SOE policy

Profiting the SASAC way

by Barry Naughton

Since their low point in the mid-1990s, China's state-owned enterprises (SOEs) have made a stunning return to profitability. In the mid-1990s, industrial SOEs were losing almost as much money as they were making. At the low point in 1997, once all losses were set off against all profits, the entire state-owned industrial sector made total profits just below 0.6% of GDP. Since then the world has changed dramatically: in 2007, state industrial enterprises made over Rmb1 trn of profits, equal to 4.2% of GDP. Non-industrial SOEs racked up another 2% of GDP in profits.

State-owned enterprises have made a stunning return to profitability since the mid-1990s

How was this remarkable turnaround achieved? There is no simple answer to this question. Many factors contributed, some accidental and unforeseen; yet behind this multiplicity lies the consistent focus of the Chinese government on returning firms to profitability. The government has been willing to subordinate other agendas – such as privatization – to the quest for a robust state enterprise sector that was financially self-sufficient and able to contribute to the government revenue base as well. Since 2002, the primary executor of this agenda has been the State-owned Assets Supervision and Administration Commission (SASAC). SASAC did not cause the return to profitability, but in crucial respects it facilitated the most important changes. In this article I look first at the most important immediate causes of the profitability revival, then examine SASAC's agenda today, and conclude with a consideration of the likely direction of state enterprise reform in the next few years.

A host of factors contributed to the state sector's revival ...

The great shut-down

The sequence of causes leading to the SOE profitability surge goes something like this. In the late 1990s, China's leaders finally developed the political will to shut down loss-making enterprises. As a result, they created a much stronger group of state companies which operated increasingly in a few market-protected sectors. These firms were then well positioned to take advantage of a cyclical investment boom in China and the consequent global resources boom. These factors would not have been enough, however, without the additional reforms enacted by SASAC, and preferential government policies that favored state firms.

... including continued preferential treatment

The closure of thousands of loss-making enterprises was the essential starting point. Much of the apparent financial weakness of the state sector in the 1990s came from the persistence of zombie firms which the government feared to shut down and whose losses canceled out two-

Closing loss-making firms was the starting point

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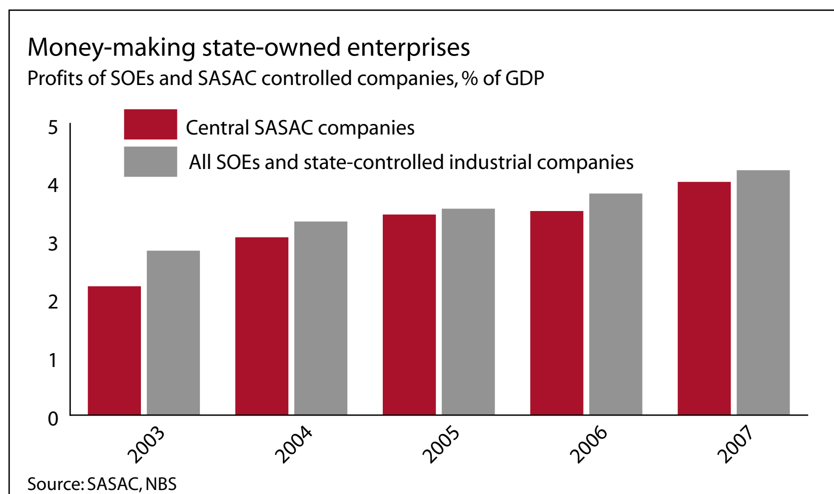

China still has some 26,000 state-owned enterprises

thirds of the profits of solvent SOES. The number of industrial SOEs fell from its mid-1990s high point of 80,000 to 26,101 by the end of 2006, and the process of clearing out the dead wood is still ongoing. The most recent round of government-managed closures, through the end of 2006, pushed 4,251 firms through administrative bankruptcy and reassigned 8.4 m workers..

The remaining SOEs are concentrated remaining firms in a handful of strategic sectors

This downsizing increasingly concentrated state firms in several strategic sectors. Industrial state firms now primarily operate in energy and power, industrial raw materials, military industry and large-scale machinery-building; state firms also dominate the transport and telecommunications sectors. All these sectors have high barriers to entry, sometimes because non-state competitors are simply forbidden (as in oil, telecoms, electricity generation and military equipment). In other cases, high capital requirements combine with discriminatory regulatory treatment to discourage non-state entrants, even when they are theoretically allowed (steel, non-ferrous metals and airline transport).

