Chinese Strategic state-owned enterprises and ownership control

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This paper reviews recent reforms of the relationship between the Chinese central government and strategic state-owned enterprises (SOE), following the establishment of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC). Specifically, it examines the government’s re-evaluation of its ownership policy and the introduction of a centralised operating and budgeting system for SOEs. The Chinese central government has re-established tighter financial control over strategic SOEs, both on the income and the expenditure side. The paper argues that the government aims to maintain significant ownership control over SOEs operating in industries deemed to be strategic, while relinquishing control of less important enterprises. Topics: State-owned enterprises. JEL-codes: G32, G38, P26.

1. Introduction

State-ownership of enterprises is a perennial political issue in many countries. For two decades, the prevailing trend in Western economies was for the state to retreat from direct ownership interests in commercial enterprises. However, there have lately been clear signs of a turn in the tide, with increasing critique of excessive privatisation, in particular of utilities and public service providers, political pressures against foreign acquisitions of national champions, and re-nationalisation of key energy assets, as well as large swathes of the financial sector.

There are good economic arguments for why certain enterprises ought to be privatised, primarily the prospects of improving corporate efficiency and manager incentives.\(^1\) A long array of studies has, for example, attested to Chinese state-owned enterprises being less efficient than other enterprise forms.\(^2\) There are also sound arguments for why the state ought not to exit other enterprises in certain circumstances, for example, in industries prone to market failure or an insufficiently developed economic environment.\(^3\) However, at the end of the day, where governments choose to draw the line between public and private ownership is an inherently political question, subject to prevailing political preferences. Practically all governments maintain ownership of some enterprises, most commonly utilities, public service providers, and defence companies. The rationale for maintaining state ownership tends to be one of the following: natural monopolies unsuitable for private enterprises, social or developmental goals, investment returns used to support budgetary objectives, or national economic security. In this paper, I focus on the last two rationales for maintaining state ownership, as they lie at the heart of the current policy debate within the People’s Republic of China (PRC) on the relationship between the government and key SOEs.

Most governments consider some companies vital enough for national security in order for the state to maintain a controlling stake in them. Sometimes this understanding is tacit, while in other cases specific lists of strategic companies are compiled. For example, in 2004 Russia compiled an extensive list of strategic companies in which the government intends to maintain control.\(^4\) However, the ways of maintaining government control differ. The most straightforward method in the case of shareholding companies is to simply retain an ownership stake in excess of 50 percent. In many countries state control is further reinforced by legal stipulations that require specific parliamentary approval (e.g. in Finland and Sweden) or presidential authorisation (e.g. in Russia) if state ownership is to drop below a controlling stake. Another method is to give state shares disproportional control through special voting or veto rights, so-called “golden shares”. Such a system has been applied by Singapore, but several EU countries have also used golden shares to prevent foreign takeovers of...
their newly privatised “crown jewels”, a practice which the European Court of Justice has ruled incompatible with the EU’s free movement of capital.5

In the case of profit-making enterprises, the state naturally also has an interest in the cash flow generated by enterprises as operational profits, or through the proceeds from partial or complete privatisation. In most countries, the state collects dividends from its enterprises. Dividend and privatisation proceeds commonly go either directly to the treasury/finance ministry as general revenue, are directed to a social security fund, or are earmarked for a specific purpose such as reducing public debt. Collecting dividends from SOEs could be considered a minimum level of influence over enterprise capital allocations. In the literature on dividends, taking away surplus cash from company managers is seen as a key rationale for the use of dividends, owners thereby preventing managers from making unprofitable investment decisions on the back of excessive funds.6 Some governments retain even broader influence over SOE finances and investments.

While the collection of dividends from SOEs to state coffers is standard practice around the world, handing over the bulk of collected funds to an organisation with an ambitious industrial policy, rather than budget balancing or social security goals, is unusual. The international precedents from similar experiments with state-owned shareholding funds are generally not encouraging.7 Mainstream Western views on the relative advantages of the market versus the state in allocating investments efficiently holds that a market-oriented financial system, in general, is more efficient in allocating capital than a state-dominated financial system, despite occasional market failures.

In the PRC, as a legacy of the planned economy, the government previously had very broad control over state companies. The Chinese government has also throughout the reform period had a preference for active economic management, perhaps as a legacy of the planned economy. This active management has been particularly evident in macroeconomic policy and in bank lending. Based on the Chinese case, some scholars have even challenged the prevailing view that a centrally managed finance system is necessarily less efficient than a market-based one.8 In this respect, it is an anomaly, both internationally and in relation to the PRC’s own economic history, that the Chinese government, until recently, did not collect dividends from state-owned companies. In 1994, Chinese SOEs were exempted from having to pay dividends to the state. However, stock market-listed SOEs still had to pay dividends to their non-listed wholly state-owned parent companies that often in effect are holding companies. They in turn have, as a rule, retained all profits rather than passing them on to the government,9 which for the most profitable SOEs suggests that their parent companies are awash with cash.

