

# China's State-Owned Enterprises: Thriving or Crumbling?

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# Asia Pacific

## I S S U E S

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**S U M M A R Y** Even though China's state firms lost their near-monopoly status after 1978, they still form the country's financial and industrial nucleus. Nevertheless, in early 1996 the total losses of these state-owned enterprises (SOEs) exceeded profits for the first time. With the economy threatened, officialdom issued a mandate in 1997: SOEs must become profitable in three years. In 2001, statistics showed a massive turn around, and victory was declared. Despite doubts about the official statistics, substantial improvement did seem evident. The question was, what caused it? While massive layoffs and corporate restructuring did increase efficiency, most improvements have been the result of external factors such as debt restructuring and government-arranged buy-outs and mergers. This strategy offers short-term rewards, but could be a disaster in the long term. Real reform of China's state sector requires financial reforms that bite (even more urgent with WTO entry), serious moves toward a social security system for displaced workers, and more outright privatization of state firms to give non-state shareholders real power on their boards.

*The unanswered question is whether restructuring is making real progress*

During the last 20 years the Chinese economy has been transformed, gradually moving away from a centrally planned system to one that is strongly influenced by market forces. Nonetheless, vestiges of the centrally planned economy remain, especially among state-owned enterprises (SOEs). Although SOEs have retreated from their near-total monopoly over the means of production, they still form the nucleus of China's industrial and financial system. State-owned and state-holding enterprises dominate the heavy industrial, transportation, and raw material extraction sectors in China, accounting for more than one-half of industrial employment, two-thirds of industrial assets, almost one-half of industrial output, and more than two-thirds of all liabilities held by Chinese industry.<sup>i</sup>

Yet, despite their importance, state enterprises entered a crisis in the late 1990s. In the first quarter of 1996 the total losses of industrial SOEs exceeded their gross profits for the first time in the history of the People's Republic.<sup>ii</sup> This declining financial performance was the result of an increasing number of SOEs operating in the red and a significant portion of SOE production capacity lying idle.<sup>iii</sup> Their declining performance, however, did not stop state enterprises from absorbing 50 percent of fixed asset investment and 60 percent of domestic loans extended by state banks.<sup>iv</sup> SOEs thus used scarce capital very inefficiently, putting a drag on productivity increases and undermining the already weak, state-dominated banking system. Recognizing this threat to the economy, Zhu Rongji, then China's vice-premier, announced in late 1997 an ambitious goal: Within three years' time the great majority of SOEs would escape from their difficulties, stop bleeding red ink, and turn a healthy profit.

In 2001, Zhu Rongji's new deputy, Li Rongrong, the State Economic and Trade Commission minister, declared victory: "The steady profit increase of state firms has demonstrated that our reforms over the past three years have been successful."<sup>v</sup> Indeed, official statistics show a massive turn around in the fortunes of the Chinese state sector. Of the 6,599 large and medium-sized SOEs that recorded losses in 1997,

65 percent made profits in 2000. Overall, state sector profits reached 239.2 billion RMB (US\$28.9 billion) in 2000, an increase of 190 percent over 1997.<sup>vi</sup>

Despite these reports, both Chinese and foreign analysts have shed doubt on the state sector's turn around, noting the notorious inaccuracy of China's statistical system and anecdotal evidence that state enterprises are riddled with incompetence, corruption, and an inability to compete with private and foreign companies. Doubts about the accuracy of state sector statistics are corroborated by a recent survey conducted by the Chinese auditor-general, Li Jinhua. While auditing the 1999 financial records of 1,290 large and medium-sized SOEs, Li found that the accounts of 68.45 percent of these enterprises did not truly reflect their financial situation or operational results. In fact, 11 percent of the total assets of these firms were found to be bad.<sup>vii</sup>

Even so, it would be difficult to explain the state sector's reversal of fortune reported by the Chinese government solely by statistical fabrication. The unanswered question is whether, alongside the corruption and dubious accounting, the process of restructuring SOEs is making real progress. Have restructuring efforts actually shifted SOE management patterns and truly increased their efficiency? Or have favorable government policies and state handouts temporarily obfuscated the true nature of SOE performance? Ultimately, are China's state enterprises thriving or crumbling?

