *Forging Reform in China*, 45.

[111] Shahid Yusuf, Kaoru Nabeshima, and Dwight H. Perkins, "Reform in China," in *Under New Ownership: Privatizing China's State-Owned Enterprises* (Washington, D.C.: The World Bank, 2006), 71.

[112] Ibid., 71.

Congress in 1992 spurred an economic boom after establishing sweeping economic reforms. Deng and his council sought to "establish a socialist market economic system and proposed that the market should play a fundamental role in the allocation of resources under the state's macro-control."[113] Around the time, FDI in China began to increase rapidly, growing from $3 billion in 1991 to $11 billion in 1992 to more than $27 billion in 1993. This resulted in a huge inflow of foreign firms that SOEs could supply and work with. The growing foreign influence in China's economy also impacted the way Chinese businesses operated as "these [foreign] companies brought with them access to foreign markets and management skills," which prompted significant reforms of SOEs in the proceeding years.[114]

The Company Law, which was passed in 1994, would shape the corporate governance of many SOEs and permit others to fail through the subsequent decade. It allowed SOEs of all sizes to be converted into limited liability companies or shareholding corporations in order to "increase the independence of these companies from the government and reduce the government's responsibility for their losses."[115] Many insolvent SOEs that provided welfare and services were allowed to fail. Other SOEs were chosen to list on the stock market but they needed restructuring to incentivize investors. Naughton explains, "to make the new listed companies attractive, severe overstaffing had to be addressed. Some 360,000 workers were laid off from CNPC [one of the three oil SOEs] by 2000, leading to unrest in the famous oil city of Daqing in northern China. Virtually all SOEs followed this path to listing firms."[116] However, many SOEs remained unlisted, particularly those that were considered the largest and most valuable to the Chinese economy, which prompted what is still considered the largest step in China's SOE reform.

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[113] Xi Jinping, "Explanation on the 'Decision of the Central Committee of the Communist Party of China on Several Major Issues in Comprehensively Deepening Reform,'" *Xinhua*, November 15, 2013, http://www.xinhuanet.com//politics/2013-11/15/c_118164294.htm.

[114] Yusuf et al., 73.

[115] Ibid., 88.

[116] Naughton, 346.

A major SOE reform plan began in 1995 which embodied the term "grasp the large, let go of the small."[117] Most state-owned small- and medium-sized enterprises (SMEs) became privatized or went bankrupt while the largest or most important firms known as the "commanding heights" were strengthened by the state.[118] China's balance sheets greatly improved after most of these SOEs were converted because this move eliminated the majority of non-performing loans. Consequentially, however, nearly 50 million SOE employees were laid-off as a result, eliminating their lifetime welfare benefits mentioned earlier.[119] Fortunately, the promotion of private start-ups enabled more new jobs to emerge than those that were lost, but these did not carry the assurances of permanency or social safety net that the state once provided. The government installed reemployment centers that provided stipends to "surplus workers" that were laid-off for up to three years to ease unemployment shocks while they sought employment in the private sector.[120]

Due to the growing flow of investments into China, lending by the central Chinese banks was liberalized, but this created massive inflation of consumer goods and interest rates. The CCP recognized the social discontent from consumer prices rising and sought to solve this with appointing a hardline official, Zhu Rongji to lead the central bank. He imposed and enforced lending quotas on banks, ostensibly shifting the control of resource allocation back into the hands of centralized government.[121] This, he hoped, would apply pressure to Chinese firms, including SOEs, and force them to make adjustments to become more credit-worthy when competing with other firms for loans.[122] But SOEs, however, still performed poorly and experienced major losses between 1996 and 1998, compounding

[117] Chang-Tai Hsieh and Zheng (Michael) Song, "Grasp the Large, Let Go of the Small: The Transformation of the State Sector in China," *Brookings* (blog), March 19, 2015, https://www.brookings.edu/bpea-articles/grasp-the-large-let-go-of-the-small-the-transformation-of-the-state-sector-in-china/.

[118] Kroeber, *China's Economy*, 93-4.

[119] Lardy, *Markets Over Mao*, 45. Economy, *The Third Revolution*, 105.

[120] Naughton, 214.

[121] Ibid., 75.

[122] Ibid., 85.

the non-performing loans on banks' balance sheets.[123] As his position increased to Premier of the PRC State Council, Zhu targeted the systemic problems of inefficiency within SOEs.

After Zhu Rongji ascended to Premier in 1998, he made major changes to the preferential treatment of SOEs in the Chinese economy through conditions agreed upon to improve China's access to global markets. Several years before Zhu came into power, Chinese leadership had been unsuccessful in negotiating terms for PRC entry into the World Trade Organization (WTO) because the demands of free trade would strip most of the protections the PRC gave to its companies. Yusuf et al. observes this dilemma: "If China wanted to enter, it had to accept the abolition of all quantitative restrictions on trade, lower tariffs to levels that would give only limited protection to a few infant industries, and accept Western advanced-country definitions of intellectual property rights" as well as "open up its financial sector to direct competition" with foreign financial and non-financial institutions.[124] Instead, Zhu entered into negotiations with the Clinton administration to broker a deal that would satisfy the demands of the U.S. instead of absolute restrictions demanded by the WTO. This resulted in the U.S. working with China to "dismantle many of the measures that had been used to protect SOEs from foreign competition."[125]

China's accession into the WTO in 2001 appeared to indicate that a more marketized approach was underway in China as international trade barriers were removed and private sector access was on the rise.[126] Toward the end of the decade, prices were mostly marketized with the exception of key production inputs such as energy, land, and capital, enabling limited growth opportunities for those sectors specifically and access to those inputs by the non-state sector. However, SOEs continued to enjoy lower prices and preferential access to resources than private enterprises were able to acquire, creating an opportunity disparity between state and private sectors.

[123] Ibid., 76-77.

[124] Ibid., 83.

[125] This "included an agreement to reduce the average tariff on imports of industrial products to 8.9 percent" and "eliminate all quantitative barriers on imports no later than 2005." Ibid., 84.

[126] Economy, *The Third Revolution*, 103.

4. The Hu and Wen Era

When Hu Jintao and Wen Jiabao came into power in 2002 and 2003, respectively, the new leadership proposed to shift from an achievements-based agenda of their predecessors and focus their efforts to become "one that governs in the interest of the people."[127] As a result, they proposed three objectives that would direct their tenure: "(1) more-balanced regional economic development, (2) increased concern for social justice and fairness, and (3) greater political transparency and institutionalization."[128] This would be achieved through a "scientific development concept," which renewed the role of the centralized government in economic planning and 'adapted Marxism to Chinese conditions."[129] While these policies occupied the government's attention, SOE delivered sizable profit gains between 2003 and 2007 partially due to China's WTO entry, but primarily because of the elimination of non-viable SOEs in the late-1990s continued to effect the following decade.[130]

The State-Owned Assets Supervision and Administration Commission (SASAC) was established in 2003, which would "represent the interests of the state as shareholder" and "preserve, and enhance, the value of central SOEs" as it took the lead in implementing SOE reform during the Wen and Hu tenure.[131] Some of the first policies implemented through SASAC were to oversee the transitions of management buyouts of SOEs and of SOE shares becoming circulated and listed on the stock market. Its role followed one of Hu and Wen's three policy objectives: "to provide a modicum of transparency and

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[127] Cheng Li, "Hu's New Deal and the New Provincial Chiefs," *China Leadership Monitor* 10 (April 30, 2004): 3.

[128] Ibid., 3.

[129] Alice Miller, "Leadership Presses Party Unity in Time of Economic Stress," *China Leadership Monitor*, no. 28 (May 8, 2009): 1–2.

[130] Hong Yu, "Reform of State-Owned Enterprises in China: The Chinese Communist Party Strikes Back," *Asian Studies Review* 43, no. 2 (April 3, 2019): 332, https://doi.org/10.1080/10357823.2019.1590313; Barry Naughton, "China's Distinctive System: Can It Be a Model for Others?," *Journal of Contemporary China* 19, no. 65 (June 1, 2010): 446, https://doi.org/10.1080/10670561003666079.

[131] Zhao Huanxin, "China Names Key Industries for Absolute State Control," *China Daily*, December 19, 2006, http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm; Barry Naughton, "SASAC Rising," *China Leadership Monitor* 14 (April 30, 2005): 2.

oversight to privatization as it occurs, but without setting off a fully transparent and comprehensive privatization process."[132] Specific industries were listed by SASAC which "the State must have absolute control" over to include "armaments, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping industries."[133] SASAC also promoted certain central SOEs to lead as "natural monopolies" in industries like information technology, iron, steel, machinery, construction, and automobiles, and merged or consolidated SOEs to become more efficient.[134]

SASAC Chairman Li Rongrong announced in 2006 that the government's focus on reform would enable non-essential central SOEs to transfer hands through mergers or exit the market by 2008, attempting to cut the number of central SOEs from 161 to no more than 100.[135] The result left 108 central SOEs, 97 of which are non-financial and under SASAC supervision.[136] However, because of the layers of subsidiaries these 108 nonfinancial central SOE oversee, SASAC still controls an estimated 50,000 SOEs.[137] Many smaller "local" SOEs are also controlled by SASAC, but they are "less prevalent and less important in regions that have a more developed private sector or have more foreign

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[132] Barry Naughton, "SASAC Rising," 2.

[133] Zhao, "China Names Key Industries for Absolute State Control."

[134] "Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform," China.org.cn, January 16, 2014, II.7, III.10, http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602_2.htm; Zhao, "China Names Key Industries for Absolute State Control." SOEs in these pillar industries have formed natural monopolies and are considered exempt from the 2008 Anti-Monopoly Law, which only pertains to "relevant markets." "Innovative China: New Drivers of Growth" (Washington, D.C.: World Bank and Development Research Center of the State Council, P. R. China, January 29, 2020), 44, https://issuu.com/world.bank.publications/docs/9781464813351.

[135] Zhao, "China Names Key Industries for Absolute State Control."

[136] Barry Naughton, "State Enterprise Reform Today," in *China's 40 Years of Reform and Development*, ed. Ross Garnaut, Ligang Song, and Cai Fang, 1978–2018 (Canberra, Australia: ANU Press, 2018), 380, https://www.jstor.org/stable/j.ctv5cgbnk.28.

[137] W. Raphael Lam, Markus Rodlauer, and Alfred Schipke, "State-Owned Enterprise Reform," in *Modernizing China: Investing in Soft Infrastructure* (Washington, D.C.: International Monetary Fund, 2017), https://www.elibrary.imf.org/view/IMF071/23209-9781513539942/23209-9781513539942/ch11.xml?lang=en&redirect=true, 308.

investments."[138] Local SOEs also receive preferential treatment from their local governments when licensing and contracts need to be awarded.[139] However, the central SOEs are larger, carry more influence on China's economy, and have been given more resources and preferential access than those before, making them grow in power, size, and influence with multiple subsidiaries and branches. These "national champion SOEs" have provided insurmountable political leverage for the CCP by providing an artificially stimulated boost in China's economy when doubts of the Party's validity have surfaced in the past, and directly support national objectives in domestic and foreign policy.[140]

When the GFC hit in 2008, China's leadership abruptly shifted to a state-led Keynesian macroeconomic strategy through massive lending in an effort to stimulate and stabilize the economy, which exacerbated income inequality and the preferential treatment of SOEs.[141] This stimulus package eventually ballooned to double the original investment of more than $585 billion by the end of 2010, which created a harrowing investment-consumption imbalance.[142] This shift led to another round of centralized interventionist policies, but direct subsidization of SOEs were being phased out, which eliminated any cause for SOEs to improve their efficiency.

The decade of Wen and Hu's leadership reverted China's economic direction back toward a command economy, prompting many pro-market China analysts to call it "the

[138] Fan Gang and Nicholas C. Hope, "Chapter 16 – The Role of State-Owned Enterprises in the Chinese Economy," in *US-China Economic Relations in the Next Ten Years: Towards Deeper Engagement and Mutual Benefit* (Hong Kong: China-United States Exchange Foundation, 2013), 8–9, 14, https://www.chinausfocus.com/2022/wp-content/uploads/Part+02-Chapter+16.pdf.

[139] Ibid., 2.

[140] McGregor, *No Ancient Wisdom, No Followers*, vii.

[141] Derek Scissors, "China's Economic Reform Plan Will Probably Fail," American Enterprise Institute, February 11, 2014, 1, https://www.aei.org/research-products/report/chinas-economic-reform-plan-will-probably-fail/; Christine Wong, "The Fiscal Stimulus Programme and Public Governance Issues in China," *OECD Journal on Budgeting* 11, no. 3 (September 1, 2011): 13, https://read.oecd-ilibrary.org/governance/the-fiscal-stimulus-programme-and-public-governance-issues-in-china_budget-11-5kg3nhljqrjl.

[142] Scissors, "China's Economic Reform Plan Will Probably Fail," 9. "The Chinese government's official Gini index peaked at 0.49 in 2008-2009" with other estimates placing that number higher. Kroeber, *China's Economy*, 197.

lost decade."[143] Reforms that would have greatly strengthened China's economy were sidelined by conservatives all while allowing the inefficiencies that stagnated sectors dominated by SOEs to compound on preexisting debt and mismanagement. The government continued to manipulate prices of vital production inputs, gave preference for resource allocation in the form of loans, land, and energy to SOEs before private firms, and poured assets into the modernization and development of its core remaining SOEs.

Xi Jinping's inheritance incorporated massive SOEs monopolizing most major sectors—especially those that are most capital-intensive—which carried a substantial share of national assets.[144] The preferential treatment toward SOEs limited both state and private sectors from achieving efficient economies of scale. Complete privatization was never fully realized because the central government was conflicted in making these firms more profitable and efficient while simultaneously retaining government control over them as "willing agents of state policy when needed"—a balance that Xi would seek to preserve in order to maintain Party stability and continue China's economic growth.[145]

B. XI'S THIRD PLENUM GOALS

At the 2013 Third Plenum of the Eighteenth Party Congress, the newly elected leader of the PRC, Xi Jinping, revealed his plans for China's economic future, which presented contradictory goals indicating that China was about to make a drastic shift toward a market-based system while elevating SOE strength simultaneously. Some of the pro-market statements within the Third Plenum and after endorsed market mechanisms that would determine resource allocation, administrative separation from the government, the break-up of monopolies, improving competition and efficiency across all sectors, and the like. Xi wanted to achieve most of these economic targets by 2020 and lead China into a "moderately well-off society" by 2021.[146] But the dual pursuit of market mechanisms and

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[143] Economy, *The Third Revolution*, 9.

[144] Kroeber, *China's Economy*, 2016, 89.

[145] Ibid., 91.

[146] Xi, "Explanation on the 'Decision;'" Ehizuelen Michael Mitchell Omoruyi, "China's March towards a Moderately Well-off Society," *China Daily*, March 16, 2018, //www.chinadaily.com.cn/a/201803/16/WS5aab21d6a3106e7dcc142020.html.

stronger SOEs created confusing guidance that resulted in minimal reform implementation, which will be examined in the next section. This section highlights some of the key propositions made by Xi at the Third Plenum and after.

