Hearing on "Chinese State-Owned and State-Controlled Enterprises"

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Andrew Szamosszegi, Principal, Capital Trade, Inc.

It is my pleasure to appear today before the Commission on this important topic. My written remarks are based largely on the study I co-authored for the Commission with Cole Kyle of Capital Trade, Inc. Below, I respond to several questions put forth by the Commission prior to the hearing.

What is the scope of SOE activity in China?
Simply put, SOEs are ubiquitous. They play a role in virtually all main economic sectors. The direct role of SOEs has been diluted in manufacturing, but SOEs and their subsidiaries remain major players in several manufacturing industries. SOEs also play a prominent role in service sectors.

How much of the economy is state owned? State controlled?
How much of the economy is state-owned? There is no straight-forward answer because the level of detail in the public domain varies from sector to sector. To answer the question in a straight-forward way, you would want value added data by industry for all industries in the economy split between SOEs, non-SOEs, and enterprises with mixed ownership whose ultimate beneficial owner is an SOE. The so-called state-holding enterprises capture some of this last category, but not all of it, so a precise and dead-on accounting of the size of the state sector in China is not possible.

However, in our study for the Commission, we found that if one makes reasonable assumptions regarding the service sector and the construction sector, then the share of GDP accounted for by state-owned and controlled enterprises – which we term the visible state sector-- is nearly 40 percent and the share of non-agricultural GDP accounted for is approximately 45 percent. When you consider other forms of public enterprise such as government-owned township and village enterprises, urban collectives, and firms that are not registered as SOEs but are controlled by affiliates of one or more SOE, then it is not a far stretch to conclude that the share of GDP owned and controlled by the state is approximately 50 percent.

Has the state sector grown since 2001?
By most measures, the size of the state sector has expanded in absolute terms since 2001. However, the state sector has shrunk in importance due to the growth of the non-state sector. The one indicator where the state sector has declined in both absolute and relative terms is employment. The absolute number of SOEs has also declined.

How many SOEs are there? How about non-central SOEs?
There are approximately 117 SOEs under the control of the central State-owned Assets Supervision and Administration Commission. There are also a few hundred provincial, municipal, and county-level SASACs that own SOEs. According to the National Bureau of Statistics, there are more than 100,000 SOEs in total, the vast majority of which are not owned

by the central SASAC. In general, the absolute number of central and local SOEs has been declining due to a number of factors, including the government's desire to consolidate SOEs, and the tendency of SOEs to increase their efficiency by adopting mixed forms of ownership, and the government's desire to embrace the large and let go of the small. But the central-SOEs have been expanding both in absolute terms and relative to non-central SOEs. It is also important to recognize that the prevalence of SOEs varies significantly across China's provinces.

What are the differences between SOEs and other entities with state "involvement" (i.e., state "invested" enterprises)?
State-owned enterprises are business entities established by central and local governments and whose supervisory officials are from the government. In official statistics, this category of firms includes only wholly state-funded firms. This definition excludes share-holding cooperative enterprises, joint-operation enterprises, limited liability corporations, and shareholding corporations whose majority shares are owned by the government, public organizations, or the SOEs themselves. A more encompassing category is "state-owned and state-holding enterprises." This category includes state-owned enterprises plus those firms whose majority shares belong to the government or other SOE. This latter category, also referred to as state-controlled enterprises (SCEs), can also include firms in which the state- or SOE-owned share is less than 50 percent, as long as the state or SOE has a controlling influence over management and operations.

Are the differences similar at the town and village enterprise level?
As with so much of China, the central structures are repeated at lower levels of government. Thus, at the local level, one will find SOEs that are wholly owned by the local SASAC. That SOE will have subsidiaries, some of which are registered as non-SOEs and may include some private capital. The term township and village enterprise (TVE) refers to the location of the enterprise rather than its ownership structure. During the early years of reform, TVEs supported by private capital grew rapidly in China's countryside, but since the mid 1990s TVEs owned by local governments have been ascendant.