Competition works

Very few large state firms enjoy absolute monopolies

An important nuance is that while large state firms have some market power, they almost never have absolute monopolies, so they are exposed to continuous competitive pressure. In sector after sector, planners have created oligopolies where two or three large state firms compete with each other. Three national oil companies produce all of China's oil and gas; four telecom companies provide all basic telecom services; three airline companies carry 82% of the domestic air passengers. These companies enjoy enough protection that they can earn rich profits, but not so much protection than they can enjoy a "quiet life," the ultimate, stagnant reward of a pure monopolist. In a few sectors, large, centrally-run flagship firms operate in a fiercer competitive environment. Baosteel and Chinalco have the most expensive and sophisticated production technologies in their sectors, and are moving out on to the global stage.

This combination of protection and competition has produced large, and apparently sustainable, profits for the 153 enterprise groups directly under central government control via SASAC. SASAC-controlled firms' aggregate profits rose from 2.2% of GDP in 2003 to 4% in 2007. Profits are heavily concentrated: in 2006, nine enterprises accounted for 69% of SASAC firms' aggregate profit (equal to 2.5% of GDP): PetroChina, Sinopec, CNOOC, China Mobile, China Telecom, Baosteel, Chinalco, Shenhua Energy, and the State Electricity Grid.

Protection combined with competition has led to large, apparently sustainable profits

Control of resource extraction and processing sectors by central SOEs has meant that they have profited handsomely from the global resource boom – which in turn is largely a result of the Chinese investment boom that SOE restructuring helped create, and which changed global relative prices massively in favor of raw materials. Of the nine firms just mentioned, four are upstream producers of oil, gas or coal, and two are dominant producers of steel and aluminium, key construction materials. Increasingly, SOE resource firms are expanding production overseas, meaning that their profits are not limited by domestic resource constraints. The three state oil companies produced 35 m tons of oil overseas in 2006, along with 184 m tons domestically. Chinalco is now limiting new investments at home and focusing on construction of smelters overseas where energy costs are lower.

Resource companies have fared particularly well

Making the grade

Concentration in high-margin natural resource and heavy industry sectors does much to explain the resurgence in SOE profits, but an additional factor is the firm-level reform drive that since 2002 has been overseen by SASAC. SASAC did not invent this program: some of these reforms have been around for so long that it is a shock to realize that they are only now being implemented in many state firms.

Company-level reforms are still being implemented at many firms

The earliest key step was the reorganization of SOEs under the 1995 Company Law. Such corporatization was greatly accelerated by SASAC, which was created in 2002 to represent central-government shareholder interests in 196 major enterprise groups, a figure since reduced to 153, mainly through mergers.* Of the firms under central SASAC, only 30% had been reorganized under the Company Law in 2002; by the end of 2006 that figure had risen to 64%. When reorganized, these firms typically become joint stock corporations, or wholly-owned state corporations. Most have boards of directors and corporate organization is relatively clear. Most firms have independent outside directors on their boards, and in 14 large experimental firms, independent directors make up a majority of the board.

Around two-thirds of SASAC held companies have been reorganized into joint-stock or other types of corporation

SASAC has also strengthened managerial incentives. In 2004, all central SASAC firms signed three-year performance contracts, outlining annual

Stronger managerial incentives have played a key role

*Distinct SASACs have been created at the provincial and municipal levels to reorganize enterprises controlled by local governments. The local state sector is about as big as the central state sector, with 20.8m workers and Rmb4.2 trn in capital, compared to 17m workers and Rmb5.6 trn in capital for central enterprises.

Companies are given grades of A to E annually

and three-year targets. On the basis of these contracts, SASAC evaluates each CEO's performance on a 100-point scale, grading them A through E. Managerial salaries depend on the grade: incentive payments range from three times base salary (for A+ managers) down to zero (for those who get an E). In 2005, half of SASAC firms got Bs, and one-sixth got As. Four firms got Ds, for failing to meet profit targets, and two firms received Es, for falsifying records. Firm performance ratings were published.* Profit plays the dominant role in performance evaluation. On the annual 100-point scale, 30 points are based on profit relative to target, 40 on the rate of return on equity (relative to sectoral averages), leaving 30 available for sector-specific targets. The three-year evaluation criteria are based on growth of capital value and revenues as well as annual profit results.

Only the top three companies in any sector will be allowed to survive with SASAC

The reduction of SASAC firms from 196 to 153 reflects the pressure on central firms to become large and competitive: SASAC companies have been told that only the top three firms in each sector will survive. This creates strong incentives for growth. SASAC encourages firm strategies organized around commercial, service or investment markets, not just traditional industrial produ ction. An example is Sinosteel, a company that provides logistic and technological services to the steel industry – including development of metal ore mining around the world, and trading scrap and coking coal – and whose revenues topped US$15 bn in 2007.

