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Short History of Reforms Concerning Chinese State Owned Enterprises

It has been a common trend in recent years for various countries to tackle the performance of their state owned enterprises (SOEs). Among those, the reform and efforts made by Chinese government are surely not negligible.

Former President Deng Xiaoping's guideline for the reform was "crossing the river by feeling the stones under one's feet". After over two decades experimental approach based on trial and errors, the Chinese reform of SOEs has made remarkable progress. The number of loss-generating enterprises was reduced year by year, and the competitiveness of SOEs has been greatly improved in a market driven economy, alongside the rapid growth of the private sector.

However, it is now probably the time to cross the deep-water area. With the intensified transformation of enterprise mechanisms and the restructuring of state owned enterprises, the reform has encountered unprecedented challenges, but also new opportunities.

1. History of Chinese SOEs

After the founding of the P.R. China in 1949, the government nationalised almost the entire industrial economy by taking over the previous state owned companies, subsidiaries of foreign firms as well as private companies. Two categories of ownership were created along the Soviet model: ownership by the state and ownership by the people, often called collective ownership. By 1958, the state sector accounted for 89.17% of the industrial output, up from 32.69% in 1949 (Jian Sun, 1999). On the eve of the economic reforms in 1978, the SOEs accounted for 80.8% of the total industrial output (Justin Yifu Lin, Beijing University, 1999).

Under the former planned economy, the SOEs had little discretion over their business operations. Production, purchase, sales and even the wage rates were all decided and allocated by the government. Moreover, SOEs had multi-functions at that time. On the one hand, they were enterprises supposed to reach production targets and generate profits, on the other hand, they should act as policy executors who had to provide job opportunities and undertake social welfare functions for their body of employees. With this burden of multiple and sometimes conflicting tasks, the economic performance of the state-owned sector was extremely poor. Many SOEs just survived on the government's protection and subsidies, e.g. cheap raw materials and low interest loans from the state banks, among which a large percentage became non-performing eventually.

At that time, the secure jobs in this kind of enterprises were called "large canteen meal" and "iron rice bowl". Even if the bowl fell to the floor it never broke.

2. Reform of Chinese SOEs

2.1 Preliminary achievements

Since late 1978, China started its economic reform and opening-up policy, which has made its growth rate maintain an annual average rate of 9.7%, leading to an absolute economic growth

increase by 9.5 times in the last 25 years. The reform of the SOEs has always been on the priority list of the overall economic and managerial reform. A series of measures aiming at improving the efficiency of the SOEs and creating a mixed-ownership structure was adopted, including administrative decentralisation, liberalisation of the state material allocation system, profit retention and authority to invest and to import and export, as well as the introduction of Contract Responsibility System in SOEs. As a result, the SOEs were gradually deprived of their public administrative functions and the performance of quite a number of them has been greatly improved. Others were just closed down.

The government started to take initial steps towards labour market reform in mid 1980s. The Tentative Stipulations on the SOEs Labour Contract System, which was later replaced by the Labour Law (1994), the Regulation on Unemployment Insurance for State Enterprise Employees (1991) and Resolution on Unified Enterprise Basic Pension Insurance System (1997), was promulgated in July 1986 to terminate the permanent employment system in SOEs. However, the new labour contract system applied only to new employees, until the first half of the 1990s, most employees in the SOEs still retained lifetime employment (Wu Zengxian, Europe-Asia Studies, Nov. 1997).

Under the former planned economy, the lifetime employees depended solely on their enterprises for health care, housing and retirement pensions, therefore the arrangement of the laid-off workers during the re-structuring of SOEs remained an arduous task. The government has been working to establish a sound social security system to cover the unemployment insurance, retirement pension as well as social relief and welfare since 1987, but apparently there is still a long way to go.

After 1998, particularly after 2003, when the 16th National Party Congress was held, the reform of SOEs has been accelerated. By reorganisation, acquisition, sell-off, close-down, and bankruptcy, the number of SOEs shrank year by year. The efforts to re-structure the SOE sector turned positive and became quite fruitful.

According to government statistics, from 1998 to 2003, the number of state enterprises dropped by 40% from 238,000 to 150,000, but the aggregate profits that these SOEs realised, had soared by 22.2 times, from an initial 21.37 billion yuan (US$ 2.58 billion) to 495.12 billion yuan (US$ 59.9 billion). The total value of SOEs rose by around 60%, from RMB 5.2 trillion (US$ 628.8 billion) to RMB 8.4 trillion (US$1.02 trillion). It was reported that in the first 10 months of 2004, the 181 central SOEs and their groups had gained overall profits of 418.9 billion yuan (US$ 50.6 billion), a 53% increase from the same period of the previous year.

Meanwhile, the competitiveness of SOEs has also been improving rapidly. According to a government report, the economic profits of SOEs stopped declining in 1999 and keep climbing since then. The scale of assets of profitable SOEs continues to expand. By the end of 2004, over 1,000 SOEs were listed in domestic and overseas stock markets, with an clear upgrading effect on their corporate governance and efficiency. As a result, 14 Chinese SOEs rank now among the top 500 enterprises in the world, compared to only 5 in 1998.

2.2 Obstacles and Challenges

2.2.1 Chronic problems

Undoubtedly, the performance of SOEs, the first pillar of the former Marxist economic structure, has improved quite a lot, but is still far from that of the non-state sectors. Benefiting from legalisation of private ownership and the relaxation of the state monopoly over industry, the private business, which had been considered as the source of capitalism (so called “capitalist tail”) and should have been eliminated, has become a dynamic component of China’s economic growth and its contribution to the national economy is rising continuously.

