History of State Owned Enterprises (SOEs) reforms:

During the last 30 years, China has carried out profound economic reforms and achieved tremendous success. The characteristics of the reform reflect decentralization of the macro economy, liberalization of the market, and privatization of SOEs. China’s economic development has experienced four stages: 1) planned economy; 2) planned economy combined with market adjustment; 3) socialist market economy; and 4) new socialist economy under WTO framework in the 21st century. Since SOEs accounted for the major share of the planned economy before 1978, the SOEs reform has become one of the focuses in the process of the economic reform. Accordingly, SOEs have paralleled approximately the same development stages as the entire economy:

1. Under the planned economy (before 1978).

The SOEs were an absolute majority of the economy under the planned economy before 1978. The state owned SOEs and controlled their daily operations. All of the materials needed were allocated by the government, all of the capital was funded either by government or government-owned banks and most involved subsidies. The output of products and services were allocated by the government as well. The SOEs’ profits were remitted to the State and the losses were subsidized by the State. The managers were appointed by the State, usually CPC members (Communist Party of China). The government at this stage was like a giant “Mother Enterprise”, and all of the SOEs were only a division under the “mother enterprise” with no right and necessity to decide what to produce, where to purchase raw materials and at what cost, who to hire, how and how much to sell, etc. SOEs were the extension of the government. The employees of SOEs enjoyed the full benefits like government employees. Under the system, SOEs did not have autonomy for decision-making nor incentives for effective management.

2. Under the planned economy combined with market adjustment (1978-1992)

Major economic reform was officially launched in 1978. During the following 15 years, the SOEs have carried out a series of reforms:

SOEs were granted a certain level of autonomy in decision making (1979), including some authority and power on decisions about marketing, technical innovation, and most importantly, the quantity and variety of output beyond mandatory planning targets. meanwhile, SOEs were allowed to retain part of their total profit instead of remitting 100% of their retained earnings.

Development of Township and Village Enterprises was encouraged (1979), which promoted competition and has served to be a benefit to the whole economy. These non-SOEs, as new competition, started to push SOEs to reform.

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The feature at this stage was the introduction of the dual tracks of plan and market: co-existence of a commanding plan but also a market channel for resource allocation, product pricing and profit distribution. Even though the SOEs were achieving some autonomy in decision making, and the market base was getting more liberal, planning still dominated.

The Shanghai and Shenzhen stock exchanges were established in 1990 and 1991, which launched a new stage for economic development and provided a necessary precondition for further economic reform.


In 1992, the 14th CPC Party Congress proclaimed that the ultimate objective of economic reform was a “socialist market economy”, introducing modern corporate systems to SOEs. Therefore, 1992 marked the turning point for China toward creating a market economy. In 1993, China overhauled its tax system, unifying and standardizing most of the taxes. Under the new tax framework, SOEs, non-SOEs and foreign companies have the same income tax rate even though different rules still apply to tax deductions. A general corporate law came into effect in 1994.

The fast development of non-SOEs, including private companies and foreign funded companies, and the liberalization of the market, revealed that SOEs have many disadvantages in their performance. Therefore, the Modern Enterprise System was originated to improve SOE performance through organizational changes, improvement of corporate governance, and reform of property rights. In the following years, a national level “100 firm corporatization experiment” was announced by the State Council. The 100 large and medium industrialized SOEs were selected to participate in the program by mid-1995. The central government was to aid the pilot firms in corporatization through reform of property rights and corporate governance systems. This has initiated China’s SOE organizational reform. During the next few years, the “Experiment” program has expanded across the country.

The 15th Party Congress in 1997 has endorsed the shareholding system as the new model. The plan was to convert SOEs into shareholding corporations. In 2000, most of the mid to big SOEs had implemented organizational reform. According to a survey, 2,016 SOEs had carried out organizational reform accounting for 81.5% of the survey total, 603 (29.9%) of which have become limited liability companies, 713 (35.4%) of which have become share-holding limited companies and 700 (34.7%) of which have become solely state-owned companies. SOE organizational reform also pushed other types of entities, especially collectively-owned enterprises, to carry out the similar reforms as well. Ownership was diversified and state-ownership was diluted through these organizational reforms, however, the state still owns a majority of mid to big SOEs.