1. SOE Reforms Announced in the 2013 Third Plenum

In a statement released by the government following the Plenum, the "Decision On Some Major Issues Concerning Comprehensively Deepening The Reform" (henceforth "Decision"), announced that the economy would implement a more "decisive" role for market forces in allocating resources to Chinese businesses.[147] This presented a surprising shift from previous CCP statements that characterized market forces as "basic" or "important."[148] The Decision also declared that the state sector would continue to play a "dominant role" in China's future as it "is an important pillar of the socialist system with Chinese characteristics and is the foundation of the socialist market economy."[149] A clear contradiction is presented by these two statements. Kroeber observes, "if market forces are really decisive, then the dominant role of the state cannot be guaranteed (state firms might lose out to private ones in the market). Conversely, if the dominant role of the state is guaranteed, then market outcomes must sometimes be suppressed and therefore cannot be decisive."[150]

A communique released by the government following the Third Plenum clarified that "establishing a unified, open, competitive and orderly market system is the basis for the market to play a decisive role in the allocation of resources."[151] However, the term "orderly market system" appears to be a contradiction in this context as "orderly" implies government guidance, indicating that though market forces are being applied in some

[147] Perkins, "The Complex Task of Evaluating China's Economic Reforms," 139.

[148] Kroeber, "Xi Jinping's Ambitious Agenda;" Kroeber, *China's Economy*, 224; Xi, "Explanation on the 'Decision.'"

[149] "Decision." The term "an economy with public ownership at its core" has been used in Third Plenum rhetoric since 1988 when the legal framework for the private sector was simultaneously introduced. Rutkowski, "The Third Plenum and State-Owned Enterprises."

[150] Kroeber, *China's Economy*, 2016, 225.

[151] "Communiqué of the Third Plenary Session of the 18th Central Committee of the Communist Party of China."

respects, SOEs will not be allowed to lose because of market mechanisms. Furthermore, allowing market forces to determine resource allocation would inevitably damage many of the poorly performing SOEs because they are inefficient, less productive, and incur massive debt and overhead which disables them from effectively competing against other sectors.[152]

The marketization promotion reflected in the Decision and communique was likely due to the influence of the "383 Plan" developed by the Chinese State Council's thinktank, the Development Research Center, from the Center's work with the World Bank on reform recommendations for the coming years.[153]

> The plan recommended three broad areas for reforms (the roles of markets, government, and enterprises), identified eight sectors in need of special attention (finance, taxation, state assets, social welfare, land, foreign investment, innovation, and good governance), and described three desired breakthroughs (broader market access, a basic social-security scheme covering both urban and rural people, and the ability to sell collectively owned rural land).[154]

The newly elected CCP leadership included some of these recommendations in the Third Plenum while leaving out the more liberal-capitalist ideas, enabling the Party to continue leveraging the economy to achieve its political objectives.

The incorporation of preserving SOEs into this design clearly undermines other pro-market attempts such as improving the efficiency and competition in all sectors. Reforms would allow SOEs to retain their "leading role" in China's economy and bolster them up to increase their "vitality, controlling force, and influence."[155] Additionally, the Decision called to raise SOE competitiveness "on an equal footing," improve management

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[152] Rutkowski, "The Third Plenum and State-Owned Enterprises: A Step Backward or Forward?;" "Communiqué of the Third Plenary Session of the 18th Central Committee of the Communist Party of China."

[153] For the World Bank and the Development Research Center joint report, see "China 2030: Building a Modern, Harmonious, and Creative Society" (Washington, D.C.: World Bank, March 23, 2013), http://documents.worldbank.org/curated/en/2013/03/17494829/.

[154] Christian Murck, "The Third Plenum: Prospects for Reform in China," *The National Bureau of Asian Research* (blog), December 4, 2013, https://www.nbr.org/publication/the-third-plenum-prospects-for-reform-in-china/.

[155] "Decision," II.

and reorganize if necessary, raising SOE assets and capital value, and open up existing SOEs to private capital investments and shares.[156] The latter presents no real change to the overall structure of SOEs as the state would remain the largest shareholder.[157] However, if SOEs are forced to compete more equally with private businesses such as equal access to *all* resources, dismissal of "irrational" regulatory barriers, and elimination of "local-protectionist barriers to investment" as the Decision proclaims, they will be forced to merge or become more efficient.[158]

The Decision also announced plans for government administrative separation from SOEs and plans to break-up monopolies where possible.

> In natural monopoly industries in which state-owned capital continues to be the control shareholder, we will carry out reform focusing on separation of government administration from enterprise management, separation of government administration from state assets management, franchise operation, and government oversight, separate networks from operations and decontrol competitive businesses based on the characteristics of different industries, and make public resource allocation more market-oriented. We will continue to break up all forms of administrative monopoly.[159]

Surrendering administrative control of SOEs and restructuring corporate governance has been an objective of the government since the Company Law in 1995 which issued a campaign to corporatize leading SOEs.

Several other notable SOE reforms proposed incorporate long-term efficiency, accountability, enabling bankruptcy if necessary, and deregulating prices in several industries. Fiscal responsibility and transparency were also highlighted, calling on the state to "strengthen investigations into the accountability of SOE operations and investment" in

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[156] Ibid., II.6-7.

[157] Scissors, "China's Economic Reform Plan Will Probably Fail," 6.

[158] Kroeber, "Xi Jinping's Ambitious Agenda;" "Decision," II.8; Nargiza Salidjanova and Iacob Koch-Weser, "Third Plenum Economic Reform Proposals: A Scorecard," Staff Research Backgrounder (Washington, D.C.: U.S.-China Economic and Security Review Commission, November 19, 2013), 3, https://www.uscc.gov/sites/default/files/Research/Backgrounder_Third%20Plenum%20Economic%20Reform%20Proposals--A%20Scorecard%20(2).pdf.

[159] "Decision," II.7.

order to create an "incentive and restraint mechanism" for existing corruption.[160] Perfecting the bankruptcy system for certain enterprises in private, mixed, and public sectors was also stated, offering a way out for those that were no longer profitable. The benefits that SOE managers have long enjoyed since the 1980s such as inconsequential expenditures, preferential job placement, and inconsistent salaries would be targeted in the coming years. This would also serve to ease government subsidization and mounting debt accrued from SOEs, but not solve it completely. Although there was no mention of implementing market prices, the Decision did mention the State Council "will push ahead with pricing reforms of water, oil, natural gas, electricity, transportation, telecommunications and some other sectors while relaxing price control in competitive areas" such as land leasing or purchasing and agricultural products.[161]

The Plenum established the Central Committee Leading Small Group for Comprehensively Deepening Reform that would take charge of implementing reforms across nearly all major policy sectors and work with existing institutions such as SASAC to administer incremental changes.[162] Reports circulating around the Third Plenum that were later confirmed in the State Council's "Guiding Opinions of the Communist Party of China Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises" (henceforth "Guiding Opinions") in 2015 also revealed that the SASAC would be shifting its responsibilities "from managing assets to managing capital."[163] Kroeber assesses that "this shift of emphasis is significant: in recent years SOEs have fortified their

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[160] Ibid., II.7.

[161] Ibid., III.10-11.

[162] Alice Lyman Miller, "Xi Jinping and the Evolution of Chinese Leadership Politics," in *Fateful Decisions: Choices That Will Shape China's Future*, ed. Thomas Fingar and Jean C. Oi, Studies of the Walter H. Shorenstein Asia-Pacific Research Center (Stanford, CA: Stanford University Press, 2020), 40. Six of the seven major policy sectors under the Central Committee Leading Small Group for Comprehensively Deepening Reform includes China's Party, economy, law, culture and media, social management, and ecology. The last policy sector—the military—falls under the simultaneously established State Security Commission that would "oversee the nation's pervasive security apparatus." Kroeber, "Xi Jinping's Ambitious Agenda."

[163] "State-Owned Enterprise Policy Reform," Asia Society Policy Institute and Rhodium Group, Spring 2020, https://chinadashboard.asiasociety.org/spring-2020/page/state-owned-enterprise; "Guiding Opinions of the CPC Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises," Peking University Center for Legal Information, August 24, 2015, http://en.pkulaw.cn/display.aspx?cgid=26c39a43ea095fcebdfb&lib=law.

baronies by building up huge mountains of assets, with little regard to the financial return on those assets (which appears to be deteriorating rapidly). Forcing SOEs to pay attention to their capital rather than their assets implies a much stronger emphasis on efficiency."[164]

2. Statements on Reform following the Third Plenum

The aforementioned Guiding Opinions and other documents released by the State Council in 2015 to include "Guiding Opinions on Mixed Ownership Reform" largely reiterated much of the Third Plenum's statements, though with a few clarifications. First, "rather than allowing the market to decide the future of SOEs, the State Council proposed utilizing market mechanisms to make SOEs bigger, stronger, and more efficient while maintaining control by the government...The plan was to allocate state capital toward strategic industries and reduce direct intervention in SOEs' day-to-day operations, thereby improving efficiency."[165] Second, the documents released from the State Council in September made no mention of allowing market mechanisms to play a "decisive role" in China's economy. When China's stock market crashed in the summer of that same year, Leutert observes that "Chinese stock market turmoil solidified conservative political elites' conviction that party-controlled *yangqi* [centrally-owned companies] are an essential part of the government's toolkit for averting financial crisis."[166] Furthermore, the Chinese government "would strengthen SOE corporate governance but made clear that it viewed Communist Party supervision as critically important."[167]

The Thirteenth Five-Year Plan encompassing economic targets between 2016 and 2020 also demonstrated similar statements to the Third Plenum. Notably, there was a distinct emphasis on reforms that are "helping [SOEs] exercise a greater level of influence and control over the economy, increasing its resilience against risk, and enabling it to

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[164] Kroeber, "Xi Jinping's Ambitious Agenda;" Zhang Bin, Fangjia Xi, and Yang Ye, "SASAC Brews a New Round of Strategic Reorganization of State-Owned Enterprises Xinhua News Agency," JJCKB, November 15, 2013, http://www.jjckb.cn/2013-11/15/content_476619.htm.

[165] "State-Owned Enterprise Policy Reform."

[166] Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," 90.

[167] "State-Owned Enterprise Policy Reform."

contribute more effectively to accomplishing national strategic objectives."[168] Restructuring was a key subject regarding SOE reforms, particularly through management, mixed ownership, and that SOEs should allow the market to inform performance and capacity. The plan mentioned that SOEs should operate "under the principle of the survival of the fittest," but does not delineate that those operations should be autonomous from government sponsorship.[169]

The Nineteenth Party Congress work report following the Third Plenum in 2017 also restated much of the previous reform goals. Xi reemphasized the importance of improving the distribution system, increasing the value of state assets, making structural adjustments to management and operations, and encouraging strategic reorganization for middle managers' operational authority.[170] The report also reiterated the importance of market-driven production resource allocation and of the negative effects administrative monopolies have had on developing fair competition between Chinese companies.[171] He called on the state to "speed up the reform of market-based pricing of factors of production, relax control over market access in the service sector, and improve market oversight mechanisms."[172] Overall, the common theme of striving to increase or strengthen the Party's role in all forms of ownership—including private firms—rippled throughout the Nineteenth Party Congress and the National People's Congress documents.[173]

C. THE IMPLEMENTATION

The economic policy statements and proposals initiated by Xi Jinping at the 2013 Third Plenum indicated that the Chinese economy was going to become significantly more marketized, but as time would reveal, those ends never came to fruition. SOEs, however,

[168] "The 13th Five-Year Plan for Economic and Social Development of the People's Republic of China (2016–2020)" (Beijing: Central Committee of the Communist Party of China, March 17, 2016), 34, https://en.ndrc.gov.cn/policyrelease_8233/201612/P020191101482242850325.pdf.

[169] Ibid., 34.

[170] Xi Jinping, "Full Text of Xi Jinping's Report at 19th CPC National Congress."

[171] Kroeber, "Xi Jinping's Ambitious Agenda;" Chris Buckley and Keith Bradsher, "Xi Jinping's Marathon Speech: Five Takeaways."

[172] Xi Jinping, "Full Text of Xi Jinping's Report at 19th CPC National Congress."

[173] Lardy, *The State Strikes Back*, 20.

did become stronger but only through a deepening dependence on government subsidization, resource allocation, and unfair competition, not because of efficient business practices and stronger market competition. The failure to implement market mechanisms in SOE operations has disincentivized SOEs from correcting inefficiencies and prevented private firms from entering “commanding heights” sectors. Among the statements made regarding SOE reforms, only four have shown progress: strengthening the importance of SOEs in China’s economy, allowing more private financing to own shares of SOEs, improving corporate governance, and eliminating corruption from SOE management. Overall, the Third Plenum statements of a more marketized Chinese economy have fallen short of analysts’ expectations thus far and have not manifested by the proposed deadline of 2020.

1. Implementation of Xi’s SOE Reforms

Among the roughly 150,000 nonfinancial SOEs run either by SASAC, the National Development and Reform Commission, the Ministry of Finance, local governments, or mixed owners, little has been done within SOE reform to achieve the objectives envisaged in the Third Plenum. Deng Xiaoping’s goal for incentivizing SOE efficiency has yet to be realized, despite the decades of profound reform that has minimized the number of SOEs and incorporated mixed ownership. Instead, Xi has only solidified the sector’s claim to national assets and its position in China’s economy. The existing contradictions in the 2013 Decision have resulted in meager reforms implemented to avoid significant restructuring. Scissors identified this contradiction in his pessimistic assessment months after the 2013 Plenum, arguing that one of the most important prospects for meaningful pro-market reform in China encompass corporate competition. Part of the contradiction in the importance of market forces equal to the importance of SOEs is that “intensified competition requires rolling back regulatory protection and fiscal subsidies received by state-owned enterprises.”[174]

[174] Scissors, “China’s Economic Reform Plan Will Probably Fail,” 2.

In the years since the Third Plenum, SOEs have received even more preferential treatment than they were privy to in the two decades before without making any significant improvements in market competition.[175] Some reforms have been delayed and others were reversed so much so that the update in the Nineteenth Party Congress work report regarding "major breakthroughs in deepening reform" was a brief and ambiguous paragraph that made no specific mention of areas where or how the 1,500 reform measures had been implemented.[176] This is in part because the ad hoc measures involving mixed ownership and mergers have been unsuccessful in effectively exposing SOEs to market pressures. Ambiguity in proposed reforms have allowed the government to operate with flexibility—implementing small-scale reforms and avoiding large-scale reform commitments when politically beneficial. For example, no specific industries or sectors were named where monopolies would be dissolved, nor was it specified which formerly inaccessible enterprises would allow investments by private capital.[177] Additionally, Xi reiterated in April 2020 that he would move forward with incorporating marketized mechanisms for resource allocation but offered a tangential solution that incorporates state salary reform and continues to restructure corporate governance.[178]

According to a publication released in 2017 by the International Monetary Fund, "SOEs still account for about half of total bank credit and 40 percent of total industrial assets. Also, they continue to benefit from implicit government support on factor inputs, including land and preferential access to credit, amounting to about three percent of GDP."[179] As a result of the state's financial commitments to SOEs, China's credit toward nonfinancial corporations increased by 20 percent annually between 2009 and 2015,

[175] Economy, *The Third Revolution*, 106–8.

[176] Xi Jinping, "Full Text of Xi Jinping's Report at 19th CPC National Congress."

[177] Salidjanova and Koch-Weser, "Third Plenum Economic Reform Proposals: A Scorecard," 3.

[178] "Spring 2020 China Dashboard Net Assessment," Asia Society Policy Institute and Rhodium Group, Spring 2020, 2, https://arraysproduction-0dot22.s3.amazonaws.com/aspi/websites/5ee3de659e57c204e0d2bdb2/pages/5ee3de6b9e57c204e0d2bdbc/pdf/SOE--Spring2020.pdf.

