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Mikael Mattlin

The Chinese government's new approach to ownership and financial control of strategic state-owned enterprises

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Mikael Mattlin: The Chinese government's new approach to ownership and financial control of strategic state-owned enterprises

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Mikael Mattlin

The Chinese government's new approach to ownership and financial control of strategic state-owned enterprises[1]

Abstract

This paper reviews recent regulatory and policy changes that affect the Chinese central government's ownership and authority over the capital allocations of strategic state-owned enterprises (SOE). The paper examines the reform of the central government's relationship with key SOEs as a consequence of the establishment of the State Assets Supervision and Administration Commission of the State Council (SASAC) in 2003, the coming introduction of a centralised operating and budgeting system for SOEs, and the government's ongoing re-evaluation of its ownership policy. SASAC appears to have the potential to develop into a major actor in China's domestic capital allocation, with an active role in strategic financing and restructuring of key sectors of the Chinese economy. The data reviewed for this paper strongly suggests that the Chinese central government aims to retain significant ownership control over key SOEs and, by extension, over a major part of the domestic economy. The new operating and budgeting system is set to significantly enhance central government control over SOEs' capital allocation.

Key words: State-owned enterprises, privatisation, corporate governance, China
JEL classification: G32, G38, P26, P31

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Mikael Mattlin

The Chinese government's new approach to ownership and financial control of strategic state-owned enterprises

Tiivistelmä

Tutkimuksessa tarkastellaan Kiinan valtion omistajapolitiikkaa uusien säädösten ja viimeaikaisten politiikanmuutosten valossa. Keskushallinnon ja keskeisten valtionyhtiöiden suhde on muuttumassa vuonna 2003 perustetun valtioneuvoston valtionomistuksen valvonta- ja hallintakomission (SASAC), tulevan keskitetyn valtionyhtiöiden toiminta- ja budjetointijärjestelmän ja meneillään olevan omistajapolitiikan uudelleenarvioinnin seurauksena. Kiinan sisäisissä pääomien kohdentamispäätöksissä valtionomistuksen valvonta- ja hallintakomissiosta näyttäisi kehittyvän merkittävä toimija, jolla on aktiivinen rooli keskeisten valtionyhtiöiden strategisessa rahoituksessa ja avaintoimialojen uudelleenjärjestelyissä. Tätä keskustelualoitetta varten koottu aineisto viittaa vahvasti siihen, että Kiinan valtio pyrkii omistajapolitiikallaan säilyttämään vahvan omistuksen keskeisissä valtionyhtiöissä ja sitä kautta myös vahvan roolin valtiontaloudessa. Uuden toiminta- ja budjetointijärjestelmän myötä keskushallinnon määräysvalta strategisten valtionyhtiöiden pääomien kohdentamisiin näyttäisi kasvavan merkittävästi.

Asiasanat: valtionyhtiöt, yksityistäminen, yritysten hallintakäytäntö, Kiina
JEL: G32, G38, P26, P31

1 Introduction

Despite three decades of economic reforms in the People's Republic of China (PRC), restructuring of large state-owned enterprise groups has proceeded at a slow pace in recent years. While a variety of different measures and reform models have been tried since the 1980s, these have mostly been half-hearted or unsuccessful. The founding of the State Assets Supervision and Administration Commission of the State Council (SASAC) in 2003 marks a new phase in efforts to deal with the outstanding challenges and unresolved problems of China's state-owned enterprises (SOEs). The founding of SASAC launched a process of redefining the relationship between central government and the so-called 'central enterprises' (中央企业) – the key SOEs that have been selected by the government to form the basis from which China's future top global companies will be created. Central enterprises account for the bulk of SOE profits and around a quarter of SOE corporate investment. This paper reviews recent legal and policy changes and case studies that illuminate the changes in this relationship, focusing on the issues of state ownership and state financial control over SOEs. The research question we ask is: to what extent and through what arrangements does the Chinese central government intend to maintain ownership and financial control of the central enterprises?

The Chinese government's commitment to the market versus the state has fluctuated over the course of the reform period. In the planned economy, state-owned enterprises were an integral part of the state budgeting system, with all their financing needs being covered by the state, and with profits and losses directly included in the state budget. In the late 1970s, more than half the budget revenues came from state-owned enterprises (*World Bank policy note* 2005, p. 2). The low incentives provided to SOE managers in this system led the government to experiment with various models of profit retention, such as the 'contract management responsibility system', through which managers could retain a part of the profits after meeting government-set targets (Choe and Yin 2000, pp. 101–102). Following a tax reform in 1994, wholly-owned SOEs were exempted from paying dividends to the government. Between then and now, SOEs have retained almost all their post-tax profits.

