2

Reform of State-Owned Enterprises

While major economic reform initiatives from the late 1970s through at least the mid-1980s focused primarily on agriculture, China's government also launched various experiments in the 1980s to reform state-owned firms, particularly industrial firms (Lin, Cai, and Li 1996, 211–19). These reforms aimed to expand enterprise autonomy with regard to production, marketing, and investment decisions, in part by allowing firms to retain a portion of their profits rather than handing them over in their entirety to the Ministry of Finance, as had previously been the case. These reforms were paired with experiments in enterprise finance and price setting. Fixed asset investment was no longer financed almost entirely by budgetary grants, but rather through retained earnings and bank loans. What came to be called a dual-track pricing system replaced a unitary system of state fixed prices. The State Price Commission continued to set the prices of a broad range of raw materials, intermediate inputs, and final goods, but these prices applied only to planned units of output while above-plan output could be sold at prices determined by the market (Wu and Zhao 1987). This approach meant that scarcity-based prices increasingly influenced firm production decisions at the margin, leading to a more efficient allocation of resources. This reform became increasingly important in the mid-1980s, when the State Planning Commission discontinued ratcheting up annual output requirements, allowing firms to channel virtually all incremental output to the market (Naughton 2007, 93).

These initial reforms did little to improve the economic performance of state-owned industrial firms. For a number of reasons, profits of state-owned firms declined steadily in the 1980s and well into the 1990s. First, relaxation of the government's monopoly over wide swaths of industry led large numbers of startup, mostly private firms to enter profitable segments of the industrial sector (a phenomenon analyzed in chapter 3). The new firms increased competition, eroding the profits of the incumbent state-owned firms (Naughton 2007, 94).

Second, rural reforms depended initially on reducing and ultimately largely eliminating the high tax implicit in government-set procurement prices for agricultural products. This led to rapid increases in prices that farmers received for grain, cotton, and other important agricultural products, eroding profits of state firms, especially in the food processing, textile, and garment industries (Lardy 1983, 88–92). These branches of industry were disproportionately dependent on inputs from the agricultural sector and thus had unusually high levels of profitability as reform was getting under way (Lardy 1983, 123–27; 1998, 48).

Third, employment in the state sector expanded substantially in the first phase of reform. Between 1977 and 1993, employment in the state sector broadly defined expanded by 50 percent. In state-owned industry, where the share of output had declined to half of output by 1992 compared with its four-fifths share in 1978, employment also had increased by half, to 45 million. In short, it appears that state-owned firms continued to bear a major responsibility for absorbing new entrants into the urban labor force, meaning that the significant levels of excess staffing seen in the prereform era continued after 1978. At least 20 percent of the employees of state-owned firms at the end of 1993 were surplus labor, according to an official from the Ministry of Labor (Hu Xiaoyi 1996, 125).

Fourth, state-owned firms devoted a growing share of their revenues to providing benefits to their workers, everything from health care and pensions to subsidized housing. For example, workers in state-owned firms who had entered the work force in the 1950s began to retire in large numbers in the 1980s, pushing the ratio of retirees to employees from less than 4 percent in 1978 to 18 percent by 1993. Given the pay-as-you-go nature of China's pension system, the premiums paid by firms rose steadily (Hu Xiaoyi 1996, 125–26).

Even before these four developments, which put downward pressure on the profitability of state enterprises, about a fifth of all state-owned firms were posting financial losses in the early 1980s. Though this share dipped to as low as one-tenth for a few years in the mid-1980s, it rose to an average of one-quarter in 1990–92 and then 30 percent by 1993. More worrying, the magnitude of financial losses of state-owned firms soared, reaching a peak of 3 percent of GDP in 1990 (see table 1.2).

Other indicators confirmed the increasingly precarious financial condition of state-owned firms. The average debt to equity ratio of state firms rose steadily, exceeding 100 percent in 1989 and reaching 300 percent by 1994. Eighty-five percent of the liabilities of these enterprises was bank debt (Lardy 1998, 41, 243). By 1994 state-owned firms were so heavily indebted and their profitability so low that their total annual profits covered only a little more than half of the interest payable on their bank debt.[1] This suggests that many state-owned firms continuously expanded their bank borrowing to cover operating losses and/or to finance capital investment that generated returns insufficient to amortize the loans.