The precise reasons for the dividend exemption included in the 1994 tax reform are somewhat unclear. However, at the time, SOEs were in dire straits, with lots of loss-making firms and few profitable ones. Consequently, collecting dividends for state coffers was not seen as a priority. Keeping the SOEs afloat was a more pressing concern. In this respect, the situation has changed in recent years. While there are still many loss-making SOEs, some parts of the state-owned economy are now highly profitable.

In the context of the long-running macro-economic debate on the Chinese economy's overheating, which centred on excessive (and wasteful) investments, SOE retention of profits rose onto the political agenda. World Bank economists had for years advised the Chinese government to start collecting dividends and direct the proceeds to the treasury, thereby making them subject to standard budgeting processes.10 This would curb excessive enterprise investments and shore up state finances, in particular cover shortfalls in the government's social security commitments. Over-capitalisation of some SOEs due to the moratorium on state dividend collection, in conjunction with politically influenced bank lending, contributed to over-investment in many industries.

In the next sections I will subsequently elaborate on three main steps that have been taken in bolstering political control. I start with describing
the consolidation of the state’s ownership representation in SASAC. The following section elaborates on which sectors the government considers as strategic. The fourth section subsequently examines the Chinese government’s introduction of a centralised operating and budgeting system that tightened government control over SOE finances, both on the income and on the expenditure side.

2. Chinese SOE reforms and the establishment of SASAC

Despite three decades of economic reforms in the PRC, restructuring of large state-owned enterprise groups has proceeded at a slow pace. While a variety of different measures and reform models have been tried since the 1980s, these have mostly been half-hearted or unsuccessful. The establishment of the State Assets Supervision and Administration Commission under the State Council in 2003 marked a new phase in efforts to deal with the outstanding challenges and unresolved problems of China’s state-owned enterprises. The founding of SASAC launched a process of redefining the relationship between the central government and the so-called “central enterprises” (zhongyang qiye), the key SOEs that have been selected by the government to form the basis from which China’s future top global companies will be created. Central enterprises account for the bulk of SOE profits and around a quarter of SOE corporate investment.

In the planned economy, state-owned enterprises were an integral part of the state budgeting system, with all their financing needs being covered by the state, and profits and losses directly included in the state budget. In the late 1970s, more than half the budget revenues were drawn from state-owned enterprises. The low performance incentives provided to SOE managers in this system, led the government to experiment with various models of profit retention, such as the “contract management responsibility system”, through which managers could retain a part of the profits after meeting government-set targets. Following a tax reform in 1994, wholly-owned SOEs were exempted from paying dividends to the government, allowing SOEs to retain almost all their post-tax profits. In 1994, the Company Law was also promulgated, providing a legal framework for SOE reforms. The guiding principle of the SOE reform strategy became the expression zhua da, fang xiao, or “grasp the big and let the small go”, a reference to a policy enshrined in the 9th Five Year Plan (1996–2000) concentrating the government’s resources on the larger SOEs, while relaxing state control over smaller SOEs. Government controls over enterprises’ investment and management decisions loosened, and government supervision in general progressively entered a state of disarray following the break-up of links between ministries in charge of specific industries and enterprises, and the corporatisation and partial public listing of big SOEs.

The establishment of SASAC contains both centralising and decentralising features. On the one hand, by clearly separating central, provincial and municipal SOEs and handing control over them to SASAC offices at the respective administrative levels, the principle of local control over local SOEs was clarified and institutionalized. On the other hand, by taking all central enterprises away from the control of various government agencies and putting them under the unitary supervision of an organ that reports directly to the State Council, the central government asserted its authority. SASAC strives to centralise several functions that were formerly dispersed over various government agencies.

SASAC strives to centralise several functions that were formerly dispersed over various government agencies.
Local SASACs, those at the provincial and city levels, handle SOEs within their respective jurisdictions, with independent powers over SOEs delegated to the local level. Although the central enterprises under the management of central-level SASAC comprise only 136 major companies out of a total of nearly 120,000 SOEs, their size and importance to the national economy in many respects surpasses that of all the other SOEs combined. Central enterprises account for roughly 70 percent of all SOE profits (equivalent to 20 percent of government revenues), and their listed subsidiaries stand for around one-third of the entire valuation of Chinese domestic stock exchanges. The combined value of the assets of central enterprises amounted to around 1.2 trillion euros in 2006, which is just over one-quarter of all state enterprise assets.

