WHOSE MONEY?

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THE TUG-OF-WAR OVER CHINESE STATE ENTERPRISE PROFITS

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Mikael Mattlin
Researcher
The Finnish Institute of International Affairs

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- China's recently approved five-year plan envisions a reorientation of the economy towards a more socially equitable and environmentally sustainable growth model.

- The new plan lays the foundation for a new social contract, a Chinese 'New Deal'.

- The state is to collect more dividends from state-owned enterprises than before, improving its ability to fund China's developing social security system.

- New measures have been introduced to control speculative investments by enterprises.

- Politically influential central-level state enterprises, the so-called *yangqi*, have resisted efforts to wrest control over profits and investments away from them.

The Global Security research programme
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The headquarters of China National Petroleum Corporation and PetroChina in Beijing. Photo: Charlie Fong / Wikimedia Commons.

While China's reform strategy has largely been a success story that has seen living standards rise tremendously, it has also led to widening income gaps, regional disparities, and much wasteful investment. Large income gaps breed social discontent that may turn into political demands. The ruling Communist Party has proved itself adroit at preventing such demands from emerging, by taking timely pre-emptive action in response to people's needs.

True to this track record, the 12th five-year plan, accepted in March 2011 by the National People's Congress, places much emphasis on income redistribution, developing a functioning consumer economy and promoting basic public services. At the heart of the plan is the message that a more equitable and sustainable growth model is necessary. In effect, the plan sets out a road map for building a new social contract between the government and the people. Ultimately, the aim is to secure the legitimacy of the party's claim to power.

In order to encourage domestic consumption, a more comprehensive social security system is called for. Chinese consumers commonly save a hefty portion of their income, due to an inadequate social security network. In a country with a population of 1.3 billion, any improvement in social security is, however, bound to be an expensive affair that requires someone to pay up.The profits of state-owned enterprises (SOEs) have in recent years emerged as a potent source of funding. As major Chinese SOEs clearly increased their profitability over the past decade, the use of their profits became a bone of contention in the policy debate. According to Chinese Ministry of Finance figures, last year SOEs made an aggregate profit in the region of 2 trillion Chinese yuan, equivalent to 230 billion euros, or around 20% of the national budget.

State officials regard the profits of state-owned companies as a key building block in funding the evolving Chinese social security system, as well as in restructuring the state-owned economy and in creating globally competitive Chinese enterprises. How SOE profits are used affects many key issues in China's macroeconomic management. This paper looks at the background to the dividend issue and its relationship to social security funding and the arduous task of reining in speculative real estate and stock market investments.

The rise of the *yangqi*

With the state-owned sector's share of the Chinese economy in long-term decline and widespread interest in the development of China's private corporate sector, it is easy to forget the often crucial role that SOEs continue to play in the Chinese economy. Contrary to the bankrupt situation of many state-owned enterprises in the 1990s, the biggest SOEs are now tremendously profitable. As a key component of what has been called the 'inside the system' (体制内)[1], they are also often in a special position vis-à-vis the authorities. For example, the bulk of a massive 4 trillion yuan (about 500 billion euros) infrastructure spending package announced by the government in November 2008 to counter the effects of the global economic downturn was channelled through SOEs.

Another reason for increasing public interest in the use of enterprise profits is that big SOEs are a very visible and central part of the Chinese economy. The number of 'central enterprises' (央企 *yangqi* in Chinese), namely national-level state companies, has dropped from an original 196 to 121 due to mergers and restructurings. A stated aim is to reduce their number further to approximately 30-50 globally competitive enterprises. In 2010, the *yangqi* made a combined net profit of 849 billion Chinese yuan (almost 100 billion euros) on revenues of 16.7 trillion yuan.

There was a time when terms like *keiretsu* and *chaebol* were practically household names that aroused competitive anxieties in Western corporate leaders. *Yangqi* as a term has not yet entered common parlance outside of China, but the state-owned enterprises that the term denotes have certainly been at the centre of great international interest in recent years. Of the 43 Mainland Chinese companies on the latest Fortune Global 500 list, 30 are *yangqi*, while nine are state-owned banks or insurance companies, and two are other SOEs. Only two can be considered non-state enterprises. The *yangqi* list almost reads like a 'who's who' of China's corporate elite. For example, the parent companies of telecom operator China Mobile, oil company Sinopec and the national flag-carrier Air China are all *yangqi*. *Yangqi* are dominant in a number of major industries in China. In particular, they control the energy, civil aviation and defence industries, and are also major players in the metals, heavy machinery, shipbuilding, construction and car industries. These industries have been designated by the state as either 'strategic' or 'pillar' industries.

The big SOEs are the enterprises chosen by the party-state to secure the party's grip on power. The successful restructuring and reorganization of major SOEs is therefore a crucial task for the party-state. Unsurprisingly, big state enterprises have a number of political aims, such as ensuring that the state-owned sector still dominates the Chinese economy and that future Chinese global champions are state-owned.