Collectively-owned Enterprises refer to industrial enterprises where the means of production are owned collectively, including urban and rural enterprises invested by collectives and some enterprises which were formerly owned privately but have been registered in industrial and commercial administration agency as collective units through raising funds from the public. In 2003, there were 22,964 collectively-owned companies that generated $119 million gross industry output according to China Statistics Yearbook 2004–Chapter 14.
4. SOEs under WTO frame (2001-current)

China entered the World Trade Organization (WTO) in 2001. This has forced the country to open the door for fair competition internationally with the condition that tariff protection will be lifted gradually. It is obvious that SOEs are facing more international competitors in addition to domestic ones. The State intends to continue to reinforce retained SOEs but encourage a more vigorous economy by consolidations, mergers, acquisitions and selected terminations.

As the door opens, tariff protection has been reduced, and domestic private companies and foreign invested companies are growing dramatically. Both international and domestic competitions push SOEs to a critical stage – survive or go bankrupt. The State’s SOE policies and strategies are being challenged: which SOEs should be kept and why? How to solve post-SOE problems – social security and unemployment? How to solve the bad debt problem of the State-owned banks triggered by the fact that many of the SOEs are not making money and some are facing bankruptcy?

**The current situation of SOEs**

According to the National Bureau of Statistics of China (NBSC), there are 34,280 state-owned and state-holding companies which contributed about $658 million gross industrial output in 2003. SOEs are still “the pillar of the national economy”. During the last half century, SOEs have contributed substantially to the national economy and to the national social benefit and stability, and they have survived many challenges and continued to grow:

1) SOEs are able to control key areas of the economy, which directly benefit the nation’s stability and security, especially in the field of high-technology industry, transportation, natural resources, and energy resources development. Due to the specific roles that SOEs play, SOEs have contributed to the national growth in economic, social and even political strength.

2) SOEs still account for an important proportion of the national economy even after decentralization and privatization. State-owned and state-holding enterprises accounted for 37.5% of gross output, and added 44.9% of new value to the economy in 2003.

3) With the reform of SOEs and China’s access to WTO, SOEs have become more adapted to the domestic and international competition. SOEs’ production, marketing and management capacity have broadly expanded.

However, SOEs have had lots of problems and weaknesses. It is widely reported that one-third of China’s state-owned enterprises are losing money, one-third barely break even and only one-third are making profit.

SOEs’ production capacity and productivity is low. In 2003, SOEs held 55.9% of the national total assets and 63.75% of the fixed assets (net value), but only produced 37.5% of the gross industrial output and added only 44.9% of new value.

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4 From *China Statistical Yearbook 2004* - Chapter 14. Gross industrial output value is the total volume of final industrial products produced and industrial services provided during a given period. It reflects the total achievements and overall scale of industrial production during a given period.

5 The 16th CPC report (2002).

6 Calculated from *China Statistical Yearbook 2004* - Chapter 14. Value-added of Industry refers to the final results of industrial production of industrial enterprises in money terms during the reference period.

7 Zhu, Tian *State-owned enterprises to shareholding companies: an evaluation of China’s Corporatization drive*, Division of Social Science, Hong Kong University of Science and Technology, April 1998.
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SOEs have high debt ratio and therefore high financial costs and unstable financial status. SOEs debt ratio (total liability / total assets) in 2001, 2002 and 2003 has not improved and remained the same at about 60%. The high debt ratio increases the operating costs of SOEs. More importantly, if China doesn’t solve this problem, the continuous loss of SOEs will trigger a potential state-owned banking crisis in the future and even ruin the foundation of the whole financial system. According to the China Banking Regulatory Commission, Non-Performing Loans (NPL) of State-owned Commercial Banks were $194.46 billion, accounting for 15.57% of their loan balance and 9.31% of total assets as of the end of 2004. Some economists claim much higher NPL than official statistics and this adds to concern about the overall collapse of China’s banking system in the next few years.1

