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"Chinese State-Owned Enterprises and U.S.–China Bilateral Investment"

The Fall and Rise of Chinese State-Owned Enterprises

There are two basic observations concerning state-owned enterprises in China:

(i) The large majority operate very differently than they did 20 or even 15 years ago, and
(ii) They account for far more of the economy than popularly believed.

These observations serve to reconcile debates over the state sector. It is certainly true that there has been an important and considerable change in the Chinese economy as a result of changes in state-owned enterprises (SOEs). However, it is not true that SOEs have faded into the background or that they are no longer "state-owned enterprises." In fact, the state sector and non-market behavior still predominate on most measures.

History Sketch

Phase 1 (1979-1986): SOEs, broadly understood, are allowed to move beyond the plan
Phase 2 (1987-1992): Partly commercial entities arise
Phase 3 (1993-2001): The state sector shrinks; the truly private sector expands
Phase 4 (2002-2007): Restructuring of SOEs; contraction ends
Phase 5: (2008-present) Active re-enlargement of state sector
Phase 6: (2014?): SOEs exert greater political influence

Disputes over the historical progression of SOEs are unavoidable, but it is clear much has changed. There were no true commercial entities in the PRC in 1975, because there were no markets in which to operate. In the latter half of the 1970s, agricultural cooperatives (effectively rural SOEs) in certain counties were permitted to act independently if they first met planned economy requirements. This independence was formalized at the fall 1978 Communist Party plenum, signifying the start of the reform period.

By the mid-1980s, quasi-state entities began appearing. These included town and village enterprises and firms with minority foreign ownership. These were technically controlled by the state but they had commercial latitude. In some ways, they were the forerunner of current SOEs. This type of firm grew in number and importance for more than a decade.

For much of the 1990s, many SOEs were partly or entirely sold. They were replaced in some cases by quasi-state enterprises which looked much like the old SOEs utilizing some commercial operating principles. However, they were replaced in other cases by

private firms, including foreign majority-controlled companies and the first domestic genuinely private firms with more than just a few employees.[1]

The sale of public assets was slowed by economic duress from the Asian financial crisis and political criticism in the late 1990s. Shrinking the state sector was replaced by "reform." This reform has been widely misconstrued. It consisted of converting most SOEs into share-holding entities, which had explicit state entities as majority holders but also sold stock in Shanghai, Hong Kong, or elsewhere. These share-holding firms took on multiple characteristics of truly commercial operations, including some form of profit orientation and public reporting, but they were still state-controlled and directed.[2]

At some (disputable) point in the mid-2000s, the reform process was reversed entirely and SOEs began to wax again. The reversal can reasonable be dated to late 2006, when the State Council formally set aside the core of the economy for SOEs,[3]

> [T]he State should solely own, or have a majority share in, enterprises engaged in power generation and distribution, oil, petrochemicals and natural gas, telecom and armaments. The State must also have a controlling stake in the coal, aviation, and shipping industries.... Central SOEs should also become heavyweights in sectors including machinery, automobiles, IT, construction, iron and steel, and non-ferrous metals.

This omits state dominance in banking, insurance, and the rest of finance, media, tobacco, and railways. This was a daunting list, representing a wide swath of the economy set apart for state distortions. The reversal was codified by Wu Bangguo, second in the Party hierarchy, when he listed privatization with other intolerable developments.[4]

> We have made a solemn declaration that we will not employ a system of multiple parties holding office in rotation; diversify our guiding thought; separate executive, legislative and judicial powers; use a bicameral or federal system; or ***carry out privatization*** (emphasis added)

SOE Features

The discussion of SOEs has been undermined by a fundamental error: the conflation of restructured, share-holding firms with the truly private sector. Share-holding SOEs are manifestly not private actors and assessments of the corporate sector that assume so are

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[1] Yasheng Huang, *Capitalism with Chinese Characteristics: Entrepreneurship and the State* (Cambridge: Cambridge University Press, 2008).
[2] OECD, "China: Defining the Boundary Between the Market and the State," 2009, at http://www.oecd.org/dataoecd/35/45/42390089.pdf
3 Zhao Huanxin, "China names key industries for absolute state control," *China Daily*, December 19, 2006, at http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm
[4] Michael Sainsbury, "China Rules Out Political Reform," *The Australian*, March 14, 2011, at http://www.theaustralian.com.au/news/world/china-rules-out-political-reform/story-e6frg6so-1226020720813

fatally flawed from the outset. The origin of this mistake is historical. As quasi-state entities emerged and proliferated, it was clear some sort of separate treatment was necessary and the concept of "non-state" was created. This was never intended to indicate "private"—quite the opposite: it was meant to signify that the creation of corporate forms quite different from SOEs could occur without privatization and its ideological pitfalls.