[179] Lam, et al., "State-Owned Enterprise Reform," 24.

resulting in an unsurmountable debt-to-GPD ratio because of widespread SOE underperformance.[180]

In addition to preferential lending to SOEs, government subsidies have also undermined reform ambitions. Steinfeld examines the long-term internal impacts of subsidization on firms, identifying opportunities for local agencies to exploit taxation, inflate prices, and distort performance results all without fearing financial or legal reprisal to the firm.[181] Granted, those who were engaging in these activities for personal gain are now being punished through the anti-corruption campaign discussed later. However, many of these firms that use these methods in standard operating procedure are enabled to do so with the state's blessing and disregard the company's weakening financial condition. Direct subsidies to almost three-thousand non-financial SOEs or subsidies accounted for nearly 14 percent of listed profits in 2015, a nine percent increase from five years prior.[182] This substantial increase could be attributed to the $1.1 trillion government stimulus package in 2015 compounded on the existing $1.6 trillion infrastructure plan between 2014 and 2016.[183] However, these numbers may not be as distorted based on the massive stimulus package the Chinese government used in response to the GFC launched 2008 which continued to expel an estimated total of $3.5 trillion through 2010.[184]

Subsidies have been granted and are promised to continue through 2020 to SOEs that further government initiatives like shifting away from China's dependence on coal to petrochemicals and financing infrastructure projects to develop Chinese industries ranging from domestic energy production to a domestic film industry. Additional subsidies are offered to SOEs with overcapacity in order to avoid downsizing and labor lay-offs.[185] Any

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[180] Wojciech Maliszewski et al., *Resolving China's Corporate Debt Problem* (Washington, D.C.: International Monetary Fund, 2016), 2.

[181] Steinfeld, *Forging Reform in China*, 46-47.

[182] Lardy, *The State Strikes Back*, 139.

[183] Owen Haacke, "New Stimulus? Questions About China's $1 Trillion Investment Plan," US-China Business Council, January 21, 2015, https://www.uschina.org/new-stimulus-questions-about-china%E2%80%99s-1-trillion-investment-plan.

[184] Victor Shih, "Local Government Debt: Big Rock-Candy Mountain," *China Eonomic Quarterly*, June 2010, 26.

[185] Lardy, *The State Strikes Back*, 140.

efforts toward "repositioning the state as a capital investor rather than operator" continue to be pushed back due to various market impacts such as U.S.-China trade relations under the Trump Administration or disruptions from the coronavirus global pandemic.[186] These Keynesian government actions indicate shortcomings in four prominent areas of Third Plenum SOE reform: failure to allow market mechanisms to determine fiscal resource allocation, failure to allow fair competition between SOEs and other sectors, failure to inspire or incentivize efficiency gains within SOEs, and failure to separate government administration from enterprise management and operations.

First, little has been done to relinquish SOE assets control and management by the state through SASAC.[187] Prior to the Third Plenum, the firms under SASAC supervision were essentially holding companies that controlled an estimated 50,000 firms and subsidiaries.[188] The goal following 2013 was to reassign SASAC's role as an asset management company that resembles Singapore's Temasek financial holding company, which is responsible for financial returns on assets but doesn't interfere with operations.[189] Instead, SASAC has retained the role of direct management through the last decade and SOE top management positions are determined by the Party through corporate governance restructuring which will be discussed in further detail later.

Progress in breaking-up "natural monopolies" has largely regressed. According to a reputable Chinese economist and professor, some of the monopolies broken up during Zhu Rongji's tenure in the late 1990s and early 2000s have instead reformed with the encouragement of SASAC since the Third Plenum.[190] Mergers have been noted between two railroad manufacturers in 2015, CNR Corporation Ltd. and China CSR Corporation

[186] Lam, et al., "State-Owned Enterprise Reform," 318.

[187] Economy, *The Third Revolution*, 106.

[188] Lardy, *The State Strikes Back*, 86–87; Lam, et al., "State-Owned Enterprise Reform," 308.

[189] Sharmin Mossavar-Rahmani et al., "Walled In: China's Great Dilemma," Insight (Goldman Sachs, January 2016), 27, https://www.goldmansachs.com/what-we-do/investment-management/private-wealth-management/intellectual-capital/isg-china-insight-2016.pdf.

[190] Gao Xiqing, "China: Impact of the Thirteenth Five-Year Plan," Council on Foreign Relations, April 19, 2016, https://www.cfr.org/event/china-impact-thirteenth-five-year-plan.

Ltd., in order to eliminate redundancy and generate better competition on a global scale.[191] In the fourth quarter of 2019, SOEs in key industries such as energy, defense, telecommunications, and shipping accounted for 83.3 percent of all industrial and service shares of revenue. SOEs in "pillar" industries such as construction, equipment manufacturing, metals, technology, and automobiles carried 45.4 percent of shares—decreasing from 88.8 percent and 51.3 percent respectively five years prior.[192] This decrease is marginal and continues to fluctuate each quarter, indicating little-to-no progress in creating opportunities to open these industries up to the private sector and "oppose monopoly and unfair competition."[193]

In conjunction with the state's dominant monopolies, entry restrictions continue to disable private firms from developing in certain sectors and entry barriers largely remain in-tact, disincentivizing firms from attempting to compete against government sponsored SOEs. Some access to credit has become available to private firms that was unavailable before 2010. But the majority of these opportunities derive from China's booming shadow banking sector that emerged because of existing barriers for private enterprises to access resources and accounted for anywhere between 26 and 69 percent of China's GDP in 2015.[194] These finance options are often issued off balance sheets, which deepens in ambiguity the status of China's debt crisis.

The government's attempt to establish competition incentives began in 2014 through a series of mergers and promotion of private minority shares in SOEs but have had little effect on SOE market competition. These efforts have fallen short of intended results as "none of these measures has been sufficient to reshape SOEs' incentives in line with market principles or redefine their role within the economy."[195] Incorporating mixed

[191] Mossavar-Rahmani et al., "Walled In: China's Great Dilemma," 28.

[192] "State-Owned Enterprise Policy Reform."

[193] "Decision," III.9.

[194] Kellee Tsai, "The Rise of Shadow Banking in China: The Political Economy of Modern Chinese State Capitalism," Institute for Emerging Market Studies (Hong Kong: Hong Kong University of Science and Technology, August 2015), https://iems.ust.hk/publications/thought-leadership-briefs/tsai-rise-of-shadow-banking-in-chin.

[195] "State-Owned Enterprise Policy Reform."

ownership was designed to levy private incentives to draw out inefficiencies and boost production. Problems stemming from this design were often due to government intrusion. For example, the state's official shares in Jiangxi Salt dropped to around 47 percent after the firm gained four new investors. However, these four companies who invested are either administered or owned directly by either SASAC, the Ministry of Finance, or the state and were brokered into buying shares of Jiangxi Salt.[196] Mixed ownership in this case only reflects government leveraging, not private market-driven engagement, undermining the mixed-ownership purpose expressed in the Guiding Opinions as "the most significant means to improve the efficiency of SOEs."[197]

The value of assets owned by the state has decreased since the Third Plenum despite SOE-favored resource allocation. Lardy identified that "the return on assets of state firms in industry and services fell by two-thirds and two-fifths, respectively, between 2007 and 2016."[198] After much of the state sector recovered from a global drop in commodity prices in 2015, profits of SOEs' gross capital under SASAC were only 2.6 percent in 2017compared to 6.7 percent in 2007.[199] State owned assets continue to underperform each quarter compared to the asset growth of the private sector.[200]

The progress on reforming prices of crucial inputs since the Third Plenum is difficult to discern. While prices may appear the same for any firm interested in investing, SOEs have historically benefitted from reduced taxes and fees on various resource purchases.[201] Because of this loophole, progress in reforming price controls and resource allocation in products like water, energy, telecommunications, and transportation and services like real estate leasing will likely remain stalled and continue to benefit SOEs most of all, regardless if prices are set based on the market.

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196 Mossavar-Rahmani et al., "Walled In: China's Great Dilemma," 28.

197 "China Issues Guideline to Deepen SOE Reforms," *Xinhua*, September 14, 2015, http://www.china.org.cn/business/2015-09/14/content_36575657.htm.

198 Lardy, *The State Strikes Back*, 41, 54-59.

199 Naughton, "State Enterprise Reform Today," 377.

200 "State-Owned Enterprise Policy Reform."

201 "In some sectors, the government sets prices above those in world markets supporting profitability, often in sectors dominated by SOEs." Lam, et al., "State-Owned Enterprise Reform," 315.

Among the numerous SOE reforms announced from the Plenum, four have been partially or comprehensively implemented. First, the importance of SOEs within China's economy has been refortified based on mergers, monopolies, and increased government subsidies. Second, the opening up of existing SOEs to private capital investments and shares has been somewhat successful. In March of 2020, SASAC "announced that under the 'double-hundred actions' campaign, 41.6% of SOE group holding companies and 62.7% of subsidiaries had achieved 'mixed ownership'–adding private shareholders."[202] The pending reclassification of SOEs to private enterprises after gaining private shareholders will likely reflect positive growth in private assets and losses in state assets. To avoid this negative outcome, the Chinese government is likely to stall or avert these reclassifications to retain current state sector asset growth rates. Instead, reclassifying unlisted enterprises to demonstrate positive reform progress while avoid market impacts will likely occur.

Corporate governance reforms have been successfully implemented by way of corporatizing all of the 97 top SOEs controlled by SASAC and establishing a board of directors for each firm.[203] However, these individuals are hand-selected Party members chosen based on their political alignments and are appointed with the contingency that they are committed to supporting national policy objectives. Furthermore, "the promotional criteria for SOE managers – which frequently involve political projects or developmental objectives, do not always coincide with economically rational incentives to increase profit or productivity."[204] While the government has successfully relinquished its administrative control directly over the top SOEs, those that are leading these massive enterprises continue to act on behalf of the government toward achieving national objectives.

The fourth area of successful reform has been the result of Xi's vision for weeding out corruption within the Party, state, and corporate leadership, which has fundamentally

[202] Ibid.

[203] Naughton, "State Enterprise Reform Today," 380.

[204] Dominic Chiu, "CSR 2019: Challenges to SOE Mixed Ownership Reform in China – A Case Study," *The SAIS China Studies Review* (blog), October 30, 2019, https://saiscsr.org/2019/10/30/csr-2019-challenges-to-soe-mixed-ownership-reform-in-china-a-case-study/; Lardy, *The State Strikes Back*, 87.

changed the culture of SOE management. The anti-corruption campaign, launched in 2012 prior to the Plenum itself, has charged over 1.5 million government officials with corruption—at least 322 among the highest ranks of provincial governments, and three that were Politburo Standing Committee members.[205] This served to mend inefficiencies where subsidized funds were allocated directly to individuals' and effectively reorganized and improved the incentives of management personnel based on Third Plenum goals. However, it also offered a way to eliminate any opposition against Xi or his proposed reforms and has enabled him to consolidate his power in various commissions and small leading groups throughout the government and military. Now, out of fear of reprisal for engaging in unauthorized financial activities, these remaining or newly appointed managers and government officials avoid projects altogether unless directly ordered by the central government, essentially denying FDI opportunities which impede on economic growth potential.[206]

D. CONCLUSION

The statements made by Xi Jinping to allow market mechanisms to take a more dominant role in the arena of SOE reforms has disappointed pro-reformists. Since the Third Plenum and the follow-on Decision lacked specification on how the Party would carry out its SOE reform ambitions, the results of implementing market mechanisms in such areas as equal competition, increased private participation, government separation from enterprise management, and monopoly termination have all fallen short of the broad and non-comprehensive progress expected to occur by the end of 2020.

The retention of the state sector's role in China's economy has clearly been prioritized over any meaningful efforts to restructure SOEs and enable production, efficiency, and asset value gains. The promise of market forces determining resource

[205] Peter L. Lorentzen and Xi Lu, "Personal Ties, Meritocracy, and China's Anti-Corruption Campaign," SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, November 21, 2018), 3, 5, https://doi.org/10.2139/ssrn.2835841; "Visualizing China's Anti-Corruption Campaign," ChinaFile, August 15, 2018, https://www.chinafile.com/infographics/visualizing-chinas-anti-corruption-campaign.

[206] Economy, *The Third Revolution*, 32–35.

allocation, the even access of crucial inputs for both state and non-state sectors, and the separation of government from SOE operations have not been met. Instead, the Chinese government has consolidated its control of SOEs, strengthened sectorial monopolies, continued to grant SOEs subsidies and easy access to resources, and announced progress in diversifying SOE ownership where new investors are puppets of the state.

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III. ECONOMIC LOGICS OF STATE-OWNED ENTERPRISE REFORM SINCE 2013

The political, economic, and societal roles of state-owned enterprises (SOEs) within China's contemporary history have been extensive since the People's Republic of China (PRC) was founded in 1949. Today, their role is dramatically different from what it once was, but they continue to act as the pillars under which Chinese economic success and expansion are mounted. Although the remarks from the Third Plenum of the Eighteenth Party Congress instilled optimism for pro-market reformers when Xi Jinping called for markets to play a "decisive" role in the economy and resource allocation, the PRC's leverage gained from SOEs may to be too robust to surrender.[207] Based on the findings of Chapter II, the state of SOE reform under Xi since 2013 lack substantive pro-market progress and SOEs continue to receive government support while they operate inefficiently. The reform measured implemented have not only been ineffective, but SOEs' role in achieving China's domestic and geostrategic objectives continue to expand, which has driven the limited reforms. While SOEs appear on the surface to be unacceptably inefficient government subsidized mega companies that rob private firms from access to resources, they are more effective in providing production and services in commanding heights sectors than private firms.

This chapter will analyze three purely economic arguments. The first will examine SOEs' impact on China's annual gross domestic product (GDP) and GDP growth. The second will examine SOEs' role in both creating and ameliorating excess capacity. The third will examine SOEs' ability to influence the global economy. These three economic arguments will attempt to marshal evidence for the economic logics and analyzes the persuasiveness of SOEs to the economic argument in order to validate or invalidate the rollout of SOE reform since 2013 by the Chinese Communist Party (CCP) and the State Council. The findings reveal that the economic logics behind avoiding meaningful reform

[207] Arthur R. Kroeber, "Xi Jinping's Ambitious Agenda for Economic Reform in China," The Brookings Institution, November 17, 2013, https://www.brookings.edu/opinions/xi-jinpings-ambitious-agenda-for-economic-reform-in-china/.

of China's SOEs based on the evidence examined are mixed overall. Although SOEs still represent a sizable portion of China's GDP, SOEs' impact China's economic growth is negative and unconvincing, providing a poor explanation for their retention. The leverage gained by China when utilizing its SOEs to influence global markets and resources while furthering national economic objectives provides stronger evidence in support of economic logics as these objectives could not be accomplished if those SOEs were privatized. Finally, the evidence of SOEs' impact on ameliorating excess capacity while supplying material for global economic expansion and access through international infrastructure projects is more convincing and provides a stronger explanation. However, the problem of excess capacity that derives from SOEs remains systemically unresolved and cannot be sustained long-term.

This chapter will be organized starting with a brief examination of the role of SOEs in the evolution of economic development to provide the foundational context for understanding the economic value of SOEs. The three economic arguments will then be examined followed by an assessment of the outcomes.