Reforms have made managers subject to considerable shareholder pressure

State enterprise managers under SASAC are thus a far cry from their bureaucratic predecessors: they are professional managers facing considerable shareholder pressure to produce profits and benchmark themselves against best world practice. It is thus no wonder that state sector profits have risen, not just in absolute terms but also relative to capital employed: central SASAC enterprises saw the ratio of pre-tax profit to capital rise from 3.6% in 2003 to 6.7% in 2007. State enterprises under provincial and local SASACs have also increased profitability, but still lag behind, with profit equal to 3.9% of capital in 2007.

New and improved cheap loans

Creating national champions remains the ultimate goal

If shareholder pressure is the stick of SOE policy, preferential treatment is the carrot. SASAC has repeatedly articulated the goal of creating internationally competitive state firms that are big enough to join the global Fortune 500. This objective, sometimes bordering on obsession, leads the government to provide potential national champions with favorable policies or injections of resources. Such favoritism is in principle available to non-state firms (a familiar example is telecoms equipment manufacturer Huawei Technologies) but in practice the biggest recipients of favor are state-owned. All 22 mainland Chinese firms on the most recent Fortune

*SASAC, "Provisional Methods for Assessing Performance of Responsible Managers of Central Enterprises," 30 December 2006 (http://www.sasac.gov.cn/gzjg/yjkh/200701310039.htm); "Results of 2005 Performance Assessment for Central Enterprises" (http://www.sasac.gov.cn/gzjg/yjkh/200608220155.htm). In 2005, two firms had their grades lowered for safety or environmental violations (PetroChina and the Railroad Construction company), and another eight firms lost points for safety or financial infractions.

Global 500 list, based on 2006 data, are state-owned. Sixteen are central government firms under SASAC, and five were financial institutions (four banks and People's Insurance Co.), with different central shareholding agencies. Shanghai Automobile Industry Corp. was the single locally-owned state firm on the list.* These firms have disproportionate access to credit and other state-guided inputs, such as the more than US$20 bn in low-cost credits the China Export-Import Bank grants annually.

All 22 Chinese companies in the Fortune 500 are state-owned

Yet today's cheap credit is not the same as the cheap credit of the 1980s and 1990s that led to the write-off of more than Rmb3 trn in non-performing loans from 1998-2006. The basic difference is that then, cheap loans were used to keep fundamentally unprofitable enterprises afloat; now, they go to firms that can justify their use in expanding their businesses. SOE balance sheets, though still heavily debt reliant, are far less parlous than in the past. In 1994, industrial SOE debts equaled 68% of total assets, so SOEs owed over two dollars for every dollar of net equity. In 2006 the debt-asset ratio for all SOEs was just below 57% of total assets.**

Whereas bank loans were previously used to keep money-losing companies alive, now they are used to fund growth

Technology policy is a further source of state-subsidized inputs. China's drive for technological upgrading leads to expansive definitions of research and development and generous tax credits for R&D expenses. In 2006, central SASAC firms classified Rmb124 bn (16% of their total profits) as R&D expenditure. The exact impact is exact to quantify, but it seems clear that state policies and greatly reduce the cost and risk of R&D expenditure.

Technology policy is a major source of state-subsidized inputs

Lower taxes, higher dividends

The state sector's return to profitability is a real achievement, but it is only the first step in a broader transformation of SOEs and their relationship to the government envisioned by SASAC. Shortly after its creation in 2002, SASAC laid out a long-range blueprint for the state sector, whose key elements included an increase in the value of the state's equity, structural adjustment of enterprises and institutional reform of enterprise-government relations.

An important milestone came in late 2007, when SASAC began collecting dividends from its firms. This marked a dramatic shift in the relationship between the government and the state sector. The government stopped collecting after-tax profits (dividends) from SOEs in 1994 because profits were so small that it was better to let the firms keep them and strengthen incentives. By 2007 the SOE financial recovery was deemed to be sufficiently solid that dividend payments could be reinstated.

In 2007 SASAC began collecting dividends for the first time

*In addition, there were six Taiwan and two Hong Kong firms. See "16 Central Government Firms enter the Fortune Global 500 List" (http://www.sasac.gov.cn/n1180/n1226/n2410/n314259/n315149/1527842.html)

**The comparison is not precise because accounting standards have changed, but the general size of the debt reduction is certainly right. The reduction in the state sector's aggregate debt ratio is itself a contributing factor to increased SOE profitability. Assuming an average interest rate of 6%, the 11 percentage-point reduction in the aggregate debt ratio would accounts for a 0.66 percentage-point rise in the profit/capital ratio.

