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The Fall and Rise of Chinese State-Owned Enterprises: American Policy
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A lot has changed in a year. In February 2011, the Commission was compiling information on the expanding role of Chinese state-owned enterprises (SOE's). Since then, the debate has noticeably swung in favor of those believing that SOE's are a global economic problem, one which requires considerable improvement in American policy.[1] How to make that improvement, unfortunately, has not been settled.

There are two components to the SOE challenge. The original and fundamental matter is the sealing off of China's huge internal market in order to protect and enhance SOE's. A new issue, less important now but perhaps equivalent in the long term, is the expansion of SOE's into the U.S. and other markets outside China.

The two are obviously related but require distinct policy responses. With regard to the Chinese market, the Communist Party's commitment to SOE's is so strong that only a decisive and extended American effort, implemented at the highest level, has a chance to lead to a significant reduction in government support. The most effective response to long-term Chinese competition outside the PRC is improving long-term American competitiveness both at home and in third markets.

The Status of SOE's

The confusion over SOE's stems from their history, in which market-oriented reform was followed by "restructuring" that renewed state prerogatives and blunted progress toward true commercial status.[2] Most SOE's are unquestionably different than they were in 1995. Their ownership status has changed, to the point where most have mixed ownership of a sort and some can be argued not to be "state-owned" at all. They are required to behave in more commercial fashion because they operate in different markets, due to both changes at home and expansion overseas. It can be shown, though, that, a large group of very large firms can still be grouped under the SOE rubric as state-owned or controlled.

A common perception is the state began to re-advance with the financial crisis in 2008, but the process actually started with the 2002 Party Congress and political transition. The

[1] John Bussey, "U.S. Attacks China Inc.," *The Wall Street Journal*, February 3, 2012, at *http://online.wsj.com/article/SB10001424052970204662204577198833989249406.html* (February 10, 2012).
[2] This following two sections draw on Derek Scissors, "Chinese State-Owned Enterprises and U.S.-China Economic Relations," testimony before the U.S.-China Economic and Security Review Commission, March 30, 2011, at *http://www.heritage.org/research/testimony/2011/04/chinese-state-owned-enterprises-and-us-china-economic-relations* (February 10, 2012).

new regime, led by new Party General Secretary Hu Jintao, engineered a powerful economic stimulus starting with lending expansion by state banks (which utterly dominate banking). State banks loan overwhelmingly to state firms and, as early as September 2003, it was clear that the trend of shrinking the state had been altered.[3]

The extent of the policy change was obscured by implementation of WTO membership requirements and extremely rapid expansion of all parts of the economy. By 2006, though, it was obvious the Hu government was restoring state leadership of the economy, for strategic reasons, to control macroeconomic cycles, and to represent China overseas.

Strategic goals were addressed through regulatory protection, the most powerful subsidy SOEs receive. The core of regulatory protection is suppression of competition. There is a broad and sustained program to consolidate industries from airlines to yarn, because having too many participants is said to cause disorder.[4] When market concentration is already high, in contrast, the State Development and Reform Commission preserves it. This explains why China ranked 151st of 183 countries in World Bank's measure of the ease of starting a business.[5]

The ultimate protection from competition is by statute. The industries deemed strategic by the government, such as power, telecom, and shipping, are required to be state-dominated. There are additional sectors that are *de facto* state dominated, such as banking and the media. In both groups of sectors, SOE officers move freely back and forth into government positions.[6]

Where The State Must Rule

Autos	Information Technology	Petrochemicals
Aviation	Insurance	Power
Banking	Machinery	Railways
Coal	Media	Shipping
Construction	Metals	Telecom
Environmental Technology	Oil and gas	Tobacco

The situation is deteriorating, as some SOEs are now gigantic on a global scale. China has 61 of the Fortune 500, with the oil majors and State Grid in the top 10. National

[3] China Watch, "The Emergent Industrial Policy," Derek Scissors, September 19, 2003.
[4] "Measures to Stop Disorderly Competition," *People's Daily Online*, March 2, 2005, at http://english.peopledaily.com.cn/200503/02/eng20050302_175221.html (February 10, 2012) and Katie Cantle, "Global Competition," *Air Transport World*, November 1, 2011, at http://atwonline.com/airline-finance-data/article/global-competition-1109 (February 10, 2012).
[5] The World Bank, "Doing Business: Economy Rankings," 2011, at http://www.doingbusiness.org/rankings (February 10, 2012).
[6] 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 (February 10, 2012) and 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 (February 10, 2012).

banks and telecoms are on some measures the world's largest.[7] State-dominated steel and coal production are approaching half the world total.[8] These firms provide massive amounts of tax revenue and employment. They are run by high-level Party cadres or their children. It was easier to build the monster than keep it chained.

