Paulson Policy Memorandum

Fixing China's State Sector

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About the Author

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Introduction

The sheer size and scope of China's state sector makes that country unique among the world's major economies. According to its Ministry of Finance, China has more than 100,000 state-owned enterprises (SOEs), with combined assets of roughly $13 trillion. The business dealings and competitive practices of the most important of these Chinese SOEs have also frequently drawn scrutiny abroad and criticism at home. It is not uncommon for outside observers to urge China to carry out large-scale systemic privatization and to substantially shrink its state sector.

But the nation's leadership has consistently held the view that SOEs should occupy a central position in China's economic structure. And at the Third Plenum of the 18th Chinese Communist Party (CCP) Central Committee in November 2013, the leadership reiterated that view, declaring that state ownership is a "pillar" and "foundation" of China's distinctive system and its "socialist market economy."[1]

Bluntly put, this means that China's SOEs are here to stay—and this includes not just the 113 "central" firms under the State Owned Assets Supervision and Administration Commission (SASAC) but also the tens of thousands of companies controlled by various local governments. The debate within China is not about whether there should be SOEs but rather what kinds of companies these should be and how they should be managed.

This debate has been driven by China's continued progress toward an economy in which market forces play a bigger role. That means the desire to maintain a strong and sizable SOE sector has sometimes come into conflict with other priorities. In 1997, for example, the government launched a major round of SOE reforms once officials recognized that state firms were accumulating debt at a pace that would put a huge burden on China's finances.

The late-1990s reforms introduced two broad principles that helped to reconcile socialist ideals with market realities. First, Beijing has aimed to make SOEs financially stable and commercially successful firms that do not require direct support from the government. Second, the leadership has wanted to concentrate SOEs in sectors on the commanding heights of the economy—strategic areas that contribute to China's national security, improve its global competitiveness, and increase the pace of indigenous technological progress.

From 1997 until about 2003, the implementation of these principles led the Chinese government to push poorly performing SOEs to exit the market. And this process greatly improved the performance of the remaining SOEs. Not coincidentally, it also helped to create huge new opportunities for China's private-sector entrepreneurs.

This policy memorandum argues that in the years since 2003, however, China's policy for SOEs has increasingly diverged from this successful model. The environment has been further complicated since 2008 by a dramatic loosening of monetary policy and lowering of lending standards, as well as the government's mobilization of many SOEs to engage in public sector stimulus projects.

The government's own data on SOEs show that neither of its two principal priorities for the state sector is now being achieved: SOE assets are not, in fact, being concentrated in the sectors the government wants; and the returns on SOE assets have sharply deteriorated. As a result, a significant part of the Chinese economy is underperforming.

This creates a drag on economic output at a time when many other changes—an aging population, the maturing of housing and other infrastructure, and weak demand in the developed economies—are already shifting China onto a slower growth trajectory. Thus, these problems present a strong case for rethinking the policies now governing the state sector.

This memorandum takes the view that the problems increasingly evident in China's state sector today—falling returns, rising debt, and a loss of strategic focus, among others—are a result of the departure from the successful model introduced in 1997. Since 2003, the Chinese government has become extremely reluctant to allow any SOE—large or small, central or local—to shut down or change ownership. In combination with loose monetary policy and political pressure on SOEs to support short-term growth, this shift has worsened the incentives for the managers and supervisors of state-owned firms.

China's government does have the ability to improve the financial performance of its SOEs. And it can help them to fulfill their original mandate while also boosting the potential for future growth across the entire Chinese economy. This policy memorandum argues that the best solution is to return to the policy orientation of the 1997-2003 period, when the government encouraged the exit of underperforming SOEs. The memo also proposes some ideas for how to get China's SOEs back on track and more closely aligned with their core mandates.

Making this old strategy work in a new environment will require a set of interrelated changes. These include the following: a more flexible approach to managing the government's SOE assets; a clearer strategic focus for the SOE sector overall, with performance targets that are calibrated to various goals that different SOEs must meet; the creation of a clear process for underperforming firms to close down or be transferred to private ownership (in other words, an "exit" mechanism); and reduced political interference in SOE investment decisions.

Data Note

This memorandum assesses the allocation of SOE assets and returns by using publicly available data from China's Ministry of Finance (MoF). MoF's annual yearbook publishes figures on the financial performance of all SOEs outside the financial sector, both centrally and locally controlled. These figures cover indicators like assets, revenue, and profits, and are broken down by sector.