The reality is that while some increases in efficiency have occurred in China's state sector due to massive layoffs and SOE corporatization, most improvements over the past three years can be traced back to external factors. Lower interest rates, massive debt-equity swaps, and government-arranged mergers and buyouts have formed a package of government policies that have favorably influenced the performance of state enterprises. However, relying on state support is hardly a sustainable option to turn around the state sector's fortunes. Tough reforms that increase the internal efficiency of China's large and medium-sized state firms must be made to bite.

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### China's Partial State Sector Reforms

In 1978, as market reforms were initiated, the Chinese planned economy was modeled upon its Soviet counterpart.<sup>viii</sup> This system assembled all parts of the economy into one large pyramidal structure. At the tip of the pyramid stood the planners, who sought to concentrate all resources into a government-run investment program that favored state-owned industrial firms. Industrial SOEs thus constituted the linchpin of the centrally planned economy, accounting for the majority of savings, investment, productive capacity, and growth in the economy. Moreover, the close integration of SOEs with the state bureaucracy caused them to function as extensions of the state administrative structure.

Due to insufficient administrative and technical skills, the Chinese government was never able to operate the planned economy in as much detail as did governments in Eastern Europe and the Soviet Union. Authority over a majority of SOEs devolved to provincial and sub-provincial governments. This decentralization made it easier for local governments to launch experiments with state enterprise reform after the green light to tinker with the existing economic structure was given in 1978. Several of these local experiments were later introduced on a national basis, including the Economic Responsibility System from 1981 to 1983, the Liguaishui (Tax for Profit) reforms from 1983 to 1986, and the Contract Responsibility System from 1987 onward. Most of these reforms established a contractual relationship between the state enterprise and its governmental supervisory agency, allowing SOE management a degree of decision-making autonomy and to retain a certain amount of enterprise profit for reinvestment. Managerial incentive to maximize profits were thus enhanced.

In addition to these internal reforms, a number of financial and market reforms altered the environment under which state enterprises operated. The gradual introduction of market-determined commodity prices exposed SOEs to the forces of demand and supply, while capital allocated to state enterprises was converted from direct government grants to bank loans.

Most importantly, during the 1980s local governments implemented measures that enabled a variety of new enterprise ventures to enter the once-coveted markets of the state industrial and commercial sector. The growth of these non-state enterprises, including foreign invested enterprises, subjected many SOEs to increased competitive pressure.

Nevertheless, the fundamental structure for industrial organization and administrative oversight in the state sector remained virtually unchanged. Up until the mid-1990s most SOEs continued directly under the authority of governmental supervisory agencies, such as line ministries at the central level and sectoral bureaus at the provincial level. This led to serious problems.

First, SOE management autonomy remained insufficient. The party and the state continued to interfere with operations and personnel appointments. Second, continued state control hampered the development of markets for capital, technology, labor, and managerial skills. Finally, the close ties of SOEs to the state administrative apparatus supported a broad range of regulatory and policy distortions. Price controls, subsidized loans, and barriers to the entry and exit of firms all sheltered SOEs from making fundamental changes.

The result was widespread management inefficiency. The state sector's plight was further aggravated by the competitive onslaught of the many newly established non-state firms, which caused the profitability of state industry to decline rapidly. Readily observable SOE inefficiencies and mounting losses moved Chinese leaders to formulate a radical and fundamental reform program in the mid-1990s. Central to this program has been one policy goal: to fundamentally restructure SOE ownership institutions in order to separate SOE management from the state bureaucracy and instill efficiency-oriented management incentives.

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### China's Struggles with SOE Corporatization

China's new phase of state sector reform can be traced back to mid-1994, when the National Company Law became effective. This law forms the legal backbone

*By the 1980s, new competitive pressures threatened the state sector*

for China's efforts to organizationally restructure SOEs into limited liability corporations with majority state ownership. SOEs are required to form boards of directors, hold shareholder meetings, and establish boards of supervisors to independently oversee and evaluate the behavior of directors and managers. On the surface, implementing these institutional changes in SOEs has been simple. More challenging has been the process of clarifying which bodies are to execute the state's ownership rights in SOEs.