SASAC has a broad mandate that includes drafting laws and regulations regarding state-owned assets, managing and restructuring state assets so that their value develops positively, and hiring and firing the executives of SOEs (who are equivalent to civil servants) under its supervision, at the behest of the Communist Party, which ultimately retains the authority over key appointments. The foundation for SASAC was laid during the 16th Party Congress in 2002, which reformed the management systems for state assets, emphasising that primarily the central and local governments should exercise their legal duties and rights as investors in state assets. Secondly, it stressed that the management of (state) assets, people and matters shall be unified. Thirdly, it stated that the respective jurisdictions of the central and local levels of government as well as the roles of investors and managers needed to be clearly demarcated and clarified in order to prevent overlapping authorities. SASAC was bestowed with the rights of the principal investor in state assets, implying the rights to enjoy dividends from enterprise cash flow, to take major decisions regarding enterprises and to choose enterprise managers. Officially, SASAC is defined as a ministerial-level “special organisation” reporting directly to the State Council (guowuyuan zhishu teshe jigou). Incidentally, SASAC is the only organ in this organisational category, which appears to have been established exclusively for it.

Yet, in its first years, the legal position of SASAC has been unclear, partly because China had not yet established a law on state assets. This shortcoming was addressed in October 2008, when China finally passed a long-debated Law on Enterprise State Assets (qiye guoyou zichan fa). The new enterprise state assets law does not explicitly mention SASAC, either. However, paragraph three of the law states that the State Council, as a representative of the state, exercises the ownership right over state assets. Furthermore, the law refers a few times to “organisations supervising and administering state assets” (guoyou zichan jiandu guanli jigou). This seems to imply that SASAC, as the State Council unit designated to handle issues related to state assets, in turn represents the State Council. Other sections of the law refer in a more circumspect way to “organisations that exercise the investor responsibility” (lüxing chuziren zhize de jigou). Nevertheless, SASAC’s legal status has been indirectly established through other laws. In the new Company Law that took effect in January 2006, the section on wholly state-owned companies repeatedly mentions SASAC as the organisation that wields ultimate power in matters related to these enterprises. SASAC itself refers to the Company Law as one of the legal bases for its existence. The previous version of the law vaguely referred to “state-authorised investment organisations or agencies” (guojia shouquan touzi de jigou huoze guojia shouquan de bumen).

Although one of the original aims of establishing SASAC was to more clearly separate regulation from ownership, it still exercises both roles. Scattered case-based evidence suggests that SASAC has not been shy to use its de facto regulatory authority. It has also begun to exercise its ownership interests more actively. However, SASAC has many auxiliary aims. One of the more laudable aims is to tackle the asset stripping and corruption, that had become a festering problem in SOEs, by putting restrictions and strict requirements on ownership transfers, e.g. through management buy-outs (MBOs). Some sources note this as one of the key aims of putting the SOEs
under unitary control. Among the more dubious facets of the reform is that an activist state-owner hampers effective management of SOEs by unnecessarily reshuffling enterprise management or letting local government meddle in the management of successful companies. Furthermore, while the central government has a point in saying that SOE profits are not always reinvested in sound ways, there are no guarantees that a governmental body with ambiguous goals and affected by political considerations will do a better job.

Recently, there have been reports suggesting that regulatory and ownership functions may in the future be more clearly separated. Specifically, SASAC has since 2005 experimented with creating asset management companies (AMC), such as the State Development and Investment Corporation and the China Chengtong Group, to manage state investments. A three-layered structure consisting of state-owned enterprises, asset management companies and SASAC would allow SASAC to exercise a more general supervising, policy-formulating and regulating role, while leaving the day-to-day enterprise management to SOE managers and state asset management functions to AMC managers.

3. Determining which companies are strategic

Hardly any country is indifferent to the loss of important national assets, especially to foreign owners. Often the privatisation of formerly state-owned units becomes a highly political issue. Until recently, China’s model for maintaining state control was to retain a clear shareholding majority, commonly 55 to 70 percent of the share stock, as non-tradable shares in the hands of government agencies, wholly-state owned holding or other government-linked legal persons. However, this model has recently changed, as non-tradable shares have been converted into tradable shares, so that most shares of stock-market listed SOEs are now in principle openly tradable on the market.