In 1994, the Company Law was also promulgated, providing a legal framework for SOE reforms (Lin and Wei 2006, pp. 124–125). The guiding principle of the SOE reform strategy became the expression 'zhua da, fang xiao' (抓大放小) or, grasp the big and let go of the small – a reference to a policy enshrined in the 9th Five Year Plan (1996–2000) concentrating the government's resources on the larger SOEs, while relaxing state control over smaller SOEs. Government controls over enterprises' investment and management decisions loosened, and government supervision in general progressively entered a state of disarray following the break-up of links between line ministries and enterprises, and the corporatisation and partial public listing of big SOEs. Of late, it appears that the pendulum between state and market in the governance of SOEs has again swung in favour of a greater role for the state and against giving the markets more say. Several research and policy papers released by government agencies and government-linked research centres have lately been highly critical of the growing role of private and foreign interests in the economy, and argued that the government should retain control of key parts of the economy.

The establishment of SASAC contains both centralising and decentralising features. On one hand, clearly separating central, provincial and municipal SOEs and handing control of them to SASAC offices at the respective administrative level clarified local control over local SOEs. On the other hand, by taking all central enterprises away from the control of various government agencies and putting them under the unitary supervision of an organ that reports directly to the State Council, central government appears to be asserting its authority. SASAC strives to centralise several functions that were formerly dispersed over various government agencies and party organisations. Central-level SASAC handles the state's ownership interests as well as regulation and supervision of central enterprises,[2] while the Ministry of Finance (MoF) retains overall responsibility for all state-owned enterprises as well as the financial matters of non-corporate entities, such as government agencies (Appendix 1, documents 16 & 17). SASAC's mandate does not cover financial organisations. In the financial sector, ownership and regulatory functions are more clearly separated. SASAC's ownership role is performed by the Central Huijin Investment Company (中央汇金投资有限责任公司), which is a controlling owner in some of the big state-owned commercial banks (SCBs), while supervision of financial organisations is the responsibility of the Central Banking Supervisory Committee (CBRC), and practical management of bad assets is performed by asset management companies (AMCs).

Local SASACs at the provincial and city levels handle SOEs within their respective jurisdictions, with independent powers over SOEs delegated to the local level for the first

[2] While it is recognised in China that ownership and regulatory functions need to be separated (Mako and Zhang 2004, p. 4), such a functional division does not appear to have been implemented in the case of SASAC.

time (Appendix 1, Document 4; see also Naughton 2006, pp. 3, 16). Although the central enterprises under SASAC management comprise only 159 major companies (at the time of writing),[3] their size and importance to the national economy in many respects surpasses that of all the other SOEs combined. Central enterprises account for roughly 70% of all SOE profits (representing 20% of government revenue), and their listed subsidiaries stand for one third of the entire valuation of Chinese domestic stock exchanges. The combined value of the assets of central enterprises amounted to around 1.2 trillion euro in 2006 (*Xinhua* 25 January 2007).

SASAC has a broad mandate that includes drafting laws and regulations regarding state-owned assets, managing and restructuring state assets so that their value develops positively, and hiring and firing the executives of SOEs (who are equivalent to civil servants) under its supervision at the behest of the Communist Party, which ultimately retains the authority over key appointments. However, the legal basis for its mandate is unclear. The foundation for SASAC was laid during the 16th Party Congress in 2002, which resolved to reform the management systems for state assets by emphasising that central and local government shall exercise their legal duties and rights as investors in state assets; that the management of (state) assets, people and matters shall be unified; and finally that the respective jurisdictions of the central and local levels of government as well as the roles of investors and managers need to be clearly demarcated and clarified in order to prevent overlapping authorities.

During the process of setting up SASAC, the State Council official tasked with formulating SASAC's future role, Li Baomin, described SASAC's character through four negations: it would *not* be an administrative organ of the government, its personnel would *not* be civil servants, it would *not* be included in the formal government sector, and it would *not* have the same function as the former State Assets Bureau (国资局). SASAC exercises the rights of the principal investor in state assets, implying the rights to enjoy dividends from enterprise cash flow, to take major decisions regarding enterprises and to choose enterprise managers. In the State Council's organisational set-up, SASAC appeared for the first time in the spring of 2003. Officially, SASAC is defined as a ministerial-level 'special organisation' reporting directly to the State Council (国务院直属特设机构).[4] Inci-

[3] The list can be found in Chinese on SASAC's website at <www.sasac.gov.cn>. The number of firms is slowly dropping due to SASAC-supervised restructuring and merging efforts.
[4] According to Naughton (2004, p. 12), this status was adopted to circumvent the National People's Congress.

dentally, SASAC is the only organ in this organisation category, which appears to have been established exclusively for it.

The legal position of SASAC is unclear, partly because China has yet to establish a law governing the control of state assets (Naughton 2005, p. 8; Chen 2005, p. 114). So far, only interim regulations on the management of state assets have been issued (in 2003) as well as various follow-up guidelines. However, SASAC's legal status is being indirectly established through other laws. In the new Company Law that took effect on 1 January 2006 the section on wholly state-owned companies repeatedly mentions SASAC as the organisation that wields ultimate power in matters related to these enterprises. SASAC itself refers to the Company Law as one of the bases for its existence. The previous version of the law vaguely referred to 'state-authorised investment organisations or agencies' (国家授权投资的机构或者国家授权的部门). Nevertheless, apart from the references in the Company Law, there is as yet only a weak legal basis for SASAC's broad mandate (Appendix 1, documents 1 & 2).