China's state sector inherited a fragmented oversight system from the planned economy. In this system the state's ownership rights were executed by various functionally specialized government agencies. SOEs were under the direct supervision of government agencies in charge of specific industrial or commercial sectors, such as chemicals or textiles. At the same time, agencies handling labor, finance, taxation, and personnel management affairs in one jurisdiction influenced SOE management. Chinese corporatization reforms seek to centralize the ownership of SOEs in state holding corporations. Indeed, the intention is for Chinese state holding corporations to form a corporate layer that separates SOE management from the state's bureaucracy.

Additional reforms have accompanied the restructuring of China's state sector. Bankruptcies and mergers in the state sector have gradually increased over the course of the late 1990s, though most of these restructuring efforts are planned and directed by government agencies. Chinese capital markets have also made great strides, developing rapidly and providing one key means for infusing private capital into SOEs. In a similar fashion, a huge influx of foreign investment is injecting much-needed capital and technology into parts of China's state sector.

Despite these changes, inoperative mechanisms of corporate governance persist in SOEs. Inadequate accounting institutions and the absence of crucial factor markets (such as markets for corporate control, capital, and managerial skills) are creating problems. Perhaps more fundamentally, corporatization has failed to adequately disentangle the party and the state from the corporate governance of SOEs and state holding corporations, since a politically expedient

course has been pursued to deal with the vested interests of cadres and bureaucrats in the SOE supervisory agencies.<sup>ix</sup>

Most Chinese cities and provinces have converted sector-specific SOE supervisory agencies directly into state holding corporations. For example, bureaus in charge of whole industrial sectors in Shanghai, such as the Shanghai Textile Bureau and the Shanghai Measurement and Electronics Bureau, have been directly transformed into state holding corporations after streamlining their staff and undergoing some internal restructuring. In a similar fashion, the leading cadres of the Ministry of Metallurgy at the central level have been transferred to the boards of directors of large enterprise groups formerly under the ministry's supervision, such as the Anshan Iron and Steel Complex. Subsequently, these enterprise groups were superficially converted into state holding corporations.

As many Chinese analysts have noted, former government bureaucracies and large state-owned enterprise groups converted into state holding corporations are likely to continue old behavioral patterns. Little incentive exists for their managers to efficiently manage state assets. This problem is compounded by the fact that state holding corporations remain under the sway of government agencies for different aspects of their governance. The Communist Party's organization apparatus is responsible for the selection, remuneration, and appointment of corporate executives, while economic bureaucrats continue to influence many corporate decisions.

Chinese state holding corporations also suffer under an additional problem: they preside over far-flung corporate empires. Many are in charge of thousands of subsidiaries. For example, in 1999 the Shanghai Textile Holding Corporation had almost 2,000 subsidiaries, among them about 500 joint ventures and 1,200 tertiary service units spread over more than five generations. Managers of these subsidiaries (especially those a few generations down) often try to carve out spheres of autonomy for their personal benefit.

Even the diversification of SOE ownership has had only limited success. The Hongguang Television Tube Corporation listed on the Shanghai stock exchange, for instance, became notorious after it was revealed

***Reforms sought to create a corporate layer between SOE management and the state's bureaucracy***

in 1998 that its management had concealed major problems in its operations and falsified accounts for several years. At the time, Hongguang was considered one of the listed corporations with the most diversified ownership. A state holding corporation based in Sichuan Province held only 34.6 percent of its shares, while private and institutional investors controlled the rest. However, the management of Hongguang remained under the sway of the state holding corporation, which was able to exercise control over its board of directors inside the shareholding structure.

Today, China's system for managing state assets remains in disarray. State holding corporations are unable to effectively exercise ownership functions, since they are prone to interference from government agencies and often lack the capacity to monitor and control managerial behavior within their corporate empires. Perhaps a more effective and far-reaching change in SOE conditions has come from changes in labor markets.

Since the late 1990s labor markets in China have become far more flexible, allowing many Chinese SOEs to lay off or furlough employees. In fact, more flexible labor markets and the diminishing political status of Chinese workers have allowed SOEs to shed 28.7 million workers between 1997 and 2000, about 40 percent of the state sector's workforce in 1997.<sup>x</sup> Clearly, these massive layoffs have improved the bottom line of SOEs and must be partially credited for the improvement in the state sector's performance, especially given that the costs of unemployment are often borne by local governments.