Is any Chinese corporate entity truly "private" and a "market" player and not subject to government control?
Yes. There are numerous entities in China that are privately owned, respond to market-based incentives, and are not controlled by the government. However, these private entities operate in policy, regulatory and financial environments in which the state wields enormous clout and influence. As such, even private entities are influenced strongly by state goals and must respond accordingly. It is not hard to find prospectuses and corporate releases in which privately-owned companies trumpet their adherence to the state's plans for their industry. This circumstance is present to some degree in all economies, but it seems more prevalent in China due to the government's institutionalized planning activities and greater economic involvement.

In addition, the CCP now allows private entrepreneurs to join the Party and has other means of co-opting or influencing private firms, including access to capital. The web of state control does not prevent private firms from responding freely to market forces, but it does create an environment that encourages fealty to government development plants.

What kinds of government support do SOEs receive?
There are number of different types of subsidies conferred upon SOEs. These include programs where the benefit is relatively straight forward, such as grants, capital injections, preferential loan rates from state-owned banks, and preferential tax rates that encourage favored activities. They also include programs in which the financial contribution and benefit are more subtle. Some examples of this include inputs provided at favorable prices, such as electricity provided by state-owned utilities and steel provided by government-owned steel mills; debt forgiveness provided to SOEs that are technically bankrupt; and better access to capital relative to non-SOEs.

The subsidy rates calculated in countervailing duty investigations offer some guidance as to the extent of subsidization in China, but these rates are company-specific and cannot be applied to the SOE sector as a whole. However, subsidies and preferences afforded to SOEs are significant. According to the Chinese Think Tank Unirule, these subsidies and preferences account for the entire profits of the state-owned sector from 2001 to 2009. Absent subsidies the real return on equity of SOEs would have been minus 1.5 percent. Similarly, a study by the Hong Kong Institute for Monetary Research, cited in *The Economist*, found that SOE profits would disappear if they had to pay a market interest rate.

Can SOEs be considered to be "commercial" and, if so, in what respects?
SOEs certainly seek to earn profits, though profits are probably more important to some SOEs than to others. SASAC, at least in theory, now judges management performance on the basis of financial performance. Thus, there are incentives in place to encourage commercial behavior. On the other hand, SOE managers are also judged by the CCP's Organizations Department. This aspect of their review is more likely to include an assessment of how well the SOE is achieving the goals of the state as laid out in the overarching five-year plan and industry-specific development plans. This more political assessment of management performance may not matter if the financial objectives of the SOE do not work at crosscurrents to the goals of the state. But commercial behavior is not likely to prevail when the financial objective come into conflict with the goals of the state.

Do they pay dividends? Taxes? To whom?
Although the central SASAC is entitled to dividends from the central-SOEs it controls, it has not always received them. Dividend payments to the central SASAC have been rising and averaged 3.8 percent of profits in 2010. In addition, there are other SOEs under the purview of government ministries. Those SOEs typically pay dividends to the ministries if they pay them at all. There is a move to have these ministry supervised SOEs also pay dividends to the central SASAC. SOEs owned by subnational SASACs and government agencies pay dividends to those entities if they pay dividends at all. It is believed that the subnational SOEs pay less than the central SOEs. Dividends do not necessarily make it into the national budget, but are instead recycled into SOEs.

SOEs are responsible for paying value added taxes, the enterprise income tax, and other taxes. SOEs have been subject to the enterprise income tax since 1994 and the taxes paid by SOEs are considered budgeted revenue. Sub-national SOEs also are subject to the enterprise income tax.

How does the current five-year plan integrate SOEs and other Chinese firms into achieving the objectives of the state?

China's five-year plans provide a national "blueprint" for industrial development. They serve as economic and industrial instructions for planning agencies, local and provincial governments, banks, and state-owned enterprises. However, these entities are not always mentioned explicitly.

