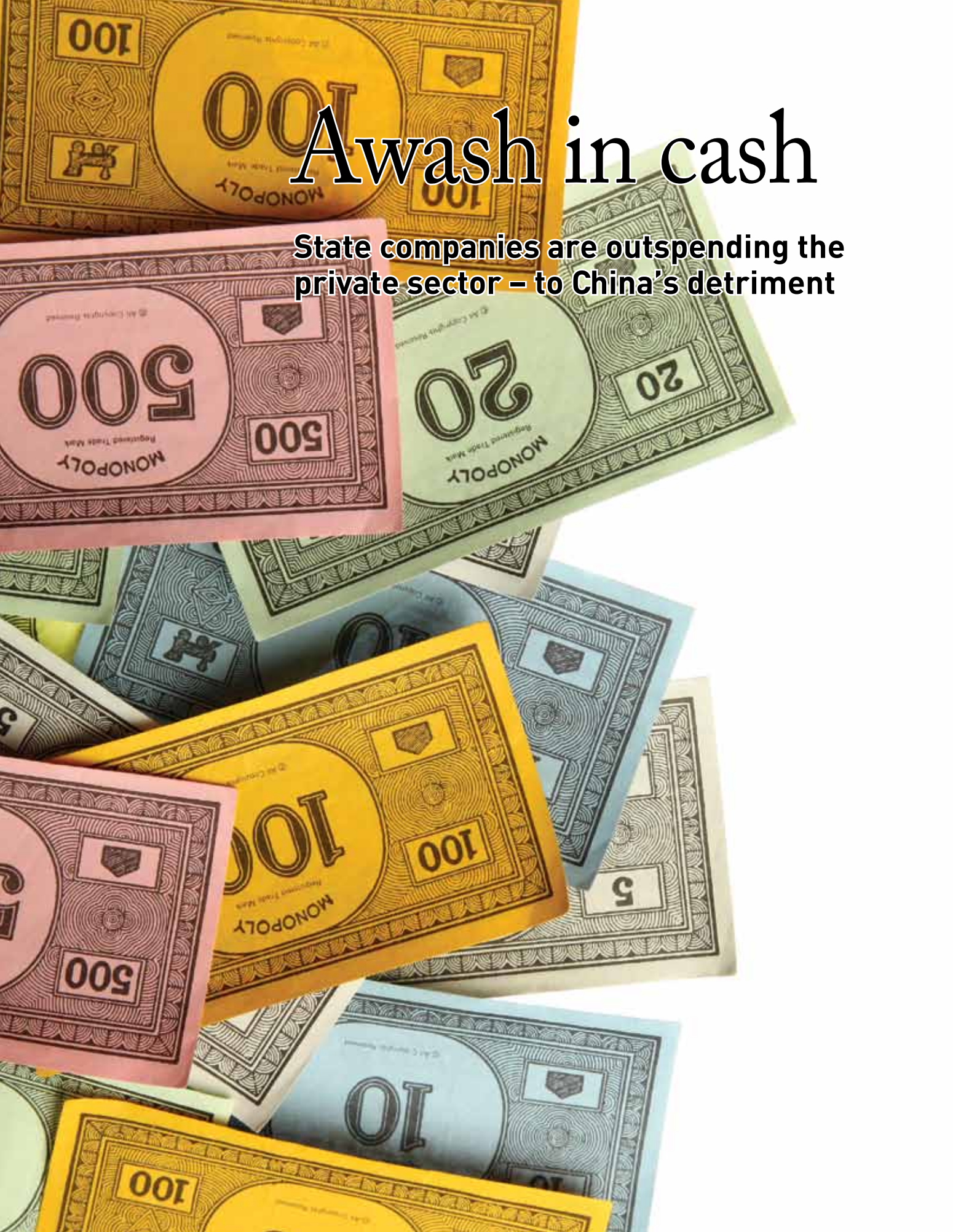
Awash in cash

State companies are outspending the private sector – to China's detriment



"In the 80s and early 90s, many government officials and professors went into business to make money. Now, many people don't have that courage. Popular opinion, the capital environment, institutions, all are more complementary to the development of big firms than small, entrepreneurial ones," Wang Jianlin, chairman of real estate conglomerate Dalian Wanda, told journalists at the signing ceremony for his company's purchase of US cinema chain AMC Entertainment in May.