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#### **Reaching the Three-Year Deadline: Government Policy Support**

The organizational restructuring of SOEs has produced limited results in terms of improved corporate governance and enterprise efficiency. At the same time, the SOE worker layoffs can be credited with fundamentally improving SOE performance. Nonetheless, even these large layoffs can hardly explain the massive turn around in the fortunes of China's state enterprises. What else can account for the dramatic improvement in SOE performance?

Concurrent with efforts at organizational restructuring and labor force retrenchment, a number of government-sponsored policy changes have directly affected the financial condition of state enterprises. These policy changes account for the bulk of the state sector's reversal of fortune over the past three years. The State Economic and Trade Commission admitted this in late 2001 when it suggested that only about 30 percent of the improved performance in the state sector could be traced to efficiency increases. Seventy percent of the turn around in SOE performance was thus due to policy-induced external factors.<sup>xi</sup> Three such factors have been particularly significant.<sup>xii</sup>

First, interest rates were reduced seven times between 1996 and 1999 in China, from an average of 8.6 percent for one-year loans in late 1997 to 5.6 percent in 2000. Since SOEs in general have very high debt-to-asset ratios, the reductions have dramatically lowered SOE interest payment obligations. In turn, lower interest payments bolstered the bottom line and augmented profits.

Second, a lot of number jumbling has taken place during the last three years in China's state sector. Following government fiat, many loss-making enterprises have been merged with more profitable ones. For example, of the 6,599 medium and large SOEs losing money in 1997, 2,500 were taken over, merged, or absorbed into more successful businesses by the end of 2000. This triggered a remarkable drop in the number of enterprises in the red. It also improved profits, since mergers and absorptions in the Chinese state sector are induced by tax breaks, reduced interest payments, and debt write-offs.

Third and perhaps most importantly, debt restructuring has gained momentum since 1998. Over the past three years, China's large state banks have written off 126.1 billion RMB (US\$15.3 billion) in non-performing loans to SOEs. However, these debt write-offs have been very small in comparison to the amount of bad debt generated by China's state sector. To tackle this issue China's four big state banks each established an asset management corporation in 1999. Asset management corporations are taking over bad debts from the major state banks with the intent of using a variety of restructuring methods to

*The reduced political status of Chinese workers has permitted SOEs to shed 28.7 million workers, about 40% of the state sector workforce in 1997*

*The effectiveness of debt-equity swaps—a key tool in reform—is in doubt*

gain a maximum amount of return. Restructuring has focused chiefly on debt-equity swaps, although asset sales, asset leasing, debt write-offs, and asset rearrangements have been concurrently employed.

By late 2000 China's four asset management corporations had purchased 1,393.9 billion RMB (US\$168.3 billion) worth of bad assets from the state banks. This was followed by arrangements to swap debt for equity in SOEs with bad debts. So far, though, limited progress has been made on this front. In mid-2001 only 271.2 billion RMB (US\$32.8 billion) of the bad debts taken over by the asset management corporations, 20 percent of the total, had been dealt with, meaning these bad debts had been swapped for equity in SOEs, sold by auction, or written off.

More fundamentally, the effectiveness of debt-equity swaps has been called into doubt. Under market conditions, debt-equity swaps are regarded as an extreme measure. They are meant to resolve intrinsic governance problems suffered by an enterprise that cannot be resolved by renegotiating loan terms. Once the swap is completed, a new owner—in China the asset management corporation—gains ownership rights, including the authority to appoint managers, transfer ownership to other parties, or totally liquidate the assets of the firm. Chinese asset management corporations, however, have lacked these powers and thus encountered difficulties in firing managers and selling off assets. Indeed, many SOE managers have lobbied heavily for debt-equity swaps, arrangements that run counter to their interests. SOE managers do not fear that asset management corporations will fire them because local party apparatuses control their tenure and remuneration. Moreover, debt-equity swaps are seen as beneficial, since they instantaneously relieve an enterprise's interest payment burdens and pump up short-term profitability.