Grasping the Large, Releasing the Small

The limited success of the early efforts to raise productivity and profitability in state-owned firms by increasing enterprise autonomy led to a second stage of economic reform following the Third Plenum of the 14th Party Congress in November 1993. This plenum "marked a major turning point on China's road to a market economy" (Qian and Wu 2003, 36). It called for the creation of market-supporting institutions, such as fiscal federalism, emphasized the separation of state-owned enterprises from the government, and, most importantly, for the first time broached the privatization of smaller state-owned firms. The Central Committee gave this latter initiative a further boost in the fall of 1995 when it explicitly endorsed the idea of "grasping the large and releasing the small" (Garnaut et al. 2005, 3). The number of state-owned industrial enterprises fell from 127,600 in 1996 to 61,300 in 1999. There were only 34,280 by the end of 2003 as money-losing firms went bankrupt, were merged with profitable firms, or were privatized (National Bureau of Statistics of China 2000, 407; 2004, 514). Privatization of small state-owned firms typically took the form of sale of shares to employees, where the sale price of the firm frequently was equal to the value of outstanding bank loans plus other debt. These firms thus were transformed from state-owned companies into stock cooperative companies (股份合作企业). After the 1994 Company Law made it possible, many later converted to limited liability companies, typically after managers bought a controlling number of shares from workers (Lardy 1998, 53–54).

Simultaneous with this initiative to reduce the number of small, loss-making state-owned companies, the government launched a reform of large state-owned companies. This "grasping the large" component of economic reform focused not on privatization but rather corporatization. It involved reorganizing traditional state-owned companies into joint stock companies or limited liability companies. Even before the new law introduced these forms of legal organization in China, local experiments in corporate reform had been launched in Shenzhen in south China.

Corporatization was designed to give managers more authority to ensure

1. Estimated based on the statement of an economist at the Central Party School that as of the end of 1994 state banks would have to write off RMB1.215 trillion in loans to state-owned enterprises (SOEs) to reduce firm indebtedness to a level where firm profits would cover interest payments (Lardy 1998, 38). In 1995, loans outstanding to state-owned firms stood at RMB3.36 trillion (Lardy 1998, 83). Assuming loans to SOEs grew at the same 24 percent increase in all bank loans, SOE loans at end-1994 would have been RMB2.710 trillion. Thus the necessary writeoff can be estimated as 45 percent of loans outstanding to SOEs at the end of 1994.

the alignment of interests of managers and government owners, and to allow diversification of ownership, sometimes through a public listing (Naughton 2007, 315). Managers of corporatized state-owned enterprises are accountable to the firm's board of directors, and if the firm is listed on the Shanghai stock exchange, regulations require one-third of the board members to be independent. When these firms are listed, the state typically retains control, because only a minority of the firm's shares are sold. For this reason the National Bureau of Statistics of China classifies corporatized state-owned companies, in which the state remains the majority or dominant shareholder, as state-controlled shareholding companies. For details, see box 2.1. Over 10,000 traditional state-owned industrial enterprises, about a fifth of the total, were corporatized as early as 1999. They accounted for almost two-fifths of industrial output, indicating that corporatized firms on average were much larger than the remaining traditional state-owned industrial enterprises. While the number of state-controlled industrial shareholding companies remains at about 10,000, by 2011 these firms accounted for three-fifths of all state companies and 70 percent of the industrial output produced by traditional state-owned companies and state-controlled shareholding companies combined (National Bureau of Statistics of China 2012b, 501, 512–13).[2]

The corporatization initiative extended beyond the industrial sector. In 1996 there were 442,000 traditional state-owned corporations, three-quarters of them outside of the industrial sector. By 2003 this number was reduced to 370,000 and by 2012 to only 160,000 (National Bureau of Statistics of China 2013c, 29). This significant reduction reflected the transformation of about 100,000 of these companies into state-controlled limited liability and shareholding limited companies, the bankruptcy and exit of small, loss-making industrial firms, and the widespread privatization of traditional state-owned enterprises in some components of the service sector. These latter transformations are detailed in chapter 3 on the rise of the private sector.

While data limitations preclude measuring these reforms' effects on the service sector, it is clear in the case of state-owned industrial enterprises that the reforms, plus the opening to foreign competition during China's negotiation to join the World Trade Organization, sparked a decade-long, substantial improvement in their financial performance. The share of state industrial enterprises losing money declined from a peak of two-fifths in 1998 to only a quarter by 2007, and the losses of these firms fell from 1.4 percent to only 0.3 percent of GDP (see table 1.2). And, as will be shown in chapter 3, the return on assets of state firms quintupled to about 5 percent in 2007 compared with 1996–97, substantially closing the gap with the superior financial performance of private companies. But, as also analyzed in chapter 3, the financial performance of state industrial firms declined in absolute terms after 2007 and fell dramatically compared with that of private firms.