In 2008, most SOEs will begin to remit 5% of their after-tax profits to the government as dividends paid to their owner. Seventeen central SASAC firms deemed to operate in monopoly sectors will remit 10% of profits. Rmb50 bn-60 bn will be remitted by central enterprises in 2008 from 2007 profits, along with a much smaller amount from local SOEs. These remittances, however, will make little difference to the firms' income

Where the state is still king

To demonstrate the breadth of the empire over which SASAC presides, and how vastly more powerful the state sector is than the private sector, we present a list of the 20 biggest SASAC enterprise groups and a comparative list of the 20 biggest Chinese private companies.

Three patterns stand out immediately. First, the state companies are far larger than the private ones: the combined 2007 revenues of the SOE top 20 were Rmb5.4 trn, eight times the Rmb693 bn for the top 20 private firms in 2006 (latest available data). The number 20 firm on the SOE list, China Netcom, is bigger than the top name on the private list. Second, the SOEs are overwhelmingly involved in resource extraction, utility networks, and heavy industry. The private firms are predominantly in retail, light manufacturing, and real estate. Finally, the SOE groups each concentrate on a single core industry, while private enterprise groups often diversify into completely unrelated businesses.

The definition of "private" is rather arbitrary. It is usually impossible to determine the exact ownership structure of firms claiming to be private, and in many cases a significant state shareholding lurks behind an apparently entrepreneurial boss. Take white goods company Hai'er, run for two decades by chairman Zhang Ruimin as his personal fief, but ruled by the Qingdao city SASAC to be a local government SOE in 2005.

In most cases such clear-cut information is unavailable, so we rely on judgment. Computer-maker Legend, for example, which tops many private sector lists, is excluded because the biggest shareholder of its group holding company is the China Academy of Sciences, with a controlling 35% stake. On the other hand we include Huawei Technologies, which claims to be owned by its employees but has never provided information to verify that claim and is rumored to have direct or indirect shareholdings by many state entities. – *Arthur Kroeber*

Top of the heap

20 biggest state enterprises by revenue, 2007

	Rmb bn
China Petroleum & Chemical Corp (Sinopec)	1,065
China National Petroleum Corp (PetroChina)	894
State Grid	855
China Mobile	286
China Southern Power Grid	223
China Telecom	198
Shanghai Baosteel	181
China Railway Engineering Corp	164
China Railway Construction Corp	149
First Automobile Group	149
China State Construction Engineering Corp	145
China National Cereals, Oils & Foodstuff Corp	143
Dongfeng Automobile Corporation	142
China Minmetals	135
China National Offshore Oil Corp. (CNOOC)	132
China Ocean Shipping (Group) Co. (COSCO)	123
Aluminum Corp. of China (Chinalco)	106
China North Industries (Norinco)	106
China South Industries	101
China Network Communications (Netcom)	97
Total	**5,392**

Source: SASAC, company reports

Best of the rest

20 biggest private companies, 2006

	Rmb bn	Main businesses
Gome	87	Retail
Suning	61	Retail
Jiangsu Shagang	59	Steel, pharmaceuticals
Huawei Technologies	53	Telecoms equipment
Midea	46	Household appliances
Shanghai Fosun	39	Steel, catering, retail
Guangsha Holding	32	Construction, real estate
Wanxiang	31	Auto parts
Orient Group Industrial	30	Finance, building materials
Sichuan Huashi	29	Real estate, construction
Minsheng Bank	29	Banking
Jiangsu Yurun Food	28	Food, retail, real estate
Tianjin Rockcheck Steel	25	Steel products
Gree	24	Household appliances
Wumart	23	Retail
Ningbo Jintian Copper	22	Copper products
East Hope Group	21	Aluminum, animal feed
Zhejiang Hailiang	21	Trade, metals, real estate
Hangzhou Wahaha	19	Beverages, snacks, garments
Eternal Asia	18	Logistics
Total	**693**	

Source: Industry associations, Forbes, Dragonomics research

statements. This is because even as they pay more in dividends, state enterprises are paying less in taxes: the corporate income tax rate on domestic firms was lowered from 33% to 25% on 1 January 2008, as part of the equalization of tax rates on domestic and foreign-invested firms.