Fortune 500 Ranks

Sinopec	5
CNPC	6
State Grid	7
ICBC	77
China Mobile	87
China Railways	97
China Railway Construction	105
Construction Bank	108
China Life	113
Agricultural Bank	127

Source: "Global 500," *CNN Money*, July 25, 2011, at *http://money.cnn.com/magazines/fortune/global500/2011/countries/China.html*

The State Share

The Hu government's second objective, macroeconomic control, is achieved through the ability to order SOE's to expand or contract, regardless of conditions. SOE's defy market pressures that apply to other firms, consistently over-producing and over-employing.[9] In a downturn, they do not fire workers - instead receiving loans to keep paying them - and are certainly not permitted to go bankrupt. When growth is too fast, state entities are initial targets for cooling policies.[10]

[7] 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* (February 10, 2012) 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* (February 10, 2012).

[8] Press Release, "World Crude Steel Output Increases by 6.8% in 2011," World Steel Association, January 23, 2012, at *http://www.worldsteel.org/media-centre/press-releases/2012/2011-world-crude-steel-production.html* (February 10, 2012) and World Coal Association, Coal Statistics, August 2011, at *http://www.worldcoal.org/resources/coal-statistics/* (February 10, 2012).

[9] "70% of China's Products to be Oversupply," *China Economic Net*, August 1, 2005, at http://bn2.mofcom.gov.cn/aarticle/chinanews/200508/20050800219859.html (February 10, 2012) and "70% of China's Products to be in Oversupply," *China Daily*, August 2, 2005, at http://news.e-to-china.com/show-9495.html (February 10, 2012).

[10] Victor Shih, "Chinese Banks' Great Leap Backward," *The Wall Street Journal*, December 19, 2008, at *http://online.wsj.com/article/SB122961611056318369.html* (February 10, 2012) and "China Rules Target Big Banks: CBRC," *Bloomberg*, March 15, 2011, at *http://www.taipeitimes.com/News/biz/archives/2011/03/15/2003498191* (February 10, 2012).

The principal means of this macroeconomic control is investment. In 2001, under the previous government, urban investment stood at 2.8 trillion yuan, equivalent to 29 percent of GDP. In 2003 and 2008, SOE's responded to stimulus directives in a much more intense way than private firms. As a result, by 2011, urban investment had increased by more than a factor of 10 to 30.2 trillion yuan and was equivalent to 64 percent of GDP.[11] Investment has driven Chinese growth.

While the domestic private role is waxing, investment remains largely the province of SOE's, which generate two-thirds of the huge total. The State Statistical Bureau changed its investment survey in 2011, making numbers not quite comparable over time. Still, investment data offer the most complete breakdown by ownership. The private share has been undercounted and, with wholly foreign-owned ventures), is now at a reasonable level of 25-30 percent. The explicit state share has fallen to barely one-third.

Share of Urban Investment (type of firm)

	State-owned	Limited liability Corp.	Domestic private	Wholly foreign-owned	Partly foreign-owned	Share-holding	Other mixed ownership
2005	41.6	22.4	13.5	4.9	6.1	9.0	2.5
2008	37.1	23.5	19.2	4.8	4.7	7.9	2.8
2011	33.7	26.0	24.3	3.1	3.1	6.3	3.5

Source: China Monthly Statistics, Volume 12, 2001 – Volume 1, 2012, National Bureau of Statistics, Beijing.

This still leaves 40 percent of the story. Share-holding was the first manner of SOE reorganization.[12] It has given way over time to limited liability corporations (LLCs), in part due to the need for liability protection for overseas-listed entities.

Despite the obvious commercial designation, LLC's have always been treated separately from private firms. They are composed of subsidiaries of state enterprises such as ChemChina. These are concentrated in areas dominated by the state, the areas in which giant Chinese firms have been formed and sold stock for the purposes of domestic market protection and overseas expansion – the national champion notion.[13] The true public sector includes the state, LLC's, and shareholding entities. Hence, its investment share is approximately two-thirds (the remainder is not possible to characterize).

The state also leads elsewhere. Investment is financed chiefly by loans, where state firms absorb perhaps 80 percent. In bonds, the biggest "corporate" issuer has been the Ministry

[11] China Monthly Statistics, Volume 12, 2001 – Volume 1, 2012, National Bureau of Statistics, Beijing.

[12] Gary H. Jefferson and Jian Su, "The Impact of Shareholding Reform on Chinese Enterprise, 1995-2001," *William Davidson Institute Working Paper No. 542*, September 22, 2003, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=429700 (February 10, 2012).