From an external perspective, SASAC has conflicting regulatory and ownership interests, as its mandate combines both functions. Scattered case-based evidence suggests that SASAC has not been shy to use its *de facto* regulatory authority.[5] Lately, it has also started to exercise its ownership interests more actively. However, SASAC has many auxiliary aims, several of which are laudable, and some of which are more dubious. Among the more laudable aims is to get the asset stripping and corruption that had become a festering problem in SOEs under control by putting restrictions and strict requirements on ownership transfers, eg through management buy-outs (MBOs). Some sources note this as one of the key aims of putting the SOEs under unitary control (see eg *Stratfor* 27 May 2003). Among the more dubious facets of the reform is that an activist state, represented by SASAC, may wreak havoc in the management of SOEs, eg by unnecessarily reshuffling enterprise management or letting local government meddle in the management of successful companies. Furthermore, while central government has a point in saying that SOE profits are not always reinvested in sound ways, there are no guarantees that a semi-governmental body with ambiguous goals and affected by political considerations will do a better job.

The data used for this paper includes new regulations and policy papers that affect state ownership (Appendix 1), policy statements, illustrative case studies and statistical in-

[5] In a notable case, SASAC ruled that Haier, one of China's most successful companies, belongs to the Qingdao city government, and that management buyouts in big SOEs were forbidden (*The Economist* 1 September 2005).

formation mainly originating from the PRC National Bureau of Statistics (NBS). Chapter 2 provides a literature review. In Chapter 3, we examine attempts at re-defining the scope of state ownership with regard to which industries and enterprises the state will retain control of when restructuring the SOEs. Chapter 4 looks into the specific modes of maintaining state control in the future, following the share structure reform. In Chapter 5, we examine the new policies on SOE dividends and investments, focusing on the central enterprises. Finally, conclusions are presented in Chapter 6.

2 Literature review

State ownership of enterprises is a perennial political issue in many countries. For a number of years, the prevailing trend in Western economies has been for the state to retreat from direct ownership interests in commercial enterprises. However, there have lately been some signs of a possible turn in the tide, with increasing critique of excessive privatisation, in particular of utilities and public service providers, and political pressures against foreign acquisitions of formerly state-owned companies or national champions. In a few countries, primarily in Latin America and Russia, governments have even resorted to measures that smack of re-nationalisation, in particular of key energy assets (eg Reynolds and Kolodziej 2006). Thailand is currently also considering putting an end to arrangements whereby shares with different voting rights have allowed foreign investors to circumvent foreign equity restrictions and gain control of Thai firms.

There are good economic arguments for why certain enterprises ought to be privatised, primarily the prospects of improving corporate efficiency and manager incentives (Shleifer and Vishny 1994). A long array of studies has attested to Chinese SOEs being less efficient than other enterprise forms (eg Xu et al. 2006). There are also sound arguments for why the state ought not to exit other enterprises in certain circumstances, for example, in industries prone to market failure or an insufficiently developed economic environment (Zinnes et al. 2001). However, at the end of the day, where governments choose to draw the line between public and private ownership is an inherently political question, subject to prevailing political preferences. Practically all governments maintain ownership of some enterprises, most commonly utilities, public service providers, and defence companies and, to a lesser extent, national flag carrying airline companies. In some market economies, such as the UK, privatisation efforts have gone a long way, while in others, such as Singapore, the state directly or indirectly still controls a substantial share of the economy.

There are, generally speaking, four kinds of rationale for maintaining state ownership. The economic sector in which the company operates may be deemed unsuitable for private companies, eg in the case of natural monopolies with high and non-profitable capital investment needs. The state may also have other than economic goals, such as softening the social blow in transitional economies downsizing the state sector. Alternatively, the state may adopt an investor role (often in the absence of strong private institutional investors), with an interest in promoting domestic economic development or in achieving good investment returns, as in the case of Singapore's Temasek Holdings. Finally, the state may wish to maintain its ownership for strategic reasons, related to national or economic security. In this paper we chose to focus on the last two rationales for maintaining state ownership, as they lie at the heart of the current policy debate within China on the future relationship between the government and key SOEs.

Most governments consider some companies vital enough for national security for the state to maintain a controlling stake in them. Sometimes this understanding is tacit, while in other cases specific lists of strategic companies are compiled. For example, in 2004 Russia compiled an extensive list of strategic companies in which the government needs to maintain control. However, the ways of maintaining government control differ. The most straightforward method in the case of shareholding companies is to simply retain an ownership stake in excess of 50%. In many countries state control is further reinforced by legal stipulations that require specific parliamentary approval (eg in Finland and Sweden) or presidential authorisation (eg in Russia) if state ownership is to drop below a controlling stake. Another method is to give state shares disproportional control through special voting or veto rights, so-called 'golden shares'. Such a system has been applied by Singapore (Shome 2006, p. 11; also Ang and Ding 2006), but several EU countries have also used golden shares to prevent foreign takeovers of their newly privatised 'crown jewels', a practice which the European Court of Justice has ruled incompatible with the EU's free movement of capital.