The dividend policy represents an important shift in enterprise-government relations, but in other respects the transformation of state enterprises envisaged by SASAC remains a distant dream. First, it is important note that the aggregate improvement in SOE profits is largely a function of the outsized profits earned by a few giant firms in protected sectors – especially natural resource companies that have benefited from astronomical prices. Loss-making firms have not disappeared, and they still burn up 0.5% of GDP. But on the other side of the ledger, PetroChina has earned over Rmb100 bn annually in the last two years – essentially offsetting the losses of all loss-making state firms and accounting for one-seventh of central SASAC profits all by itself. If the price of oil falls sharply, or if China's investment-led boom falters, SOE profitability will plummet.

Large aggregate profits for SOEs can mainly be attributed to outsized earnings at just a few firms

Second, the recent increase in state profitability is probably too much of a good thing. Flooded with profits, state sector firms invest too much. They cannot legally distribute the profits to managers, and dividend payments to the government are still small, so most profits are plowed back into investment. This contributes to an unbalanced and ultimately unsustainable growth pattern, and to the vast discrepancy between the purchasing power of corporations and ordinary households. China increasingly looks like a "rich business, poor people" economy, and many of those rich businesses are state-owned.

Swimming with cash, SOEs are overinvesting in productive capacity

Who's the boss?

Third, the growth of profits has taken the steam out of efforts for deeper structural reform. SASAC's long-run vision involves restructuring all operating companies into joint-stock corporations. That means getting rid of the semi-bureaucratic and opaque holding companies that now control the operating companies. Ultimately SASAC wants to repackage the assets of these holding companies with their subsidiaries in new corporations to be listed on the stock markets as "integrated firms." Most holding companies would be abolished, but a few would be converted into investment companies, creating wealth funds which could compete with each other in capital markets. The consequent maturation of capital markets would enable SASAC to link executive compensation to stock market performance. This is obviously a long-term agenda, but a key short-term goal was to start listing integrated firms. A handful have done so but far fewer than anticipated, and SASAC recently acknowledged that future progress is unlikely to be much faster.*

Current strong performance is an obstacle to further, deeper reform

*"Guoziwei fayanren tan yangqi zhengti shangshi gongzuo youguan qingkuang [SASAC spokesman discusses some situations surrounding work of integrated listing of central enterprises]," *Caijing*, 17 October 2007; "Guoziwei: Guli budaibiao suoyou yangqi dou yao zhengti shangshi [SASAC: The encouragement we give to integrated listing doesn't mean it's the right option for every central enterprise]," *Caijing*, 8 November 2007.

Multiple bureaucratic actors are fighting over the direction of state sector reform

Finally, state sector reform is an arena increasingly crowded with multiple bureaucratic actors following conflicting agendas. SASAC may want to increase the efficiency and accountability of state firms, but those firms are eager to retain their hefty profits, and intent on deflecting SASAC's attempts to make them more transparent and accountable. China's new sovereign wealth fund, the China Investment Corporation, would prefer not to have SASAC create competing wealth managers. And the National Development and Reform Commission (NDRC) continues to assert its influence over the state sector in its role as top economic policy agency. Most obvious is its recent commitment to fight inflation by intensifying latent controls over SOE pricing. As inflationary pressures have mounted, NDRC has tightened controls of coal and refined petroleum products. As a result, in the first quarter of 2008, profits in the coal and petroleum sectors dropped by a third, and overall state industry profits slid by a few percentage points. It is the first break in the steady increase in state industry profits since the beginning of the decade.

Whether SOEs can improve their efficiency further will depend on they manage the different demands of their managers and owners

Whether China's SOEs continue their trajectory toward improved efficiency depends to a large extent on how they balance the competing objectives imposed on them by their managers and bureaucratic overlords. Even SASAC's messages are not entirely consistent: it promotes profit-driven efficiency and increase in shareholder value, but the most prominent items on its website now relate to corporate social responsibility (CSR). If CSR is a tool for greater transparency and adherence to government regulations, it could be a good thing. But it also risks undermining progress towards efficiency by introducing a competing objective.

The other question is whether SOEs will continue to improve efficiency as profit growth slows. The era of dramatic increases in state sector profitability has likely reached an end. This is partly because the central government is no longer panicked about the solvency of the big firms, and so is willing to sacrifice their profitability to other goals. A good example is the current anti-inflation drive, in which central SOEs are asked to bear the brunt through price controls on refined oil and electricity prices.

If SOE profitability levels off or even declines a bit, the impact on the overall economy would probably be positive, since it would reduce excess investment and lead China to a more balance economic path where the benefits of growth move beyond corporations and into the household sector. The risk that SOEs would drag the economy down has passed. The next challenge is to bring state firms up to truly world-class management standards, and to open up the economy further under a regime of regulated competition. If this difficult transition can be made, the impressive achievements of state sector reform will finally translate into broad benefits for the Chinese population as a whole.