The meaning of "non-state" is very well understood by the Chinese government. The (sometimes willful) misunderstanding outside China rests on two shaky pillars. The first is a mis-rendering of "non-state"—where the PRC sees the opposite of state as non-state, many foreign observers see the opposite of state as "private" and simply re-label accordingly. The second is more sophisticated and based on the share-holding change.

Neither specification of share-holders nor sale of stock by itself does anything to alter state control. The large majority of firms listed on domestic stock markets are specifically designated as state-owned.[5] The sale of small minority stakes on foreign exchanges could be construed as recasting mainstays such as CNPC (through its list vehicle PetroChina), China Mobile, and Chinalco as non-state entities of some form. However, they are still centrally directed SOEs, as explicitly indicated by the Chinese government.

More broadly, firms are defined by inputs and outputs. Most Chinese firms sell in a market environment that is unrecognizably different from the operating environment in 1975 and sharply different even from the one in 1995. In this sense almost none of them are still traditional Chinese SOEs. On the output side, however, the requirement that the state predominate in so many sectors is meant to sharply confine competition, so that SOEs operate within markets but they operate primarily within state-controlled markets. This regulatory protection is the most powerful subsidy many SOEs receive.

The input side also continues to distinguish SOEs clearly from foreign or domestic private companies. Production inputs comprise labor, capital, land, and other physical resources such as energy. For SOEs, including those which have completed share-holding reform, all of these show the state's overwhelming role. It is routine for Chinese officials to bounce back and forth from corporate to government posts at the behest of the Party, no less so at China Mobile and the like than anywhere else.[6]

In stark contrast to private firms, which often cannot buy land at any price, SOEs have immediate call on free land, which is all technically owned by the state. The main barrier to SOEs acquiring land is other SOEs. SOEs as a matter of course also receive hefty power and other input subsidies not available to genuinely private firms

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[5] Vincent Fernanado, "Here's Why Chinese Stocks Remain a State-Controlled Façade," Business Insider, June 22, 2010, at http://www.businessinsider.com/heres-why-chinese-stocks-are-a-state-controlled-facade-2010-6

[6] Chen Jialu, "CEO Reshuffles Signal New View of Watchdog," *China Daily*, August 24, 2010, at http://www.chinadaily.com.cn/bizchina/2010-08/24/content_11194717.htm

As for capital, every aspect is dominated by the state. All large financial institutions are state-owned, the People's Bank assigns loan quotas every year, and, within these quotas, lending is directed according to state priorities. Interest rates are also controlled, and last year real borrowing costs were barely above zero. Conveniently, then, loan quotas and bank practices strongly inhibit non-state borrowing. Securities markets are also dominated by the state. As an illustration, the volume of government bond issuance utterly dwarfs corporate bonds and is growing relentlessly, crowding out private firms.

SOE Investment Share

The popular question regarding SOEs is what portion of the economy do they comprise? The one clear answer is: significantly smaller than the 100 percent share 35 years ago, as well as smaller than the somewhat uncertain share 20 years ago.

Beyond that, the State Statistical Bureau (SSB) provides insufficiently precise data. Even the number of SOEs is not published. There are fewer than 120 centrally controlled SOEs, and the number is still slowly shrinking. These, however, typically each have dozens of subsidiaries, including nearly all the Chinese companies most people are familiar with. There are also thousands of provincially and municipally controlled SOEs. Meanwhile, truly private firms number in the tens of millions, though are comparatively very small. There are also millions of firms of mixed or unclear status.

Data provision for urban fixed investment was considerably enhanced starting in 2004. For the PRC, urban fixed investment is critical, because it drives the economy. In 2004, urban investment stood at 5.9 trillion yuan and was equivalent to 43 percent of GDP. Just six years later, it was a stunning 24.1 trillion yuan and equivalent to 61 percent of GDP.[7] The Chinese economy was formerly driven by exports; it is now driven by urban investment (2010 rural investment was only 3.7 trillion yuan).

Table 1: Urban Investment Shares (percent)

	State-owned	Limited liability Corp.	Domestic private	Wholly foreign-owned	Partly foreign-owned	Share-holding	Other mixed ownership
2004	44.0	20.8	11.1	4.5	7.3	9.3	3.0
2007	36.9	23.6	18.3	5.2	5.2	7.8	3.1
2010	38.0	24.3	21.1	3.3	3.3	6.7	3.4

Because urban investment has almost quadrupled, all raw figures have increased and even the clearly waning foreign role represents greater absolute investment. Volume comparisons over time are thus misleading. An unmistakable trend is dynamic growth in

[7] All figures in this section, including the table, are taken from China Monthly Statistics, Volume 12, 2004 – Volume 1, 2011, National Bureau of Statistics, Beijing.

what the SSB labels as private investment. Domestic private investment may have been undercounted in 2004 but, regardless, it is now in excess of one-fifth of total investment.