One of the key issues in relation to the central enterprises is whether the government will seek to retain them as wholly or majority state-owned indefinitely. Given that almost all the biggest Chinese companies are currently state-owned, this issue is central when gauging the nature of future globally operating Chinese companies in general. Of late, it appears that the pendulum between state and market in the governance of SOEs has again swung in favour of a greater role for the state. Some government officials and scholars at government-linked research centres have in recent years been critical of the growing role of private and foreign interests in the economy, and argued that the government should retain control of key parts of the economy.

The Chinese discourse on SOEs is full of terms that denote the importance of certain companies and sectors, such as “backbone enterprise” (**gugan qiye**), “pillar industry” (**zhizhu chanye**), “central enterprise” (**zhongyang qiye**) and “key industry” (**zhongdian hangye**). However, until recently the Chinese government had not specifically defined which sectors it considered to be critical or strategic. The list of central enterprises was probably the best proxy for which companies the Chinese central government in the foreseeable future will not relinquish control of. Among the 136 companies currently listed are most companies that in other countries would be considered key to national security (energy and defence-related companies) and most other major companies outside consumer electronics and finance (e.g. car manufacturers, shipbuilders, telecom companies).

A more precise demarcation of which industries and companies the Chinese government considers strategically important, and clearer guidelines on how tightly these companies ought to be controlled, was needed. A list of specific industries was made public for the first time at the end of 2006, when SASAC chair Li Rongrong revealed that seven sectors (among central enterprises) are considered strategically important, as they are related to national or economic security, and that the government has to maintain absolute control in these sectors, through either sole ownership or
an absolute controlling stake. The seven industries are defence, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping (Table 1).

<table>
<thead>
<tr>
<th>Categories</th>
<th>Industries included</th>
<th>Ownership objective</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic and key industries</td>
<td>Defence, power generation and distribution, telecom, oil &amp; petrochemical, coal, civil aviation, shipping</td>
<td>Maintaining 100 percent state ownership or absolute control; increasing state-owned assets in these industries.</td>
<td>40</td>
</tr>
<tr>
<td>Basic and pillar industries</td>
<td>Machinery, auto, IT, construction, steel, base metals, chemicals, land surveying, R&amp;D.</td>
<td>Absolute or conditional relative controlling stake; enhancing the influence of state ownership even as the ownership share is reduced where appropriate</td>
<td>60</td>
</tr>
<tr>
<td>Other industries</td>
<td>Trading, investment, medicine, construction materials, agriculture, geological exploration.</td>
<td>Maintaining necessary influence by controlling stakes in key companies; in non-key companies state ownership will be clearly reduced.</td>
<td>40</td>
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Table 1. The government's state-ownership objectives and approximate number of companies. Source: State Council opinion released 5 December 2006 [www.gov.cn/gongbao/content/2007/content_503385.htm]; Xinhua interview with SASAC chair Li Rongrong (State Council website, 18 December 2006) and reporting on press conference with Li Rongrong explaining the rationale of the policy paper.

Many of the biggest and most profitable Chinese companies operate within these seven industries. In all these sectors, the role of foreign and private investors would be restricted. Foreign companies would e.g. be confined to participating in developing downstream petrochemical products or value-added telecom services. In addition, the state will also maintain absolute or relative controlling stakes in another group of industries, denoted as “pillar industries”. Only a small share of the assets of central enterprises would then be sold to non-state owners.

The list of strategic sectors is fairly typical of similar lists of strategic sectors drawn up by other countries. However, the Russian experience shows that lists of strategic enterprises tend to be modified over time, adding or dropping companies and industries from the list, depending on changes in policy preferences. The state’s determination to keep key industries in its own hands was reinforced with new merger and acquisition (M&A) regulations, issued in 2006. These rules call for acquiring companies to submit to a review by the Ministry of Commerce if there is a possibility that Chinese economic security is endangered: if well-known brands and trademarks are involved or if acquisitions involve important companies or occur in “key industries” (zhongdian hangye).25 Presumably, the key industries referred to were the same as those on the list of strategic and pillar industries.

However, there was a complication involving the structure of the central enterprises. Most of the 136 large companies that appear on the list are only umbrella-structures for intricate corporate empires, some of which have evolved towards having pyramidal features.26 The central enterprises have more than 17,000 subsidiaries, often on as much as five different hierarchical levels.27 Many productive assets are actually in private or partially privatized subsidiaries. As a consequence, SASAC often does not have control over what happens on lower subsidiary levels when corporations are restructured. Following insider trading by managers of company shares and manager buyouts, SASAC could still lose its grip over
valuable strategic assets at the subsidiary level, despite having categorized the “umbrella companies” as strategic industries. Perhaps in order to remedy this situation, it was in January 2009 reported in the media that the government was in the process of drafting a list of key central enterprise subsidiaries, whose sale (or privatization) was also not allowed. Purportedly, key subsidiaries in the seven industries deemed strategic were to be included, possibly with the addition of some sectors from the batch of basic and pillar industries.