2. The share is rising because the number of traditional state-owned industrial enterprises shrank to only 6,707 by 2011. The reduction from about 115,000 in 1996 is due to mergers, exits, and takeovers by private companies.

Box 2.1 Definitions and terminology

Ownership of Firms and Measurement of Output

In China there are now two types of state-owned firms. The first, formally known as enterprises owned by the whole people (全民所有制企业), are usually simply referred to as "state-owned enterprises" (国有企业). The second are state-controlled shareholding companies (国有控股企业), frequently confusingly translated in English-language Chinese sources as state holding companies. State-controlled shareholding companies are independent legal entities, usually registered as limited liability companies or shareholding limited companies, in which the state is the majority or dominant shareholder. State-controlled enterprises also exist in two other registration categories: state joint ownership enterprises (firms owned jointly by two state-owned enterprises) and joint state-collective ownership enterprises (firms owned jointly by a state-owned enterprise and a collectively owned enterprise). But in 2011 there was only a minuscule number of firms of these two latter types, and together they accounted for only one-tenth of 1 percent of national industrial output (National Bureau of Statistics of China 2012b, 501). State-controlled shareholding companies may be publicly listed, but most are not. State firms may be under the control of the central government, via an industrial ministry or by the State-owned Assets Supervision and Administration Commission (SASAC), or under the control of a provincial or local government, via an industrial bureau of the provincial government, a provincial-level SASAC, or a municipal government.

The National Bureau of Statistics of China in September 1998 for the first time publicly set forth the concept of state-controlled ownership and the methodology for identifying state control in Regulations for the Statistical Division of the Economy. Appendix 3 of this document is titled "Measures for the Statistical Classification of the Portion of the Economy That Is State-controlled." In November 2006 the National Bureau of Statistics in the document "Measures for the Statistical Classification of the Public and Nonpublic Portions of the Economy," extended the control concept beyond the state sector by adding the categories private-controlled, collective-controlled, Hong Kong–Macau–Taiwan-controlled, and foreign-controlled.[1]

By 2012 there were 278,479 state firms, of which 159,644 were traditional state-owned companies. The balance were state-controlled shareholding companies.

(box continues next page)

1. The documents cited in this paragraph are available at www.stats.gov.cn (accessed on August 20, 2013).

Box 2.1 Definitions and terminology *(continued)*

In the industrial sector there were 17,851 state firms that qualified as above-scale, of which 6,770 were traditional state-owned enterprises; the balance were state-controlled shareholding companies (National Bureau of Statistics of China 2013c, 27–29, 473–81).

The terms "state firms," "state enterprises," and "state companies" in the text generally refer to the combined universe of traditional state-owned enterprises and state-controlled shareholding companies organized under the 1994 Company Law. This is because data on a range of variables are available for this broad universe. But since data for many economic variables are not yet regularly published for the universe of registered private companies plus firms in other registration categories where the majority or dominant owner is private, some of the analysis is based on the narrower universe of registered private companies. In 2012 there were 6,552,049 private companies, of which 5,917,718 were registered private companies. The balance were limited liability companies and shareholding limited companies in which the majority or dominant owner was private (National Bureau of Statistics of China 2013c, 27–29).

Disaggregating China's GDP

China's statistical authorities disaggregate GDP into three components or sectors: primary, secondary, and tertiary. Primary includes agriculture, forestry, animal husbandry, and fisheries. Secondary includes industry and construction, with the former further disaggregated into manufacturing, mining, and utilities. Tertiary includes 14 service sector activities.

Emergence of SASAC

Although "grasping the large and releasing the small" substantially increased the role of the private sector in many segments of the economy, there are several domains in which state firms—whether traditional ones or limited liability firms and shareholding limited companies in which the state is the majority or dominant shareholder—remain dominant. State firms continue to maintain a monopoly or near monopoly position in basic telecommunication services, financial services, oil and gas extraction, tobacco, and public utilities such as water and electric power. Moreover, while the number of state firms has declined dramatically, the remaining ones are much larger and, according to the critics of state capitalism, have increased their market power dramatically. Particularly notable are the large profits generated by these firms relative to private firms. James McGregor (2012, 23), who has characterized China as an example of "authoritarian capitalism," notes that in 2009 the total profits of two large state companies, China Mobile and China Petroleum & Chemical Corporation (Sinopec), exceeded the combined profits of China's 500 largest private enterprises.