A. GENERAL ECONOMIC LOGICS OF STATE-OWNED ENTERPRISES

SOEs have played a major role within a planned economic strategy, enabling a state's economy to gain access to necessary upgrades and promoting the development of new sectors. But when that economy matures and integrates in the global market economy, SOEs are generally unable to compete with private firms, often become sources of government debt, and stunt economic growth. Before understanding Chinese government's logics of retaining SOE operations under the current method, it is useful to examine the general economic logics of SOEs and the associated benefits and obstacles the produce throughout the evolution of a state's economic development.

1. Drivers of the State Sector within Underdeveloped Economies

Underdeveloped states have used a state-centric economic structure to develop its industrial base using a state-led development strategy. SOEs play the crucial role of providing the materials to supply infrastructure development of such projects as roads, bridges, railways, ports, and buildings—projects that are unable to gain investors and make profits to offset the cost. SOEs are vital to early industrial development because they supply materials, guide economic upgrades, and promote the development of other sectors.[208] The government grants SOEs preferential resource allocation such as personnel, capital, and raw materials in order to continue operation and production and complete projects necessary to develop the infrastructure for a burgeoning economy. Under the employment of the state sector, workers typically benefit from even wages, uncompetitive work environments, are guaranteed life-long employment, and are provided welfare services by the enterprises themselves.

2. Challenges with the State Sector within Developed Economies

Of those states that followed the Soviet economic system, market mechanisms like supply and demand were eliminated in order to maintain income equality and avoid capitalism, but this introduced systemic inefficiencies to their economy. Elimination of market mechanisms often resulted in moral hazard as it "stunted the motivation, productivity, and creativity of farmers, workers, and firms" which often lacked an incentive to compete with their private sector counterparts—creating massive operational inefficiencies.[209] Jiang observes, "one of the main reasons for lossmaking state-owned enterprises centers on ineffective management...the huge debt burden resulting from shortages of capital, the slow process of renovation and reform due to the limited profits enterprises have retained over a long term, and heavy historical burdens such as pension payments and redundant employees."[210]

Many governments that used a planned economic strategy following World War II eventually gained enough capital formation to allow market forces to enter and become competitive in the global economy. As developing economies grew under the state-led developmental strategy, a shift in resource allocation from the state sector to non-state firms often logically followed to enable emerging industries and sectors the access they

[208] Jiang Hong, "Role of State-Owned Enterprises in a Market Economy," *Beijing Review* 39, no. 44 (October 28, 1996): 15.

[209] Economy, *The Third Revolution*, 102.

[210] Jiang, 16.

required to grow. Over time, private or mixed-ownership industries would emerge and begin to generate greater profit margins and growth than state-owned industries could. If SOEs were allowed to continue their unfettered access to domestic resources, the more profitable non-state sector would suffer and economic growth at the national level may not reach its full potential. Thus, many states that applied an economic strategy similar to the Soviet and mid-twenty-first century Chinese system in the early stages of economic development had eventually transitioned completely or partially to a marketized economy and most, if not all workers are exposed to labor market competition.

3. SOEs in Socialist-Market Economies

Socialist or formally socialist states have introduced market mechanisms to create a hybrid economy such as the Russian Federation, Vietnam, and China, though most have transitioned entirely to a market economy and gradually eliminated SOEs altogether.[211] The Russian Federation is continuing its state-led development strategy, utilizing SOEs to "contribute a significant share of output and employment in Russia's economy" following the collapse of the Soviet Union.[212] Vietnam has progressively been equitizing or diversifying the ownership of its SOEs and increasing the investor share to strengthen these firms' competitiveness and eliminate the inefficiencies they create.[213] China has been less transparent about its remaining centralized and local SOEs and the tens of thousands of subsidiaries they have. Mixed and privatized ownership has been announced for most publicly known SOEs over the last three decades, but not enough information is available to determine the economic burden of the state sector. A wide consensus among analysts and economists assert that Chinese SOEs restrict the growth potential of China's economy

[211] Przemyslaw Kowalski et al., "State-Owned Enterprises: Trade Effects and Policy Implications," *OECD Publishing*, OECD Trade Policy Paper, no. No. 147 (April 24, 2013): 22, https://doi.org/10.1787/5k4869ckqk7l-en.

[212] "State-Owned Enterprises in the Russian Federation: Employment Practices, Labor Markets, and Firm Performance," World Bank, June 18, 2019, https://doi.org/10.1596/32098.

[213] Yee Chung Seck and Lan Phuong Nguyen, "Vietnam Issues Decision No. 26 on the List of State-Owned Enterprises to Be Equitized by End-2020," Baker McKenzie, September 9, 2019, https://www.bakermckenzie.com/en/insight/publications/2019/09/vietnam-issues-decision-no-26.

because of the market distortions and inefficiencies they introduce.[214] This begs the question of what are the economic logics, if any, of China's leadership in avoiding meaningful SOE reform since 2013?

B. ECONOMIC LOGICS OF CHINA'S STATE-OWNED ENTERPRISE SECTOR

Unlike many other market-transitioned economies, China has retained and strengthened its state sector following the strategy of government subsidizing. However, unlike other planned economies, China's approach stands out. As Naughton identifies, the installation of early policy choices like the dual-track pricing system enabled short- and long-term stability—the state-sector was able to retain its autonomy and new enterprises were able to enter.[215] Under this system, the state sector "was an essential link to the creation of a competitive marketplace," but remained the dominant sector since China's economic opening.[216] Despite the "non-public" sector's exponential growth from both government-led reforms and unauthorized support structures like shadow banking, Chinese-based private firms are still dwarfed by SOEs' size, access, and leverage over China's economy as a whole, which continues to operate independent from market mechanisms.

This section examines the three arguments and analyzes their persuasiveness in attributing economic logics to explain why China has strengthened its SOEs instead of reforming them. First, this section will examine SOE contributions to China's GDP and its growth rate. The second argument examines the economic logics of employing excess capacity derived from SOEs to expand international infrastructure development. The third argument explores SOEs' capacity for marshalling influence in the global economy that meet China's strategic economic objectives to identify if evidence is convincing that supports economic logics.

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[214] Lardy, *Markets Over Mao*, 124.

[215] Barry Naughton, *Growing out of the Plan: Chinese Economic Reform, 1978-1993* (New York, NY: Cambridge University Press, 1995), 7.

[216] Douglas Guthrie, "Growing out of the Plan: Chinese Economic Reform, 1978-1993," *Journal of Economic Literature; Nashville* 37, no. 4 (December 1999): 1738.

1. Contributions to GDP and Growth

This section will examine the contribution of SOEs to China's annual GDP and the means by which SOEs are influencing China's overall economic growth potential. The findings indicate that SOEs continue to carry a large share of China's GDP but their overall contributions to China's economic growth potential are negative due to their preferential treatment of gaining capital and resources that would otherwise be allocated to competitive, private businesses. Additionally, they are wholly inefficient when compared to private sector enterprises. These outcomes provide weak evidence for the use of economic logics when rationalizing SOEs' major role in China's economy.

Based on a report by the World Bank's International Finance Corporation, SOEs contributed 37 percent of China's GDP in 1998.[217] Although Chinese statistical reports have become less transparent with enterprise ownership and performance, analysts like Kroeber and Holz have made empirical attempts to evaluate the contributions of SOEs to China's GDP in the last decade. Among state-owned units, Kroeber and Holz attribute SOEs with 35 percent of GDP in 2011 and 39 percent of GDP in 2015, indicating that efforts to strengthen the role of Chinese SOEs in its economy have been successful when considering the number of new private firms that have entered the economy and their contributions to GDP.[218] After deducting privately-owned enterprises, which the government claimed accounted for 60 percent of GDP in 2017, and foreign invested enterprises, Zhang deducts that between 21 and 28 percent of GDP derived from the public sector.[219] While this contribution does not represent the quantitative majority of China's economy, Chinese SOEs involved in vital sectors and services does raise their value of

[217] Neil F. Gregory, Stoyan Tenev, and Dileep M. Wagle, *China's Emerging Private Enterprises: Prospects for the New Century* (Washington, D.C.: International Finance Corp, 2000), 17.

[218] Carsten A. Holz, "The Unfinished Business of State-Owned Enterprise Reform in the People's Republic of China," *CESifo Working Paper Series*, CESifo Working Paper Series (CESifo, 2019), 10, https://ideas.repec.org/p/ces/ceswps/_7688.html; Kroeber, *China's Economy*, 2016, 101.

[219] Xi Jinping, "Speech at the Symposium on Private Enterprises," *Xinhua*, November 1, 2018, http://www.xinhuanet.com/politics/2018-11/01/c_1123649488.htm; Zhang, "How Much Do State-Owned Enterprises Contribute to China's GDP and Employment?," 3, 7.

contributions to the production chain as it relates to sustained access to resources, operations, and production output for other Chinese businesses.[220]

As SOE continue to receive preferential access to China's financial, labor, and land resources as well as state and private investments, SOEs fail to improve their economic performance.[221] Quite the opposite has occurred in the past decade in fact, as SOE performance has continued to deteriorate through the "the extent of loss making, reliance on subsidies, return on assets, the ratio of debt to equity (the leverage ratio), and the burden of interest payments relative to pretax, preinterest earnings."[222] Meanwhile, "private firms consistently outperform SOEs on a number of measures including profit margins, cash flows, and return on assets."[223] The World Bank reported that SOEs' return on assets were still lower than private firms midway through 2020 after private businesses had effectively shut down from the global pandemic and SOEs maintained relatively normal operations.[224] Based on these factors, SOEs have continued to create a lag on China's economic growth potential where private firms with stronger performance have helped stimulate growth.[225]

Although SOEs continue to represent a large share in China's overall GDP, retaining the current method of operations without implementing meaningful reform toward improved efficiency, return on investment, and capital allocation limits China's economic growth potential and weakens this argument for economic logics driving SOE continuity. In Xi's Nineteenth Party Congress speech in 2017, he accurately identified the root of China's dilemma in balancing SOE resourcing with developing a modern economy

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[220] Kroeber, *China's Economy*, 2016, 94.

[221] "In 2015, state firms accounted for 45 percent of all investment in services." Nicholas R. Lardy, *The State Strikes Back: The End of Economic Reform in China?* (Washington, DC: Peterson Institute for International Economics, 2019), 75-80.

[222] Lardy, *The State Strikes Back,* 50. For a brief characterization of SOE performance in these areas, reference pp. 50-64.

[223] Economy, *The Third Revolution*, 106.

[224] "Private firms...average return on assets (ROA) fell to 5.1 in 2020H1 from 6.6 percent in 2019, but was still a lot higher than the 2.9 percent for SOEs." World Bank, "China Economic Update, July 2020: Leaning Forward - COVID-19 and China's Reform Agenda" (Washington, D.C.: World Bank, July 2020), 28, https://openknowledge.worldbank.org/bitstream/handle/10986/34264/China-Economic-Update-Leaning-Forward-COVID-19-and-China-s-Reform-Agenda.pdf?sequence=6&isAllowed=y.

[225] Lardy, *The State Strikes Back,* 50.

and a "moderately well-off society" in China. He stated, "We should pursue supply-side structural reform as our main task, and work hard for better quality, higher efficiency, and more robust drivers of economic growth through reform. We need to raise total factor productivity."[226] In order to navigate economic development to achieve sustained, high GDP growth and avoid the middle-income trap, a comprehensive alteration in resource allocation is fundamental. While SOEs' major contributions to China's GDP continue to provide convincing economic evidence for their survival, they have been manufactured to do so to the detriment of greater GDP growth, which weakens this evidence altogether and is unconvincing in the use of economic logics to avoid SOE reform.

There remains an undiscussed fault within this argument. Many of the largest SOEs operate within sectors that are vital to the CCP, the state, and the population to include energy, transportation, communications, agriculture, infrastructure, heavy industrial production, and military equipment.[227] Due to China's immensity, privatizing these commanding heights SOEs and eliminating their government subsidization would fail to maintain accessibility and continuity within "essential growth sectors" that are "the foremost drivers of employment, production, and consumption."[228] Artificially low-priced supplies and services enable a greater return on investment in non-state sectors that utilize

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[226] Xi Jinping, "Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era" (19th National Congress of the Communist Party of China, Beijing, CN, October 18, 2017), 26, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf.

[227] Arthur R. Kroeber, *China's Economy: What Everyone Needs to Know*, 1st edition (New York, NY: Oxford University Press, 2016), 94.

[228] Arnold Kling and Nick Schulz, "The New Commanding Heights," *National Affairs*, Summer 2011, 3. Furthermore, due to China's lower purchasing power parity per capita, applying market mechanisms such as market pricing on vital goods and services would drive up prices and impact China's lower- and lower-middle class the most, which accounts for more than an estimated 68 percent of the total population as of 2017. "GDP per Capita, PPP (Current International $)," accessed October 24, 2021, https://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD?end=2020&start=2020&view=map; China Power Team, "How Well-off Is China's Middle Class?," *ChinaPower Project* (blog), April 26, 2017, https://chinapower.csis.org/china-middle-class/. Yingqi summarizes, "Market reform 2.0 faces the upmost challenge in striking a balance between market liberalization and social welfare, between unsustainable fiscal burden and unfulfilled promise to citizens, and between economic efficiency and social stability." Yingqi Tan, "Reform in Deep Water Zone: How Could China Reform Its StateDominated Sectors at Commanding Heights," *Harvard Kennedy School, Mossavar-Rahmani Center for Business and Government*, M-RCBG Associate Working Paper Series, no. No. 153 (July 2020): 258, https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/AWP_153_final.pdf.However, accessibility for China's lower-middle class deviates from the purely economic argument.

what SOEs supply. While SOEs' share of GDP is marginal in comparison to other Chinese enterprises, their impact on production, supply chain networks, and providing basic needs is unmeasurable but likely substantial.

2. Alleviating Excess Capacity Through International Infrastructure Development

The Chinese government has attempted to ameliorate the decades-old issue of excess capacity by employing material for foreign infrastructure development projects, however, the massive infrastructure push from the Global Financial Crisis (GFC) intensified the problem. Although this effort has improved the transit and access of goods throughout the world, it does not provide a solution to the issue of excess capacity that derives from SOEs because production output continues independent of production demand. This provides mixed support for economic logics behind avoiding meaningful SOE reform.

The continued production outputs of SOEs and the disregard for market demand has resulted in an industrial overcapacity of goods. For decades, the central government has instructed SOEs to continue operations and keep workers and factories active without being held accountable for the number of units sold. As a result, these SOEs have been producing more than can be utilized, causing a form of market distortion that drives down the price of products to eliminate competitors that are unable to turn a profit. This has also enabled the central government to develop infrastructure using cheap, domestically manufactured excess materials. The problem of excess capacity intensified when the government implemented a stimulus package that enabled SOEs and other large factories to continue building materials after the 2008 GFC slowed down the world economy and decreased market demand.[229] This stimulus package initiated infrastructure projects that "generated a rapid recovery and expansion in upstream sectors such as steel, machinery, and metals...These factors, coupled with a massive demand for construction machinery and

[229] Min Ye, *The Belt Road and Beyond: State-Mobilized Globalization in China: 1998–2018* (Cambridge, UK: Cambridge University Press, 2020), 120.

building materials amid the country's rapid urbanization" resulted in massive overcapacity.[230]

An example of overcapacity can be found in the crude steel industry which, between 2008 and 2015, the scale of overcapacity increased from 132 million tonnes to 346 million tonnes as a result of a surge of lending and infrastructure investment projects when global demand flatlined during the GFC. In that same period, the utilization rate of China's steel production decreased from 80 percent to 70 percent.[231] Figure 1 identifies some of the major industrial sectors within China that reflect similar outcomes following 2008.