Wang, a self-made man who now flaunts a 24-meter yacht and a private jet, said he's seen many successful Chinese entrepreneurs sell their companies and emigrate in recent years. "When most of our entrepreneurs no longer have the motivation to strive, they just sell their businesses to go enjoy themselves, then this country is done for," he said.

Wang's comments offer a glimpse into a debate quietly raging in China: whether the country's economic structure is crushing private industry. As usual in the country, at the core of the concern is a snappy, codified slogan: *guojin mintui*, meaning "the state advances, the private retreats."

Control over the commanding heights of key industries has always been one of the Communist Party's defining political philosophies, but China has slowly liberalized, shifting in fits and starts from a stagnant economy dominated by state enterprises in the 1970s to a booming mix of free-market capitalism and state-run businesses today. However, this tide of reform has shifted in the past decade, said Mark Williams, chief Asia economist at Capital Economics in London.

"We've seen the emergence of very powerful industrial groups with strong links to the state," said Williams. "That trend only intensified in 2008, when the government shifted its focus entirely to securing growth, and did that by channeling funds to the state sector to invest." Meanwhile, private firms have been left out in the cold, buffeted by declining demand from the developed world, rising wages and limited access to credit within China.

Some Chinese view state-owned enterprises (SOEs) as a cornerstone of the economy, while others see their growing dominance as a dangerous departure from the reform legacies of Deng Xiaoping and Zhu Rongji.

"There's a real kind of clash of perceptions here about the way forward," said Patrick Chovanec, an associate professor at Tsinghua University's School of Economics and Management in Beijing. "Is the Chinese model of market socialism or state capitalism not just successful but actually dominant in the world? Does that symbolize the future? Or is there something deeply wrong with it – is it unsustainable, does it desperately need to be changed?"

Economic research suggests that the model does need to be changed. Many economists agree that China's era of rapid growth fueled by exports and investment – a period in which SOEs thrived – is drawing to a close, and that Beijing needs to cultivate other sources of growth, in the form of individual consumers and private enterprise. But curtailing the position of SOEs in the Chinese economy will be politically difficult – perhaps impossible.

Born lever-pullers

Not all economists agree with the idea of *guojin mintui*. Louis Kuijs, project director of the Fung Global Institute, a Hong Kong-based think tank, argues that the advance of the state sector at the expense of the private sector is not borne out by China's economic data.

"This *guojin mintui* concept has become very much part of the folklore. However, if you look at any of the data, of the share of SOEs in investment or assets or production, that share has continued its decline," he said.

That may be true, yet the position of SOEs vis-à-vis private enterprise has changed significantly in recent years, in ways that deserve attention, writes Rosealea Yao, an analyst at research firm GaveKal. The state's once-rapid retreat from a central role in the national economy has slowed, and the average SOE is a much tougher competitor than it was a few years ago, larger and financially stronger, according to Yao.

This strengthening of the state sector has had many supporters in China, in part because the system has given Beijing more flexibility in the financial crisis. Central and local governments have convinced or coerced SOEs into keeping the economy chugging along by hiring new college graduates, limiting product price increases and investing in new infrastructure.

Many Chinese say SOEs play an important role as tools for the government's industrial policies, >>