James McGregor's argument that state-owned firms returned to prominence in the decade of leadership of President Hu Jintao and Premier Wen Jiabao (2003–12) has also been advanced by the US-China Economic and Security Review Commission (2011, 40–50; 2012, 47–79), a number of leading academic specialists, and numerous columnists.[3] Several developments during the Hu Jintao–Wen Jiabao era appear to be consistent with their hypothesis of the rising importance of state-owned firms in China. In March 2003, China created the State-owned Assets Supervision and Administration Commission (SASAC), a high-level government agency that was charged with transforming large state-owned companies into "national champions." In early 2006, the Chinese State Council promulgated the National Medium and Long-Term Plan for the Development of Science and Technology (2006–20), which called for strengthening basic research and reducing the country's reliance on foreign technology. The broad plan was followed in 2007 by aggressive industrial policies that appeared to give large state-owned companies an edge over both foreign and indigenous private firms and included government procurement policies with strong domestic content requirements designed to promote indigenous innovation. The government also launched a Strategic Emerging Industries initiative in October 2010.

Two of the developments that appear to support the resurgence hypothesis came early in the Hu-Wen era: a substantially enhanced role for the National Development and Reform Commission (NDRC) and the creation of SASAC, which was the first economic initiative after Wen assumed office. The State Development and Planning Commission was renamed the NDRC in 2003 and took over the functions of the State Economic and Trade Commission and some of the functions of the State Council Office for Economic Restructuring, substantially enhancing its role. Shortly thereafter, the NDRC regained the authority to approve all major investment projects, in part to improve the efficiency of investment.[4] These developments allowed it to dominate economic policymaking from almost the beginning of the Hu-Wen era.[5] In a further

3. Minxin Pei, a professor of government at Claremont College, argues, "Evidence of the demise of economic reform is easy to spot. The Chinese state has reasserted its control over the economy." "Remembering Deng in our era of crony capitalism," *Financial Times*, January 23, 2012. Available at www.ft.com (accessed on January 24, 2012). Gideon Rachman writes that "the key target that liberalisers have in their sights is the network of mammoth state-owned enterprises, whose role has actually expanded over the past decade." "How China plans to prove the skeptics wrong," *Financial Times*, November 5, 2013, p. 9.

4. State Council, "Decision concerning reform of the investment system," August 12, 2005. Available at www.gov.cn (accessed on March 24, 2014).

5. Peter Martin, "The Humbling of the NDRC: China's National Development and Reform Commission Searches for a New Role Amid Restructuring," *China Brief* 14, no. 5. Available at www.Jamestown.org (accessed on March 24, 2014).

reshuffling of the bureaucracy in 2008, the NDRC absorbed the National Grain Bureau and the National Energy Bureau, in effect making the NDRC "a Super-Ministry, one half-step above everyone else in the government, the general headquarters of the economy." It had "a high propensity to intervene in market operations and outcomes" (Naughton 2014).

The new government entity, SASAC, took charge of about 200 of the most important nonfinancial state enterprises owned and controlled at the central level.[6] The creation of SASAC led James McGregor (2012, 13) to charge that "state-owned firms, which had faded into the background during Deng Xiaoping's reforms . . . returned to prominence under the Hu Jintao and Wen Jiabao administration as anointed 'national champions' to lead China's international ambitions and serve as guarantors of Party supremacy." Similarly, Rosalea Yao (2012, 1) argues that "the average SOE is much larger and financially stronger than it was a few years ago, and so a tougher competitor to private firms."

SASAC firms include the three national oil companies—China National Petroleum Corporation (CNPC), Sinopec, and the China National Offshore Oil Corporation (CNOOC); the large state telecommunication companies—China Mobile, China Unicom, and China Telecom; most of the large state power-generating companies such as China Guodian Corporation and China Huadian Corporation; Shenhua Group, China's largest state-owned coal producer; the major state power distribution companies, State Grid Corporation and China Southern Power Grid Company; as well as the major state airlines—Air China, China Southern, and China Eastern.

The Boston Consulting Group calls SASAC "the world's largest controlling shareholder."[7] The US-China Economic and Security Review Commission (2012, 48) characterizes SASAC as "the world's largest and most powerful holding company." The commission (2011, 44–45) points out that three SASAC-controlled state corporations ranked in the top 10 in the 2010 Fortune Global 500 list of the largest corporations ranked by revenue. Only two American corporations made the top 10.