[230] "2016 Annual Report to Congress" (Washington, D.C.: U.S.-China Economic and Security Review Commission, November 2016), 103–4, https://www.uscc.gov/sites/default/files/annual_reports/2016%20Annual%20Report%20to%20Congress.pdf.

[231] China's problem of overcapacity existed long before the GFC in 2008 but was augmented by the export of these subsidized goods to foreign consumers because domestic consumption "was not sufficient to absorb production." While China was still integrating into the global economy in the 1990s and following its WTO ascension in 2001, its overcapacity did not reflect major market distortions and trade surpluses like it does today. Jörg Wuttke, "The Dark Side of China's Economic Rise," *Global Policy* 8, no. S4 (2017): 63–64, https://doi.org/10.1111/1758-5899.12439.

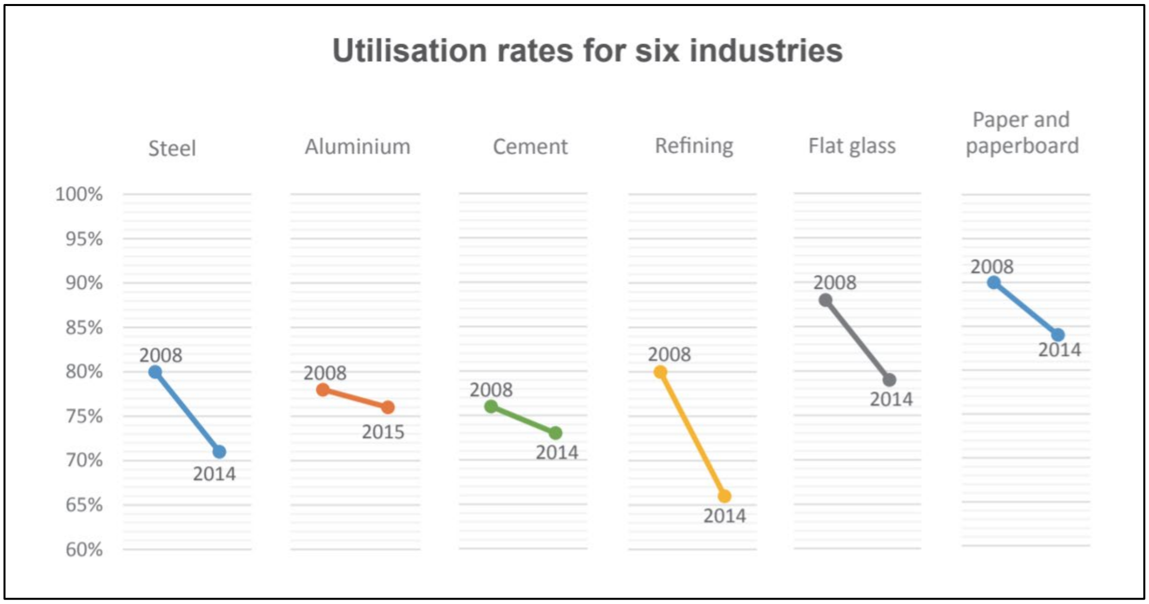

Figure 1. Overcapacity utilization rates of six industries in China between 2008 and 2014.[232]

After decades of domestic infrastructure development and a surge during the GFC, China had reached an apex—surpassing the limit of domestic infrastructure needs where commerce was being transported.[233] SOEs that manufacture infrastructure material not only had the capability and capacity to keep building, but factories that produce materials such as concrete and steel needed an outlet to employ their surplus. The projects under "One Belt, One Road" or the Belt and Road Initiative (BRI) have provided this outlet to build infrastructure in developing states while advancing China's international influence. Since Xi launched it in September of 2013, just two months prior to the Third Plenum, BRI projects have served as Xi's primary economic foreign policy—sponsoring infrastructure

[232] Source: "Overcapacity in China: An Impediment to the Party's Reform Agenda," European Chamber Publications (Beijing: European Union Chamber of Commerce in China, 2014), 3, https://static1.squarespace.com/static/5537b2fbe4b0e49a1e30c01c/t/56cc3017cf80a1fc057c84e4/1456222242257/Overcapacity_in_China_An_Impedim.pdf.

[233] Daniel Kliman and Abigail Grace, "Addressing China's Belt and Road Strategy" (Washington, D.C.: Center for a New American Security, September 20, 2018), 5, http://files.cnas.org.s3.amazonaws.com/documents/CNASReport-Power-Play-Addressing-Chinas-Belt-and-Road-Strategy.pdf.

development, strengthening global connectivity, and fortifying the international dependence on China's economy.[234]

The proliferation of BRI investments and projects began to manifest following its implementation outlined by the National Development and Reform Commission (NDRC) in 2015. It has thus created a dependence on cheap materials produced by SOEs for China's government to continue spreading its influence throughout the world. This long-term strategy would utilize the industrial surplus of materials for international projects while preventing capital flight.[235] These projects have put excess construction materials and machinery to use through international projects that employ Chinese workers overseas through Chinese service providers with Chinese materials. It was a winning strategy for the CCP and the State Council. Meltzer notes that "BRI allows China to double-down on its growth model by finding new markets where it can continue doing more of the same—building infrastructure using SOEs and state finance."[236] Since the NDRC's BRI outline was released in 2015, more than 60 states have hosted projects such as ports, bridges, railways, roadways, dams, energy pipelines, and telecommunications networks.[237]

These global development projects are a significant contribution to the economic logic of SOEs as they "are the main support to the Belt and Road Initiative and the main sources of fiscal revenue for the central government," according to economics professor

[234] Xiaojing Zhang and Xin Chang, *The Logic of Economic Reform in China*, China Insights (Berlin, Heidelberg: Springer Berlin Heidelberg, 2016), 68, https://doi.org/10.1007/978-3-662-47404-4.

[235] Min Ye, *The Belt Road and Beyond*, 121. "China's most important industrial sectors of overcapacity include steel, coal, plate glass, cement, electrolytic aluminum, shipbuilding, photovoltaics, wind power and petrochemicals," all of which can be used in a variety of ways to support BRI projects. Kevin G. Cai, "The One Belt One Road and the Asian Infrastructure Investment Bank: Beijing's New Strategy of Geoeconomics and Geopolitics," *Journal of Contemporary China* 27, no. 114 (November 2, 2018): 838, https://doi.org/10.1080/10670564.2018.1488101.

[236] Joshua P. Meltzer, "China's One Belt One Road Initiative: A View from the United States," *Brookings* (blog), June 28, 2017, https://www.brookings.edu/research/chinas-one-belt-one-road-initiative-a-view-from-the-united-states/.

[237] Andrew Chatzky and James McBride, "China's Massive Belt and Road Initiative," Council on Foreign Relations, January 28, 2020, https://www.cfr.org/backgrounder/chinas-massive-belt-and-road-initiative.

Lin Jiang at Sun Yat-sen University in Beijing.[238] There is a negative side to this strategy: the development of BRI did not solve the problem of excess capacity. The resource cost from overproduction not only remains but is now compounded by the cost of exporting the surplus to supply these projects—though the unit costs are lower than that of international suppliers.[239] The State Council attempted to curb overcapacity in 2016 and 2017 by transferring labor to other enterprises and cutting production capacity by 10 percent where excess occurs, but the efforts have been minimal to avoid drastic SOE restructuring and market shocks like the coronavirus pandemic continue to fortify China's government stimulus strategy of retaining the existing methods.[240]

The geopolitical and domestic benefits may outweigh the fiscal burdens, but this convolutes the purely economic logics with political ones. BRI allows overcapacity to be justified on an international front using a global infrastructure development narrative while advancing China's economic growth model and political influence. Meanwhile, it does not address the root cause of overcapacity, which is a waste of manpower and materials. It may also alleviate some of the domestic employment and production pressures that have mounted in the last decade, but these are political problems that garner stability for the CCP more so than the economy. Overall, the evidence for employing overcapacity instead of reducing it provides a weak argument in support of economic logics.

3. Influence and Control of Global Markets

Chinese SOEs have grown in size and strength so much so that they are now able to inform how their respective sectors, and in effect, other facets of the global markets

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[238] Colin Peebles Christensen, "Private Firms in China Retreat as SOEs Advance," CKGSB Knowledge, March 25, 2019, https://knowledge.ckgsb.edu.cn/2019/03/25/chinese-economy/soes-versus-private-firms-in-china-retreat/.

[239] Min, *The Belt Road and Beyond*, 141. For examples of loss-making SOEs and BRI enabled recovery, see 139–42.

[240] W. Raphael Lam, Markus Rodlauer, and Alfred Schipke, "State-Owned Enterprise Reform," in *Modernizing China: Investing in Soft Infrastructure* (Washington, D.C.: International Monetary Fund, 2017), https://www.elibrary.imf.org/view/IMF071/23209-9781513539942/23209-9781513539942/ch11.xml?lang=en&redirect=true, 318; Hu Yongqi, "End Excess Capacity and Boost Quality, Li Tells SOEs," *China Daily*, May 24, 2016, http://europe.chinadaily.com.cn/china/2016-05/24/content_25433842.htm; Zhiyao (Lucy) Lu, "China's Excess Capacity in Steel: A Fresh Look," PIIE, June 29, 2017, https://www.piie.com/blogs/china-economic-watch/chinas-excess-capacity-steel-fresh-look.

operate. The Chinese government has strategically built up select SOEs to act as agents of China's national interests as they relate to foreign competition, market pricing, and resource security. The placement of these SOEs has afforded the Chinese government leverage over the global market but at substantial fiscal cost, causing mixed results for economic rationale.

Mentioned in Chapter II, China's "national champion SOEs"—those central SOEs that the State Assets Supervision and Administration Commission (SASAC) oversees—and their tens of thousands of subsidiaries have grown or merged since Xi came to power in 2012.[241] In official statements following the 2013 Third Plenum of the Eighteenth Party Congress, SOEs were destined to become larger and stronger with assistance from the government in order for them to "exercise a greater level of influence and control over the economy."[242] In 2020, China surpassed the U.S. for the first time with the total number of companies listed in the Fortune Global 500 ranking of the largest corporations in the world.[243] Even more impressive and concerning is that almost 75 percent of these 124 Chinese companies are SOEs that specialize and dominate in strategic sectors such as rare earths, telecommunications, energy, and shipping.[244] Explained in Chapter II, these SOEs are heavily subsidized by the Chinese government, protected from competition, and are not liable for antitrust violations.

In addition to the aforementioned domestic importance of commanding heights SOEs, these SOEs are being used to act on behalf of the Chinese state to purchase stakes

[241] James McGregor, *No Ancient Wisdom, No Followers: The Challenges of Chinese Authoritarian Capitalism* (Westport, CT: Prospecta Press, 2012), vii; Lam, Rodlauer, and Schipke, "State-Owned Enterprise Reform," 308.

[242] "State-Owned Enterprise Policy Reform," Asia Society Policy Institute and Rhodium Group, Spring 2020, https://chinadashboard.asiasociety.org/spring-2020/page/state-owned-enterprise; "The 13th Five-Year Plan," 34.

[243] China now has 124 companies listed to include those based in Hong Kong (the total including Taiwan would be 133) compared to 121 US companies. Geoff Colvin, "U.S.-China Relations Intensify as the Asian Superpower Is Home to More Global 500 Companies than America," Fortune, August 9, 2020, https://fortune.com/longform/us-china-relations-global-500-companies-trade-xi-trump-business/.

[244] Jude Blanchette, "Confronting the Challenge of Chinese State Capitalism," Center for Strategic and International Studies, January 22, 2021, https://www.csis.org/analysis/confronting-challenge-chinese-state-capitalism.

in foreign firms in order to control those firms' activities and influence global markets.[245] The NDRC has been granting funds to certain SOEs that have the position to purchase foreign firms' market shares to leverage international developments within their respective sectors. Once a large enough percentage of a foreign firm's shares are purchased, Chinese SOEs, which are controlled by SASAC, can influence and manipulate foreign companies to satisfy the interests of the state. Such interference has resulted in mergers blocked to limit firms from growing large enough to control a major portion of the global supply of natural or manufactured goods.[246] Economy explains one instance when "Beijing used the state-owned mining company Chinalco to control the global price of iron ore" using an under the table exchange. Norris reports that China's Chinalco aluminum corporation acquired a large enough share of stock through an after-hours purchase via the London Stock Exchange to keep Rio Tinto from merging with BHP Billiton that "would have left 70 percent of one of China's most strategic imports in the hands of two foreign suppliers."[247] These actions were not economically driven. Economy observes, "In the end... [Chinalco] ended up with a $10 billion loss; however...China's national interest paid off" and a merger was foiled that could have driven up the global price of iron ore eightfold.[248]

A trend has been unveiled that the Chinese government is not only ensuring resource security in multiple sectors to enable sustained economic growth, but the CCP also seeks to control the way those sectors run. Concurrently, as stated in Chapter II, China has been diligent in completing a number of mergers between major SOEs since 2012, and these SOEs have continued to grow from offshore asset acquisitions to eventually form into monopolies within their own sectors.[249] Furthermore, China is the only country with

[245] "China Reality Check: SOE Reform" (Center for Strategic and International Studies, June 8, 2016), https://www.csis.org/events/china-reality-check-soe-reform.

[246] Ibid.

[247] William J. Norris, *Chinese Economic Statecraft: Commercial Actors, Grand Strategy, and State Control* (Ithaca, NY: Cornell University Press, 2016), 1, http://ebookcentral.proquest.com/lib/ebook-nps/detail.action?docID=4517907.

[248] Economy, *The Third Revolution*, 110.

[249] Ibid., 110–11.

the ability to hold this much influence. Economy explains, "even as its SOEs take majority stakes in mines, ports, oil fields, and electric grids across the world, [China] prohibits other countries' multinationals from doing the same in China."[250] This gradual approach is effectively allowing a "decisive role of the market and industry" to transform the form and function of Chinese SOEs, but not in conventional terms. The Chinese government is taking control of the market and dominating industry without having to conform its SOEs into anything other than economically inefficient and politically masterful agents of the state.

The evidence for retaining SOEs to leverage the global market in various commanding heights industries is very strong, but the methods for acquiring that leverage and reasons for maintaining it are not entirely based on economic logics. China's quest to keep market prices artificially low also follows a political logic that mirrors the tenants of Communism and forfeits potential profits that could raise its SOEs' return on assets. A likely explanation of this derives from two of Xi's core domestic policy initiatives of raising the Chinese standard of living and achieving indigenously produced high-tech able to compete with top brands labeled "Made in China 2025," of which neither can be achieved without low-priced materials and services.

C. CONCLUSION

Overall, the three arguments provided mixed evidence for economic logics behind the strengthening of China's SOEs. The purely economic logics of allowing commanding heights SOEs to operate under the existing centrally controlled SASAC are largely undermined by their cumulative inefficiencies and overheads. After analyzing the SOE contributions to the three arguments of GDP growth, alleviating excess capacity through international infrastructure development, and global economic influence, the logics of strengthening SOE operations appear mixed from an economic standpoint.