To our knowledge, this is the most comprehensive available data set for assessing the composition and performance of the state sector. Much public discussion of Chinese SOEs focuses on the subset of very large "central" firms controlled by SASAC, but local SOEs account for about half of total SOE assets and more than two-thirds of total firms.

Much of the published academic work on SOEs' financial performance covers only the industrial sector; the National Bureau of Statistics' surveys provide data on both state and private firms. But a focus on industry alone is inadequate for evaluating the entire state sector, as major SOEs exist in service sectors like transportation, media, and communications. In this memorandum, unless otherwise indicated, SOEs refer to the entire sector as defined in the MoF data, including all central and local state firms outside of the financial sector.

The Allocation of State Assets

Chinese policymakers have a clear set of priorities for the economic roles they want SOEs to play. These are identified with strategic sectors through which SOEs can provide spillover benefits to the broader economy.

The current industrial policy framework for SOEs was articulated in 2006 by Li Rongrong, then the head of SASAC, which functions as China's central SOE regulator.[2] In a few "key sectors" closely linked to national security and the "lifelines" of the economy, Li argued, SOEs must dominate absolutely. These sectors are defense, electricity, oil and petrochemicals, telecommunications, coal, aviation, and shipping. (In practice, the Chinese government also treats two other sectors as "strategic" and reserved for SOEs: the operation of the national railway network and the manufacture of cigarettes and tobacco products.) In addition, Li said, SOEs would need to have a strong presence in several "pillar industries," namely equipment manufacturing, automobile manufacturing, electronics, construction, steel, nonferrous metals, chemicals, surveying, and scientific research.

While private sector companies would also be expected to compete in the less important of these sectors, the implicit argument was—and remains—that strong SOEs will ensure that China has a robust competitive position in global markets and can undertake research and development to raise the level of domestic industry.

"The investment and operation of state-owned capital should serve national strategic goals, and should be directed more toward the important industries and key sectors connected to national security and the lifelines of the national economy."

Li's purpose in clearly identifying these strategic sectors was not just to defend the current layout of SOEs, but also to articulate a vision of how the state sector should evolve in the future. SASAC would "promote the concentration of state assets" in these various key sectors, he said. This broad goal has been repeated several times since then, including in the following statement from the documents approved at the CCP Third Plenum in November 2013: "The investment and operation of state-owned capital should serve national strategic goals, and should be directed more toward the important industries and key sectors connected to national security and the lifelines of the national economy."[3]

In the years since it was first laid out, this list of strategic sectors has been criticized by China's trading partners for being excessively long, lacking in clear economic justifications, and acting as a deterrent to investment in these sectors by private firms, both domestic and foreign. What is more, the government's support of SOEs in some of the sectors where they compete with private firms also raises the question of whether the state can, in fact, play the role of a neutral referee in regulatory or commercial disputes between state and private firms.

Judging from the language adopted at the Third Plenum, however, the Chinese government is aware of some of the problems created by this system While the plenum sixty-point decision document did not change the list of strategic sectors reserved for SOEs, it did state that SOEs should focus on the provision of public services and the development of future strategic industries—implying a move away from direct competition with private-sector firms. The Decision also said that SOEs should observe rules of fair market competition, and that non-state companies should be free to compete in almost all sectors.[4]

But perhaps the most straightforward criticism of this industrial policy is that it is not succeeding even on its own terms. Indeed, it is possible to measure what proportion of SOE assets is concentrated in strategic sectors and what proportion is not, using MoF data.[5] The overall "asset allocation" of China's state sector can thereby be quantified, and assessed to see whether SOE assets are actually concentrated in the sectors the government wants them to be.

Figure 1. SOE Asset Allocation

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Key sectors*	29%	31%	30%	31%	32%	34%	36%	35%	34%	26%	25%
Railway and tobacco monopolies	5%	5%	5%	5%	6%	6%	6%	6%	6%	6%	6%
Pillar industries**	23%	22%	21%	22%	21%	22%	21%	21%	21%	20%	20%
Total of strategic sectors	57%	58%	56%	58%	59%	62%	62%	62%	60%	52%	51%
Share of non-strategic sectors	43%	42%	44%	42%	41%	38%	38%	38%	40%	48%	49%

* electricity, oil, post/telecom, coal, aviation, shipping
**equipment, autos, electronics, construction, steel, metals, chemicals, surveying, search
Source: Ministry of Finance

This simple exercise yields a rather surprising finding, and one that may well be concerning to Chinese policymakers. The assets of SOEs are not, in fact, mainly in those sectors officially designated as "strategic." To the contrary, they have become *less* concentrated in these sectors over time (see Figure 1).