Against that, what the SSB labels as the state-owned share is not quite two-fifths. This figure corroborates claims that the non-state sector comprises 60 percent or more of the economy. But it hardly indicates the private sector is anything like that large—with wholly owned foreign investment, the genuinely private share is a bit short of 25 percent. The other 38 percent often called “private” is of various kinds of mixed ownership.

Within this mixed grouping, there are three lesser categories. To qualify as partly foreign owned, a firm need be only 25 percent foreign-invested, even if the majority partner is state or private. Yet this figure is still small and declining. Shareholding is larger but also declining. “Other” ownership is small. The bulk of the mixed ownership category is limited liability corporations (LLC), which are approximately equal in share to what is officially designated as the private—domestic plus foreign—sector.

What is this last group? It is manifestly not private. It has always been treated separately from domestic private companies. It includes subsidiaries of centrally controlled state giants such as Sinochem. Most important, it necessarily overlaps greatly with sectors that are required or admitted to be dominated by the state. The best single characterization of this group is that it is organized and behaves in a way that is starkly different than the SOEs of 1990, but that the bulk of LLC investment is still controlled by the state.

In sum, the verifiable private sector accounts for one-fourth of urban investment. That share has risen since 2004, though the rate of climb has more recently slowed.

Other Measurements

Beyond investment, information is scattered. Chinese industrial production data are often used to represent GDP and then to divine state and private shares of the economy. This is a mistake for several reasons, the most immediate being that the production data do not even accurately portray production. They have always been internally inconsistent and, starting in 2006, were split into categories seemingly chosen to obfuscate.

The best guess is that the truly private share of industrial production is somewhat higher than it is for investment. As private firms are universally accepted— even by the Chinese government—to be more efficient than SOEs, their share of inputs such as investment and employment will be higher than their share of outputs such as production or sales. A reasonable range for the genuinely private share of production is thus 30-35 percent.

Elsewhere, reporting by SOEs is notoriously bad. However, it is suggestive, at least, that China National Petroleum and China Mobile claim more 2009 profits than the top 500 firms combined. The State-owned Assets Supervision and Administration Commission indicates that the assets of its firms have grown from the equivalent of 60 percent of GDP

in mid-2003 to 62 percent of GDP in mid-2010, despite the rapid GDP gains during that period.[8]

Official data on employment are again limited to cities but not as detailed as for investment. Through the third quarter of 2010, the explicit state share of employment was 57 percent, though that is well below the 74 percent announced seven years earlier. Unfortunately, the non-state share is here designated only as "other," which obscures whether this includes restructured firms that are still manifestly state-controlled, as in the investment categories. The sectors which SOEs must or plainly do dominate accounted for 80 percent of the capitalization of domestic stock exchanges at the end of 2010. Similarly, tax revenue from private domestic firms is less than 15 percent of the total.[9]

Trade is an area of private sector strength. Domestic private firms generated 30 percent of exports in 2010. In addition, foreign-funded enterprises account for over half of total trade.[10] However, since "foreign-funded" can still include a private or state majority owner, these numbers cannot simply be added. Still, the combined private share of trade is considerably higher than it is in investment and may exceed 40 percent of volume.

In contrast, SOEs utterly dominate outward investment. The Heritage Foundation's China Global Investment Tracker provides information on the size and originating company, among other aspects, for large Chinese non-bond investments since the start of 2005.[11] It corresponds well to official figures but contains far more information.

On Heritage data, total non-state investment appears to be below $13 billion since 2005, which is less than 6 percent of the total. The four largest investors—China National Petroleum, China National Petrochemical, China Investment Corp. (CIC), and China Aluminum—alone accounted for half of Chinese investment through the end of 2010. All are centrally controlled, with CIC one of the two sovereign funds.

All large investors, such as such as China Minmetals and Industrial and Commercial Bank of China, are centrally controlled. This reflects the national champion concept, that the PRC should have national firms with economies of scale sufficient to be competitive on global markets. Almost all firms that might qualify as national champions are SOEs.