The 10th Five Year Plan for National Economic and Social Development, covering the period from 2001-2005, called for "energetically optimizing and improving [the] industrial sector" by enhancing traditional industries with new technologies and intensifying construction of transportation, energy, and other infrastructure facilities. After the successful implementation of the 10th Five Year Plan, the government was confronted with overcapacity in several key industries such as steel and chemicals. The subsequent 11th Five Year Plan, covering the years 2006-2010, focused on consolidation of capacity, along with the creation of new, high-efficiency facilities that can compete on a global scale. The result was an unbalanced economy heavily dependent on exports and investment. The 12th Five Year Plan, unveiled in March of 2011, focuses on "rebalancing" the economy through a greater emphasis on consumption.

In addition to this focus on rebalancing, the 12th 5YP has an ambitious emphasis on "Strategic Emerging Industries" such as energy, health care, and technology. The government aims to create new "backbone" industries, such as biotechnology, new energy, high-end equipment manufacturing, energy conservation and environmental protection, clean-energy vehicles, new materials, and next generation IT. "National champions" are to take the lead in developing these industries. The plan states that the government must "{c}hannel state capital into industries pertinent to national security and the economy through discretionary and rational capital injection or withdrawal." Clearly, SOEs have an important role to play in this transformation of China's industrial structure.

Based on the overall plan, industry-specific five year plans are then formulated. These plans can be vague with respect to the anticipated role for SOEs. The plans generally emphasize favored industrial sectors. Five year plans are then formulated at the provincial level. These plans mirror the national plans but are tailored to the needs of a specific province. These plans will sometimes mention "key" enterprises in favored industrial sectors. Specific requirements about state-ownership are not often listed. However, often times "key" enterprises are state-owned.

It does not matter that the 12th Five-Year Plan does not mention SOEs explicitly with regards to key development projects and industry goals; the SOEs are already dominant in most of the industries which are mentioned in the plan. Moreover, in cases where projects require large capital expenditures, SOEs are in the best position to make such investments.

A review of a partial translation of the 12th Five-year Plan indicates SOEs will be affected by efforts to:

- Improve the services industries in China, many of which are currently dominated by SOEs;
- Support the old industrial base in Northeast China;
- Improve income distribution;

- Optimize investment structure;
- Channel investments into industries considered important to national security and the economy;
- Develop national champions and Chinese brands;
- Develop strategic emerging sectors;
- Implement industry innovation projects;
- Reform energy production.

Just to give an example of how this process might work, take the hotel sector. Over the past decade or so, SOEs have decided that they needed to own hotels. SASAC decided that these were non-core investments and in 2010 ordered SOEs not focused on tourism to exit the hotel business within five years. The hotels are being transferred, sometimes free of charge, to other SOEs like the China National Travel Services (HK) Group.

Does the CCP choose or influence the choice of directors and top management of SOEs?
The CCP does choose and influence the choice of directors and top management at SOEs. The Central Organizations Department of the CCP ("COD") chooses the top three positions in the most prominent central SOEs. An analysis by Pei Minxin published in 2006 found that the CCP had appointed four-fifths of the chief executives at SOEs and more than half of all senior executives.

The importance of the COD is hard to overstate. China scholar Tony Saich of Harvard's Kennedy School describes the COD as follows:

> The Central Organization Department and its affiliates play a crucial role in maintaining discipline and adherence to the party through their control over members' personnel files, their evaluation of performance and recommendation for promotion. Basically, the Department oversees the CCP's *nomenklatura* appointments; these cover all senior military appointments, senior judicial appointees, heads of major state-owned enterprises, top university presidents such as Beijing and Tsingshua, the editors of key party publications and other media, provincial leaders and directors of think-tanks. Not surprisingly it becomes the turf for numerous battles between different factions and groupings in the party. Its influence is pervasive and party members bend over backwards to please and flatter the staff. One senior retired official told me that the CCP really only needs two agencies – the organization department and the propaganda department. He should know as he had headed both of them at different times.

In other SOEs the top three positions and other high level posts are filled by SASAC. But the COD plays a prominent role here as well. A source for our study who was also a high-ranking member of the personnel department of the Ministry of Science and Technology stated in an interview that it is still the COD that wields the real power behind the scenes for major personnel appointments at every stratum of Chinese society.