Based on analysts' assessments, SOEs make a substantial contribution to China's overall production output and GDP growth, but this is largely accomplished at the behest

[250] Ibid., 17.

and expense of the government. The SOE share in GDP contributions is almost entirely due to government support of these firms through economic policy that favors the state sector, the reinforcement of natural monopolies, continued subsidization, and the promotion of projects generated for the purposes of utilizing the products or services of SOEs.

The central government's use of leveraging SOEs to influence global sectors, industries, and resources has resulted in positive short- and long-term economic outcomes such as resource security, price manipulation, and industry monopoly. These outcomes could only be achieved with heavy government oversight and guidance, providing strong evidence for sound economic logics behind SOE retention. However, these gains can equally support political logics as such influence can ultimately result in strategic diplomatic and political leverage in global affairs.

The overcapacity of SOEs has supplied numerous BRI projects and helps explain why SOEs continue to receive favorable resource allocation. However, SOEs' overcapacity issues continue to generate market distortions and lower the market price of products, which has generated international scrutiny against the central government's subsidization practices. Internal to China's economy, utilization of some excess capacity material for these projects masks the fundamental problem that overproducing has on SOEs' return on assets as well as the waste of resources and manpower in manufacturing it. They provide sizable material support to BRI programs, which helps the central government justify SOEs' excess capacity issues, but BRI does not present a long-term economic solution to this issue.

Based on SOEs' contributions to economic growth, international development, and global economic influence, the incentives of avoiding drastic SOE reform do not appear economic in nature. Instead, SOEs have been preserved to serve immediate and long-term national-level strategic goals.

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IV. POLITICAL LOGICS OF STATE-OWNED ENTERPRISE REFORM SINCE 2013

As Chapter III examined the economic logics behind state-owned enterprises (SOEs) since 2013, this chapter will assess the persuasiveness of some of the political logics behind SOE retention during that same period. These political arguments will reveal that there are some social benefits of SOEs, which garner social stability, thus, strengthening political stability for the dominant Chinese Communist Party (CCP). Based on the findings of Chapter II, the state of President Xi Jinping's SOE reform achievements since 2013 lack substantive pro-market progress and SOEs continue to operate inefficiently backed by government subsidies. The largest SOEs with their tens-of-thousands of subsidiaries (also known as "national champion SOEs") continue to provide insurmountable political leverage for the CCP by validating its regime over society.[251] The economic power of SOEs also create the means to implement or directly support national objectives in domestic and foreign policy.

This chapter identifies the political logics of SOE retention in three arguments: first, SOEs' impact on China's employment; second, their ability to stabilize the Chinese economy during periods market volatility in order to secure political stability; and third, their ability to marshal political, diplomatic, and security leverage on a domestic, regional, and global level. The strength of these arguments will be assessed to determine if political logics are behind SOEs' centralized control and dominance in the Chinese economy. The findings reveal that the political logics guiding SOE reform since 2013 are stronger than those arguing for economic logics based on the persuasiveness of evidence garnered from these three arguments. SOE contributions to employment are negligible on a numeric and efficiency scale, but serve a more significant role in social stability, which serves to protect political stability. The CCP's use of SOEs to alleviate economic slowdown and mitigate global crises also acts to preserve socio-economic stability, which strengthens the argument for use of political logics. Finally, the way SOEs have been leveraged to act on behalf of

[251] McGregor, *No Ancient Wisdom, No Followers*, vii.

the CCP to acquire diplomatic opportunities that strengthen China's position globally and the CCP's reputation domestically also offer compelling evidence in support of political logics.

This chapter will be organized starting with a brief examination of possible theories explaining how the CCP has retained its political monopoly while China's own private sector emerged and how it continues to utilize SOEs as policy enforcement institutions. Then, the three political arguments will be examined followed by an analysis of the results.

A. CHINA'S POLITICAL MONOPOLY

The CCP has retained its political monopoly over the last 70 years despite China's substantial pro-market transition. There are several theories that help to explain why this has occurred in China when most other former-Communist states have transitioned to a fully or majority-market economy with political diversity and free and fair elections. In several examples of post-Communist or semi-capitalist transitions, political stability was retained due to what King and Szelényi identify as "capitalism from below."[252] This phenomenon is characterized by a society's self-organized network of small enterprises or "integrated industrial clusters" operating within a market system under the radar of, and around the entry barriers established by, the central government.[253] Amidst this, Nee's theory of "the market power thesis" argues that the political monopoly was preserved within states such as China, Vietnam, Hungary, Poland, and Estonia for a period because financial gains from a growing capitalist influence were benefiting "direct producers" the most while undermining opportunities for exploitation along the supply chain.[254] This theory helps explain the CCP's attempts of political stability through its economic policy objectives within China such as eliminating poverty, increasing household incomes, and

[252] Lawrence King and Iván Szelényi, "Post-Communist Economic Systems," in *The Handbook of Economic Sociology*, ed. Neil J. Smelser and Richard Swedberg, Second (Princeton: University Press, 1994), 210–11.

[253] Victor Nee and Sonja Opper, *Capitalism from Below: Markets and Institutional Change in China*, Illustrated edition (Harvard University Press, 2012), 132–33, http://www.economyandsociety.org/wp-content/uploads/2017/10/capitalismfrombelow.pdf.

[254] Victor Nee, "A Theory of Market Transition: From Redistribution to Markets in State Socialism," *American Sociological Review; Washington* 54, no. 5 (October 1989): 666.

growing the Chinese middle-class. These objectives have not only been attempted but almost entirely achieved. According to the China Power Project, "over the last two decades alone, China's gross national income per capita grew more than ten-fold from just $940 in 2000 to $10,410 in 2019."[255] Using the World Bank's international poverty standard of approximately $1.90 a day, China has decreased its percentage among the total population to 0.5 percent.[256] This can be attributed to the high economic growth rates that China has achieved in the last two decades, which Xi and the CCP have openly declared as a political win.[257]

While corruption and arbitrage ran rampant in the decades prior to Xi's leadership and caused significant societal discord, the anti-corruption campaign launched by Xi in 2012 has improved the central government's reputability. As briefly explained in Chapter II, the vastness of this campaign further solidified President Xi's position in the years to follow by consolidating power around him and eliminating opposition within the CCP. As a result of the decreased corruption, the CCP under the leadership of Xi gained even more support from the Chinese population.[258]

The CCP continues to benefit from the substantial political leverage it wields from SOEs' dominance over the Chinese economy. This is in large part due to the ambiguity of proposed reforms and implementation methods—avoiding politically difficult large-scale commitments while using small-scale reforms to suggest progress toward marketization.

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[255] China Power Team, "Is China Succeeding at Eradicating Poverty?," *ChinaPower Project* (blog), October 23, 2020, https://chinapower.csis.org/poverty/.

[256] Maria Ana Lugo, Martin Raiser, and Ruslan Yemtsov, "What's next for Poverty Reduction Policies in China?," *Brookings* (blog), September 24, 2021, https://www.brookings.edu/blog/future-development/2021/09/24/whats-next-for-poverty-reduction-policies-in-china/. According to Gill, "For upper-middle-income countries like China, [the World Bank] reckons that a reasonable poverty line is $5.50 a day. In other words, the Chinese government uses a poverty line appropriate for a country making the transition from low- to lower-middle-income, even though China is 10 times as wealthy." Indermit Gill, "Deep-Sixing Poverty in China," *Brookings* (blog), January 25, 2021, https://www.brookings.edu/blog/future-development/2021/01/25/deep-sixing-poverty-in-china/.

[257] The State Council Information Office of and The People's Republic of China, "Poverty Alleviation: China's Experience and Contribution" (Foreign Languages Press Co. Ltd., April 2021), http://english.www.gov.cn/archive/whitepaper/202104/06/content_WS606bc77ec6d0719374afc1b9.html.

[258] Jiangnan Zhu, Huang Huang, and Dong Zhang, "'Big Tigers, Big Data': Learning Social Reactions to China's Anticorruption Campaign through Online Feedback," *Public Administration Review* 79, no. 4 (2019): 500–513, https://doi.org/10.1111/puar.12866.

Additionally, the politically instituted control structures from the State-Owned Asset Supervision and Administration Commission of the State Counsel (SASAC) have reconsolidated the CCP's ability to control SOEs to advance politically strategic objectives both domestic and international. Despite their economic burden explained in Chapter II, SOEs are maintained to carry much of the CCP's political power by enforcing policy. Kroeber observes, "[SOEs] are often used as instruments of macroeconomic policy and industry regulation in place of relatively weak formal policy and regulatory instruments. So the power and importance of SOEs are much greater than implied by economic statistics alone."[259] This will be examined further in the next section.

B. POLITICAL LOGICS OF CHINA'S STATE-OWNED ENTERPRISE SECTOR

This section analyzes the persuasiveness of strengthening and retaining SOEs based on political logics by examining three arguments that may present evidence of politically motivated SOE reform implementation since 2013. First, this section will examine SOE contributions to China's employment through current employment numbers, job growth, employment efficiency, and societal significance. The second argument examines the political logics of doubling down the financial support to, and centralized control of, SOEs in order to provide a stabilizer to China's economy during market shocks. The third argument explores SOEs' capacity to implement China's foreign and domestic policies that meet the CCP's strategic objectives to identify if their leveraging power is convincing to support political logics.

1. Contributions to China's Employment

The first argument that will be examined is the state sector's contributions to economy-wide employment.[260] In order to identify SOE contributions to employment of Chinese citizens, two factors can be examined: the rate of job growth in the labor market as it compares to the growing total population, and the existing number of Chinese

[259] Kroeber, *China's Economy*, 2016, 89.

[260] Economy-wide employment includes employment of workers 15-years of age or older that contribute to agriculture, industry, or service sectors.

employed by SOEs. Global and domestic market shocks since the 2013 Third Plenum include the Chinese equity market collapse in 2015 (better known as the Chinese stock market crash) and the global pandemic in 2020. China's total employment rate growth slowed or decreased significantly following those events, which are depicted in Figure 2. The rate increase seen during 2010 is largely due to China's drawn-out infrastructure stimulus package in response to the Global Financial Crisis (GFC) in 2008. While China's employment rate has rapidly grown after 2010 at a rate of 0.4 percent before it plateaued in 2016 and declined from 2018 on,[261] China's population has consistently grown at a rate of around 0.5 percent (Figure 3). During these periods, state sector employment has remained largely unchanged. The following paragraphs will explain how and why this has occurred.

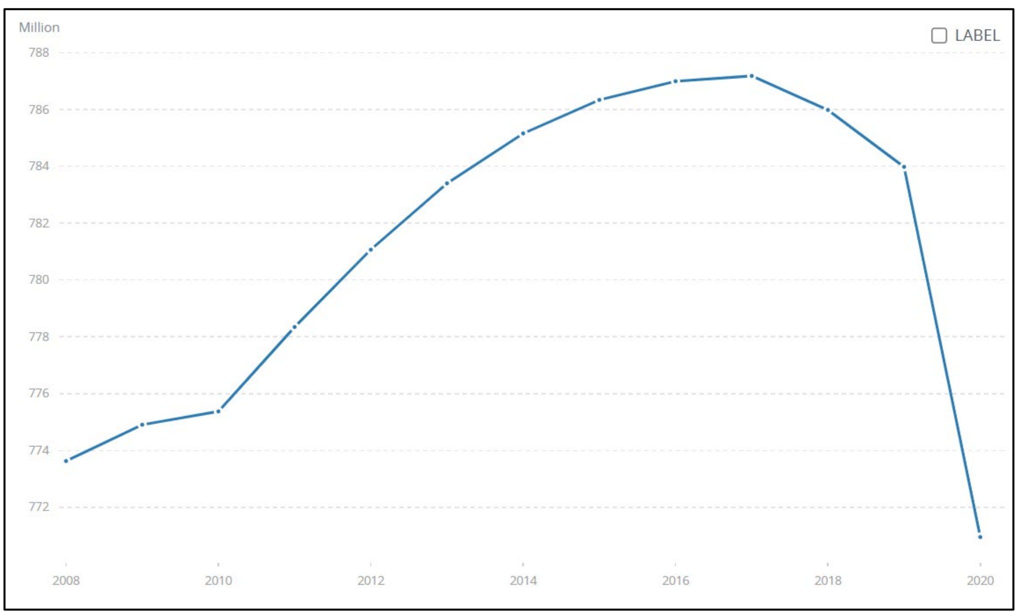

Figure 2. China's employment rate of workers 15 years of age and older between 2008 to 2020[262]

[261] Employment growth rates are 2009: 0.16%; 2010: 0.06%, 2011: 0.38%; 2012: 0.35%; 2013: 0.29%; 2014: 0.22%; 2015: 0.15%; 2016: 0.08%; 2017: 0.02%; 2018: -0.15%; 2019: -0.26%; 2020: -1.66% based on "Labor Force, Total – China Data," World Bank, June 15, 2021, https://data.worldbank.org/indicator/SL.TLF.TOTL.IN?end=2020&locations=CN&start=2008.

[262] Source: "Labor Force, Total – China Data."

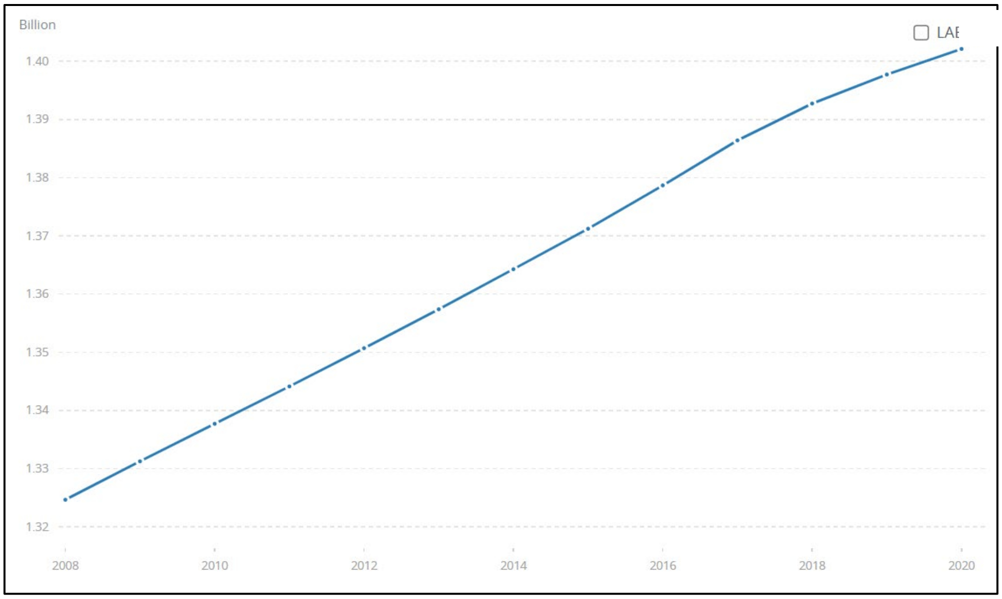

Figure 3. China's population growth rate was at 0.5 percent between 2008 and 2018, then dropped to 0.4 percent in 2019 and 2020.[263]

The accurate contributions of SOEs to China's employment is difficult to discern. Like other records from the National Bureau of Statistics, employment figures are listed under "state-owned units" without defining what those specifically entail, such as if these units include government, financial, and non-financial institutions and if these units incorporate 100 percent state-ownership or if the state holds the majority equity stake.[264] Furthermore, what constitutes as employment to be counted in these figures is not overt.[265] Based on the 2014 SASAC Yearbook, the non-financial state enterprise sector encompassing central and local state enterprises accounted for five percent (39.2 million) of economy-wide employment, of which 56 percent of that employment is within corporatized mixed-ownership firms, 24 percent is within corporatized SOEs, and

[263] Source: "Population, Total – China Data," World Bank, accessed August 16, 2021, https://data.worldbank.org/indicator/SP.POP.TOTL?end=2020&locations=CN&start=2008&view=chart.