For the past decade, China's 'model' for maintaining state control has been to retain a clear shareholding majority, commonly 55–70% of the share stock, as non-tradable shares in the hands of government agencies, wholly-state owned holding companies (granted the right to act as a 'state-authorised investment organisation') or government-linked legal persons, eg SCBs, policy banks or AMCs. However, this model is set to change, as all non-tradable shares are currently in the process of being converted into tradable shares. The share reform is examined in Chapter 4.

In the case of profit-making enterprises, the state naturally also has an interest in the cash flow generated by the enterprises from operational profits, or through the proceeds from partial or complete privatisation. In most countries, the state collects dividends from its enterprises. Dividend and privatisation proceeds commonly go either directly to the treasury/finance ministry as general revenue, are directed to a social security fund, or are earmarked for a specific purpose such as reducing public debt. World Bank economists have advised that dividend proceeds should be directed to the treasury and be subject to standard budgeting processes in China, too (World Bank policy note 2005, pp. 6–9, 18–20; Mako and Zhang 2004, p. 35).

Collecting dividends from SOEs could be considered a minimum level of influence over enterprise capital allocations. In the literature on dividends, taking away surplus cash from company managers is seen as a key rationale for the use of dividends, owners' thereby preventing managers from making unprofitable investment decisions on the back of excessive funds (World Bank policy note 2005, pp. 4–5). Some governments retain broader influence over SOE finances and investments. In the PRC, as a legacy of the planned economy, the government has previously had very broad control over state companies. In this respect, it is an anomaly, both internationally and in relation to the PRC's own economic history, that the Chinese government currently does not collect dividends from state companies. Since 1994, Chinese SOEs for the most part have not paid dividends to the state. However, stock market listed SOEs pay dividends to their non-listed parent companies. They in turn have, as a rule, retained all profits rather than passing them on to the government (World Bank policy note 2005, p. 10), which for the most profitable SOEs suggests their parent companies are awash with cash.

The precise reasons for the dividend exemption included in the 1994 tax reform are somewhat unclear. However, at the time, SOEs were in dire straits, with lots of loss-making firms and few profitable ones. Consequently, collecting dividends for state coffers was not seen as a priority. Keeping the SOEs afloat was a more pressing concern. In this respect, the situation has changed in recent years. While there are still many loss-making SOEs, some parts of the state-owned economy are now highly profitable (see Chapter 5).

In the context of the macro-economic debate on the Chinese economy's overheating, which has centred on excessive (and wasteful) investments, SOE retention of profits has risen onto the political agenda. World Bank economists have for years advised the Chinese government to start collecting dividends from SOEs in order to curb excessive enterprise investments and shore up state finances, in particular, shortfalls in the government's social security commitments.[6] Over-capitalisation of some SOEs due to the moratorium on state dividend collection, in conjunction with politically influenced bank lending, contributes to over-investment in many industries. China's incremental capital-output ratio (ICOR) has been trending upwards since the early 1990s, implying that it takes more investment to produce the same output, although the returns on investment are perhaps not as low as commonly believed (Bai et al. 2006, pp. 16, 40).[7]

While SASAC represents the ownership interests of the Chinese state, it has not had actual control over the budgets and profits of the enterprises under its supervision (Naughton 2005, p. 6). This, however, is set to end. A potentially major change in the financial management of SOEs was decided on in principle in 2005, as a consequence of which SASAC's role in guiding the major SOEs' budgets and investments may soon be greatly enhanced. Henceforth, SASAC will compile a 'state assets management budget' (国有资本经营预算) for the central enterprises that will consolidate the investment funds for the companies under its supervision and require that they turn over a portion of their post-tax profits to the state. When implemented, the reform is set to shift a significant share of the authority on allocating profits and guiding corporate investments from the individual enterprises to central government, and in the case of the central enterprises, probably to SASAC.

While the collection of dividends from SOEs to state coffers is standard practice around the world, the possibility that the bulk of funds would be handed over to an organisation with an ambitious industrial policy rather than commercial goals is unusual, and the international precedents from similar experiments with state-owned shareholding funds are generally not encouraging (Mako and Zhang 2004, pp. 9–12). Nonetheless, SASAC seems adamant on getting operational control of most of the funds generated by the central enterprises. The question of who controls state asset earnings and to what extent and for what purposes they will be collected, is inseparable from the larger issue of how the Chinese

[6] Lately, the economic press has also picked up the issue, see eg *Financial Times* 4 October 2006.
[7] Goldstein and Lardy have noted that reported returns on foreign direct investments in China are also modest relative to returns on similar investments elsewhere (Goldstein and Lardy 2005, p. 13).

government in the future will organise its state assets management, and what role SASAC will eventually have, which is why the issues are examined together in this paper.