Are SOEs in the United States and other foreign markets primarily expected to turn a profit or to gain market share or to pursue other non-commercial goals?
All SOEs should not be considered free market actors because the government of China still exercises a substantial degree of control. Profits are not unimportant, but it would be a mistake to view profit maximization as the primary motivator of outward FDI by SOEs.

For the past five years, the government has encouraged its SOEs to "go out" into foreign markets. Foreign investments by Chinese SOEs are not a new phenomenon, but they are more prevalent now than ever before.

SOEs are pursuing both market oriented and state goals. Clearly, there has been a policy encouraging SOEs to buy into resource producing entities in foreign markets. In these cases, profits clearly take a back seat to the state objective of securing resources that the government thinks China needs. The government is also pursuing other strategies, such as the famous brands and indigenous innovation policies, which encourage foreign investments for reasons other than short-term profitability.

SOEs generally seek to make money while meeting the state's policy objectives. State policy may dictate certain types of investments and SOEs will consider profitability when choosing among these investment options. Certainly, increasing market share for Chinese branded products is an objective of the famous brands policy, and some SOEs that invest abroad my seek to gain market share. State capital is likely to be more tolerant than private capital of strategies that maximize market share at the expense of profitability.

In a recent essay Li Zhaoxi described China's "go global" policy as a combination of national goals and company objectives. Li's opinion should be interpreted as reflecting the policy tilt of China's government as he is the senior research fellow and deputy director of the Enterprise Research Institute of the State Council's Development Research Center.

According to Li, government encouragement of outward investment has three primary goals:

- securing natural resources, especially energy and raw materials;
- contributing to China's economic adjustment by eliminating excess supply, promoting capital accumulation, and accelerating technological innovation; and
- improving international competitiveness by establishing overseas distribution networks, developing managerial talent, and promoting Chinese brands.

Thus, official support for overseas investments by Chinese firms is not simply an expression of pride in China's successful economic development over the past three decades or a natural outgrowth of China's globalization. For Beijing, the expansion of China's businesses is a means to achieve certain policy goals for China's economy. Because of China's size and its large economy, its efforts to achieve these goals are likely to have, and are already having, noticeable impacts in international markets.

What is the allocation of capital resources in China between SOEs and "private" entrepreneurs? What is the cost of capital for each?

It is now conventional wisdom that SOEs have favorable access to capital in China. This means that they are able to get favorable interest rates from state-owned banks and interest free loans from local governments, and that they are able to borrow money when they are uncreditworthy. This favorable access is a sore point with private entrepreneurs who often have to borrow from outside normal channels because the state-owned banks that dominate China's landscape still favor their state-owned clients. In the past, state-owned banks have been reformed to make them behave less like financial utilities, but the general perception is that they remain beholden to the CCP and will behave like utilities when it suits the needs of the CCP. The state-owned banks are also a powerful tool for encouraging firms to pursue the activities specified in the five-year plans.

This is not to say that private firms cannot borrow money from state-owned banks. They can, especially if they are well connected.

The cost of capital for SOEs is lower on the debt side because Chinese firms have lower cost access to bank funds, but also because they have better access to equity markets through their subsidiaries. A study of firm finance covering 2000 to 2007 found an interest rate spread of 4.1 percentage points between the borrowing rates of SOEs and private firms. A more recent study pegged the gap at 3.1 percent. These results are particularly striking because the private firms were significantly more profitable than the SOEs.

Are SOEs first in line for direct subsidies on land, energy, infrastructure, and indirect subsidies in the form of low regulations or outright exemption on workers' rights, health, and safety and environmental protection?

SOEs are well placed for obtaining direct subsidies, indirect subsidies, and preferences. However, the state will also provide subsidies to privately owned firms that are investing in industries favored by the state. As far as outright exemptions on worker rights, health, safety, and environment, it is not clear that SOEs receive special treatment. For example, many of the firms who dominate the electronics supply chain and have been in the news lately are not SOEs.