KING OF THE HILL: China Mobile has earned big bucks from its monopoly position

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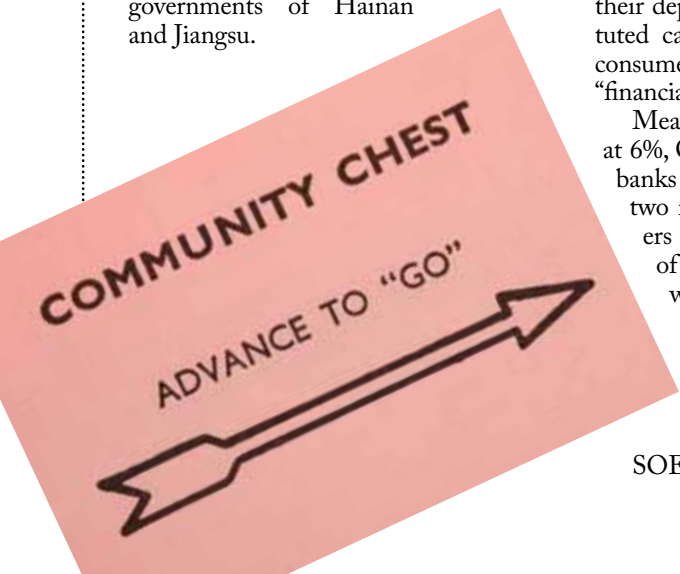
>> helping to develop strategic sectors such as aerospace or defense. They are also the country's "national champions," cultivating brands that earn soft power abroad and bringing technologies, resources and revenues home. The number of Chinese companies in Fortune magazine's ranking of 500 global companies has shot up from just three companies in 1997 to 61 last year, with more than two-thirds of those being state-owned enterprises.

SOEs can also complete certain intra-provincial development goals that private companies cannot, said Zhang Jianyu, general manager of the Shanghai branch of provincial-level SOE Jiangsu Guoxin Real Estate. For example, Zhang said that his company recently expanded a four-square kilometer development in Hainan province to a 33-square kilometer "international city" after participating in discussions with the provincial governments of Hainan and Jiangsu.



"Private companies rarely have this capacity or degree of trust," Zhang said. Jiangsu Guoxin Real Estate recently acquired plots in Anhui and Hunan through similar methods.

Big appetite

However, these advantages come at a price, the most obvious being lost efficiency. Fixed investment by SOEs often costs 20-30% more than that of private companies and takes about 50% longer to complete, economist Andy Xie wrote in an editorial in Chinese magazine *Caixin* in late June. "The leakage through overpriced procurement and outsourcing and underpriced sales is enormous."

This "leakage" is essentially financed by ordinary Chinese people who deposit their savings in banks. Account holders (mostly China's high-saving households) earn only a lowly 3% interest or less on their deposits under a government instituted cap. This reduces their ability to consume, a situation that economists call "financial repression."

Meanwhile, by fixing the lending rate at 6%, China's central bank ensures that banks pocket the difference between the two rates in profit, and that borrowers (often SOEs) can obtain plenty of cheap loans. Private enterprises, with higher risk of default than SOEs, are often unable to obtain loans at all.

This ready source of cheap capital permits a shocking degree of waste among some SOEs. Michael Pettis, a finance professor at Peking University's Guanghua School of Management, points to the Sino Iron mine that state-owned CITIC Pacific is developing in Western Australia as an example.

Fixed investment by SOEs often costs 20-30% more than that of private companies and takes about 50% longer to complete

Four times bigger than any domestic iron project, the mine was first projected to cost less than US$2.5 billion in 2006. Now the project is three years behind schedule, the cost has already ballooned to US$7.1 billion, and some analysts believe the final total will surpass US$10 billion. It's highly unlikely that the deal is still profitable "unless the Australians were extraordinary stupid and sold something that's really worth US$10 billion for US$2 billion," Pettis said.

"If you were a US corporation … your board of directors would have stopped you and probably fired you. But this just keeps on piling up, which suggests to me that capital is not an issue. [SOEs] can just keep on borrowing at very low rates, and whether or not [they] make a profit is almost totally irrelevant," Pettis said.

The price isn't right

SOEs also drive up costs for private companies and households through monopolistic pricing. While SOEs have mainly retreated from downstream sectors of the economy, they continue to monopolize upstream sectors such as resources, real estate and infrastructure construction, said Xi Li, a professor at the Hong Kong University of Science and Technology. This position allows SOEs to charge high prices to downstream businesses, such as the exporters that saw their business boom after China joined the WTO.

For example, China Mobile, the country's largest telecom company, charges many fees that don't exist in other countries, according to Beijing University of Posts and Telecommunications Professor Kan Kaili. In 2005, China Mobile took in US$5.9 billion – nearly half its profits that year – from mobile roaming charges, a service which entailed almost no cost to the company.

These profits come at the expense of not just small enterprises, but also labor income more broadly. Higher prices charged by monopolistic SOEs act as a tax on private industries, and companies in turn pass along costs to employees by keeping wages artificially low. This is one reason that the share of labor income of China's total GDP has fallen persistently since 1992, even as growing international trade increased the demand for exports.