[264] "China Statistical Yearbook 2019," National Bureau of Statistics of China, accessed August 10, 2020, http://www.stats.gov.cn/tjsj/ndsj/2019/indexeh.htm.

[265] For specific information on what employment figures refer to according to the National Bureau of Statistics, see Lardy, *Markets Over Mao*, 7.

20 percent is within non-corporatized firms in the state sector.[266] Analysts' estimations are similar to official reports, though with some disparities. Holz assesses that SOEs accounted for 4.7 percent (36.5 million) of all economy-wide employment in 2013.[267] Naughton assesses SOE employment in 2014 was 6.2 percent (48 million) compared to what he assessed to be 5.7 percent (44 million) in 2008, reflecting an increase in SOE employment from the previous decade.[268] Lardy calculates that state employment of non-financial sectors was at 5.9 percent (46 million) in 2016.[269] Even with this disparity in estimations, SOE contributions to employment are minimal to the overall labor force, reflecting higher numbers among the urban workforce (around 11 percent), which are still a relatively low contribution.[270]

Therein lies another issue with the state sector: SOEs are not generating new jobs. This places additional political strain on the retention of SOEs as civil unrest looms when SOE layoffs are announced. which the CCP needs to return to full employment, eliminate poverty, and strengthen social stability. Lardy assesses that "almost all of the growth of urban employment in China since 1978 is due to the expansion of private firms, including privately owned foreign firms."[271] This is confirmed by the State Administration for Industry and Commerce in 2016 which announced that "single-owner and private companies accounted for 90 percent of all new urban jobs."[272]

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[266] Naughton, "The Current Wave of State Enterprise Reform in China," 285. The Company Law (1994) enabled SOEs to become corporatized and improve corporate governance (establishing shareholders and a board of directors) whether they remained as "traditional SOEs organized under the old State Enterprise Law, or new corporations in which the state had a controlling interest." Naughton, *The Chinese Economy*, 345; "Company Law of the People's Republic of China (Revised in 2013)," fdi.gov.cn, accessed August 12, 2020, http://www.fdi.gov.cn/1800000121_39_4814_0_7.html.

[267] This percentage excludes state-owned financial institutions. Holz, "The Unfinished Business of State-Owned Enterprise Reform in the People's Republic of China," 10.

[268] Naughton, "The Current Wave of State Enterprise Reform in China," 285.

[269] Lardy, *The State Strikes Back*, 123.

[270] Ibid., 123.

[271] Lardy, *Markets Over Mao*, 84.

[272] Elizabeth C. Economy, *The Third Revolution: Xi Jinping and the New Chinese State* (Oxford University Press, 2018), 106; "Self-Employed, Private Firms Create a Third of Jobs in China," China.org.cn, February 8, 2016, http://www.china.org.cn/china/Off_the_Wire/2016-02/08/content_37759540.htm.

Even if the CCP were to achieve full employment, an inherently inefficient quality would remain within SOE employment: many SOE workers suffer from "hidden unemployment," which can surface in the following ways:

> (1) Cases when persons who should be employed part-time are employed full-time; (2) cases when employed persons waste their marketable skills against their wishes, albeit not cases when persons are employed below their skill level either voluntarily or because their skills are not marketable; and (3) cases when enterprises and organizations employ or are commanded to employ more people than they need due to some non-economic considerations, i.e., are overmanned.[273]

Analysts observed all three trends in SOE employment in the 1990s—redundancy being a particularly problematic issue—but all three these issues continued to exist within SOEs up into the 2010s and likely remain in large SOEs and their subsidiaries today.[274] Alternatives to these inefficient practices include employee transfers to other, more efficient firms. But many of the consolidated central SOEs suffer from the same hidden unemployment and overcapacity issues—and it is especially difficult to allocate workers when the global economy slows down and causes deeper financial losses.

The problem of excess capacity examined in Chapter II is closely linked with this issue. In 2016, Chinese officials admitted that "cutting capacity is politically difficult for the Chinese government because it risks creating a surge in unemployment and a sharp deceleration in growth."[275] A report by the European Union Chamber of Commerce in China identifies why cutting excess capacity production has not manifested. First, local governments will serve to protect industries within their jurisdiction in order to maintain employment levels and retain tax revenue. Second, in towns or regions where overcapacity industries are the main or only sources of tax revenue, employment, and funding of other

[273] Edward X. Gu, "From Permanent Employment to Massive Lay-Offs: The Political Economy of 'Transitional Unemployment' in Urban China (1993–8)," *Economy and Society* 28, no. 2 (May 1, 1999): 283, https://doi.org/10.1080/03085149900000006. (summarizing J. L. Porket, "Hidden Unemployment," in *Unemployment in Capitalist, Communist and Post-Communist Economies*, St Antony's/Macmillan Series (London: Palgrave Macmillan UK, 1995), 38–47, https://doi.org/10.1057/9780230374225_5.)

[274] "China: Reform of State-Owned Enterprises" (Washington, D.C.: World Bank, June 21, 1996), http://documents1.worldbank.org/curated/en/114421468770439767/text/multi-page.txt.

[275] "2016 Annual Report to Congress," 103.

services, a disruption of this production would threaten social stability in those regions. "Without a functioning social welfare system, keeping as many employees on the payroll—even at highly reduced wages—and producing low-end goods is preferable to overturning the established social order. This is especially the case when workers do not have highly transferable skills or strong prospects for reemployment in a slowing economy."[276] And third, removing the practice of excess capacity would forfeit the central government's ability to guide China's internal economic development and control global industrial sectors—a fundamental problem akin to SOE reform overall.[277]

The problem of state sector employment has long been a burden on China's labor reform efforts, stalling layoffs to avoid civil unrest from the backlash of massive jobs cuts.[278] The SOE reforms of the 1990s under the "grasp the big, letting go of the small" slogan had initiated widespread privatization or bankruptcy of smaller SOEs, effectively cutting SOE employment from 70 million to 37 million by the mid-2000s.[279] SOE employment before the Labor Contract Law in 2008 guaranteed comprehensive welfare services and lifetime employment, and if individuals were laid off, they received severance pay until the found other work.[280] Today, SOE employment is structured in a way that is unrecognizable from its social guarantees of the decades prior. Lardy explains that "employment is now via voluntary contracts, between workers and employers, wages are by and large market determined, and formal lifetime employment has disappeared."[281] State employment has become far more marketized with less guarantees, though Economy observes that "some still play a significant role in social welfare, providing for the housing, education, medical, and other needs of their workers."[282] Market fluctuations since the Asian Financial Crisis (AFC) in 1997 instigate further concern for state employees

[276] "Overcapacity in China: An Impediment to the Party's Reform Agenda," 40.

[277] Ibid., 40.

[278] Lardy, *The State Strikes Back*, 122–24.

[279] Economy, *The Third Revolution*, 105; Kroeber, *China's Economy*, 2016, 93–94.

[280] Louise do Rosario, "A Social Contract: Chinese Workers Cling to Their Iron Rice," *Far Eastern Economic Review; Hong Kong* 140, no. 19 (May 12, 1988): 72.

[281] Lardy, *Markets Over Mao*, 20.

[282] Economy, *The Third Revolution*, 106.

prospectively looking for work in the private sector. As private businesses temporarily shut down operations or close altogether, SOEs continue to operate at full speed—providing a crucial guarantee of continuous work to the employee devoid of market influence. This factor plays a crucial role in another argument within this chapter.

The CCP likely recognizes the uncertainty of private sector labor stability, particularly in the last two years, and has reason to continue subsidizing inefficient SOEs to maintain a semblance of stability within the socialist aspects of its economic structure that still remain. Attempts made by the State Council in 2016 to curtail the excess capacity trends of SOEs resulted in half a million layoffs and three-quarters of a million employees resettled to different firms.[283] These numbers are substantially lower than the 1.8 million layoffs that Human Resources and Social Security had drafted to implement.[284] This is likely due to the CCP's concern for further social unrest following twice the amount of labor protests between 2014 and 2016 and China's slower GDP growth rate when compared to the turn of the century.[285] The over-staffed and inefficient SOEs retain employment at their existing rates to stave off some of the pressure the CCP has created for itself when it set out to eliminate poverty, increase household incomes, and grow the Chinese middle-class.[286]

Based on these findings, SOE contributions to employment remain insignificant on a numeric scale, lack growth potential, and are inefficiently resourced, but are substantially more significant for their role in the CCP's view of social stability. Lardy observes that there was also a decline in GDP growth from 10 percent to 8.1 percent during the same time when SOE reform eliminated 37 million jobs in the 1990s, arguing that "there is little evidence that this downsizing and the accompanying moderation in economic growth led

[283] Zhiyao (Lucy) Lu, "China's Excess Capacity in Steel."

[284] Kevin Yao and Meng Meng, "China Expects to Lay off 1.8 Million Workers in Coal, Steel Sectors," *Reuters*, February 29, 2016, sec. Business News, https://www.reuters.com/article/us-china-economy-employment-idUSKCN0W205X.

[285] Economy, *The Third Revolution*, 109.

[286] Xi Jinping, "Address to the First Session of the 12th National People's Congress," The National People's Congress of the People's Republic of China, March 17, 2013, http://www.npc.gov.cn/englishnpc/c23934/202006/7954b8df92384c729c02be626840daed.shtml.

to massive labor unrest."[287] Regardless, the perceived threat that the CCP views as the potential response to layoffs is the metric used to validate the political logics of avoiding meaningful SOE reform, despite what the actual public response may be following this action. The political stability that the CCP believes it maintains from SOEs' social and economic contributions to employment strengthens this argument for political logics driving SOE retention.

2. SOE Financing and Economic Stabilization during Crises

In July of 2018, Politburo statements expressed that maintaining stability was to remain the prominent goal of China's economic policy, which would include growing employment, trade, investment, and social stability.[288] In 2017, the government began repressing shadow banking in order to reduce financial risk—one of the six areas of focus to achieve stability that the government later announced, which created a massive impact on private sector lending.[289] As a result, private-owned assets in 2018 grew only 2.3 percent, a lower rate than 2018 SOE asset growth for the first time in decades. This shift indicates that the government perceives that it will achieve stability through SOE dominance, so long as it retains its mechanisms of control over the allotment of SOE support and their strategic activities. This reflects a reversal of Naughton's characterization of China's market economy which "gradually grew out of the plan" in 1989.[290] Instead, since Xi took power, China's marketizing economy has "given way to a resurgence of the role of the state in resource allocation and a shrinking role for the market and private firms"—a trend Lardy examines in *The State Strikes Back*.[291] While this seems counter-intuitive in today's global economy, there are several political explanations behind this logic.

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[287] Lardy, *The State Strikes Back*, 123.

[288] "Editorial: How China Must Balance Transformation, Stability," Caixin Global, August 7, 2018, https://www.caixinglobal.com/2018-08-07/editorial-how-china-must-balance-transformation-stability-101312407.html.

[289] Christensen, "Private Firms in China Retreat as SOEs Advance."

[290] Naughton, *Growing out of the Plan*, 13.

[291] Lardy, *The State Strikes Back*, 2.

Guaranteeing the continuity of SOE operations through government subsidization or lending at preferential rates can alleviate some of the effects of market shocks because many domestic businesses potentially use SOE-supplied products or services, allowing access to materials and services to partially continue uninterrupted. Stone et al. observes, "During the turmoil in China's stock market in summer 2015, for example, SASAC ordered the centrally controlled SOEs to hold shares to stabilize prices."[292] Not only are they subject to state mandates, but SOE contributions to China's supply chain are still substantial 40 years after China's economy initially opened. The centrally controlled "commanding heights" SOEs are embedded in vital industrial sectors and services such as transportation, telecommunications, energy, infrastructure, petrochemicals, metals, and heavy machinery.[293] The continuation of SOE operations ensures the continuation of products and services available to mixed and privately-owned companies with stable rates and timelines. If these estimates of SOEs' impact on China's economy are relatively accurate, government subsidization and preferred lending rates to SOEs can provide some stability to China's economy during global market volatility because imports and production within SOEs can endure uninterrupted.

China has navigated multiple economic crises, a global pandemic, and waves of market fluctuations in the past 25 years without devastating economic fallout. Government-funded stimulus packages implemented in response have guided and supplied economic growth continuity within all sectors through the turmoil following the AFC, the GFC, the Chinese stock market crash, and in the recent global pandemic. When China's stock market crashed in the summer of 2015, Leutert observes that "Chinese stock market turmoil solidified conservative political elites' conviction that party-controlled *yangqi* [centrally controlled SOEs] are an essential part of the government's toolkit for averting financial crisis."[294] Furthermore, Lam et al. discerns that "SOEs were often a policy tool to stabilize

[292] Randall W. Stone, Yu Wang, and Shu Yu, "Chinese Power and the State-Owned Enterprise," *International Organization*, August 5, 2021, 1–22, https://doi.org/10.1017/S0020818321000308; *Xinhua*, "China Asks Central SOEs Not to Sell Shares amid Market Volatility," *Xinhua*, July 8, 2015, http://english.www.gov.cn/state_council/ministries/2015/07/08/content_281475142852592.htm.

[293] Kroeber, *China's Economy*, 2016, 94.

[294] Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," 90.

macroeconomic shocks, at times when the government advanced on other economic reforms."[295]

Even through the recent market shocks, China's strategy to achieve economic stability during various economic interruptions through its SOEs appears to be sound. In the Spring 2020 quarterly analysis, the Asia Society Policy Institute observed that "SOEs were central to China's response to the virus outbreak, for example, by building new hospitals in Wuhan in just a few weeks, maintaining supplies of key materials, supporting other firms by waiving rent (or simply paying their arrears), and helping to stabilize employment while most of the private sector was forced to shut down."[296] These expeditious and sweeping procurements and projects were undoubtably achieved because of SOEs' centralized control.

Based on these findings, the CCP's ability to leverage its centrally controlled SOEs to soften market shocks, maintain production output, and counteract negative effects during periods of global economic volatility are compelling. The political stability that the CCP believes it will maintain from its ability to marshal economic stability engineered through SOEs strengthens this argument for political logics driving SOE retention.

3. Political, Diplomatic, and Security Leverage

SOEs, which were once the key developers of China's industrial base, are now the key "agents of the Chinese state" on international matters in both political and economic spheres.[297] Analysts like Lardy, Economy, and Komesaroff view the decision of Xi and the CCP to strengthen and consolidate SOEs to be one guided by their long-term strategic role in China's future through domestic stability, the global economy, and the world order. President Xi and the CCP may see past the shortcomings of SOEs' economic performance and measure their impact on China's overall economy through their capacity to manage

[295] W. Raphael Lam, Markus Rodlauer, and Alfred Schipke, "State-Owned Enterprise Reform," in *Modernizing China: Investing in Soft Infrastructure* (Washington, D.C.: International Monetary Fund, 2017), https://www.elibrary.imf.org/view/IMF071/23209-9781513539942/23209-9781513539942/ch11.xml?lang=en&redirect=true, Annex 11.2.