Certainly the scope of businesses controlled by SASAC is large—far greater than suggested by the small number of firms it directly controls. While SASAC originally controlled about 200 entities, through mergers designed to build even larger, more powerful companies, this number fell to only 113 by early 2014. This small universe of enterprises exerts a large influence on China's economy because most SASAC entities have many subsidiaries, each with multiple factories. This is particularly true of group corporations and holding companies, which account for a substantial share of SASAC entities.[8] For ex-

6. Provincial-level SASACs were established at about the same time in many provinces to manage the development of companies owned by provincial and local governments.

7. Boston Consulting Group, "SASAC: China's Megashareholder," December 2007. Available at www.bcgperspectives.com (accessed on November 20, 2013).

8. Groups in China are organized under the "Provisional Rules on Business Group Registration"

ample, China Guodian Corporation, one of the five largest nationwide power-generating groups, is a sprawling conglomerate with over 100,000 employees. It owns 16 regional and provincial branch companies, 13 extra-large subsidiary companies, 2 research and development institutes, and nearly 200 power enterprises spread over 31 provinces. Its subsidiary companies include five listed companies, four of which are A-share companies listed on the Shanghai Stock Exchange and one a so-called H-share company listed on the Hong Kong Stock Exchange.[9] Similarly, Sinopec Corporation has more than 100 subsidiaries and branches. Numerous other corporations under central SASAC control similarly sprawling business empires. As a result the universe of central SASAC entities in 2010 included 23,738 firms or one-fifth of the number of state-owned firms of all types (China's State-Owned Assets Supervision and Administration Commission 2011, 739).[10]

Moreover, many of the group companies SASAC controls also have expanded their activities far beyond what might be regarded as their core businesses. China Guodian, for example, is the majority shareholder in city commercial banks in Shizuishan City in Ningxia Province and in Shijiazhuang, the capital of Hebei Province. It also has founded an insurance company and has invested in securities, trust, and fund management businesses (China's State-Owned Assets Supervision and Administration Commission 2011, 432). Large numbers of SASAC-controlled firms have also either loaned funds to or invested directly in property development companies, especially in periods when the government has sought to limit direct bank lending to property developers.

The Chinese Communist Party plays an important role in many SASAC entities, a factor that proponents of the notion that state capitalism has taken hold cite as evidence that China is not a market economy but rather one managed by the party-state. The Organization Department of the party appoints the top three executives (party secretary, chief executive officer, and chairman of the board; frequently the first two positions are held by a single individual) in 53 of the most important state-owned enterprises under the purview of SASAC, leading James McGregor (2012, vii) to argue that "this places control of the national champion SOEs that dominate all key sectors

promulgated in 1998 and must have two layers, a parent company and at least five controlled subsidiaries. Many groups have two additional levels—uncontrolled subsidiaries and other firms that collaborate with either the parent company or its controlled subsidiaries (Lin and Milhaupt 2013, 715).

9. China Guodian Corporation. Available at www.cgdc.com.cn/corporate.jhtml (accessed on May 2, 2013).

10. The 23,738 number is based on the *hu* (户) measurement concept, which includes group companies plus subsidiary firms three levels down from the group level. In 2010 there were 261,944 enterprise legal person units (企业法人单位) that were either traditional state-owned companies or state-controlled shareholding companies (National Bureau of Statistics of China 2012b, 27). This is roughly twice as many as the 124,455 state enterprises reported in the SASAC Yearbook, because it includes subsidiary firms more than three levels down from the group level (China's State-Owned Assets Supervision and Administration Commission 2011, 737).

of the economy directly in the hands of top Party bosses who deploy them to boost the economy and buttress the Party's monopoly on political power." The intimate link between the party and these top state-owned firms perhaps is best symbolized by the red phones on the desks of these firms' CEOs, which provide a direct, encrypted link between the firms and Zhongnanhai, the location of the Chinese Communist Party headquarters in Beijing. About 300 of these phones, known as "red machines," link top party and government officials as well as the heads of the largest state-owned companies, providing "the party apparatus a hotline into multiple arms of the state, including the government-owned companies that China promotes around the world these days as independent commercial entities" (Richard McGregor 2010, 8, 10). The party also appoints the top leadership in a much larger number of firms that are state-owned but controlled at the provincial and local level.