3 Redefining the scope of state ownership in policy and in practice

One of the key issues in relation to the central SOEs is whether the government will seek to retain them as wholly or majority state-owned indefinitely, ie how broad the *scope* of future state-ownership will be. Given that almost all the biggest Chinese companies are currently state-owned, this issue is central when gauging the nature of future global Chinese companies in general. In this chapter we tackle the question through two more specific issues, namely, the specification of lists of strategic and prohibited industrial sectors and stalled foreign acquisitions of SOEs. The next chapter then turns to look at the evolving modes of government ownership following the reform of the split share structure.

Hardly any country is indifferent to the loss of important national assets, especially to foreigners, and often even the privatisation of formerly state-owned units becomes a highly political issue. The Chinese discourse on SOEs is full of terms that denote the importance of certain companies and sectors, such as 'backbone enterprise' (骨干企业), 'pillar industry' (支柱产业) and 'central-level enterprise' (中央企业). However, until recently the Chinese government had not specifically defined which sectors it considered to be critical or strategic. The list of central enterprises was probably the best publicised proxy for which companies the Chinese central government will – at a minimum – not relinquish control of in the foreseeable future. Among the 159 companies currently listed are most companies that in other countries would be considered key to national security (energy and defence-related companies) and most other major companies outside consumer electronics and finance (car manufacturers, shipbuilders, telecom companies).

In recent years the Chinese government has been probing for precise definitions of which of its industries and companies are strategically important enough for the state to maintain control of them *ad infinitum*, and how tightly these companies ought to be controlled by the state. By the summer of 2006, there were indications that the government was finally in the process of drafting a list of named strategic industries where the state aims to maintain control. The specific industries were made public for the first time at the end of the year, when SASAC chair Li Rongrong revealed that seven sectors (among central enterprises) are considered strategically important as they are related to national or economic security, and that the government has to maintain absolute control in these sectors, through either sole ownership or an absolute controlling stake. The seven industries are defence, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping (Table 1). Many of the biggest and most profitable Chinese companies operate within these seven industries. In all these sectors, the role of foreign and private investors would be restricted to participating in developing downstream petrochemical products and value-added telecom services. In addition, the state will also maintain significant absolute or relative controlling stakes in another group of industries, described as pillar and basic industries. Only a small share of the assets of the central SASAC enterprises would then be sold off to non-state owners.

Table 1 The Chinese government's new policy goals on state ownership in key industries

Category description	**Industries included**	**Ownership goal**	**Approximate number of companies**
Strategic and key industries	Defence, power generation and distribution, oil & petrochem, telecom, coal, civil aviation, shipping.	Maintaining 100% state ownership or absolute control; increasing state-owned assets in these industries.	40
Basic and pillar industries	Machinery, auto, IT, construction, steel, base metals, chemicals, land surveying, R&D.	Absolute or conditional relative controlling stake; enhancing the influence of state ownership even as the ownership share is reduced where appropriate.	70
Other industries	Trading, investment, medicine, construction materials, agriculture, geological exploration.	Maintaining necessary influence by controlling stakes in key companies; in non-key companies state ownership will be clearly reduced.	50

Sources: State Council opinion released 12 May 2006 (see Appendix 1, Document 18); exclusive Xinhua interview with SASAC chair Li Rongrong (State Council website 18 December 2006) and reporting on press conference with Li Rongrong explaining the rationale of the policy paper.

The list of strategic sectors is fairly typical of similar lists of strategic sectors drawn up by other governments or established by practice. However, by including the restrictions in the second category the list becomes more expansive than the current practice in Western economies, as the second category also includes eg the car industry, construction and IT – sectors where government ownership commonly only has a minor role. The Russian experience shows that lists of strategic enterprises tend to be modified over time, adding or dropping companies and industries from the list depending on changes in policy preferences.

If the release of the list defines the limits of foreign and private investment in Chinese SOEs in theory, then the government's recent handling of foreign merger and acquisition (M&A) cases have contributed to establishing the same limits in practice. In seeking empirical evidence on how big a chunk of the economy the state intends to maintain control of in the future, the government's attitude towards foreign attempts to acquire SOEs can serve as a litmus test. While much earlier foreign direct investment in China was in the form of greenfield investments, the number and value of acquisitions has been rising noticeably in recent years, with foreign acquisitions and domestic deals amounting to USD 46 bn in 2005, according to PricewaterhouseCoopers (Levine and Woodard 2006, p. 18).[8]

With overcapacity having been built in many industrial sectors in China over the past decade, foreign companies are choosing to buy up local companies rather than build or expand their own operations. Both industrial enterprises and private equity groups have actively sought to acquire Chinese companies. In particular, the massive influx of foreign private equity attempting to buy up significant Chinese enterprises appears to have caught the Chinese government off guard (*The Economist* 23 September 2006). As yet, no attempt has been made by a foreign investor to acquire a controlling stake in a central enterprise. We are therefore confined to reviewing attempts to acquire provincial- or city-level SOEs that have been stalled or blocked. There have lately been numerous such cases, enough to draw some tentative conclusions based on a cursory review of the most prominent recent cases (see Table 2). Nevertheless, it has to be noted that foreign enterprises announced 818 acquisitions of Chinese companies in 2006 (*International Herald Tribune* 14 February 2007). Only a small proportion of these were blocked.