Such a trend should prompt the government to rethink its industrial policy for SOEs, since even after many years it has failed to meet its own consistently expressed goals.

The MoF figures show that the six "key sectors" other than defense (electricity, oil and petrochemicals, telecommunications, coal, aviation, and shipping) accounted for just one quarter of total SOE assets in 2011—the most recent year for which complete data is available—compared to 29 percent in 2001 and 34 percent in 2006, when those key sectors were formally identified. If the nine "pillar industry" sectors and the two de facto strategic sectors of railways and tobacco are added, the share of SOE assets in strategic sectors rises to barely a majority of 51 percent in 2011—a figure that has actually dropped from 57 percent in 2001 and 62 percent in 2006.

This decline in the share of SOE assets concentrated in strategic sectors probably does not mean that SOEs are actively disinvesting in those sectors. One statistical issue, for instance, is that the size of SOE assets in a residual category called "government, non-government organizations, and other" increased sharply in 2010 and 2011, which would have pushed down the relative share of other sectors. Yet while this change may exaggerate the strategic sectors' relative decline, there is also no sign that SOEs are heeding Chinese policymakers' call to concentrate their assets into strategic sectors.

Indeed, the overall landscape of China's state sector today is hardly a central planner's dream: about half of all SOE assets are sitting in non-strategic sectors, such as restaurants, retailing and low-end manufacturing, where there is increasingly little justification for them to compete with private firms. This "non-strategic" group of SOEs is quite sizable: it comprises over 90,000 individual enterprises with about 37 trillion yuan ($6 trillion) in assets, according to MoF data.

The repeated official declarations of support for SOEs' important role in the national economy become more difficult to understand in the context of this data. If SOEs are not actually holding up their end of the bargain by investing in the core strategic sectors that the government has identified, then why does the government defend SOEs' role by saying they are needed in order to invest in strategic sectors?

Return on State Assets

The more serious problem for the state is that the SOEs' financial performance has deteriorated since 2008. This trend has reversed many of the gains achieved in earlier years.

The reform and downsizing of the state sector that began in 1997 was driven by a focus on improving corporate performance and preparing state firms for the greater competition that would result from China's accession to the World Trade Organization. Reform was urgent because their losses had become an unsustainable financial burden, with the government both sending direct subsidies to money-losing firms and organizing indirect subsidies in the form of lending from state-controlled banks.

To end this unsustainable flow of public funds into failing SOEs, the government ended direct subsidies, told SOEs they had to be responsible for their own profits and losses, and closed or privatized a shockingly large number of firms. Under the slogan of "grasp the big, release the small" (*zhuada fangxiao*), the government focused on retaining and strengthening large firms in strategic sectors while closing or privatizing smaller, poorly performing and/or less strategic firms. Based on MoF figures, the total number of SOEs fell from 262,000 in 1997 to 146,000 in 2003, when SASAC was founded, while the number of SOE employees dropped from 70 million to 42 million over the same period.

Figure 2. SOE Financial Performance

	Total Profits (% of annual GDP)	Return on Assets	Return on Equity	Profit Margin
1998	0.3%	0.2%	0.4%	0.3%
1999	1.3%	0.8%	2.1%	1.7%
2000	2.9%	1.8%	4.9%	3.8%
2001	2.6%	1.6%	4.6%	3.7%
2002	3.1%	2.0%	5.7%	4.4%
2003	3.5%	2.2%	6.7%	4.8%
2004	4.6%	3.2%	9.6%	6.1%
2005	5.2%	3.7%	11.0%	6.8%
2006	5.6%	4.4%	12.4%	7.5%
2007	6.6%	5.0%	12.1%	9.0%
2008	4.2%	3.2%	8.0%	6.0%
2009	4.6%	3.0%	7.9%	7.9%
2010	5.3%	3.3%	9.2%	7.0%
2011	5.2%	3.2%	9.0%	6.6%
2012	4.7%	3.1%	n/a	5.6%