But this model no longer seems sustainable. External demand from Europe and the US has dropped off, and, as rising wages demonstrate, China's excess labor is drying up. "If [China] sticks to the current state capitalism model, the private firms will suffer first. And when the private firms collapse, eventually the SOEs will collapse as well," Xi said. "China is between a hard rock and a total collapse."

More and more economists are echoing Xi's fears. A report jointly published by the World Bank and China's Development Research Center in March argued that Beijing needs to implement a new development strategy that relies less on investment and exports and more on consumers and the private sector, the source of most of China's new jobs and innovations. It also explicitly called for the privatization of many SOEs. Some say the report was published as part of a broader liberal reform push in the government, with Li Keqiang and others signing off on it.

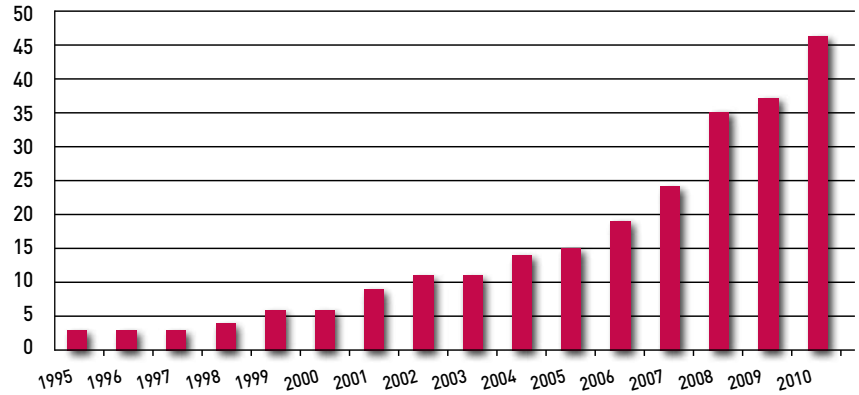
Liberal reformers in the government have long argued for curtailing the power of SOEs, while certain vested interests in China have long opposed it. But the middle ground between these two parties appears be shifting towards the pro-reform camp, said Kuijs of the Fung Global Institute.

"This is the start of an era where there is a feeling among policymakers that certain things will have to change, that China is starting a new phase in its development, a phase where some of the easy sources of growth have probably run their course," Kuijs said. "And while there is no agreement yet on … the role of SOEs, there is an agreement on the need for new sources of growth, and in that context, reform in the economy."

Baby steps

Beijing has launched several initiatives aimed at making SOEs more efficient. Since its creation in 2003, the State-Owned Assets Supervision and Administration Commission (SASAC) – a central company that holds controlling stakes in the largest and most important central SOEs (excluding banks and insurers, which are owned by the relevant ministries) – has worked to incorporate SOEs as proper companies and set up boards of directors.

Chinese enterprises in the Fortune Global 500, 1995-2010



Source: Fortune magazine, Cheng Li

Many Chinese see Singaporean state holding company Temasek as a good model for separating SOE ownership and management, said Wang Jianmao, a professor of economics at China Europe International Business School. Temasek is wholly owned by the government and has a constitutional responsibility to look after critical assets, but its board of directors is staffed with business people rather than government officials. Temasek claims to exercise only the rights of an investor and leaves the management of its companies to their boards of directors.

But critics say China's efforts to bring in directors and shareholders so far constitute no more than window dressing, since the Party has not given up operational control. The top positions in many of China's SOEs are still appointed by the Party's Organization Department, while other SASAC appointments are made with input from various party organs and ministries and subject to approval by the State Council.

Other, more significant reforms may soon target the monopoly positions enjoyed by SOEs. "There's some glimmers, some early signs that perhaps >>

FOLLOW THE LEADER: SOE chiefs at a 2011 conference on sector reform

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Decoding China Inc: Inside the black box of state-owned enterprises

Understanding China's brand of state capitalism is no easy task. The sector is both opaque and complex. As of 2010, China had 114,500 state-owned enterprises (SOEs) operating in a wide variety of sectors.

The conversation surrounding China's SOEs does little to rectify the situation. Some Westerners now argue that China's unique blend of state capitalism and free-market enterprise is a superior model, while others view the state sector as opaque and menacing, or a detrimental drag on an otherwise dynamic economy.