Moreover, the revolving door of leaders in this top group of state firms raises questions about the degree of competition among state-owned firms in the same business. For example, in 2004 the party reshuffled the top bosses at China's three telecom firms (Richard McGregor 2010, 83–84). Wang Xiaochu, the executive director of China Mobile, was appointed general manager of China Telecom; Wang Jianzhou, the chairman of China Unicom, became the chairman of China Mobile; and Chang Xiaobing, the vice general manager of China Telecom, became Chairman of China Unicom. Similarly, in 2010 the party reshuffled the leadership of China's three major national state-owned oil companies. The party secretary and general manager of the China National Offshore Oil Corporation (CNOOC) moved to the same positions at Sinopec, while a senior executive at China National Petroleum Corporation (CNPC) was appointed as chairman and party secretary at CNOOC (James McGregor 2012, 72). These rotations suggest a cozy relationship among state-owned firms in key sectors of the economy, presumably undermining whatever competition might exist in the oligopolistic market structures in these industries.

The state also issues regulations that are widely interpreted as providing SASAC-managed firms with substantial economic benefits. While mergers and acquisitions of foreign and Chinese private companies are reviewed for compliance with China's Anti-Monopoly Law, which went into effect in August 2008, "state-owned enterprises have had a free pass on M&As as the government mandates mergers of state-owned enterprise competitors within and across target sectors to develop economies of scale and cultivate state-owned enterprise national champions" (James McGregor 2012, 25). State-owned firms are further protected in many cases by strict restrictions on entry by potential competitors. The state has not allowed, for example, the creation of any mobile phone companies other than China Mobile, Unicom, and China Telecom, which in effect enjoy an oligopoly on mobile telephony services. Equally important, while SASAC-controlled group companies in many cases are the dominant owners of their many listed subsidiary companies on the Shanghai stock exchange, until 2007 these firms paid no dividends to the Ministry of Finance. Moreover, the dividends they now pay are surprisingly modest. The amounts collected in the phase-in year of 2007 were de minimis, only RMB14 billion (Lardy 2012, 72). This rose gradually to RMB97 billion by 2012, still well under 10 percent of the central SASAC firms' profits and very low compared with the United States, where industrial firms typically pay dividends ranging from two-fifths to just over half of their earnings (Lardy 2012, 72).

Finally, most of the dividends paid by SASAC-affiliated companies do not go directly to the state budget administered by the Ministry of Finance but into a separate state capital management budget. Yet almost all of the funds administered through this mechanism are reinvested in the firms SASAC controls. For example, in 2012 only RMB5 billion was transferred from the state capital management budget to the national government budget administered by the Ministry of Finance to be used for social programs to raise people's living standards. RMB5 billion represents 0.04 percent of national fiscal expenditures of almost RMB12 trillion in 2012. Instead, almost all of the dividends paid into the state capital management budget were reinvested within the universe of central SASAC and other centrally controlled firms to support mergers, reorganizations, and restructurings, or were injected into the largest power-generating companies in order to bolster their capital (Ministry of Finance 2013). In short, dividend income allows SASAC to bolster the performance of its own firms. Finally, it is asserted that state-owned banks are required to make loans on favorable terms to state-owned companies, including those controlled by SASAC, and that in some cases they are required to forgive these loans (US-China Economic and Security Review Commission 2011, 46).

The view that the state was resurgent in the past decade is further buttressed by the active use of industrial policy, much of it drafted in whole or in part by the NDRC. In sharp contrast with the preceding period when, under the leadership of President Jiang Zemin and Premier Zhu Rongji, China instituted a far-reaching restructuring of state-owned companies and brought China into the World Trade Organization, in the Hu-Wen decade fundamental economic reform slowed to a crawl. Instead, the Hu-Wen regime aggressively promoted a series of industrial policies, many of which seemed designed to promote state-owned firms at the expense of both foreign firms and indigenous private companies.

The 2006 Plan for the Development of Science and Technology (2006–20) identified 11 key industries that were to receive priority in technological development (State Council 2006a). The plan appears to have stimulated a subsequent initiative linking government procurement to indigenous innovation as well as the strategic emerging industries policy, which identified 37 subsectors in seven industries for priority development (James McGregor 2010).

Later the same year the State Council promulgated a guiding opinion on the adjustment of state capital and the reorganization of the operations of state-owned enterprises drafted by central SASAC (State Council Management Office 2006). The document was relatively balanced, calling for an acceleration of the process of corporatization of state-owned enterprises, improving the coordination of government leadership and market adjustment, and guarding against the loss of state assets. It further called for maintaining state ownership as the main element of the economy, concentrating state assets in important sectors and what it called critical realms, and strengthening the controlling power and leading role of the state economy. But it also called for state encouragement and support of individual and private businesses and the full development of the market as a tool for allocating resources.