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[8] Zhou Xin and Simon Rabinovitch, "China Inc Gets New Chairman as State-Owned Firms' Clout Grows," Reuters, September 6, 2010, at http://uk.reuters.com/article/2010/09/06/business-us-china-economy-state-idUKTRE68514720100906 and "China state giants outstrip private firms," Channel News Asia, August 30, 2010, at http://www.channelnewsasia.com/stories/afp_asiapacific_business/view/1077996/1/.html

[9] China Monthly Statistics Volume 1, 2011 National Bureau of Statistics Beijing and "China Stimulus Plan Criticized for 'Crowding Out' Private Sector," China Stakes, August 7, 2009, at http://www.chinastakes.com/2009/8/china-stimulus-plan-criticized-for-crowding-out-private-sector.html

[10] Wang Xiaotian, "Private Enterprise Exports Skyrocket," *China Daily*, February 9, 2011, at http://www.chinadaily.com.cn/business/2011-02/09/content_11967514.htm and Ministry of Commerce, People's Republic of China, "China's Absorption of FDI," July 21, 2010, at http://english.mofcom.gov.cn/aarticle/statistic/foreigninvestment/201008/20100807086430.html

[11] Derek Scissors, "China Global Investment Tracker: 2011," The Heritage Foundation, January 10, 2011, at *http://www.heritage.org/research/reports/2011/01/china-global-investment-tracker-2011*.

Can SOEs Be Rolled Back?

A distinct policy related to the status of SOEs is consolidation—shrinking the number of firms in an industry to curb "disorderly competition." Industries range from autos to yarn.[12] Where market concentration is high, the State Development and Reform Commission preserves it. For example, to avoid competition cutting into crude oil profits and driving out inefficient suppliers, it hiked taxes for crude on the state giants but subsidized them in refining where they face competitors.[13] This ensured state involvement at all points, so the suppression of competition fit perfectly with the all-too-visible hand.

The suppression of competition coincident with regulatory protection of SOEs combine to guarantee SOEs will have relatively more weight. Optimists correctly point out that SOEs shrank in importance for most of the reform period and current pro-state policies can be reversed (again). That is certainly true, but may be quite difficult.

The national champions concept began to be discussed in the PRC in the late 1990s. At that time, there was no question about the hierarchy involved: the government would consider creating national champions and SOEs so blessed would remain entirely subservient, as they had for the previous fifty years. That hierarchy is no longer so clear.

Some SOEs are now truly gigantic, not just on a national scale but a global one. The steel industry is grotesquely oversized in the international economy. National banks are on some measures the world's largest, as are Chinese telecoms.[14] The oil majors provide large chunks of national tax revenue. And State Grid dwarfs them all. They are the PRC's global representatives, provide the government with much of its money and, more important, generate massive and steady employment. They are also run by high-level Party cadres or, in some cases, their children. When the next economic reformer takes the reins as Premier and pushes the SOEs, they will push back powerfully.

The situation presents a severe challenge to the U.S. In most sectors, there is no market of 1.3 billion. Instead, there is what is left after the SOEs are handed the bulk. This applies, of course, to American companies looking to serve the Chinese market. It is no surprise that official data indicate the foreign investment share has plummeted in the past few

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[12] "Measures to Stop Disorderly Competition," People's Daily Online, March 2, 2005, at http://english.peopledaily.com.cn/200503/02/eng20050302_175221.html and Vivian Wai-yin Kwok, "Beijing Redeploys Its Carmakers For Global Race," Forbes.com, March 23, 2009, at http://www.forbes.com/2009/03/23/china-auto-stimulus-markets-equity-consolidation.html

[13] Zhu Qiwen, "Time to Take a Fresh Look at Oil Subsidies," *China Daily*, March 21, 2008, at http://www.chinadaily.com.cn/opinion/2008-03/21/content_6554797.htm

[14] Philip Lagerkranser, "China Banks Surge to World's Largest May Be Too Good to Be True," Bloomberg.com, April 29, 2009, at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aueh06DOY37A and Janet Ong, "China Tells Telecom Companies to Merge in Overhaul (Update 1), Bloomberg.com, May 25, 2008, at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYQg0d5NANkM

years. The truncated market extends to U.S. exports. The various forms of subsidy provided to SOEs are far bigger barriers to American goods than the yuan's peg to the dollar. Subsidization has been and can be increased to offset currency changes.

More generally, massive bilateral economic imbalances are on the Chinese side caused by overinvestment and underconsumption. The PRC overinvests precisely to enable SOEs to retain dominant positions despite their inefficiency. To sustain this overinvestment, consumption must effectively be taxed. The regulatory suppression of competition discourages consumers and generates additional profit to finance SOE investment. Capital subsidies also finance investment and, though the state-run banking system, transfer income from households to SOEs via controlled interest rates.

In the new five-year plan, the PRC is once again touting rebalancing. It has done so since 2004 and matters have only worsened. There is a very good reason for this: rebalancing would undermine SOEs, when the thrust of policy is to exalt them. For China to actually rebalance, Beijing will have to accept a retrenchment of SOEs and this process will be stridently opposed. It is strongly in America's interest to assist, by reorienting bilateral economic policy toward making retrenchment of SOEs by various means the top goal.