According to a 2004 audit of 10 big SOEs by the China National Audit Office (CNAO), faulty management decisions at these 10 SOEs brought about about $1.79 billion loss. Careless disposal of assets resulted in $247 million loss. Audit discovery also revealed many illegal transactions, and 9 law suits were filed with $197 million suspicious funding involved. In addition, 5 of 10 SOEs overstated their profit by $568 million. Another 5 of 10 understated their profit by $370 million. SOEs get involved in many unlawful transactions, including careless management spending, corruption, false reporting of company’s earnings or losses, and the illegal transfer of company’s assets to personal accounts.

Reasons for SOE Failures

There are lots of reasons why SOEs are not making money, nor showing competitive strength even with government support and easy funding from state-owned banks.

1. Increased competition.
China’s economic reform is a process of divestiture, devolution, decentralization and an encouragement of competition. SOEs are not the only market entity any longer. More private companies, collectively-owned companies, township companies and foreign companies all compete for a bigger market share. Competition has directly driven down SOE profit margins. China has gained significant success during the last two decades with high growth each year by encouraging competition.

2. Unclear definition of ownership, or agency problem.
SOEs are actually owned by the representatives of the state, but ownership direction is rather nominal. The nature of its ownership structure determines that managers of SOEs will exert the real control. Under an immature economy, the lack of sound corporate governance and a proper monitoring system will eventually destroy the efficiency of SOEs, and offset their advantages in terms of easy funding from government and state-owned banks. In addition, the nomination of managers by the CPC is based not on their actual performance, but rather on Guanxi (connections), seniority and political correctness. The true management ability is often not the criteria used for

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8 Calculated from China Statistical Yearbook 2004 - Chapter 14.
10 Calculated from Statistics of China Banking Regulatory Commission, based on 1:8.1 dollar to RMB ratio.
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promotion of the internal managers as well. This also makes mutual corruption possible, including siphoning off funds, stripping assets, mutual agreement to distort and conceal facts.

Because of the inherent and intrinsic disadvantage, most industrial countries do not maintain a big portion of the economy in state-owned enterprises. China should also consider the cost to keep such a significant portion of the economy in the state-owned sector.

3. Historical unfair treatment between SOEs and non-SOEs.

For a long period of time, SOEs have paid higher income tax than non-SOEs, including domestic collectively-owned companies, private companies and foreign companies, even though the tax code was dramatically revised in 1993 and tax rates were standardized. The tax treatment still differentiates between domestic and foreign companies which enjoy more tax deductions and benefits.

More than that, SOEs have borne more social burdens. Large SOEs often had their own primary schools, middle schools and even high schools to provide education to their employees’ children. SOEs have offered healthcare services to their employees too. Usually, the employment was supposed to be life-long, and SOEs had to offer pension benefits. The ratio of retirees to current employees is very high in the large and older SOEs. Housing benefits are another substantial expenditure for SOEs, and there may be other fringe benefits, including life insurance, dining subsidy, transportation subsidies and more.

Many SOEs are forced to add additional employment for political reasons – mainly social stability even if they already have redundant workers. For a long period of time, SOEs were not encouraged to lay off redundant workers. Even when SOEs cut off lots of redundant workers initiated by governmental and SOEs reform since 1998, SOEs had to establish “Re-Employment Centers” and pay one third of minimum salaries and insurances for the laid-off employees until they found new jobs. Central government and local governments pay one third respectively as well.

4. Immature macro economic environment.

China’s economy is still undergoing the period of transformation. A matured financial market has not been developed. A social security system covering the overall population does not exist yet. This will hinder the SOEs further if the Government is unable to solve the problem.

Lack of legal enforcement is another problem. The legal systems are weak and relevant laws and regulations are often either absent or not enforced. Bankruptcy clauses are included in Corporate Law. However, the enforcement has not been fully applied or not intended to be applied. Good enforcement of economic laws and regulations makes for a sound framework for individual enterprise economic behavior. Good enforcement will also contribute to a fair competitive environment for individual entities.