The top-tier state enterprises are, through their subsidiaries, already among the biggest Chinese investors abroad. For example, no less than 13 Chinese state-owned enterprises operated in Libya, with contract values amounting to several billion euros. The best SOEs have also morphed into a huge money-making machine and one of the greatest concentrations of assets globally. This state-controlled asset concentration, sometimes referred to as China Inc, naturally proffers political patronage opportunities. It is also one of the main sources of funding for China's developing social security system.

Managing state assets

China began constructing a new administrative framework for the control of state enterprises in 2003 when the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) was founded. SASAC is a ministerial-level special organization directly under the Chinese State Council that oversees a multi-trillion euro concentration of state assets. SASAC has a vast structure with a central-level organization, as well as semi-independent provincial and local offices throughout the country.

SASAC represents the state's ownership interests, but initially also held some regulatory powers over the state-owned enterprises. The somewhat unclear status of SASAC was clarified in October 2008 when a long-awaited law on enterprise state assets (企业国有资产法) was finally promulgated. The second section of the law emphasizes SASAC's role as the organization that exercises the state's ownership rights, in a similar fashion to any other large equity investor. SASAC shares its authority over the state-owned economy with various other organs; in financial matters with the Ministry of Finance, in personnel appointments with the Communist Party's organizational department, and in industrial policy with the National Development and Reform Commission (NDRC) – the former state planning commission.

1 See e.g. Walter, Carl E. and Fraser J.T. Howie (2011) *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*. Singapore: John Wiley & Sons, p. 8.

People trying to coax donkeys on a riverboat near Yangshuo. SASAC has faced a similar situation when trying to cajole dividends from state-owned enterprises. Photo: Stougard / Wikimedia Commons.

In practice, it is virtually impossible to effectively control the huge concentration of assets that has been placed under SASAC's supervision in a centralized manner. A management model that seems to be gaining ground is for a handful of central enterprises to assume roles as a kind of super holding company for other state enterprise assets, placed between SASAC and the other enterprises. As one of SASAC's key tasks is to oversee the restructuring of the state-owned economy, these enterprises are effectively a kind of asset management company dealing with mergers, restructurings and the orderly disposal of non-core assets. Since 2005, three such asset management companies have already been formed – the State Development and Investment Corporation, the China Chengtong Group and Guoxin Group. The last one was established as recently as late 2010.

In practice, SASAC has faced an uphill struggle to establish its authority over the SOEs that it supposedly controls as a representative of the state owner. This is partly by design. While SASAC is a ministerial-level unit, so are 54 of the biggest central enterprises. In other words, SASAC's chairman is equivalent in rank to the bosses of the central enterprises that it supervises, making it hard to issue direct orders.[2] The fact that SASAC is a special unit on the sidelines of the formal government apparatus, lacking independent authority over personnel appointments, financial matters and regulations, almost inevitably results in a gap between its ambition and actual powers. Even in terms of informal political influence, ever so important in China, powerful SOE executives are often much better placed than SASAC bosses. Many of the central enterprise executives hold influential party positions with a direct line to the top leadership.

The dividend issue

In most countries, the state collects dividends from its enterprises. Dividend and privatisation proceeds commonly go either directly to the state treasury (Ministry of Finance) as general revenue or are directed to a social security fund. Alternatively, proceeds can be earmarked for a specific purpose, such as reducing public debt. Collecting dividends from state-owned enterprises reduces the risk of managers making unprofitable investment decisions on the back of excessive funds. As elsewhere, Chinese enterprise managers prefer to reinvest profits, sometimes speculatively in the real estate or stock markets.

In conjunction with a big tax reform in 1994, state enterprises were exempted from having to pay dividends to the state. However, their stock market listed subsidiaries still paid dividends to the non-listed wholly state-owned parent companies. They, in turn, could retain all profits rather than passing them on to the government. For the most profitable

2 Walter and Howie, *Red Capitalism*, pp. 167–168.

listed SOEs this meant that their parent companies were frequently awash with cash. In the context of a long-running macro-economic debate on the Chinese economy's overheating, which centres on excessive (and wasteful) investments, SOE retention of profits made it onto the political agenda. Over-capitalisation of some SOEs due to strengthened profitability, the dividend exemption and politically influenced bank lending, has contributed to over-investment in many industries.

In this context, it was decided that dividends would again be collected directly from state-owned enterprises. From 2008 onwards, the state has required all wholly state-owned enterprises to pay dividends. However, the decision to resume the collection of dividends gave rise to a protracted dispute. The principal protagonists were SASAC, which wanted SOE dividends earmarked for restructuring domestic industries and strategic investment priorities, and the Ministry of Finance, which wanted the proceeds included in the regular state budget.

Not surprisingly, the dividend collection system also provoked much resistance from powerful SOEs. Eventually, a compromise solution was reached whereby SASAC became the lead agency in compiling the so-called state capital management budgets (国有资本经营预算), the main vehicle for collecting and redistributing SOE dividends. However, all proceeds were first to be remitted to the Ministry of Finance, from which funds would then be turned over to SASAC for use in the strategic restructuring of SOEs. In simplified terms, the funds flow from the state enterprises through the Ministry to SASAC, from which much of the money is eventually re-allocated to the state enterprises, and earmarked for specific purposes.