[296] "State-Owned Enterprise Policy Reform."

[297] Economy, *The Third Revolution*, 108–10.

and monopolize the world's energy and mining resources, and their ability to enable broader strategic economic objectives such as projects within the Belt and Road Initiative (BRI). SOEs are the state's primary sources of revenue, without which the government would not be able to execute its macroeconomic policies, nor would China be able to fund its growing defense budget each year.

Previously examined in Chapter III, commanding heights SOEs have been used as a front for China to gain partial ownership of competing international firms in order to influence global market prices.[298] SOEs have also served to secure access to a diversified supply of natural resources and energy in order to "minimize China's exposure to any one source of natural resources."[299] China remains the world's top natural resource consumer. Economy reports, "In 2015, it consumed 54 percent of the world's aluminum, 48 percent of the world's copper, 46 percent of the world's zinc, 28 percent of global soybeans, and 12 percent of the world's oil supply."[300] With aspirations to sustain high, long-term economic expansion, Chinese leadership had to mitigate sourcing vulnerabilities, which is no small feat for a state with such a heavy dependence on imported materials to continue its economic growth.

The relationship between SOEs and state objectives goes both ways. SOEs have been used to leverage China's diplomatic efforts in the region and world, but diplomatic engagement has also leveraged new business opportunities that utilize state sector firms. With a strong—albeit often coercive—track record of new infrastructure development in underdeveloped states, China's diplomatic commitments have become synonymous with their promotion of economic commitments. Particularly when directives come from the Ministry of Commerce (MOFCOM), centrally controlled SOEs are responsible for greatest volume of foreign direct investment (FDI). According to Stone et al. data taken from MOFCOM between 2000 to 2013 of nearly 27,000 transactions within 180 states by almost

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[298] Norris, *Chinese Economic Statecraft*, 1.

[299] Ibid., 56.

[300] Economy, *The Third Revolution*, 208.

19,000 firms identified this trend.[301] "State guidance is associated with more investment by firms of all types, but the estimated effects are substantially greater for state-owned and large firms. Firms that are not state-owned are estimated to increase investment by 74 percent when a country is added to the preferred list, while SOEs increase investment by 1.9 times, and centrally controlled firms increase it by 6.6 times."[302]

There has been substantial political pressure on SOEs to pursue high-risk investments since the BRI launched in 2013 especially. Guaranteed financial support has enabled SOEs to commit to loss-making investments with little to no retribution.[303] Stone et al. observes, "China deploys its FDI for political purposes in a way that is analogous to foreign aid, rather than treating FDI as conventional investment. Since FDI is the leading source of international capital flows, attracting FDI is crucial to the economic strategies of developing countries. Chinese FDI now dwarfs flows from multilateral organizations and U.S. foreign aid, and Chinese global influence has grown in proportion."[304]

SOE investments have not only resulted in infrastructure and natural resource agreements in developing countries; SOEs have also been pressured to invest in technological sectors in the U.S. and Europe. Economy recounts that President Xi instructed Chinese firms to invest in services and technology sectors that would usher in new tech and innovation into Chinese industry in order to develop the quality and value of goods and services derived from China.[305] This was heralded under another of Xi's leading domestic policy initiatives, "Made in China 2025," which would in part achieve his larger objective of "a moderately prosperous society" in China.[306]

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[301] Stone, Wang, and Yu, "Chinese Power and the State-Owned Enterprise."

[302] Ibid.

[303] Economy, *The Third Revolution*, 15.

[304] Stone, Wang, and Yu, "Chinese Power and the State-Owned Enterprise."

[305] Economy, *The Third Revolution*, 121–51, 209.

[306] Scott Kennedy, "Made in China 2025," Center for Strategic and International Studies, June 1, 2015, https://www.csis.org/analysis/made-china-2025; Xi Jinping, "Address to the First Session of the 12th National People's Congress."

Based on these findings, the success of centrally controlled SOEs to act as agents of the CCP to implement China's domestic and foreign policy objectives support this argument in favor of political logics. Whether for economic security or political security, the strategic sectors of commanding heights SOEs are an extension to the CCP's already incontrovertible rule in China, and to its growing influence in economic activities domestically and globally. With the CCP at the helm of these massive enterprises, SOEs not only enable China to gain economic and diplomatic access and advantages, but they also obstruct other states from acquiring the same. Retaining centralized control and strengthening SOEs for these purposes provide a strong argument for political logics.

C. CONCLUSION

The government is compelled to find ways to generate new jobs for Chinese citizens, which occurs almost exclusively through the private sector. SOE employees may have more job security than if they were to work for conventional private firms, but modernization of SOE employment conditions have removed many guarantees and welfare service requirements that SOEs used to provide. Furthermore, SOEs do not generate new jobs and some of those employed within SOEs may be suffering from hidden unemployment. But the government also seeks to preserve SOE employment for the purposes of retaining political leverage over the economy and avoiding further social unrest as a result of SOE job cuts. Based on strictly political logics, retaining SOE employment curbs a potential resurgence of social discontent while preserving a bastion of the socialist market economy that justifies the CCP's dominance.

The CCP's use of SOEs during market shocks and global unpredictability offer a strong argument in favor of the political logics behind SOE retention. The AFC in 1997, the GFC in 2008, China's stock market crash in 2015, and the coronavirus pandemic in 2020 provide substantial justification for the CCP to retain its ability to stabilize a vital pillar in China's society, which also shoulders much of the CCP's political strength.

Finally, political preservation is the state's top objective, as well as its greatest vulnerability. SOEs have served to shield the CCP from potential vulnerabilities in more ways than this chapter can encompass. Yu aptly observes, "Although Xi has called for the

SOEs to become more efficient and competitive, protecting state assets through strengthening the Party's control is the first priority."[307] Furthermore, implementing China's foreign and domestic policies through these mega economic puppets enables the state to accomplish its strategic objectives without drawing explicit international condemnation with every business decision.

Overall, the evidence behind these three arguments is very persuasive in favor of political logics driving the state of SOE reform in China.

[307] Hong Yu, "Reform of State-Owned Enterprises in China: The Chinese Communist Party Strikes Back," *Asian Studies Review* 43, no. 2 (April 3, 2019): 346, https://doi.org/10.1080/10357823.2019.1590313.

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V. CONCLUSION AND POLICY RECOMMENDATIONS

This thesis characterized the condition of state-owned enterprise (SOE) reform under Chinese President Xi Jinping, which lack substantive pro-market progress and SOEs continue to operate inefficiently backed by government subsidies. Chapters III and IV examined whether economic or political logics better explain why certain policy choices were implemented since 2013. The use of political logics provided the strongest explanation of the two. The Chinese Communist Party (CCP) has used SOEs to retain social and political stability while navigating domestic and global crises. SOEs have also acted on behalf of the CCP to achieve national objectives and spread China's international diplomacy and influence worldwide. Analysis of use of economic logics resulted in a mixed explanation of SOE strengthening. While SOEs enabled economic infrastructure development internationally, their systemic inefficiencies and preferential treatment in their access to capital and resources diverted economic opportunities and resources away from competitive and efficient private businesses, creating what analysts believe to be a significant lag on China's economic growth potential. However, because of SOEs' size and strength, China has gained the ability to both develop proprietary economic relationships with other states and influence global market prices—something that would not exist if SOEs were left to compete or privatize.

Based on the analysis of the economic and political logics, it is evident that the pace and scope of China's SOE reform has been galvanized by the political agenda of the CCP. However, the examination of both economic and political logics of SOE reform has proven that the two are inseparable from each other. The CCP's motives are to achieve as much economic growth and efficiency as possible—despite the inefficiencies that SOEs are allowed to sustain—and cannot be achieved without a stable political system. SOEs have been allowed to survive because they prop up national objectives set by Xi and the CCP, many of which have economic and political benefits. As Naughton observed, government-controlled prices enabled SOEs to become profitable despite their inefficiencies and continue to be the CCP's "the main source of government revenue," which "[gives] the Chinese government the fiscal capacity to mobilize resources" in order to achieve its national objectives.[308] Xi's reforms that allowed SOEs to retain their "leading role" in China's economy and bolstered them up to increase their "vitality, controlling force, and influence" have only reaffirmed the CCP's leveraging capacity.[309]

The next section will attempt to identify some of the hazards that SOE present to the U.S. that were not covered in previous chapters but are worth mentioning. The last section will offer a selection of policy recommendations offered by the U.S.-China Economic and Security Review Commission (USCC) to counter China's growing influence through employing SOEs in various ways.

A. RISKS THAT SOEs PRESENT TO THE U.S.

China's failure to meet competitive neutrality because of its preferential treatment of SOEs creates hazards for the U.S. and global markets worldwide. Due to its size and scope of market influence, Borst observes that "the ability of foreign businesses to compete within these sectors is either limited formally by law or constrained through the monopolistic position of SOEs."[310] Furthermore, the financial bailouts and subsidies that SOEs continue to receive "demonstrate how China's banking system remains captive to state and Party interests, and banks may make decisions on a political basis that harm U.S. investors' financial interests."[311]

As discussed in Chapter II, China's banking system has a two-decades long history of approving high risk loans and have developed ways to mitigate recapitalization and repair their balance sheets with the use of asset management companies. Still, the threat of a financial crisis looms as China's debt to gross domestic product ratio continues to climb

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[308] Barry Naughton, *The Chinese Economy: Adaptation and Growth*, Second edition (Cambridge, Massachusetts: The MIT Press, 2018), 71.

[309] "Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform," China.org.cn, January 16, 2014, II.7, III.10, http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602_2.htm.

[310] Nicholas Borst, "Has China given up on State-Owned Enterprise Reform?," The Interpreter by The Lowy Institute, April 15, 2021, https://www.lowyinstitute.org/the-interpreter/has-china-given-state-owned-enterprise-reform.

[311] Virgilio Bisio, "China's Banking Sector Risks and Implications for the United States," *U.S.-China Economic and Security Review Commission*, May 27, 2020, 19.

each year. However, the CCP remains committed to its own survivability and the reputation of its socialist-capitalist model. It's unlikely that it will allow its banks to become the root cause of the region or world's next financial crisis. Bisio confirms,

> [Chinese] authorities have so far successfully contained isolated bank failures and prevented sector-wide contagion, though the economic shock of COVID-19 could complicate this strategy by hurting overall bank profitability. If the current pandemic does lead to sustained problems in China's financial sector, exchange rates are the most likely channel through which economic pain could be transmitted to U.S. investors, as an RMB devaluation would reduce the dollar value of their mainland assets.[312]

B. POLICY RECOMMENDATIONS

This section contains recommendations that could counter some of the economic advantages Chinese SOEs receive and their impacts on the U.S. economy if they were implemented by U.S. policymakers. These recommendations aim to ameliorate or deter the CCP and Chinese SOEs from advancing their influence on U.S. and global markets as well as their impact on U.S. production capacity, access to resources, and national security. As Zhang observes, the U.S. continues to hold substantial influence over China's economy as it's "still China's most important foreign market. China still needs the United States for technological transfers and high-tech products. Additionally, the United States also has leverages in the realm of foreign direct investment, as China has been pushing its indigenous companies to be globally competitive."[313] Furthermore, all of these recommendations may be considered for implementation by other governments as well to achieve maximum effectiveness against SOEs' rising influence worldwide.

First, recognizing that Chinese SOEs are impacting more than just the U.S. economy and US-based investors, the U.S. government should emphasize a coordinated approach with like-minded states to not only condemn the CCP's coercive activities in international institutions but also develop protections among these states against victimization and destabilization from China's market distortions. A first step in this

[312] Ibid., 19.

[313] Ketian Vivian Zhang, "Chinese Non-Military Coercion—Tactics and Rationale," *Brookings* (blog), January 22, 2019, https://www.brookings.edu/articles/chinese-non-military-coercion-tactics-and-rationale/.

juncture should announce the shift in China's economic status from a developing economy to a developed economy within international institutions such as the World Bank, the World Trade Organization, and the International Monetary Fund. This would be supported by China's own statements of irradicating poverty within its own state.[314] The USCC supports this approach based on its 2021 Annual Report to Congress, which recommends "forming an economic defense coalition with allies and partners...to provide mutual support in the event of economic coercion by the People's Republic of China (PRC) against a coalition member."[315] This coalition would consider the following actions: "commitments not to seek, at the expense of the coerced party, market share created by China's action; Formal complaints to the World Trade Organization (WTO); Assistance to the coerced party to reduce its incentive to comply with Chinese demands; and Imposition of retaliatory measures against China in support of the coerced party."[316]

The second recommendation seeks to clarify the PRC's opaque labeling of state-owned entities in records such as China's Statistical Yearbook and the like in order to accurately target appropriate entities with sanctions. Additional measures may include the development of a blacklist of Chinese firms that are identified as acting on behalf of the CCP or participating in coercive economic practices that undermine competitive neutrality. This list could be widely disseminated to dissuade U.S. and international investors and companies from engaging with those firms. USCC also recommendations that the U.S. Government gain transparency into Chinese entities operating on behalf of the CCP and "pass legislation that defines categories of Chinese persons, Chinese entities, and [CCP] related persons and entities subject to full blocking sanctions and inclusion on the U.S. Department of the Treasury's...list due to actions that harm the vital national interest or the national security of the United States."[317]

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[314] The State Council Information Office of and The People's Republic of China, "Poverty Alleviation: China's Experience and Contribution" (Foreign Languages Press Co. Ltd., April 2021), http://english.www.gov.cn/archive/whitepaper/202104/06/content_WS606bc77ec6d0719374afc1b9.html.

[315] "Comprehensive List of the Commission's Recommendations" (Washington, D.C.: U.S.-China Economic and Security Review Commission, November 2021), 491, https://www.uscc.gov/sites/default/files/2021-11/2021_Comprehensive_List_of_Recommendations.pdf.

[316] Ibid., 491.

[317] Ibid., 495–96.

The third recommendation seeks to identify and diminish supply chains between the U.S. and China that enable the PRC to acquire critical material and resources that undermine U.S. economic prosperity and threaten U.S. national security. The USCC also recommends that "Congress consider legislation to create the authority to screen the offshoring of critical supply chains and production capabilities to the PRC to protect U.S. national and economic security interests and to define the scope of such supply chains and production capabilities."[318] Furthermore, the USCC recommends that this authority "develop procedures to evaluate existing and proposed supply relationships with the PRC and identify whether critical U.S. interests are being adversely affected, including the loss of domestic production capacity and capabilities."[319]

The fourth recommendation aims to weed out CCP influence within U.S. companies operating in China by regularly screening those companies to identify if there are CCP members or a CCP-influenced committee that informs U.S. companies' operations or business objectives. USCC also recommends that "Congress direct the Bureau of Economic Analysis at the U.S. Department of Commerce to amend its surveys of U.S. multinational enterprise activity in China to report on the presence and actions of CCP committees in the foreign affiliates of U.S. firms operating in China."[320]

Although the CCP has created a significant foothold in many of the critical sectors through its national champion SOEs, the implementation of these policy recommendations will obstruct the CCP's progress in achieving its coercive national objectives. International policy adoption of these recommendations would create greater disruption of Chinese SOEs' coercive influence on the U.S. and global markets.

[318] Ibid., 494–95.

[319] Ibid., 494–95.

[320] Ibid., 495.

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