Source: Ministry of Finance

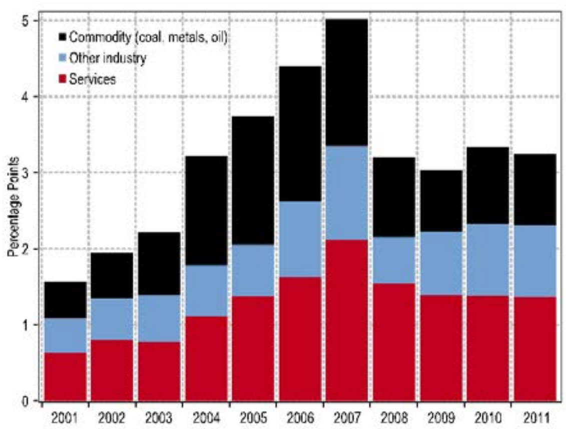
The improvement in financial performance that followed this restructuring was substantial, shown across several indicators. The total return on assets of all SOEs, for instance, rose from a marginal 0.2 percent in 1998 to a peak of 5 percent in 2007, while their return on equity surged from 0.4 percent in 1998 to a high of 12.4 percent in 2006. These results seemed to vindicate the strategy of aiming for a smaller but stronger SOE sector (see Figure 2).

Still, although SOEs did become less prevalent, their economic importance arguably increased even though their numbers shrank and masses of new private sector firms were founded. One measure of the relative economic size of the state sector—the size of total SOE profits relative to the nation's annual gross domestic product—went from 0.3 percent in 1998 to 6.6 percent in 2007.

This rising trend came to a sudden end in 2008, when the global financial crisis brought a sharp slowdown in both domestic and global growth. Indicators of SOEs' financial performance fell dramatically in 2008 compared to the peak of the boom in 2007. A cyclical decline would certainly be understandable given the scale of the downturn. But the real problem is that what started as a cyclical downturn became a structural one: all indicators of SOE financial performance have stayed low since 2008.

Despite some economic recovery both domestically and globally, the profitability of the state sector has yet to significantly recover. According to MoF, the aggregate return on assets for nonfinancial SOEs was just 3.25 percent in 2011, compared to a peak of 5 percent in 2007. Other measures such as the size of profits relative to GDP, the profit margin on revenues or return on equity, all show the same pattern.[6]

Figure 3. SOE Return on Assets by Sector



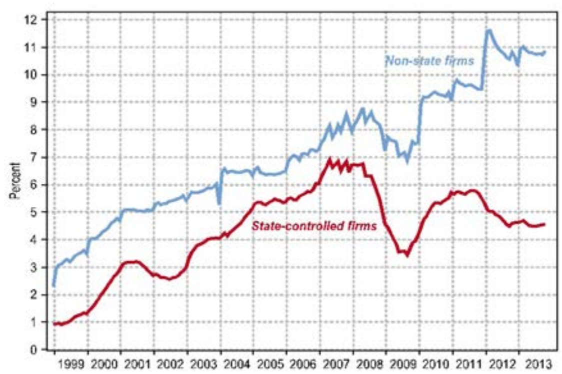
Source: Ministry of Finance, author estimates

This decline is not simply the result of a limited number of SOEs dragging down the overall performance of the entire state sector. It is true that SOEs whose fortunes depend heavily on commodity prices (mainly those in base metals and petroleum) have suffered the sharpest reversals since 2008: the return on assets of SOEs in the metals sector has fallen to 2.2 percent in recent years from a peak of 7.5 percent. But it is not hard to find examples of private sector firms in the cyclical metals and materials sectors that have done fairly well in these troubled years.[7]

And the poor performance of SOEs is not limited to the sectors driven by the commodity cycle: returns in other industrial and services sectors have also descended from their past peaks. Of the 1.8 percentage-point decline in the aggregate SOE return on assets from the 2007 peak to 2011, commodity-related sectors accounted for 0.7 percentage points, other industry 0.4, and services the remaining 0.7 (see Figure 3).

This pattern of a broad-based deterioration in financial performance suggests that, at minimum, SOEs have not done very well in adapting to the secular slowdown in China's economic growth since 2008. A comparison of state-owned and non-state firms in the industrial sector, using data from the industrial survey conducted by China's National Bureau of Statistics, is also telling (see Figure 4). For industrial SOEs, their return on assets peaked around 6.7 percent in 2007, fell as low as 3.6 percent in 2009, and has since only recovered to around 4.5 percent. Non-state firms, by contrast, had returns of around 8 percent in 2007, which dropped to around 7 percent in 2009, but since then they have recovered and more, with their return on assets currently above 9 percent.

Figure 4. Return on Assets of Industrial Enterprises



Source: CEIC Data, author estimates

To put this differently, the deterioration in private sector firms' financial performance after 2008 appears to be largely cyclical and short-term. The worsening of state firms' performance, by contrast, has been more structural and enduring. As a general rule, private firms should be expected to outperform state firms because SOEs will always face some pressure to meet non-financial objectives. But the gap in performance between state and non-state firms in the industrial sector has been widening and is now the largest in the fifteen-year history of the statistics.