[8] China Daily reported announced M&A deals in 2005 worth USD 66 bn (*China Daily* 11 April 2006).

Table 2. Selected stalled attempts to acquire Chinese companies since 2005

Acquirer (origin)	**Target** (main owner)	**Industry**	**Targeted stake; government actions to date**
Carlyle Group (US)	Xugong Construction Machinery (city government)	Machinery	85%; MofCom has stalled approval, and required that Carlyle's ownership stake be cut to 50%
Schaeffler (GER)	Luoyang Bearing Group (owned by other SOE)	Machinery	100%; *ad hoc* government inquiry following industry association resistance, possibly defensive acquisition by local companies
Citigroup-led consortium (US)	Chenming Paper (provincial government)	Paper	~ 30% controlling stake; target rejected after first approving
Citigroup-led consortium (US)	Guangdong Development Bank (provincial government)	Finance	45% foreign stake; CBRC opposed → foreign stake required to be cut to < 25%
Arcelor (FR-LUX)	Laiwu Steel (provincial government)	Steel	38.4%; local defensive merger; no government approval yet
ThyssenKrupp (GER)	Tianrun Crankshaft (JV with 60% local government ownership)	Auto parts	51%; provincial government approved, industry association objected, MoFCom has yet to approve
ZF Group (GER)	Hangzhou Advance Gearbox Group (city government)	Machinery	70%; target cancelled the deal after 3 years of talk, possibly due to government pressure
Macquarie Bank (AU) and TPG-Newbridge (US)	PCCW's (HK) assets (China Netcom and HK-banker)	Telecom	100%; deal thwarted through SASAC-administered Netcom and Hong Kong banker
Caterpillar (US)	Xiamen Engineering Machinery (city government)	Machinery	Rejected by target with support from local industry association

Note: The data for this table has been compiled from various news sources available on the Internet.

The first observation that arises from the cases is that the stalled deals do not appear to be coincidental. According to Bloomberg, 27% of all leveraged buyout deals in China, the bulk of which are made by foreigners, were stalled in the government approval process in 2006, compared with only 6% a year earlier (*Bloomberg* 18 December 2006). There are three plausible explanations for the troubles recently encountered by foreign companies seeking to acquire controlling or major stakes in Chinese SOEs. The first is the most straightforward: given a dearth of procedures and laws regulating such acquisitions, the Chinese government may have wanted to freeze approval of acquisitions pending the establishment of such ground rules. Alternatively, given the limited experience of Chinese SOEs in cross-border acquisitions and enterprise valuation, central government may simply be concerned to ensure that state assets are not sold off too cheaply. SASAC has strongly criticised selling off assets 'on the cheap' to company managers. Then again, it could also be that the state for strategic or commercial reasons is unwilling to sell off even less critical assets, and that it is seeking various ways to prevent these sell-offs.

If foreign acquisitions have been stalled mainly pending the release of more detailed rules and procedures, and more precise definitions of strategic sectors, then most of the stalled foreign acquisitions should eventually be approved. However, the accumulating number of foreign acquisitions encountering problems is more likely to indicate that the Chinese government is not keen on allowing foreign control of key local companies. A related government apprehension is that private equity investors will eventually end up selling the Chinese company to a foreign industrial behemoth operating in the same field. Numerous Chinese government officials, industry leaders and research institutes have lately come out strongly against allowing foreign multinationals to acquire key local companies or to create local monopolies through acquisitions. Prominent critics include the former head of the National Bureau of Statistics.

Secondly, while the government's own previous regulations on foreign investment in various industries have proved to be an unreliable guideline for foreign acquisitions of Chinese companies, the newly released list of strategic and pillar sectors throws some light on why deals in certain industries have had trouble getting government approval. In particular, the machinery, telecom, steel and auto industries are all areas where the government aims to maintain a high level of ownership and control. In comparison, several acquisition deals have recently been approved in the food and retail industries.

Thirdly, many of the new restrictive initiatives or *ad hoc* government reviews of foreign acquisitions of Chinese companies have been brought on by Chinese industry associations or competing local firms that have urged the government to prevent Chinese companies from falling into foreign hands and demanded government inquiries in several specific cases. The former has been the case at least in the steel, car, auto parts, machinery, bearing and cement industries, while the latter occurred in the machinery industry. This domestic pressure may have influenced new comprehensive regulations on foreign M&As that gave more leverage for the government to review and deny acquisitions. Chinese authorities signalled throughout the spring and summer of 2006 that they were taking a closer look at foreign acquisitions and were in the process of drafting new rules governing foreign acquisitions. In August 2006, six ministries and government agencies jointly issued comprehensive regulations on foreign mergers and acquisitions (Appendix 1, Document 12).