[13] Bruce J. Dickson, "Updating the China Model," *The Washington Quarterly*, 34:4, Fall 2011, at http://www.twq.com/11autumn/docs/11autumn_Dickson.pdf (February 10, 2012).

of Railways. Sectors which SOEs dominate accounted for nearly 85 percent of stock exchange capitalization at the end of 2011.[14]

The other key input to production is labor. At the end of the third quarter of 2011, the explicit state share of employment was 56 percent, falling from 68 percent in the third quarter of 2005. However, the remaining category is "other," which includes and obscures firms of mixed ownership that can be state controlled.[15]

As state firms are less efficient, their share of capital and labor inputs is higher than their share of outputs such as production or sales. Official data on production are not useful but a plausible estimate for the state share of production is below the employment number. Given that the comprehensive state share of labor is likely notably higher than 56 percent, the true state share of production is probably in the neighborhood of 50-55 percent.

What To Do, in China

The long-standing and still most important problem with SOE's is loss of access to the Chinese market. There is typically no market of 1.3 billion for American exports and firms operating within China, there is whatever the SOE's leave behind. If considered strategic, an entire sector can be closed. In sectors that are open in principle, the capacity of SOE's to outspend competitors keeps their share artificially high. This stems from state control of finance and other production inputs, especially land and electric power.

The market is also smaller than it should be, because consumption is effectively taxed. The repression of competition and subsidization of inputs that enable overinvestment by inefficient SOE's are financed by transferring income from households. Households pay more for inferior SOE goods and services, they pay more for land so SOE's may locate freely, and they receive lower returns on their savings so SOE's and state banks can both be subsidized. The State Council has embraced rebalancing consumption and investment since 2004 yet the opposite has occurred, because rebalancing would undermine SOE's.[16]

On the goal of macroeconomic control, it may be possible to nudge the Party to switch levers. Real interest rates have been negative for years but raising rates alone will do little if SOE's treat repayment as optional. Even market interest rates – which conceivably are a huge step forward - cannot curb SOE's if they are exempt. An indirect method of changing monetary policy, however, is through fiscal. The IMF recently advocated more use of fiscal policy and less of banks in the Keynesian management China applies.[17] The U.S. should support this change. If loans can be deemphasized, there will no longer be as much support for SOE's overinvestment and their market share may shrink.

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[14] China Monthly Statistics, *op cit,* and "New Masters of the Universe," *The Economist*, January 21, 2012, at *http://www.economist.com/node/21542925* (February 10, 2012).
[15] China Monthly Statistics, *op cit*
[16] "China Tackles Underlying Economic Problems," *Xinhua*, August 3, 2004, at *http://www.chinadaily.com.cn/english/doc/2004-08/03/content_357329.htm* (February 10, 2012).
[17] Shen Hong and Bob Davis, "IMF Urges Beijing to Prepare Stimulus," *The Wall Street Journal*, February 7, 2012, at *http://online.wsj.com/article/SB10001424052970204369404577206651681198934.html* (February 10, 2012).

The main event is shrinking the number of strategic sectors, as well as clarifying and perhaps capping the extent of state dominance of those sectors. Media may be a political necessity but machinery is no longer vital. Power may qualify as genuinely strategic but petrochemicals are only marginally so. Within the industries the Party refuses to relinquish, there is no sense of how big the state share must be – 51 percent, 75 percent, 90 percent? 51 percent in insurance, 75 percent in shipping, 90 percent in oil?

SOE's will naturally grab as much as they can, and are doing so. The comatose Chinese market reform effort might be revived by sustained American demands, years overdue, for both immediate transparency and the smallest possible role for SOE's across industries over time. These translate to the largest possible market shares for American goods and services and better conditions for profitable operation in those markets. Not coincidentally, they translate into the same things for Chinese private companies.

Reducing the role for SOE's will also permit actual investment-consumption rebalancing, a topic which has been discussed for years to no avail.[18] It will thus help address the trade deficit and other bilateral and global irritants. Presidential summits, the Strategic and Economic Dialogue – all tools should be employed to increase competition for SOE's.

What To Do, in the U.S. and around the World

The third goal of the Hu government's restoration of state leadership was to enable China to more successfully compete on global markets. This may seem a bit strange in retrospect but, in 2002, the trade surplus was only $30 billion and outward investment was almost non-existent. As China's trade and, now, its investment footprint has increased, responding to this new challenge from SOE's has become more pressing.

It is appealing to tie the flood of Chinese goods into the world economy since 2002 directly to the re-ascent of SOE's starting at the same time, but the link is indirect. Exports require true competitiveness and are therefore an area of relative SOE weakness.

The standard figure is that wholly and partly foreign-funded companies account for a bit over half of percent of exports.[19] Domestic private firms generated over 30 percent of exports in 2011. Since "foreign-funded" can include either a private or state majority owner, these numbers cannot be combined. However, the state share of exports is very likely to be capped below one-third and could be as low as one-fourth.