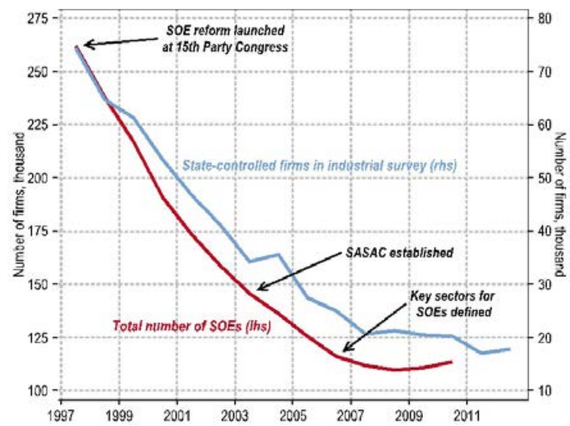
The low level of return on assets in the state sector seems likely to produce future financial problems and difficulties in repaying debts. According to the People's Bank of China's data, the average interest on one- to three-year loans has been above 7 percent since 2011, well above the return on assets for most SOEs.[8]

The Cause: No Exit Strategy

China's government, as the ultimate owner and guarantor of SOE assets, therefore faces two problems. First, the allocation of SOE assets has not moved in the desired direction, so the government's *policy* goals are not being met. Second, the returns on those assets have deteriorated, so its *economic* goals are not being met either.

To know how to remedy these problems, the underlying cause must first be identified. And this cause cannot simply be the fact that China's economy is growing more slowly now than in the boom years of 2003-07, as private sector firms have managed to successfully navigate this transition. The cause of the underperformance and misallocation of SOE assets should be sought in the structure and management of the state sector itself.

Figure 5. Size of SOE Sector



Source: Ministry of Finance, CEIC Data

This memorandum contends that the underlying cause of both problems is that the Chinese government has for the past decade not required, and often not allowed, state firms to exit the market.

The change in SOE policy that began in 2003, although little remarked upon at the time, was perhaps the most important shift in the management strategy and operating environment for the entire state sector, and represented a clear change of course.

As discussed above, the SOE reform strategy launched in 1997 focused on trimming the size of the state sector in order to improve the performance of the remaining firms. The exit of SOEs was not only tolerated but actively driven by government policy. But just as the effect of the downsizing of SOEs in the early stages of reform is dramatically apparent in the data, so is the end of that downsizing. The reduction in the number of state firms slowed after 2003, and came to a nearly complete halt after 2007 (see Figure 5).

This change in trend was linked to the creation in 2003 of SASAC, which was given a mandate to represent the government's interest in centrally controlled non-financial firms and to improve their performance. One of the major policy changes SASAC (and its counterparts at the local level) introduced involved ending the practice of allowing management buyouts of SOEs, which were often opaque, poorly regulated transactions that company insiders could easily manipulate. This policy change was made in response to direct instructions from the CCP leadership to “prevent the loss of state assets,”[9] a term for illicit privatizations at undervalued prices.

Such transactions had become increasingly prevalent as the downsizing of the SOE sector stretched into its later years, and were seen as having an unhealthy similarity with the rapid but often corrupt privatization processes in Russia and Eastern Europe. Those privatizations were also thought to have created a class of oligarchs with little loyalty to, but undue influence on, the national government. So the desire for Beijing to avoid going down the same road was understandable at the time.[10]

The policy environment since the 1990s has basically moved from “grasp the big, release the small” to grasping everything and not releasing anything.

However, the closure of this potentially corrupt and problematic avenue for state firms to exit was not replaced by the opening of a more regulated and less problematic one. The end result was a very low tolerance for any further privatizations or closures of SOEs. Instead, the policy environment since the 1990s has basically moved from “grasp the big, release the small” to grasping everything and not releasing anything.

The shift from the turbulent if dynamic environment for SOEs between 1997-2003 to the more static environment from 2003 onward has had important effects on how SOE assets are managed. Although the supervisors of SOE assets had instructions to shift the asset allocation in a particular direction, the new policy environment constrained their ability to actually do this. If SOEs cannot be readily closed or sold, then the composition of SOE assets can change only slowly, and will be heavily influenced by how much growth in certain sectors creates opportunities for new investment.