While the original impetus for the new attitude towards foreign investment may have been the failed takeover attempt by CNOOC of US oil company Unocal, which floundered on US domestic opposition, another case turned out to be pivotal in launching an active re-evaluation of foreign involvement in the economy, namely the attempt by American private equity investor Carlyle to acquire Xugong Group Construction Machinery (XCMC). The Xugong case provoked a small storm of nationalism-tinged resistance in China; led to the drafting of an *ad hoc* policy paper restricting foreign ownership in the Chinese machinery industry (see Appendix 1, Document 25); and also influenced the hurried drafting of the new regulations on foreign mergers and acquisitions. The Xugong case is briefly reviewed below.

Case study: Carlyle's attempt to acquire Xugong and the role of SASAC

Xugong is a state-owned enterprise and part of the Xuzhou Construction Machinery Group (XCMG), itself an SOE wholly-owned by the Xuzhou city government. The ownership structure is common among SOEs. Xugong is the largest truck maker in China, but a minor player globally. In October 2005, private equity group Carlyle offered to buy an 85% share of Xugong for USD 375 million, an offer that XCMG accepted. The deal is one of the biggest private equity deals in China. Both the Xuzhou city government and the Jiangsu provincial government supported the deal. However, a Chinese competitor, Sany Heavy Industry, also with an interest in acquiring Xugong, launched an attack on Carlyle's acquisition attempt, drumming up nationalistic sentiments on the Internet. This led the State Council to organise an unprecedented debate lasting three days on foreign investments, to which a broad range of participants – excluding Carlyle – were invited.

MofCom, whose approval was needed for the deal to pass, reportedly opposed it based on fears that Carlyle would later sell Xugong to a foreign firm operating in the same field (*Financial Times* 29 March 2006). Higher authorities have also held up a similar acquisition offer made by Caterpillar for Xiamen Engineering Machinery. MofCom has stalled approval of the Xugong deal for more than a year. In October 2006, newswires reported that Carlyle had agreed to lower its acquisition objective to 50% of Xugong's shares (*Bloomberg* 17 October 2006). However, MofCom has yet to announce whether or not it accepts Carlyle's less ambitious offer, and recent news reporting suggest that Carlyle may be forced to reduce its stake further (eg *International Herald Tribune* 14 February 2007).

Two features make the Xugong case particularly interesting. In the first place, the company operates in an industry where foreign investment is allowed according to the official Investment Catalogue (*Catalogue for the Guidance of Foreign Industries*). The M&A regulations specifically state that the restrictions on foreign investment cannot be violated as a consequence of a merger or an acquisition. In economic areas that require Chinese controlling ownership, foreign investors cannot take majority ownership through acquisition. In economic areas where a Chinese partner is required, the foreign investor cannot set up a wholly owned company through an acquisition. And finally, in prohibited areas, no merger and acquisition activities are allowed. However, the Xugong case and several other recent acquisition attempts that have stalled do not violate these restrictions. It also requires some stretch of the imagination to say that a medium-sized truck maker is vital to national security. Instead, it would seem that it is the more ambiguous arguments of 'economic security', 'key industries' and 'well-known companies' in the new M&A regulations that are invoked by the Chinese authorities in this case.

Secondly, the case has brought to light the lack of clarity in review procedures; in particular regarding which government agencies have the authority to approve or deny which acquisitions. In the case of foreign acquisitions, the Ministry of Commerce is the decision-making centre according to the regulations on foreign M&As. However, in this case, MofCom asked central SASAC to review the case and submit an opinion, even though Xugong is not on the list of central enterprises, but under the administration of the Xuzhou city government, and therefore should belong to the authority of the local SASAC. Formally, local SASACs are not under the direct control of central SASAC, although the latter in practice wields a great deal of influence over them (Naughton 2006, pp. 16–17). Regulations issued by central-SASAC itself define its relationship with local SASACs as one of guidance and supervision. These regulations specifically state that central-SASAC may not interfere in the work of local SASACs that is carried out in accordance with the law (Appendix 1, Document 8, Art. 13). On the other hand, if laws and regulations are not followed, central SASAC has the authority to correct local SASACs (Art. 15).

The division of labour between MofCom and SASAC appears to be that MofCom has to decide whether the acquisition will endanger national security or lead to a monopoly as well as approve the newly created foreign-invested enterprise following the foreign acquisition of a Chinese company, while SASAC sees to it that the process is conducted correctly in terms of procedures and that the assets are not divested at an undervalued price. In a recently released circular, SASAC stipulated that state assets sold to foreigners, as a rule, should be sold through official asset exchanges (产权交易市场) rather than through direct contractual transfers (Appendix 1, Document 19). While it is, in principle, easy to understand the division of authorities (see Appendix 4 for all the main authorities involved) according to which MofCom has the most important say in foreign acquisitions and investments and SASAC in ownership transfers that involve state assets (with the CSRC also becoming involved when the deal involves a listed company), in practice this arrangement may cause authority overlaps, especially in cases which involve a foreign acquisition of a listed Chinese SOE.