Even economists have difficulty understanding just what role SOEs play in the Chinese economy. "There are Western economists – and I am one of them – who, when they look at China's economy, they see many things that they are not used to, and many things that are not done according to the textbooks," said Louis Kuijs, project director of the Fung Global Institute, a Hong Kong-based think tank.

Tough nut to crack

The vast majority of China's SOEs are owned and administered by local governments. The much smaller slice of the SOEs that are administered by China's central government are typically the focus of most peoples' interest, the massive Fortune 500 companies that are referred to as "China Inc."

The centrally-controlled SOEs fall into three main groups. First are the roughly 100 companies controlled by the State-Owned Assets Supervision and Administration Committee (SASAC), which owns and administers the SOEs on behalf of the Chinese people. Some of these companies are state-owned for reasons of national security; they operate in industries such as defense, transportation, communications, natural resources, construction and industrial products.

Next come the banking and finance companies, including China's Big Four banks, by far the most profitable of the state-owned enterprises. This sector is variously governed by China's banking, securities and insurance regulators. Third are the media, publications, culture and entertainment companies, which are run by other central government agencies.

These central SOEs differ widely in terms of the power they can exert, said Curtis Milhaupt, a Columbia University law professor who studies SOE organization. Some strictly follow SASAC's marching orders, while other SOEs are technically on the same organizational rank as SASAC and might go over its head to appeal directly to the State Council.

Profitability among SOEs also varies widely. A few major firms, such as PetroChina and China Mobile, generate most of the state sector's profit from their monopoly positions, while the rest typically record significant losses.

Hold the red phone

Just how SOEs carry out central goals is often another point of uncertainty. But research suggests that SOEs are connected with the government and Communist Party through a variety of institutional links, some of which are concealed by their complex corporate structure.

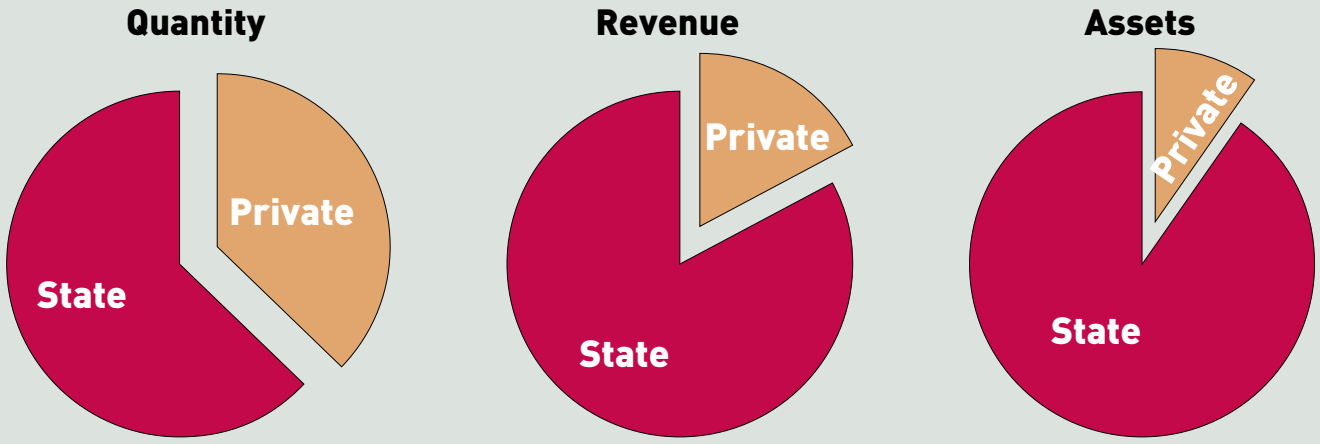
The organizational system of Chinese SOEs is best described as a "networked hierarchy" that centers on a core holding company, often 100% owned by SASAC or the other managing body, Milhaupt said. The core company owns stake and coordinates resources and information for a group of subsidies, including any listed entities, as well as a financing arm and related research institutes. SOEs are then linked into the broader "China Inc" network through a web of joint ventures, strategic alliances and equity holdings.