This inability to rapidly adjust the structure of SOE asset allocations also has an effect on their returns. This is because assets are not diverted away from poorly performing sectors and into better performing ones. Since such reallocation would have to involve shedding assets or closing companies, in the post-2003 environment it has usually not happened. This has made it harder for SOEs’ return on assets to recover from the slowdown since 2008.

For instance, there are numerous SOE assets in heavy industrial sectors that performed very well in the construction boom that followed housing market liberalization in China, but these are now struggling as the housing market matures and construction settles onto a slower-growth trajectory. The return on

SOE assets will continue to be depressed so long as such sectors make up a disproportionate share of the total.

This sectoral effect on SOEs' aggregate return on assets is accompanied by an effect at the company level on incentives. Once SOEs were no longer subject to the threat of total failure or forced privatization, the cost for poor financial performance was a secondary concern. While earlier SOE reforms emphasized the issue of "hard budget constraints"—essentially, forcing SOEs to live within their means—the loss of the ultimate sanction for companies resulted in a softening of budget constraints. If a firm was doing very badly but could not be closed, then it would get some form of official support to keep operating. The worst sanction available would be a forced merger with another SOE, a process that often left existing management in place and employees unaffected.

Photo: © Curt Carnemark / World Bank

In practice, this loss of discipline did not become an issue immediately because the change in SOE policy in 2003 coincided with a multi-year acceleration in China's GDP growth. The boom created many opportunities for new investment—not least in the newly liberalized market for housing—and meant that even poorly managed firms could benefit from rising sales. Once the boom ended in 2008, however, the economic environment in China and globally was no longer so positive. And state firms started to receive quite different signals from the government, which compounded their management problems. While the post-1997 policy for SOEs had emphasized that they should be run as much as possible like normal commercial companies, after 2008 SOEs were called on to do things to support the national economy rather than their own bottom line.

Indeed, SOEs associated with local governments played the largest role in the enormous public works program that sustained China's growth in 2009, during the aftermath of the global financial crisis, and again in 2012, when a smaller infrastructure-focused stimulus program was deployed. Many of these SOEs were entities newly created for this purpose, known as "local government financing vehicles," but existing SOEs were not excluded from the trend. The fact that the borrowing and spending of SOEs is separate from the government budget meant that this stimulus spending did not show up in the official debt and deficit figures, but it was no less consequential for that.

The International Monetary Fund (IMF) has estimated that if the borrowing and spending by local-government-owned SOEs were incorporated into the budget, then China would have run a fiscal deficit of roughly 15 percent of GDP in 2009 and 10 percent in 2012.[11] The contrast with MoF's formally reported budget deficits for those two years—2.8 percent and 1.5 percent of GDP respectively—gives an idea of the magnitude of SOE investment spending in those years.

The new pressure on SOEs to undertake these public investment projects interacted with the loss of hard budget constraints in the post-2003 policy environment. Knowing that they faced no real consequences if the projects turned out to be bad ones, SOEs had little incentive to generate decent returns.

It is true that many recent SOE investments were in infrastructure projects, which by their nature tend to generate low financial returns and tend to have very long time horizons. But in practice, it is hard to tell the difference between a project with genuinely poor financial returns and one that takes ten years to start generating decent financial returns. So the fact that SOEs' return on assets declined after 2008 is surely related to the fact that SOEs were pushed to invest in many projects with low returns. And SOEs acquiesced to this pressure because government policies since 2003 had already made very clear that there was no danger of going under if they did so.

A Way Forward

The problems that China's SOE sector faces today are therefore in large part the unintended consequences of a set of policy changes made around 2003. The decision to halt the privatization and downsizing of the state sector was defensible at the time, due to the progress that had been made and the worries about the political consequences of overly aggressive privatization. But the result was a weakening of the market discipline on SOEs to perform, since there was no official tolerance for them to actually exit the market.

This also left the government with little flexibility to change the "asset allocation" of the state sector, since existing assets in non-strategic sectors could not be sold off. The loss of hard budget constraints proved to be toxic when combined with the loosening of monetary policy and the increased political pressure on SOEs to stimulate short-term investment that followed the global financial crisis in 2008. As a result, many SOEs today are burdened with an asset base that is not generating high returns, and have increasing amounts of debt.

How can China change this unhealthy pattern? A first step would be to simply return to the principles of SOE reform from a decade and a half ago: SOEs have a responsibility to not become a financial burden on the state, and therefore need to meet some basic standards of corporate performance. A shift in this direction appears to have already begun in 2013, with much greater official attention to the problem of underperforming SOEs and poor investments.