SASAC officials prefer to actively control the restructuring of the state-owned economy, having repeatedly said that central enterprises need to merge in order to achieve a scale at which they can compete globally. The stated aim is to reduce their number to 30 to 50 globally competitive companies. The most likely candidates to form the core of these future Chinese state-controlled mega-companies are those operating in the industries defined as strategic or pillar industries. Among these are almost all the largest, most competitive and most profitable Chinese firms, with notable exceptions being some IT and electronics companies, as well as financial enterprises. In the SASAC vision, there would then in the future be less, but bigger and more competitive SOEs.

4. Enhancing financial control over state-invested enterprises

While SASAC represents the ownership interests of the Chinese state, until recently it did not have actual control over the budgets and profits of the enterprises under its supervision. A major change in the financial management of SOEs was decided on in 2005. In that year, SASAC’s role in guiding the budgets and investments of SOEs was enhanced substantially, as central enterprises were instructed to compile annual “state capital management budgets” under SASAC supervision. These budgets were expected to consolidate companies’ investment funds and required that they turn over a portion of their post-tax profits to the state. The reform shifts a share of the authority on allocating profits and guiding corporate investments from the individual enterprises to the government, and in the case of the central enterprises indirectly to SASAC.

One of the conspicuous features of China’s decade-long economic growth spurt is the very high ratio of investment to GDP, even compared with Japan, South Korea and Taiwan when they were at a similar stage of economic development. While some economists disagree with the contention that China as a whole over-invests, the mainstream view among scholars appears to be that the investment allocation system in China does not function well, as numerous cases of over-investment in various sectors of the economy indicate. Research has shown that Chinese domestic capital flows, especially capital based on loans from government-linked financial institutions, tend to favour relatively non-productive SOE-heavy areas. A major reason for China’s supernormal investment rates is enterprises that reinvest most of their earnings, rather than distributing earnings as dividends or strengthening their balance sheets. According to World Bank scholars, retained corporate earnings finance almost 75 percent of corporate investment and amount to around 20 percent of China’s GDP.

One of the main drivers of investment in recent years has been a triangular relationship between state-owned enterprises with semi-monopolistic features enabling windfall profits that are reinvested, central government hesitancy on imposing hard budget constraints on SOEs and collecting dividends from them, and local governments locked in heated competition for GDP growth and prone to local protectionism. The most profitable areas of the Chinese economy have tended to be in sectors related to raw materials and energy that are restricted to foreign competition. The companies operating in these sectors tend to be powerful and well-connected to the political hierarchy. Efforts that target managers’ decision-making freedom or reduce their ability to decide over profits have unsurprisingly encountered strong resistance from enterprise managers, often supported by sympathetic local government officials.
While there are still many loss-making SOEs, the state-owned part of the economy has, on the whole, been producing solid profits in recent years, with SOE profits multiplying both in absolute terms and relative to the size of the economy and government revenue in the past decade (Figure 1).33

![Figure 1: State-owned or -controlled industrial enterprises’ profit development. Data source: NBS.](image)

Some corners of the state-owned economy are awash with cash, but often with inadequate procedures for reaching sound investment decisions due to undeveloped corporate governance structures. While the quality of management and corporate governance has improved over the years, the high profitability enjoyed by some central enterprises is still commonly converted into new investment. Given soft budget constraints, companies often have ample incentives to reinvest profits. Investment is therefore kept at an abnormally high level. As a consequence, profits have often been ploughed into unprofitable, speculative or duplicatory investments. One motivation for the government in introducing the state capital management budget is to rein in such wasteful investments.

However, many among the mass of smaller SOEs are still loss-making, or barely break even. The bulk of SOE profits are made in a handful of big SOEs, all of which are central enterprises. The biggest industrial profits in China have been made in sectors of the economy that are dominated by state-owned enterprises, such as the oil and petrochemical, energy and metal industries. Table 2 shows the cumulative profits of the most profitable industrial sectors in the period 2000–2005, as well as the importance of state ownership in China within each sector. Several of these industries retain semi-monopolistic features, dominated as they are by a handful of SOEs and often shielded from competition by administrative and legal measures.34

In 2005, the entire state-owned sector made a net profit of Rmb 644.7 billion, according to the PRC National Bureau of Statistics figures.35 This figure is very close to the total profits recorded by central enterprises, Rmb 627.7 billion (754.7 billion in 2006). The concentration of profits goes further. Among the central enterprises, the forty most profitable firms account for 95 percent of all profits, while the twelve most profitable firms made 78.8 percent of all central enterprise profits in 2005. Given the concentration of profits in the biggest enterprises, in the SOE dividend debate, the focus has, not surprisingly, been on central enterprise dividends.