Less than two weeks after the State Council acted, Li Rongrong, the chairman of SASAC, gave an interview with reporters of the government's official news agency that was posted on the central government's website and is frequently cited by those who see a resurgence of state control during the period. His language went far beyond the document approved by the State Council. Li said that to carry out the guiding opinion it would be necessary for the state to "guarantee absolute controlling power" over enterprises in seven strategic sectors: military industry, power generation and distribution, petroleum and petrochemicals, telecommunications, coal, civil aviation, and shipping. Chairman Li also identified nine so-called pillar industries—manufacture of equipment, automobiles, information technology, construction, iron and steel, nonferrous metals, chemical industry, prospecting and design, and technology—in which the state was to maintain "comparatively strong control."[11]

The Ministry of Finance in 2007 promulgated a series of documents that required all government procurements to give priority to products embodying indigenous innovation. Within two years the government had launched an accreditation process to determine which products qualified as "indigenous innovation products." This work was subsequently embodied in lengthy product catalogues issued mostly by provincial governments. To qualify, a product's intellectual property, trademarks, and brands must be originally registered in China and embody technology that meets or exceeds international standards (US-China Economic and Security Review Commission 2010, 48). This program, "not surprisingly, was seen by foreign multinationals and their governments as a blatant blueprint for massive technology theft" (James McGregor 2012, 5).

The State Council officially launched the Strategic Emerging Industries policy in October 2010. This initiative identified seven next generation technologies and products, disaggregated into 37 subindustries, that "government officials hope will become the backbone of China's next phase of industrial modernization and technological development."[12] These industries are to be

11. China's State-owned Assets Supervision and Administration Commission, "The state economy must guarantee absolute controlling power over seven sectors," December 18, 2006. Available at www.gov.cn (accessed on October 1, 2012).

12. US-China Business Council, *China's Strategic Emerging Industries: Policy, Implementation, Challenges, & Recommendations*, March 2013. Available at www.uschina.org (accessed on September 23, 2013).

promoted through tax rebates and financial incentives to help companies conduct research and development and commercialize new technologies in industries such as next generation information technology, biotechnology, and new materials.

Did the Hu-Wen Reforms Succeed?

The combination of the creation of SASAC early in the Hu-Wen decade, the enhanced role of the NDRC, and the industrial policies outlined above undermined the previously widespread view in the West that China was in a long but steady transition to a market economy in which state monopolies would be limited to public utilities.

Despite the multiple advantages state firms allegedly enjoy as a result of state industrial policy, it does not appear that SASAC firms in financial terms have performed substantially better than other enterprises or relative to the economy as a whole. Profits of central SASAC firms more than quintupled between 2002, just prior to its founding, and 2012, seemingly supporting the view that SASAC firms earn rapidly increasing, outsized profits (table 2.1, column 2). This strong growth led some to believe that "a remarkable turnaround has been achieved in China's state-owned sector" (Oi and Han 2011, 20). But that assessment appears to have been premature. SASAC-controlled firms enjoyed the most dramatic growth in profits in the early years after SASAC's founding; profit growth slowed after 2007. The relatively weak performance of SASAC firms after 2007 is confirmed in column 3, showing the profits of central SASAC firms as a share of profits of all nonfinancial enterprises. This share rose through 2007 but since has fallen significantly to a level slightly below that of 2003. Profits of central SASAC firms as a share of GDP follow a similar path. In the first few years after SASAC's creation, profits of central SASAC firms as a share of GDP rose. But after 2007 the growth of SASAC firms' profits failed to keep up with China's GDP growth, and by 2012 SASAC firms' profits as a share of GDP had declined by a quarter compared with the 2007 peak. As will be shown in chapter 3, this decline in the relative profitability of SASAC-controlled firms since 2007 also holds for the larger universe of state-controlled firms—including central-level firms still under the control of various government ministries and state-owned firms controlled by provincial-level SASACs—and contrasts sharply with the increasingly superior financial performance of private companies, which account for a rapidly rising share of the profits of all nonfinancial enterprises.