The Chinese government exerts influence over the SOEs not only through SASAC and other shareholding organizations but also through a variety of institutional links. For example, the party's Organization Department rotates personnel between SASAC and the central SOEs it supervises, helping to maintain close ties.

SOE leaders are also educated at the party training school and sometimes given positions in government bodies such as the National People's Congress. "[T]hat certainly suggests that there's a very close unity of interests and world view between business leaders and the party leaders and the government leaders," said Milhaupt.

Decoding that world view, however, is an entirely different topic (see pg 38). ◆

Proportion of SOEs among China's top 500 companies

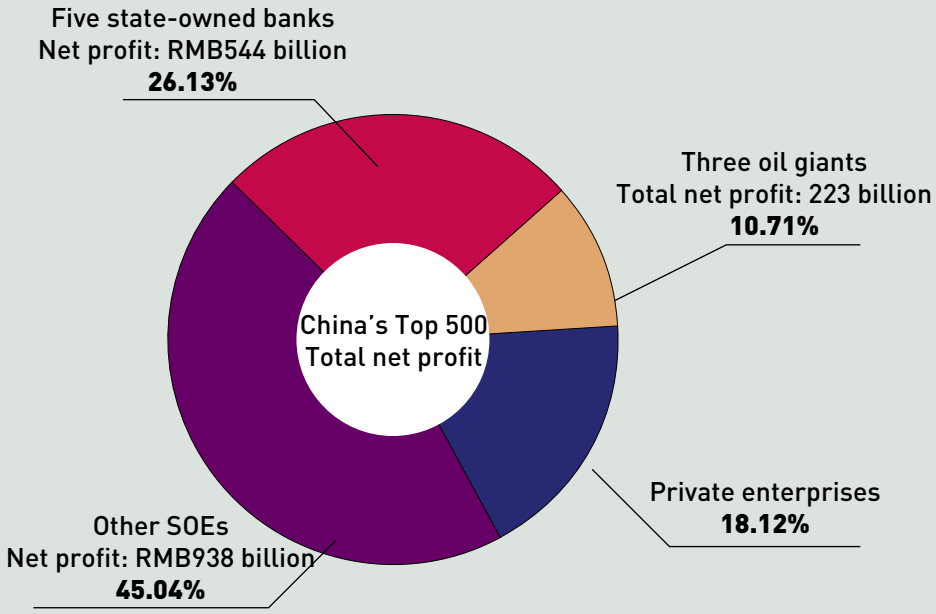


Quantity	Revenue	Assets
Number of SOEs	Revenues of SOEs	State-owned assets
316	RMB30.08 trillion	RMB97.74 trillion
63.2%	**82.82%**	**90.40%**

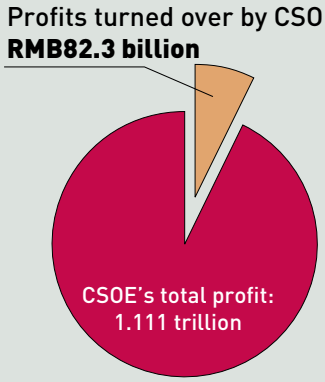
Source: CNPolitics.org, Curtis J. Milhaupt, Li-Wen Lin

How profitable are SOEs?

Profits generated by SOEs account for **81.88%** of all profits reported by China's top 500 enterprises.



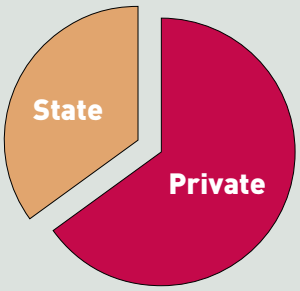
How much profit do central SOEs remit?



In 2011, central SOEs reported net profits of RMB1.11 trillion yuan, and turned over 7.4%, or RMB82.3 billion to the state.