As a consequence of a long series of administrative, corporate and fiscal reforms involving the SOEs, the central government lost many of the tools to directly guide the economy. Most investment decisions are now taken in the interaction between corporations and local government. While the number of central enterprises is limited, they account for a large share of investments, and also still enjoy a major share of loans extended by the state-owned banks (SOB). More importantly, since the central enterprises are now under the administration of SASAC, with a mandate from the State Council, it should be easier for the central government to influence the investments of this sector of the economy than either the foreign-invested sector or the privately invested sector, which receive little financing from state-owned lenders.
Table 2. Cumulative industrial profits in the 15 most profitable industries in China 2000–2005 (Billion RMB), and state ownership share of industry revenue (percent). Sources: CEIC database, NBS China Statistical Yearbook 2006. Note: State ownership refers to the combined revenues of state-owned enterprises as a share of industry total revenue.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Profits</th>
<th>State ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Petroleum and natural gas extraction</td>
<td>893.7</td>
<td>95.5</td>
</tr>
<tr>
<td>Electricity, gas and water</td>
<td>382.4</td>
<td>99.3</td>
</tr>
<tr>
<td>Electronic, computers and telecom equipment</td>
<td>366.4</td>
<td>13.5</td>
</tr>
<tr>
<td>Smelting and pressing of ferrous metals</td>
<td>332.2</td>
<td>49.4</td>
</tr>
<tr>
<td>Transport equipment</td>
<td>315.1</td>
<td>52.5</td>
</tr>
<tr>
<td>Raw chemical materials</td>
<td>289.9</td>
<td>31.6</td>
</tr>
<tr>
<td>Electric machinery and equipment</td>
<td>218.1</td>
<td>11.2</td>
</tr>
<tr>
<td>Ordinary machinery</td>
<td>171.4</td>
<td>23.7</td>
</tr>
<tr>
<td>Tobacco processing</td>
<td>159.7</td>
<td>98.8</td>
</tr>
<tr>
<td>Non-metal mineral products</td>
<td>147.1</td>
<td>13.7</td>
</tr>
<tr>
<td>Textiles</td>
<td>140.4</td>
<td>7.6</td>
</tr>
<tr>
<td>Medical and pharmaceutical</td>
<td>137.0</td>
<td>27.7</td>
</tr>
<tr>
<td>Coal mining</td>
<td>112.4</td>
<td>71.4</td>
</tr>
<tr>
<td>Smelting and pressing of non-ferrous metals</td>
<td>105.8</td>
<td>36.2</td>
</tr>
<tr>
<td>Metal products</td>
<td>98.1</td>
<td>7.8</td>
</tr>
<tr>
<td>All other industries</td>
<td>932.0</td>
<td>-</td>
</tr>
</tbody>
</table>

The Chinese central government is concerned about the ability of SOEs to re-invest profits prudently. SASAC, for one, believes that it can do a better job in guiding investments at the macro-level than enterprise managers can. Consequently, during the last few years SASAC developed a comprehensive framework for guiding SOE capital allocation decisions. As a pilot exercise, some provincial and municipal SASAC offices, including Beijing, Shanghai and Shenzhen, first gained operational control over local SOE budgets and profits. In December 2006, the Finance Minister announced that in 2007 all directly state-controlled central enterprises as well as local enterprises should begin to compile the state capital management budgets on a trial basis. The most notable consequences of the reform are that it allows the state to extract dividends from SOEs and provides it with some oversight over corporate investment. Eventually, the system will also cover state-invested financial institutions, including the SOBs.36

However, the decision to start collecting dividends gave rise to strong disputes between different government agencies. The principal protagonists were SASAC, which originally wanted control over all or most SOE dividends for restructuring domestic industries, investing in new strategic investment priorities and funding public works projects, the Ministry of Finance, which wanted the proceeds included in the regular state budget, and SOE corporate managers who more or less opposed the whole idea.37 In the intra-bureaucracy wrangling, the MoF bargaining position was stronger than SASAC’s, as SASAC decisions need to be counter-signed by the MoF in order to take legal effect.38 Eventually, SASAC had to yield to the MoF on the issue of direct control over the dividends. While it was given the responsibility as the leading organisation in compiling the state capital management budgets, all proceeds were first to be remitted to the MoF, from which a certain share would then be turned over to SASAC for use in supporting and restructuring SOEs.