5. Poor corporate governance.

During the first decade of SOE reform, decentralization and encouragement of competition were the focus. SOEs started to make independent decisions regarding choosing product lines, pricing and marketing. Corporate governance was not addressed until the mid 90’s, when corporatization was encouraged.

A comprehensive Corporate Law was not issued until the early 90s. However, the authority of management remained limited because most of the executive officers are
appointed by government instead of the board. Boards are either non-existent or not properly functioning. Some board members are not even aware of most of management decisions, nor do they understand their roles as the monitors of management.

Management misbehavior is all too common, including luxury homes, expensive cars, and traveling for pleasure at enterprise’s expense. More important is a whole range of corrupt or pathological business decisions. Resources may be wasted on un-warranted business expansion. Industries suffer from excess capacity. Hidden subsidiaries may be created to hide asset striping. Enterprise funds may be used for private advantage. Contracts may be let-through bribery and kickbacks.

SOEs management often corrupts the government in order to keep their position or to get fiscal subsidy, or to get “easy” loans from State-owned banks.

Under the WTO framework with severe domestic and international competition, in order to survive, SOEs try to become bigger and stronger. Many SOEs are working on merging with or acquiring other companies. However, mergers and acquisitions themselves will not change the corporate governance automatically; rather, they just lead to changed names rather than needed restructuring. And all too many divestiture efforts become marred in new forms of private greed and corruption.

6) Economic policy mistakes. In China, government has played an important role in the SOE development. Government has made many policy mistakes due to incorrect understanding of development patterns, resulting in excess capacity in some industrial sectors, and failure to develop other sectors. Many light-industry plants went bankrupt due to the overly-built capacity. Government investment has been controlled by Planning Commissions of all levels of government, which so often either make blind investments without sound proof or invest in many small and low volume production units with low efficiency. This leaves lots of poorly performing medium and big SOEs and low efficiency small SOEs as well. Frequent government reorganization results in ministerial conflicts of interest, lack of co-ordination and communication in decision making and waste of resources. Direct government intervention in SOEs should give way to economic principles and market adjustment.

Solutions

1. Privatization.

1) There are historical reasons why SOEs dominated in China. After nearly one century of unstable situations and wars, when the People’s Republic of China (PRC) declared independence in 1949, there was nothing left but a poor people and country. As a result, nationalization and state-ownership became necessary and fitted well with communist doctrine. Therefore, the state can mobilize and direct resources through SOEs, which served as the drivers of economic growth, mobilizers of development, and the mechanisms for achieving a better future. SOEs also provide public goods on behalf of the government pursuing the nation’s interest. SOEs also accumulate the capital for infrastructure construction and capital needs. Another reason of SOEs’ spreading in China was under Marxist theory. People thought China had reached and become a communist country and citizen ownership under communism was the same as state-ownership. Today, SOEs are not only an empirical issue but have been a theoretical question.

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During the thirty years after 1949, the SOEs, serving as a component of government, increased the supply of consumer goods and industrial raw materials, and improved the life quality dramatically by bearing lots of social burdens.

2) Due to the inherent disadvantages of SOEs, most countries do not retain a big portion of SOEs. A lot of industrial countries carried out privatization in the 1980s after the oil crisis and economic downturn in the 1970s, for example, Great Britain, France, Canada, Japan etc. At the same time, many fast-growing developing countries achieved fast economic growth only by bringing competition, thereby confronting the low efficiency of SOEs. These countries included most of East European countries like Hungary and Poland and some Asian countries such as Thailand and Malaysia. The advantages of privatization are often claimed as small government, reduction of government control in the economy, more efficient management of assets, more competitive and fairer markets and the enhancement of economic efficiency.