Meanwhile, the second pillar of the former system, the township and village enterprises, as well as urban collective enterprises, which used to be under the umbrella of the local government organisations, have mostly been transformed into private-owned firms but still retained their strong connections with local governments. At the same time, fiscal decentralisation enabled local government to retain and allocate more of the tax revenues and to levy surcharges and various duties on local enterprises. The lower governments could therefore grant preferential policies to these former collective enterprises. As a result, these companies could take advantages of the flexible management mechanism of private firms on one hand, and enjoy government support in terms of capital, resource and workforce access on the other hand. Consequently many of them have become the most dynamic sectors in local economy.

Under this circumstance the SOEs are facing strong competitions from these fast-growing private, joint-venture as well as foreign invested companies under the market force, especially after tariffs on more industries are further lowered in line with China's commitment to WTO.

Currently large key SOEs in protected industries or in monopoly positions like energy, telecommunications, steel, and automobiles are quite profitable. Some have been enlisted on the stock market in China and abroad. But it is predictable that these enterprises will be still under tight central control in the foreseeable future although minority stakes are being sold on the stock market. However, low performance efficiency, resource-draining, and insider dealing still remain major problems in China's SOEs. In 2003, the average profit rate of net assets was only 5%. According to a recent report, about 10% of SOEs face deficits. State-run enterprises in China yield, on average, a return on assets of only 3% - well below the 7% that the companies in the private sector generate (McKinsey data) – and much less than the housing property market promises.

2.2.2 Irregularities during the reform

During the process of SOEs property rights reform, some problems emerged due to legal loopholes which have resulted in the loss of State assets. In some cases, government official and company management worked together to prevent real open and transparent biddings, in order to secure underpriced sales for themselves. Some other financial scandals revealed cheating in financial reports to create deficit or hide increased value. Among all the irregularities, management buyouts (MBO) were particularly singled out and have aroused heated debate in economic and government circles.

An MBO refers to acquisitions of all or part of the equity capital of a company by its directors and senior executives. In recent years, MBOs were used in the reform of many SOEs, which, to some extent, did improve the vitality of the enterprises. But in many cases MBOs were abused by the management for personal gains.

In August 2004, Larry Lang, a Hongkong based economist, accused the inappropriate MBOs which have caused the loss of State assets in a series of articles and talk shows. Mr. Lang pointed out the question for some of China's most famous companies, including Haier, Kelong, and TCL. Thus he lit the fuse for a heated discussion in economic circles which later on caused a great deal of public concern.

In response to these concerns, the State-Owned Asset Supervision and Administrative Commission (SASAC), the watchdog agency acting as the state owner of central SOEs, stopped the MBOs of major large SOEs, and a detailed regulation on MBOs in small and medium-sized SOEs was announced to be published within the first quarter of 2005. Founded in June 2003, SASAC (http://www.sasac.gov.cn) is responsible for the appreciation of State assets as well as guiding and supervising the SOEs reform. With the deepening of China's economic reform, SASAC becomes one of the most active and important government agencies.

To improve transparency and fairness of property rights transaction, SASAC has been working on setting up state assets supervision and management organs at the city level and property rights transaction centres in big cities to organise open auctions.

3. 2005: Deepening of Reform and New Opportunities

As reiterated by the government, deepening the re-structural reform of SOEs will remain the highlight for the year 2005 – and even with bigger pace, according to Li Rongrong, the Minister heading SASAC.

Mr. Li expected SASAC to take the next five years to basically complete the restructuring procedure. SASAC has already drafted a four-year plan for policy-arranged bankruptcy to let more poor-performing SOEs withdraw. Under the scheme, around 2,800 SOEs will go bankrupt in the next four years.

In the meantime, SASAC will also try to build up more internationally competitive enterprise groups. In recent years China has been implementing its "going global" strategy to push the growth of export-oriented economy. The aim is to have 50 Chinese enterprises among the world's top 500.

To sharpen the competitiveness of the central SOEs, the government encouraged these enterprises to invest more in R&D in order to compete with international business giants. Currently China's major SOEs invest only an average 1% of their operational income in R & D, compared to the 7% of multinational companies.

According to the official plan, 2005 will be a year with pilot reforms, offering new opportunities to foreign capital as well as private enterprises.

The Chinese government recently underlined the readiness for foreign capital to be involved in the acquisition and merger of Chinese SOEs. It is said that the restructuring of the Chinese SOEs will need a capital of between 2 and 2.6 trillion yuan, while merger and acquisition by foreign capitals only accounts for 5% to 10% of the total FDI for the time being.

Official instructions were also issued to all China SOEs indicating that their non-core businesses must be sold off - the risk not to follow would go as far as these entities being taken away by the Government and dismantled. Actually many of the targeted operations are profitable or possess significant assets such as land. Furthermore, some non-core businesses are in important sectors like chemical industry, electrical appliances and telecommunications and have a profound business network. On the other hand, the governments at various levels are also happy to introduce foreign investment to upgrade their industries. It is said that international acquisitions will become an important way for local government to attract foreign investment. Even in Shanghai where capital is quite available, 40 enterprises with 600 billion yuan (UD$ 72.5 billion) worth of projects were opened to foreign investors for acquisition and co-operation last year.

However, many factors, including financial loopholes, redundant workers, as well as unclear regulations, still need to be taken into consideration before a merger or an acquisition of a Chinese SOE.

Generally speaking, the year 2005 may expect to see considerable changes in the process of China's SOEs reform, while the depreciation of the US dollar, the shortage in the supply of power, as well as the fluctuation of the crude oil price may have a negative impact on the overall growth of the economy, and thus create difficulties in SOE development.

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Commercial Section