The question of at what level dividends were to be collected became a subject of debate. Local SASACs in several trial locations (Beijing, Shanghai, Fujian) collected dividends at a ratio of 20 percent of net profits in 2006, a rate that had also been proposed as a national rate. However, when rolled out nationally, the dividend level was set lower, with rates of ten, five and zero percent applied, based on enterprise categorisations (fenlei shouqu). The most profitable companies were required to pay the highest rate, while military-industrial enterprises and research institutes were largely exempt
from remitting profits to the state. As profits are highly concentrated, in practice, a 10 percent rate is applied to the most profitable central enterprises. This generates a substantial cash flow to state coffers.

SASAC has grouped central enterprises into various categories and defined “core industries” for each company, beginning in 2004. SASAC restricts core business areas, even in the case of large enterprises, to a maximum of three. This exercise has several implications. As part of the state capital management budget, side-business investments will, at least in theory, be strictly controlled, with SASAC reserving to itself the right to deny enterprise investments when these are deemed as not serving the strategic objectives of the core business. According to regulations, side-business investments have to be reviewed and approved by SASAC, while core business investment only needs to be reported to SASAC. Thus, the rules on investments and business definitions are designed to directly tackle the widespread SOE practice of using their surplus cash to diversify into businesses that have no relation to the core business, or speculating in the stock and housing markets. However, according to SASAC, side-business investments only accounted for three to four percent of all central enterprise investments in 2005, so the impact of these regulations on overall corporate investment levels should be limited.

In conjunction with SASAC’s goal of listing related businesses within an enterprise comprehensively on the market (zhengti shangshi), companies with separately listed subsidiaries that do not fall within the core business areas will probably be pressed to divest these non-core subsidiaries, as e.g. petroleum company Sinopec has already done in some cases, or buy up and consolidate subsidiaries in core industries. In the spring of 2006, SASAC chair Li Rongrong stated with regard to defining core businesses that, in the future, state assets would be concentrated in four economic areas: in those industries that are related to national security and key to the “lifeline” of the economy; in those areas that possess competitive advantages or may develop into future leading industries; on big internationally competitive industrial groups and companies; and on the core businesses of central enterprises. The first of these criteria uses almost word for word the same expression as in the definition that was used for strategic industries and later enshrined also in the Law on Enterprise State Assets that took effect in May 2009. This, of course, is no coincidence. The characterisation was already stipulated during the 15th Party Congress (1997), which decided that the state has to retain control of sectors that concern national security, the national economic lifeline, basic infrastructure, key resources and strategic high-tech fields.

Through SASAC and the establishment of the state capital management budgeting system, the government now has stronger, although far from perfect, control over both the expenditure and income of SOEs. Specifically, the government has enhanced its financial control via two key requirements. Firstly, companies have to remit a share of operating profits, asset sale proceeds, liquidation proceeds and other profits to the government. Secondly, pre-approval is required for non-core business investments and pre-notification of core business investments. However, tightening government control over SOE profits and expenditures is not a one-way street. While SASAC tried to rein in rampant and wasteful corporate investments in times of double-digit growth figures; at the onset of the economic crisis that erupted in 2008, state asset managers were quick to lend a helping hand to central enterprises. Based on the 2008 capital management budget, a cash injection for central enterprises of Rmb 54.78 billion was announced by SASAC in November 2008, with 49 percent of the money going to increase state ownership over assets related to national economic security and people’s livelihood, 36 percent to cover SOE losses incurred...
due to natural calamities, and the rest to cover corporate restructuring costs.45 With the global economic crisis hitting China’s shores, SASAC also announced emergency financial support to some ailing central enterprises. The state’s hold on SOE finances has then strengthened both in the case of profitable and loss-making enterprises.

5. Conclusion: Less ownership, more state control

The long process of loosening the ties between SOEs and the government that started with the onset of China’s economic reforms appears to have reached a turning point. While most of the previous SOE reform efforts resulted in enhanced managerial and/or local government control over enterprise management and financial decisions, several recent government initiatives appear aimed at re-establishing central government authority over key SOEs. In some ways, these efforts are only giving teeth to a strategic direction stipulated already in the mid-1990s on letting go of the small, while grasping the large SOEs.