The ways of privatization are different in different countries. Canada carried out its privatization during 1980s, which was preceded by outright sale of state-owned enterprises to individuals and privately-owned companies. Often priority was given to employees and local individual investors through early access or preferential share allocations. Big SOEs had offered the public, fixed price share sales on a first-come-first-serve basis. Another way was to set a minimum price and ask the investors to bid the maximum price they were willing to pay. Hungary created the State Property Agency (SPA) in 1990, which owned all state assets and was responsible for the privatization process. French law required that each SOE sold must first be appraised by an independent Privatization Commission comprised of seven experts in law, economics and finance. Poland encouraged participation by individual investors during its privatization process in the 1990s: individual investors were able to purchase state-issued discounted bonds that could in turn be exchanged at par for privatization shares at a discount of 20% of the nominal offer price. Employees were able to buy up to 20% of their company’s shares at concessionary prices as low as one half the regular offering prices.14 In Great Britain, employees were given free shares, plus bonus shares.

Most countries implement privatization in competitive industries without reservation. However, for monopoly industries, including utility and transportation, different countries have taken a different approach. Great Britain sold its utility SOEs and thus shifted from state ownership and direct government control of utilities toward the US model of price-regulated, government-franchised, but privately-owned monopoly utility firms. France made no attempt to privatize public utility monopolies in telephone, electricity, gas, transportation, or water supply. Different countries could have different rules for employees too.

In some cases, the government retained partial control via a golden share that confers the right to veto certain transactions such as takeovers by foreign corporations (England).15 In order to prevent malicious foreign takeovers, regulations work more effectively than ownership control. Most countries require government or even legislation approval when certain percentages of ownership would be acquired by foreign companies.

14 Dewenter, Kathryn L. and Paul H. Malatesta Public Offerings of State-Owned and privately-owned enterprises: an international comparison, University of Washington, School of Business, November 1996.
15 Ibid.
3) China’s approach to privatization:
   During the last ten years since mid 90’s, SOEs have experimented with different
types of privatization. Big SOEs often form group companies through combination,
merger and acquisition and many of them become public companies. Usually the
government deliberately retained a large equity in large SOEs for many reasons, most
important of which is to control the key industries related to energy and natural resources.
Most of mid-sized SOEs either have been sold to bigger companies, or have bought small
companies to diversify ownership and enhance their competitive power. Most small
SOEs have been either terminated or sold to individuals including managers, employees
or outside investors. The process of privatization has been full of speculation and chaos
together with many successful stories.

   The State-Owned Asset Administration Bureau was first established in 1988 to
manage the SOEs, and was merged into the Ministry of Finance (MOF) during the
governmental restructuring in 1998. According to the State Council Institutional Reform
Scheme approved at the First Session of the 10th National People’s Congress of the
PRC, the State-owned Assets Supervision and Administration Commission of the State
Council (SASAC) was set up in 2003, and it became the owner of SOEs for the central
government. Similar institutions were then set up to represent the ownership of
governments at local levels. Clear and definite ownership becomes a pre-condition for
further reform. SASAC performs the responsibility as the investor on behalf of the state,
supervises and manages the state-owned assets of enterprises according to law; and
guides and pushes forward the reform and restructuring of SOEs. 16

   China’s theme of SOEs reform has been described as “Grasp the large, release the
small”. The report of the 16th CPC in 2002 advanced the theme as keeping sole state
ownership in a few SOEs that control the industries which are key to the nation’s stability
and security, and privatizing other SOEs by transferring shares to individuals and other
non SOEs. This had shown that China has entered a new stage of reforming SOEs,
converting or privatizing not only medium and small SOEs, but some of the big SOEs.
The government is expecting to withdraw its ownership from some big SOEs.

   Within this policy framework, several issues are important. Given the size of the
SOEs and the complications, the conversion process should be standardized. SASAC and
its counterparts in local governments should be monitoring the entire process.

   After SASAC was established, a number of regulations and rules have been
established17. This has provided a sound legal basis for the further reforms of SOEs.

   During the practical application, the fairness and transparency of the transfers
should be guaranteed. Some of the SOEs are sold or transferred to the new owners while
boards and employees were never notified or had any right to participate in the decisions.
Individual investors should also be encouraged and protected.