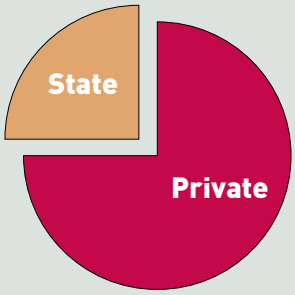
Behind the glory of SOEs

Patents



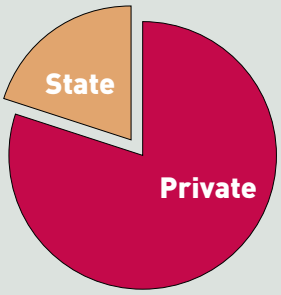
Private companies hold **65%** of all patents

Innovations



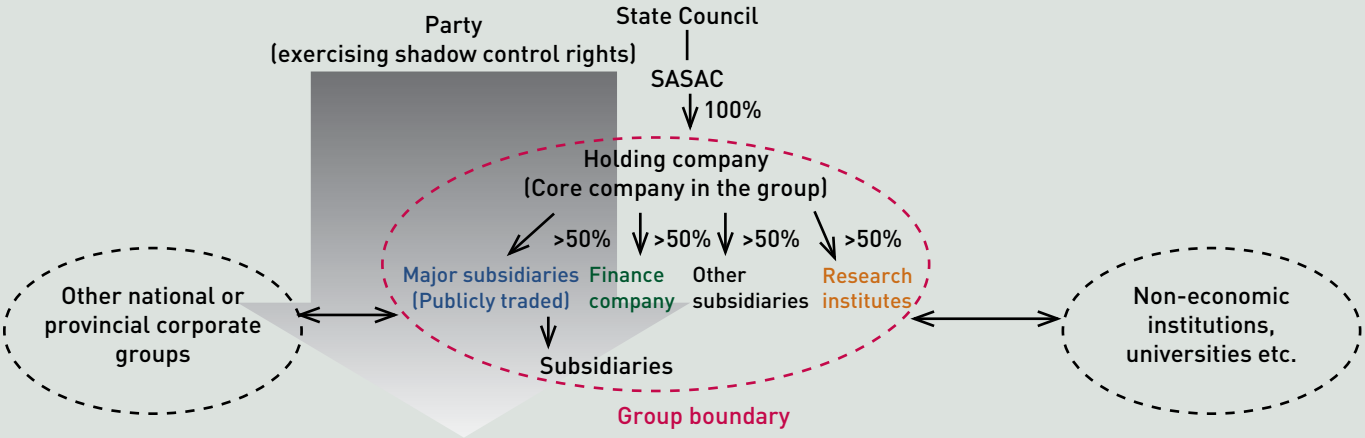
Private companies contribute **75%** of technological innovations

New products



Private companies make **80%** of new products

National champions as networked hierarchy



>> the authorities will begin to look more closely at anti-competitive conduct in the SOE sector," said Curtis Milhaupt, a law professor at Columbia University who studies the organizational structure of Chinese SOEs.

Thus far, SOEs have been exempt in practice from prosecution under China's anti-monopoly law. But last November, Chinese authorities launched an investigation into China Telecom and China Unicom for monopolistic activity in the internet broadband market. In May, China's Supreme People's Court issued a landmark ruling that will theoretically allow individuals and private firms to initiate civil cases against SOE monopolies.

Reformists aim to allow more competition to enter non-strategic industries (including perhaps steel and cars), forcing out those SOEs that are too inefficient to compete. But some say that is unlikely to happen, because the playing field for SOEs and private enterprise is so uneven.

Tsinghua University's Chovanec pointed out that China opened up its energy sector to foreign companies back in the 1990s, but today all but one or two have left. "The reason is because the game was rigged through price controls and subsidized inputs, so that the only people who could actually profit were the state-owned competitors," he said.

The central problem is that many Chinese SOEs now profit by investing cheap capital, winning government contracts, and taking advantage of monopoly positions, rather than through efficiency or innovation

Taking a toll

Another popular idea is increasing the dividends that SOEs pay to the government. Kuijs of the Fung Institute said he continues to see this as an obvious area for reform. "Everybody that uses capital is supposed to compensate the holders of that capital, and in the case of SOEs, that shareholder is the state," he said.

Chinese SOEs are now required to pay back 15%, 10% or 5% of their profits in dividends to SASAC, depending on their profits and strategic value. These rates are much lower than SOE dividends in other countries: A 2009 World Bank study found the average dividend for SOEs in five developed economies to be 33%, with established industrial SOEs in the US paying 50-60%. Even Chinese SOEs listed in Hong Kong pay an average dividend of 23% to their shareholders.