In a speech in October 2013, SASAC vice chairman Huang Shuhe used fairly strong language: "We are determined to clean up and dispose of inefficient and inactive assets in order to stop the bleeding. We will strictly supervise investments by state-owned enterprises to control investments that exceed their financial capacity or go into non-core businesses and excess capacity sectors."[12]

Yet for this kind of threat to have credibility and bite, there will need to be consequences for firms that fail to deliver. So the government should also restore a credible threat of closure and market exit for the worst-performing SOEs. In this respect, it is positive that the Third Plenum's sixty-point decision document called for creating a "market exit mechanism" based on the principle of "survival of the fittest." However, even as the decision discussed bankruptcy processes, it did not specifically mention the exit of SOEs.[13]

It is also noteworthy that the Third Plenum's decision placed much emphasis on the role of "mixed ownership" in improving SOE performance: it calls for introducing more non-state shareholders to SOEs, and for increasing the role of investors more attuned to financial performance, such as the National Social Security Fund. As Huang, the SASAC vice chairman, subsequently explained, this does mean that the government is prepared to allow private-sector investors to take over some of the less strategic SOEs.[14]

To build on these steps toward SOE reform, China's government should create a process for consistently underperforming SOEs to close down in an orderly way, and for their remaining assets to be distributed transparently. It should also actively help to arrange transactions that would serve as a demonstration of the principle that private investors will be allowed to take effective control of some SOEs.

Actual change on this front is likely to happen fastest for SOEs that are owned and managed at the local government level. The financial performance of local SOEs is generally much poorer than central SOEs, and most of the smaller, non-strategic firms that would be plausible candidates for closure or privatization are at the local level. The small group of 113 or so major firms directly managed by SASAC generally have a stronger strategic justification for their existence and a better track record of financial performance (see Figure 6).

Figure 6. SOE Financial Performance

	Return on Assets		Profit Margin	
	Central	Local	Central	Local
2001	2.9%	0.6%	6.3%	1.4%
2002	3.3%	0.8%	6.9%	2.0%
2003	3.6%	1.1%	6.7%	2.6%
2004	5.2%	1.4%	8.5%	3.2%
2005	6.0%	1.7%	9.2%	3.6%
2006	6.2%	2.2%	9.5%	4.8%
2007	6.4%	3.1%	10.5%	6.7%
2008	3.8%	2.2%	6.7%	5.0%
2009	3.5%	2.3%	8.2%	7.4%
2010	4.1%	2.5%	7.4%	6.5%
2011	4.0%	2.5%	6.8%	6.3%
2012	3.7%	2.4%	5.8%	5.4%

Source: Ministry of Finance, CEIC Data, author estimates

Local governments also have accumulated significant off-balance-sheet debts as a result of their stimulus spending since 2009 and will be under pressure to make good on those debts without going to Beijing for a bailout. In those circumstances, raising cash from the sales of state assets could seem increasingly attractive.

The central government could play a useful role by encouraging local governments to experiment with different strategies for managing and streamlining SOEs under their jurisdiction. The challenge is to prevent a recurrence of the very real problems the government faced in 2003, with a proliferation of privatizations dominated by company insiders. So the design of a standard legal and political process for the closure or sale of poorly performing SOEs should not be left to local governments alone.

The key to making a new round of SOE reform successful for China is for the government to have a clearly articulated set of goals for SOEs. There is still an unresolved tension in the multiple goals China has set for SOEs: these firms are supposed to support the national economy by investing in strategic sectors with a future payoff yet are also expected to operate like normal commercial firms.

But if these strategic sectors were highly profitable, then presumably private sector firms would already be investing in them. So if state firms are to perform the venture capital-like function of exploring new frontiers, then there has to be some official tolerance for losses. Ultimately, it may not be possible for SOEs to meet both of these goals at the same time—or to put that more precisely, it may not be possible for an *individual* SOE to meet both goals.

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The goals set for SOEs should recognize that in reality China has various types of state firms performing different functions: some are essentially utilities, the operators of public infrastructure like power plants and toll roads; some are regulated oligopolies, competing against each other in industries with high natural barriers to entry like telecoms and airlines; and some are competing against domestic private and foreign firms in consumer-driven markets like cars. Rather than justify SOEs' presence in all of these different markets in the same way, while expecting them all to meet the same standards, China should treat different SOEs differently.

As the data presented in this memorandum have shown, it is not true that all, or even most, SOEs serve a strategic economic function, even based on the criteria the government itself has already adopted. So the Chinese government should not insist that all SOEs are equally valuable and, by implication equally protected from market forces. Instead, it should carry out a top-to-bottom review of the state sector and clearly identify the economic and non-economic goals that each individual SOE should be pursuing.