For instance, the Beijing Cement Factory in 2000 signed debt-equity swap agreements that lowered its debt-to-asset ratio from 80.1 percent to 32.4 percent. Central government regulations have also stipulated that all SOEs signing debt-equity swaps are relieved of paying interest on their remaining debt starting April 1, 2000. As a result, the Beijing Cement Factory returned to profitability in 2000. In another case,

though, the results were less salutary. The debt-to-asset ratio of 15 SOEs signing debt-equity swaps in China's southern province of Guangdong fell from 74.5 percent to 60.3 percent. Yet, their profitability improved only negligibly.

Basically, debt-equity swaps in China have been transformed from a novel and promising restructuring measure into a more traditional subsidization policy. Indeed, the three-year deadline imposed by China's Premier Zhu Rongji for the turn around of the state sector has increased the pressure on government officials to achieve short-term financial results. Improved profit figures brought about by debt-equity swaps in SOEs thus reflect accounting changes rather than intrinsic improvements in their efficiency.

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### Recommendations

China's state sector has made a significant turn around over the past three years. As noted by China's State Economic and Trade Commission, about 30 percent of these improvements can be assumed to emanate from improved SOE efficiency, chiefly resulting from workforce retrenchments and efforts to establish state holding corporations, corporatize SOEs, and diversify their ownership. Consequently, the bulk of improvement in SOE performance has been generated by policy-induced external factors. This holds dangerous implications for the long-term sustainability of the state sector's positive performance. In fact, Zhu Rongji's three-year deadline has led to an unhealthy emphasis on accounting changes, number jumbling, and subsidization policies. The state sector's plight is also expressed by the fact that a very large chunk of all the profits reported by large and medium-sized SOEs is narrowly based on several monopoly sectors. Of the 520 largest SOEs in China, a mere 10 generated 77 percent of total profits, and all 10 of these enterprises enjoy either monopoly or semi-monopoly positions in the telecommunications, power, oil, and tobacco industries.

Ultimately, several fundamental and longer-term problems afflicting the state sector have been only partially addressed, including widespread industrial duplication and excess capacity, limited bankruptcy

options for ailing enterprises, skewed SOE management incentives emerging from the party-state, and a dysfunctional investment decision-making structure that relies on administrative fiat and creates mounting non-performing loans in China's banking system. Therefore, tough and thoroughgoing reforms are required for Chinese state enterprises. Otherwise, China's state sector, and with it China's economy, might very well crumble. Three of the most pertinent reform packages that the Chinese government must implement for the restructuring of SOEs are outlined below.

**Strong Financial Reforms.** Chinese financial reforms must be made genuinely effective. Disturbing reports have noted that SOE managers and local governments are colluding to rip off asset management corporations by transferring good assets out of SOEs before debt-equity swaps take place. Asset management corporations must thus be given the authority to override the concerns of local governments and to effectively restructure SOEs with bad debts, including the right to appoint new managers, rearrange assets, or totally liquidate an enterprise. In addition, reforms of China's four large state banks must proceed rapidly by breaking their umbilical cord with SOEs and speeding up their transition to commercial lending standards.

With the added urgency delivered by China's entry into the WTO, some of these reforms are already being pursued. State banks are putting considerable resources into ameliorating their credit risk assessment capabilities and are increasingly loath to lend funds to unviable SOEs. Asset management corporations have also launched several initiatives to restructure and sell off the assets they have acquired to foreign and domestic private investors. Nonetheless, these reforms need to be accelerated to forestall Japanese-style economic stagnation.

**Establishment of a Social Security System.** Speeding up financial reforms will, however, most likely result in widespread SOE bankruptcies. This in turn will increase China's urban unemployment even more, the perhaps most daunting policy challenge facing China's leaders. In fact, the pressures of urban

unemployment are already generating sharper income differentials and putting strains on China's social fabric. These pressures are set to expand with the ever-growing influx of rural laborers into Chinese cities.

Under these circumstances, the continued restructuring of China's state sector necessitates the establishment of a national social security system to cushion the effects of SOE layoffs. In several provinces reforms to establish comprehensive social security systems covering unemployment, medical, disability, and retirement insurance have already begun. However, funds for most of these programs remain insufficient. One imaginative proposal is to channel part of the proceeds of SOE equity issues to the social security funds. However, at present this method does not promise to raise adequate funds, since greater issuance of SOE stock to the public threatens to depress the equity markets. Increased state appropriations and larger individual and enterprise contributions will thus be some of the necessary steps that the Chinese government must take to establish an effective social security system.