When rolled out nationally, the dividend ratios were set at ten, five and zero per cent, based on enterprise categorisations determined by SASAC. The most profitable companies were required to pay the highest rate, while military-industrial enterprises and research institutes were largely exempt from remitting profits to the state. As profits are highly concentrated in certain industries, in practice, a ten per cent rate has been applied to the most profitable central enterprises, especially in the energy sector.

At the end of 2010, the Ministry of Finance issued a directive that raises the dividend ratios across the board, commonly by five percentage points. Starting this year, the most profitable *yangqi* (such as petrochemical, power generation, tobacco and telecom companies) will pay 15% of their profits to the state, while steel companies and airlines, for instance, will pay 10%. A SASAC vice-chairman recently also indicated that the dividend ratios should gradually be raised close to the level paid to shareholders by stock market listed companies in China. Following the announcement of dividend ratio hikes, it can be expected that the state will subsequently gather more than 10 billion euros from the central enterprises into state coffers. In comparison, this would be approximately 25 times the Finnish government's dividend income in 2010.

State capital management budgeting

As a legacy of the planned economy, the government had very broad control over state enterprises until the 1980s. They were an integral part of the state budgeting system in China, with all enterprise financing needs covered by the state, and profits and losses directly included in the state budget. This control gradually loosened following the reform policies, to the point where SOEs had become almost entirely separated from state finances prior to the reinstitution of the dividend. Integral to this development was the 1994 dividend exemption. In wresting back control over enterprise profits, the state capital management budget, stipulated in the enterprise state assets law, is the main tool.

The state capital management budgets aim to consolidate companies' investment funds and require that they turn over a portion of their post-tax profits to the state. In addition to remitting a share of operating profits to the government, the enterprise state assets law also stipulates that companies have to remit part of asset sale proceeds, liquidation proceeds and other profits to the government.

Pre-approval is also required for non-core business investments and pre-notification of core business investments. Core business categories have been officially determined for each company. With too much money at their disposal and poor returns in many economic sectors, SOEs account for much speculative investing. Nowhere is this more evident than in the overheating real estate markets. Recently, SASAC ordered the *yangqi* to divest themselves of all non-essential real estate investments. However, the process has been slow with enterprise managers dragging their feet. A year ago SASAC announced that 78 *yangqi*, whose primary business is not real estate, would have to sell off their real estate investments. Yet, only 14 of the implicated enterprises did so in the first year after the announcement, again attesting to the difficulties SASAC encounters in enforcing its directives.

Following trials in pilot locations, in 2008 the state capital management budget was rolled out nationally for all state-owned enterprises. The 2008 budget for central enterprises amounted to 54.8 billion Chinese yuan (6 bn euros at current exchange rates). After being routed through the Ministry of Finance to SASAC, 49% of this money went towards increasing state ownership over assets related to national economic security and people's livelihood, 36% towards covering SOE losses incurred due to natural calamities, and the rest towards covering corporate restructuring costs. During the economic downturn in 2009, SASAC provided emergency financial support to ailing *yangqi*. The capital management budget dropped considerably during that year, to 31.5 billion yuan (3.5 bn euros). In 2010, it jumped correspondingly to 60 bn yuan (6.6 bn euros).

One of the aims of increased dividend collection from state enterprises is to raise the ability of the state to fund China's developing social security system and promote a consumer economy. To further this aim, in June 2009 the State Council also announced that all SOEs listed on the stock market since 2005 have to transfer shares worth 10 per cent of their initial public offering to the national social security fund. Demanding more remittances from state enterprises and forcing divestments of speculative real estate investments will also assist in macroeconomic adjustment.

The Chinese government's role in supervising the investments of state-owned enterprises has gradually been enhanced. However, there have understandably been some doubts as to how effective SASAC has actually been in asserting its authority over SOEs, given their political clout and the administrative constraints on SASAC. The perennial tug-of-war between SASAC and the powerful *yangqi* over the uses of their profits attests to the political strength that big Chinese state-owned enterprises have acquired, as the officially designated core of the Chinese economy.

A Chinese 'New Deal'?

The 16th Party Congress in 2002 set a lofty goal for China. By 2020, China should have achieved something referred to as a *xiaokang* (小康) society. The concept derives from classical Chinese and roughly translates as moderate wellbeing or a society that is basically well-off. A long line of policy initiatives have since been designed to further this broad objective, most notably a decision in 2005 to relieve farmers of the taxes and fees that had been a part of their lot for thousands of years. The *xiaokang* goal and the policy measures embodied in the five-year plan can be seen as something of a Chinese version of the American New Deal in the 1930s, a new social contract between the government and the people. They reorient the focus of the entire economy, from an investment-led but wasteful and uneven growth strategy to a more consumption-driven, balanced and socially just one. Wealth transfers from state-owned enterprises to the state can be seen in this context.

Mikael Mattlin
The Finnish Institute of International Affairs
Kruunuvuorenkatu 4
FI-00160 Helsinki
tel. +358 9 432 7000
fax. +358 9 432 7799
www.fiia.fi

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