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16 www.sasac.gov.cn
17 These rules and regulations include “Provisional Rule in Monitoring State-Owned Assets”(June 2003);
“Regulation for Evaluation of Assets and Appraisal of Capital in SOEs” (September 2003); “Provisional
Rules in the Performance Evaluation of Executives in SOEs of Central Government” (November 2003);
“Several Requirements in Institutional Reforms in SOEs” (November 2003); “Provisional Regulation in
State-Owned Assets Transfer” (January 2004); “Regulation in State-Owned Assets Statistics and
Reporting” (March 2004) etc.
For the privatization of big SOEs, government intervention is necessary to prevent malignant takeovers or foreign takeovers. Clear rules or regulations should be developed regarding foreign company purchase and acquisition.

2. Improve corporate governance

For a long period of time, SOE reform has been to separate ownership from management, to give SOEs greater operational autonomy. During the beginning stage of the reform before 1978, this was appropriate because SOEs were solely controlled by government, while the continuous advocacy during the years, makes SOE management power out of control. SOE management makes decisions without being properly supervised and monitored by government.

A long time misunderstanding about the modern enterprise system continues to exist in China among theoretical researchers and government officials. If we look at the welcome remarks of SASAC website, it says “On the principle of separating government administration from enterprise management and separating ownership from management power, SASAC has that responsibility…” Today, SOEs are less over-monitored, but rather SOE management power is perhaps too unrestricted because the government does not properly exercise its oversight role. Management without owners’ supervision and monitoring inevitably gives rise to inefficiency. Furthermore, this has become an important reason why SOE operations are out of order. SASAC, together with other authorities, should work on integrating ownership supervision and monitoring into the management, restoring and improving the ownership power over management power instead of the opposite.

China’s SOE reform has come to a point that integrated management and smooth corporate governance play a key role in the success of further reform. Proper corporate governance does not prevent owners from guiding corporate management without intervening in the daily operations. Owners, through their representatives – boards should direct management by approving annual budgets, and making other big and important decisions such as appointment of executive officers, planning expansions, introduction of new product lines, or major merger / acquisition decisions.

To improve the corporate governance, boards of directors have to be strengthened and empowered. SASAC must establish systems to ensure that state representatives will effectively implement state ownership in the state’s interests. SASAC also should advise and monitor SOEs by performance evaluation and other measures. Another important issue is the appointment of officers. SOE managers are often directly nominated and appointed by the government and not by boards. Appointments and promotions of officers should be open and based on economic performance.

3. Reform the macroeconomic environment.

Reform is badly needed if the tax code, legal framework and better law enforcement (including bankruptcy law) of the applicable law and regulations are not abided by.

China’s macro-economic environment should be improved especially after China accessed to WTO. At a minimum, China should abide by internationally–recognized rules in order to participate in international competition. China should first of all establish a full range of laws to protect businesses and formulate the rules for economic competition. At the same time, the tax code should be standardized for greater equality.

18 “www.sasac.gov.cn”
between domestic enterprises and foreign companies. More importantly, laws, rules and regulations should be enforced. Bankruptcy codes should be strengthened.

In a broader perspective, major reforms of social security must accompany economic reforms. It is especially important that local governments are assisted in taking over the social security system previously operated by SOEs together with the central government. SOEs should be able to lay off redundant employees without considering social stability which should be a government-wide responsibility.

As discussed earlier, state-owned bank performance is another key to economic success. State-owned banks do not have incentives to make good loans and monitor the borrower’s performance and are often required to provide loans to poor-performing SOEs. It is more assured that the government will refinance the banks if SOEs cannot pay their loans. This seriously weakens the motivations for financial responsibility in both banks and SOEs.

In order to build a strong economic foundation, further reform of SOEs is essential in China. Privatization will bring more competition, and increase the economic efficiency at large. Moreover, SOE internal organizational reform is more important and urgent. A healthy, supportive and regulative macro economic environment is the pre-condition which will otherwise restrict China’s development in the long run.

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