**Privatization.** The process of corporatization and ownership diversification in China's state sector shows that controlling shareholders, either large state-owned group corporations or state holding corporations, can easily ignore the interests of new non-state shareholders. This suggests that, whenever possible, diversification efforts should attempt to sell controlling stakes of SOEs to non-state investors.

Full-scale privatization is certainly not a panacea for improving SOE efficiency. However, it is a necessary ingredient because the corporatization reforms implemented so far have failed to disentangle state agencies and China's Communist Party from the corporate governance of SOEs. The party in particular continues to control the appointment and remuneration of state sector managers, thus influencing managerial incentives and corporate governance standards.

The next phase of Chinese economic reforms, especially those tackling the problems in China's state sector, will necessitate a certain measure of political reform. At a minimum, the party's appointment system must be separated from economic management.

*The dramatic improvements in SOE performance have been generated by external factors—with dangerous implications for the long term*

There will be a trade-off between maintaining party control over economic actors and implementing effective organizational and market reforms. China's

leaders will have to accept these trade-offs and move ahead with more fundamental economic and political reforms.

## Notes

<sup>i</sup> Figures from State Statistical Bureau. 2001. *Zhongguo tongji nianjin (Statistical Yearbook of China)*. Beijing: zhongguo tongji chubanshi.

<sup>ii</sup> Wei Jie and Hou Xiaoguo. December 6, 1996. "Guoyou qiye touzi shiwyu guoyou qiye kuisun" (The Investment Mistakes and Losses of State-owned Enterprises). *Jingji yanjiu cankao (Economic Research References)*, 986:12–19.

<sup>iii</sup> World Bank. 1997. *China's Management of Enterprise Assets: the State as Shareholder*. Washington, D.C.: World Bank, 1.

<sup>iv</sup> Fixed asset investment refers to investments in long-term capital goods, such as real estate, capital construction, and machinery. State Statistical Bureau. 1997. *Zhongguo tongji nianjin (Statistical Yearbook of China)*. Beijing: zhongguo tongji chubanshi, 152, 413.

<sup>v</sup> *China Daily*, June 12, 2001, 1.

<sup>vi</sup> *China Daily*, March 6, 2001, 2.

<sup>vii</sup> *South China Morning Post*, January 8, 2001 at <http://biz.scmp.com/ZZZICFLUPGC.html>

<sup>viii</sup> The following account is based on Naughton, Barry. 1995. *Growing out of the Plan: Chinese Economic Reform, 1978–1990*. Cambridge: Cambridge University Press; Hay, Donald A., Derek J. Morris, Guy Liu, and Shujie Yao. 1994. *Economic Reform and*

*State-owned Enterprises in China: 1979–1987*. Oxford: Clarendon Press; and Ji You. 1998. *China's Enterprise Reform - Changing State/Society Relations after Mao*. London and New York: Routledge.

<sup>ix</sup> The following analysis of China's corporatization reforms relies on archival materials and a series of 120 interviews held with government officials, SOE managers, academics, and professionals in China (Shanghai, Chengdu, Shenzhen, Beijing, and Hong Kong) from July 1995 to July 2001. All of the interviews were held in either Mandarin or Cantonese without the aid of translators.

<sup>x</sup> State Statistical Bureau. 1997. *Zhongguo tongji nianjin (Statistical Yearbook of China)*. Beijing: zhongguo tongji chubanshi, 136; and State Statistical Bureau. 2001. *Zhongguo tongji nianjin (Statistical Yearbook of China)*. Beijing: zhongguo tongji chubanshi, 116.

<sup>xi</sup> *South China Morning Post*, September 26, 2001, at <http://biz.scmp.com/ZZZ560SR1SC.html>

<sup>xii</sup> The following builds on various newspaper accounts from the *South China Morning Post* and *China Daily*, as well as on Broadman, Harry G. 1999. "The Chinese State as Corporate Shareholder." *Finance and Development*, vol 36, issue 3, 52–55; and Edward G. Steinfeld. 2000. "Free Lunch or Last Supper? China's Debt-Equity Swaps in Context." *The China Business Review*, 27(4): 22–27.

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