The second reform that many China observers suggest is allowing SOE dividends to be distributed to the government and economy more broadly through the Ministry of Finance, and perhaps from there fed into China's social safety net. Currently, all dividends are absorbed by SASAC and then reinvested into SOE development, for example to finance acquisitions.

But some economists question whether the SOEs are financially capable of returning much capital to the government. "Dividend reform on the face of it should be eminently doable, but the

question then is, what is the real financial position of some of these [companies]?" Chovanec asked.

A closer look at the finances shows that SOEs on the whole are not very profitable; their overall profits are due to only a few highly valuable monopolies. According to research firm Unirule Institute of Economics, in 2009, 70% of the net profits made by central enterprises came from 10 companies, with just two companies, China National Petroleum Corporation and China Mobile, accounting for one-third of the total profit.

Of course, forcing unprofitable SOEs to pay higher dividends might encourage them to become more efficient. But these dividends would likely fall far short of the capital that is being transferred from the state and households to SOEs.

According to Unirule's estimates, eliminating monopoly pricing and direct subsidies from the SOEs would eradicate roughly all of the sector's profits. "When you add up all the [financial] transfers from the households to the SOE sector, it could be four, five, six times the aggregate profitability of the SOE sector," said Pettis. "So when people talk about raising dividends from 10% to 30%, it's better than nothing, but just barely."

Chinese banks are in a similar situation, said Chovanec. State-owned banks report huge profits only because the financial system allows them to ignore much of their cost. Banks have two main costs of doing business. The first is the cost of deposits, which Chinese banks pay in the form of interest, though at a lower, regulated rate. The second is bad debt. Chovanec said that banks have recorded just a fraction of the non-performing loans for which they may ultimately be liable.

"Any company can record profits if they don't recognize half their cost of doing business," he said. "So are there really all these resources in the state sector, real resources in the state sector to be distributed? Maybe it's not quite what it seems."

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SAFE DEPOSIT? The hallowed halls of ICBC, one of China's Big Four Banks

Looking elsewhere for inspiration

With China's growth set to slow, reforming the SOE sector to allow private enterprise to compete seems increasingly urgent. Economists such as Xi and Pettis argue that the simplest solution would be privatizing some SOEs and transferring the revenue from the sales back to the household sector, for example using the funds to pay down banking debts, for which households will ultimately be liable, or building a better welfare system.

But this solution, however economically elegant, would be difficult to implement politically. Officials are reluctant to surrender the soft power and economic influence that their national champions have won for them, said Milhaupt of Columbia University. "They're able to use SOEs as a mechanism for transmission and accomplishment of their economic policy and goals, [and] they're deriving personal benefit from their involvement in the SOEs. Why would the government and the Party want to give up control over that?"

In addition, many powerful families in the government have risen to wealth and power on the back of state-owned businesses, and are likely to oppose reforms to this power base. "It is just not practical, from a political standpoint, to privatize all SOEs in China," said Zheng Yongnian, the director of the East Asian Institute at the National University of Singapore. "I think China's SOEs are like Wall Street: Both are too big to fail. They are too powerful."

Officials seem reluctant to liberalize interest rates or legalize private banks, and with reason. By allowing the banking system to allocate capital based on return, the Party would essentially be giving up control over the country's financial resources. Analysts say policymakers are eager to show Chinese people that they are doing something to rein in the dominance of SOEs, but they also want to avoid drastic reforms before the leadership transition later this year.

"This is the challenge," Chovanec said. "How do you do anything that actually results in any meaningful change with it taking on a momentum of its own that takes you very quickly in directions that you're uncertain about?"

But at some point Beijing will have to start that momentum of reforming the capital system. With labor costs rising and US and European demand stagnant, more and more private firms could go bankrupt, lead to mounting losses at SOEs.

The central problem is that many Chinese SOEs now make money by investing subsidized capital, winning government contracts and taking advantage of their monopoly positions, rather than making strides in efficiency or innovation. Until these incentives are changed, Chinese SOEs are unlikely to become more efficient.

"One of the basic rules of economics is that people respond to the incentives," said Pettis of Peking University. "If the incentives are misaligned, responses are not going to be efficient. That really shouldn't be a shocking statement."◆

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