The indirect link is that SOE control of the home market forces other firms, foreign and domestic, to seek customers overseas. As China gets richer, the internal market has

[18] "Curtain Falls on China-US Second Economic Dialogue," *Xinhua News Agency*, May 24, 2007, at *http://us2.mofcom.gov.cn/aarticle/chinanews/200705/20070504725847.html* (February 10, 2012).
[19] "China's Private Sector Exports Surge Amid Expansion," *Xinhua*, January 11, 2012, at *http://news.xinhuanet.com/english/china/2012-01/11/c_131354868.htm* (February 10, 2012) and "Market Profile on Chinese Mainland," *Hong Kong Trade Development Council*, January 17, 2012, at *http://www.hktdc.com/info/mi/a/mpcn/en/1X06BPS5/1/Market-Profile-on-Chinese-Mainland* (February 10, 2012).

become more attractive but it has also become inaccessible for many firms and they continue to export as a result. The best American response to SOE's in exports is, thus, the same as in China: rolling them back in their home markets to the extent possible.

A second step is to enhance competitiveness of American goods and services. This is huge topic but there are two dimensions: home and overseas. At home, among other things, simpler and fewer regulations and simpler and lower taxes will make U.S. companies more competitive against SOE's. Overseas, bilateral, multilateral, and global trade accords will improve U.S. access. The Trans-Pacific Partnership (TPP) is a potentially wonderful initiative, but a lonely one. The U.S. should identify new countries for free trade talks, as well as seeing what can be salvaged from the WTO's Doha round.

In contrast to trade, the state drives outward investment. The Heritage Foundation's China Global Investment Tracker documents large non-bond investments from 2005-2011, including totals for specific firms that are not in Chinese data.[20] On Heritage numbers, state entities generated 94 percent of outward investment in 2011, roughly the same as in 2010. The largest investors are tightly state-controlled. This is very unlikely to change – outward investment is at the heart of the concept of national champions.

Top Outward Investors

CNPC
Sinopec
China Investment Corp.
Chinalco
CNOOC

Source: Derek Scissors, "China Global Investment Tracker Interactive Map," The Heritage Foundation, January 6, 2012, at *http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map* (February 10, 2012).

In third markets, American policy concerning SOE investment should parallel trade. Enhancing corporate competitiveness and market access - the latter through investment expansion and protection such as in the TPP or bilateral investment treaties - will maintain or extend the $3.5-trillion lead the U.S. has in global direct investment.[21]

At home, there is no short-term challenge. Chinese investment outside bonds has a trivial part in the U.S. economy, with the total since 2005 equivalent to less than half a percent of a single year of American GDP. There is a long-term issue, again stemming from the treatment of SOE's in China itself. The regulatory protection and financial and other subsidies given to SOE's could enable them to eventually distort competition in American markets. Chinese companies must be subject to all U.S. laws but special

[20] Derek Scissors, "China Global Investment Tracker Interactive Map," The Heritage Foundation, January 6, 2012, at *http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map* (February 10, 2012).

[21] While the proportion of Chinese investment is rising, the annual increment to American investment is usually larger, widening the absolute lead. U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data, December 15, 2011, at *http://www.bea.gov/international/di1usdbal.htm* (February 10, 2012).

attention should be paid to anti-competitive practices, some possibly unintentional. Any major problems are some ways off but the U.S. legal system will need time to adjust to dealing with Chinese SOE's.

Conclusion: Market Over State

SOE's have become more important at home during the past eight years and are now becoming more important as international investors. The U.S. is scrambling to respond to the first event and must act soon to avoid having to scramble on the second. To improve policy, the U.S. should:

1) Make as its top bilateral economic priority the clarification and reduction of the role of SOE's, especially by trimming the large number of "strategic" sectors.

2) Support IMF efforts to deemphasize bank lending as a macroeconomic tool for China, in favor of fiscal policy.

3) Enhance the competitiveness of American companies by reducing regulatory and tax burdens.

4) Improve access to foreign markets through bilateral and multilateral trade and investment agreements.

5) Immediately begin to assess the capacity of anti-trust and other laws to address the behavior of Chinese SOE's.

There is also the matter of what the U.S. should not do. SOE's constitute a competitive challenge, in China and to a lesser extent outside. This does not mean they are superior. SOE's hurt Chinese households, waste resources and harm the environment, and strongly discourage entrepreneurship. They do not deserve imitation. The U.S. should not:

A) Subsidize exports or investment to break into the Chinese market. (Never try to compete on subsidies with the PRC.)
B) Punish American households by inhibiting competition through trade barriers.
C) Block Chinese investment in the U.S. for political reasons.

The stakes have been raised by the emergence of SOE's onto the world stage. It has become that much more important to loosen their grip on the Chinese market.