While this policy memorandum has used annual financial performance as a metric for evaluating the performance of SOEs, this is clearly not appropriate for all SOEs, particularly those undertaking very long-term investment projects. One appropriate response to this problem would be to not ignore financial metrics but rather to devise better ones. That would mean reviewing and clarifying the objectives for different SOEs.

Such a review would help to make clear precisely which SOEs need to be pushed harder to improve their bottom-line performance, which deserve some forbearance, and which do not have a clear strategic justification at all. This goal-setting exercise would thereby create the political space and economic justification for a process to allow SOEs that are not meeting their goals to exit the market. Clarifying the goals, for both the state sector as a whole and for individual SOEs would help to improve the performance of what is still a significant part of China's economy.

Endnotes

[1] See section two of the "Decision on Major Issues Concerning Comprehensively Deepening Reforms" adopted at the Third Plenum in November 2013, http://www.gov.cn/jrzg/2013-11/15/content_2528179.htm.

[2] Li's comments are found in "SASAC: The State Economy Should Maintain Absolute Control over Seven Sectors", http://www.gov.cn/ztzl/2006-12/18/content_472256.htm. This policy memorandum treats Li's definitions of strategic industries as broad political goals for the entire state sector, both central and local, rather than as a narrow instruction only to SASAC-controlled firms.

[3] See item six of the Third Plenum "Decision."

[4] See items five, six, eight, and nine of the Third Plenum "Decision."

[5] This requires matching the sectors mentioned by Li Rongrong in 2006 with the specific sectors used in the MoF data. In most cases the match is obvious, but there are a few places where the ordinary language used by Li does not exactly line up with the categories used by MoF. For example, national defense is listed as the first of the key sectors but is not broken out in the MoF data. Also, MoF treats posts and telecommunications as a single sector, although technically only telecommunications is listed as a strategic sector.

[6] This memorandum uses simple performance indicators that can be quickly calculated from public data, but the same trend also shows up in more involved calculations. See for instance the calculation of growth in total factor productivity at state and non-state industrial firms by the Organization for Economic Cooperation and Development (OECD), which also shows fast improvement at SOEs after the 1997 reforms, but much slower gains since 2007. See *OECD Economic Surveys: China 2013*, pp. 39-41.

[7] See *A Chinese Aluminum Company's Learning Curve in the US Market*, Paulson Papers on Investment (Case Study Series), The Paulson Institute, November 2013.

[8] The data on average lending rates are reported in the central bank's quarterly monetary policy report; the most recent as of this writing is available at http://www.pbc.gov.cn/publish/goutong-jiaoliu/524/2013/20131105161226267809782/20131105161226267809782_.html.

[9] See paragraph seven of the 2003 Third Plenum document at http://news.xinhuanet.com/zhengfu/2003-10/22/content_1136008.htm.

[10] For a broader discussion of the change in SOE policy after 2003, with useful context on how that change related to shifts in other areas of government policy, see Barry Naughton, "China's Economic Policy Today: The New State Activism," *Eurasian Geography and Economics*, 2011, 52, No. 3, pp. 313–329.

[11] See "People's Republic of China: 2013 Article IV Consultation," IMF Country Report No. 13/211, http://www.imf.org/external/pubs/ft/scr/2013/cr13211.pdf.

[12] See "Comprehensively Deepen Policy, Regulations, and Guidance Work To Provide Stronger Protection for State Assets Reform and Development," October 20, 2013, http://www.sasac.gov.cn/n1180/n1566/n11183/n11199/15560096.html.

[13] See item seven of the Third Plenum "Decision."

[14] In public remarks, Huang proposed a four-type categorization of SOEs to clarify which ones can have minority or majority ownership by private investors: "One, for a small number of state-owned and state-controlled companies that are related to national security, we can use the form of sole state ownership. Two, for state-owned enterprises that are related to the lifelines of the national economy, major industries and key sectors, we can maintain an absolute controlling stake for the state. Three, for important state-owned enterprises in pillar industries and high-technology sectors, we can maintain a relative controlling stake for the state. Four, for those state-owned enterprises that state capital does not need to control and can be managed by societal capital, we can use the form of [minority] participation by the state, or a complete exit." See the transcript of his remarks on December 19, 2013 at http://www.china.com.cn/zhibo/2013-12/19/content_30923263.htm?show=t.

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