This paper has argued that the central government is strengthening its financial control over a handful of the biggest and most profitable Chinese companies. The first step in this development was unifying the state’s ownership representation in SASAC and compiling a list of central enterprises that were placed under its supervision. The second step involved stipulating clearer demarcations on which industries the government considers strategic, and backing this up with a number of prohibitions on their sale or privatization that will probably also be extended to cover SOE subsidiaries. The third step was to introduce a centralised operating and budgeting system that tightens government control over SOE finances both on the income and on the expenditure side.

The shortlist of seven strategic industries implies that at least 40 enterprises on the central enterprise list (and many of their numerous subsidiaries) will be indefinitely off-limits to foreign or private control, as will probably also be the 60 or so companies operating in industries characterised as “pillar” industries. Companies operating in the strategic industries tend to be the largest among the central enterprises. Remarkably, almost all the profits among central enterprises and most of the profits in the state-owned sector of the economy as a whole are currently made by the top forty central enterprises. A number of indicators therefore suggest that the central government has concluded, “less is more”. By controlling tightly a small fraction of all SOEs, the state can maintain disproportionate control over profits, investments and the national economy, thus enabling it to let go of many small SOEs without sacrificing much control.

However, there is an inherent paradox. SASAC directors continually emphasize that they are in the process of separating the functions of government and enterprise. While this may be true with regard to the entire state-invested economy, especially if the government actively sells off non-core companies, it is dubious with regard to the central enterprises. The current trend in ownership policy, in conjunction with policy papers and statements on strengthening the state’s hold of strategic industries and channelling state assets to these sectors, provides fuel to critics who contend that big Chinese state-owned enterprises, supported by SOBs, play a role in realising ambitious policy aims.46 On the other hand, the thinking on state-ownership and financial assistance to corporate entities has undergone a sea-change over the past two years also in the EU and the USA, with a number of governments showing growing appetite for actively supporting and retaining control over “national champions”. The economic and political disasters of the beggar-thy-neighbour policies of the past should caution us to the dangers of competitive state-capitalism.

Notes and references

* This is a short and updated version of a more extended discussion paper: Mattlin, Mikael (2007), The Chinese government’s new approach to ownership and financial control of strategic state-owned enterprises, BOFIT Discussion
Papers 10/07. Helsinki: Bank of Finland, pp. 1-59. The author would like to thank Jonathan Holslag for constructive comments on how to improve the paper.


6 World Bank op. cit., pp. 4–5.

7 Mako and Zhang (2004), pp. 9–12.


9 Ibid, p. 10.

10 World Bank policy note (2005), pp. 6–9, 18–20; Mako and Zhang (2004), p. 35.


14 While it is recognised in China that ownership and regulatory functions need to be separated, such a functional division does not appear to have been implemented in the case of SASAC. Mako, William P. and Chunlin Zhang (2004), State equity ownership and management in China: Issues and lessons from international experience. Paper presented at the conference Policy Dialogue on Corporate Governance in China, Shanghai, February 25–26, 2004, p. 4.


16 The list can be found in Chinese on SASAC’s website at <www.sasac.gov.cn>.

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20 In a notable case, SASAC ruled that Haier, one of China’s most successful companies, belongs to the Qingdao city government, and that management buyouts in big SOEs were forbidden. The Economist 1.9.2005. The myth of China Inc.


22 China Daily online, 30.6.009, Managers of state assets likely soon.

23 Such legal persons are, for example, state-owned commercial banks, policy banks or AMCs.


25 Ibid.

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28 Sutherland and Ning, p. 24.
29 Kang Yi & Liu Weixun, op. cit.
33 One observer from the private equity community disagrees with the officially published profitability figures, arguing that they are artificially inflated by several accounting peculiarities. Shan Weijian (2006), The World Bank's China Delusions, Far Eastern Economic Review, pp. 29–32.
34 The steel industry is different in this respect. While the biggest companies in the steel industry are SOEs, the industry also has numerous smaller players, and profit margins are therefore thinner.
36 Caijing online, 17.8.2009, Yangqi di san ci hongli shoujiao qidong zaiji.
40 Channelling state resources into strengthening the global competitiveness of these companies is in line with China’s 11th five-year plan, which put heavy emphasis on developing indigenous Chinese technological and innovation capabilities.
41 Chen (2005), p. 105.
45 China Daily online, 27.11.2008, 55 billion yuan in support for SOEs.
46 A case in point is the decision by state-owned China Development Bank to provide a low-interest loan equivalent to over 20 billion euro to one of the central enterprises, CNPC, to fund its overseas expansion. Financial Times online 9.9.2009, CNPC boosts war chest with $30 bn loan.