Moreover, on the all-important measure of return on assets (pretax profits divided by assets) SASAC firms do not appear particularly efficient. As shown in the final column of the table, the return on assets of SASAC firms has fallen since 2007, and by 2013 they earned only 3.7 percent on their assets, a rate of return far below that achieved by China's private firms.[13] Equally impor-

13. Details on the return on assets of private industrial and service sector firms are in chapter 3.

Table 2.1 Profits of central SASAC firms, 2002–13

	All nonfinancial enterprises	Central SASAC firms			
Year	Billions of renminbi	Billions of renminbi	Percent of total profits of nonfinancial enterprises	Percent of GDP	Return on assets
2002	2,350	231	9.8	1.9	n.a.
2003	2,695	296	11.0	2.2	n.a.
2004	3,674	590	16.1	3.7	n.a.
2005	4,123	641	15.6	3.5	6.0
2006	4,783	765	16.0	3.5	6.3
2007	6,112	997	16.3	3.8	6.7
2008	7,417	696	9.4	2.2	3.9
2009	7,252	815	11.2	2.4	3.9
2010	8,226	1,143	13.9	2.8	4.7
2011	9,236	1,266	13.7	2.7	4.5
2012	10,824	1,300	12.0	2.5	4.1
2013	12,345	1,300	10.5	2.4	3.7

n.a. = not available; SASAC = State-owned Assets Supervision and Administration Commission

Notes: Total profits are earnings before corporate income tax. For the years 2002 through 2011, profits of all nonfinancial enterprises were calculated by adding corporate income tax payments to enterprise disposable income. Total profit for nonfinancial enterprises are estimated for 2012 and 2013 based on enterprise income tax receipts.

Sources: National Bureau of Statistics of China (2013c, 80–81, 329); SASAC, www.sasac.gov.cn (accessed on February 28, 2014); ISI Emerging Markets, CEIC Database; Wind Information System, Wind Economic Database.

tant, a return of 3.7 percent is well below any reasonable measure of the cost of capital. This strongly suggests that SASAC firms have grown their profits through an investment-heavy growth strategy rather than improvements in operating efficiency.

The relatively weak performance of SASAC firms since 2007 on the traditional measures of profitability and return on assets does not appear to be the result of the managers and directors of these firms pursuing noneconomic objectives. Since SASAC's establishment in 2003, managers of its traditional state-owned enterprises and managers and board members of its wholly state-owned limited liability companies and state-controlled limited liability companies, as well as members of the party committees in these firms, have been subject to both annual and three-year performance assessments that determine their bonuses. The annual assessments place substantial weight on the growth earnings before corporate income tax (EBT) and economic value added (net operating profits less capital costs) with modest positive adjustments to scores for conforming to various international standards and modest negative adjustments for any regulatory violations or errors in financial accounting. Three-year assessments take into account the annual reviews during the period, longer-term metrics such as the increase in the equity value of the firm, as well as (where relevant) negative adjustments for failure to meet pollution reduction targets.[14] The metrics for both the annual and triennial assessments would look familiar to the CEO and top managers of any publicly traded US company.

Critics charge that China's government has aggressively deployed industrial policies favoring large state-owned companies at the expense of both foreign and private domestic firms in order to create national champions that are larger, more powerful, and more profitable. Yet the evidence suggests that these policies have not enjoyed the success that the critics claim. The firms managed by central SASAC have indeed grown enormously in size as a result of both internal growth and mergers. But the massive increase in the average size of SASAC firms has not led to any visible long-run *improvement* in financial performance (Batson 2014). While the central SASAC entities did increase their share of profits of all nonfinancial corporations through 2007, this share has fallen sharply since. Similarly, SASAC firms' profits as a share of GDP rose through 2007 but since have fallen to a level a third less than in 2007. Most importantly, the return on assets of these SASAC firms has fallen steadily since 2006 to a level well below the cost of capital. These data point toward neither SASAC firms' efficient use of China's capital nor a recipe for producing national champions.

Similarly, while the NDRC may have accumulated substantial economic power in the Hu-Wen decade, it apparently has not been able to harness this

14. State-owned Assets Supervision and Administration Commission, "Temporary Regulations governing the performance evaluation of central state-owned enterprises," December 29, 2012. Available at www.sasac.gov.cn (accessed on February 4, 2014).

power to achieve the goals assigned to it: "to guarantee a rational scale of investment, to optimize the structure of investment, and raise the efficiency of investment."[15] As will be shown in the next chapter, a prime indicator of investment efficiency, return on assets, slumped badly for all state-owned industrial firms from the middle of the 2000s onward, while the returns on investment of private firms, which escaped the purview of the NDRC, rose considerably, at least through 2011. Two key factors undermine the view that 2003–13 marked the ascendency of state control of resources and a resurgence of the role of state firms: the higher share of national investment undertaken by private firms and the rising efficiency of these firms' investments, which together were a major source of economic growth in the Hu-Wen era.

15. State Council, "Decision concerning reform of the investment system," August 12, 2005. Available at www.gov.cn (accessed on March 24, 2014).