In the cases listed in Table 2, SASAC opposition to the proposed acquisitions has not been particularly prominent. Indeed, in most cases it has duly approved the acquisitions, as in the Xugong case. However, both central and local SASACs may have had an indirect influence on several acquisition cases. SASAC was probably involved in launching merger talks between Avic 1 – a defence-related central enterprise – and Luoyang Bearing, whose indigenously developed bearings are used in the Chinese space programme. There have also been rumours of other SOEs possibly acquiring Luoyang. In the case of Bright Dairy, the Shanghai SASAC and local government together engineered a merger with three other SOEs, which, coming on the heels of Danone's raising its stake in Bright, looks like an attempt to dilute Danone's holding. The adamant refusal of China Netcom (another central enterprise) to accept two foreign private equity groups' competitive bidding for PCCW's assets, a deal which would have made it a 100% profit on its 20% stake (Holcombe 2006), left many wondering whether Netcom operated on government instructions. Finally, the Guangdong provincial government reportedly received SASAC approval for selling a 19.4% stake in Southern Power Grid – a central enterprise – to two other central enterprises, State Grid and Huaneng Group, in order to finance the bailout of GDB. The Citigroup-consortium's acquisition was eventually approved as the foreign ownership share dropped below 25%. Most of the shares in GDB went to SOEs.

The new M&A rules are more detailed than earlier provisional rules promulgated in 2003. While the rules contained some good news for foreign investors, such as increased possibilities to use share swaps when making acquisitions, some other parts of the regulations may make foreign investors think twice before attempting to acquire a Chinese company. Henceforth, all bigger acquisitions have to be approved by the authorities, with the rules handing ultimate decision-making power to the Ministry of Commerce (MofCom). The new M&A regulations also call for acquiring companies to submit to MofCom review if there is a possibility that Chinese 'economic security' is endangered; if well-known brands and trademarks are involved; or if acquisitions involve important companies or occur in 'key industries' (重点行业), without defining which specific industries are referred to. Presumably, these industries are the same as on the new list of strategic and pillar industries.

A number of deadlines need to be met by the concerned parties. If they are not met, MofCom can demand that the acquisition is cancelled (Appendix 1, Document 12, Art. 12–13), opening up the possibility that deals may be rejected at least partly due to technicalities. MofCom can also reject the acquisition if it considers that it materially impacts on the economic security of the state, without specifying clear criteria for when acquisitions are permissible and when not. These requirements are new in the 2006 regulations. They were not present in the previous regulations promulgated three years ago (Appendix 1, Document 17).

The low thresholds set for governmental review of cases that may result in the forming of monopolies were already included in the 2003 regulation (Appendix 1, Document 12, Art. 51–53). As previously, the regulations determine five specific situations in which the transacting parties have to submit the acquisition case for review by MofCom and the State Administration for Industry and Commerce (SAIC) before announcing its intentions publicly. Namely, when:

- the Chinese assets owned by a party to the transaction exceed 3 billion yuan
- the revenue of a merging party in the Chinese market has exceeded 1.5 billion yuan in the year in question
- the aggregate Chinese market share of a merging party and its affiliated enterprises has reached 20%
- the aggregate market share in the Chinese market by a merging party or its affiliated enterprises will reach 25% as a result of the merger or acquisition
- as a result of the merger or acquisition one party will hold, directly or indirectly, equity in more than 15 foreign-invested enterprises engaging in related businesses in China

Also, unchanged in the regulations are the four circumstances in which the parties to the merger are required to notify MofCom and the SAIC, namely when:

- one party's revenue in the Chinese market exceeds 1.5 billion yuan in the year in question
- more than 10 acquisitions have occurred in China in related industries within a year
- the Chinese market share of a party to the transaction has reached 20%
- the Chinese market share of a party to the merger or acquisition will reach 25% as a result of the transaction

If any of the four criteria are fulfilled, a report should be submitted. In addition to the above criteria, the regulations stipulate that even if none of the above criteria is fulfilled, a report can still be requested if a competitor, a related government agency or an industrial association so requests, or if MofCom or the SAIC believes that the acquisition will have a major effect on market shares, or if there are other important factors due to which the acquisition will have a major effect on market competition. In other words, in principle a report can be demanded of any foreign investor attempting to acquire a Chinese company.

Upon receiving a full set of documents, and if they believe that the merger will result in excessive market concentration or have a detrimental effect on sound competition or consumer interests, MofCom and the SAIC together or separately then have to convene a hearing open to 'government agencies, organisations, enterprises and other affected parties', following which they will decide whether or not they approve the acquisition. This somewhat unusual practice was already contained in the previous version of the regulation, but apparently it had seldom if ever been used prior to the Xugong case. In addition, MofCom approval of the acquisition is specifically required in a number of cases, eg in all instances of share swap acquisitions and all cases of round-trip investment (Chinese investment routed through third locations). Articles 51–53 of the M&A regulations partly substitute for the anti-monopoly law that has not yet been passed.

China publishes an intermittently revised official catalogue on FDI, the *Catalogue for the Guidance of Foreign Industries* ('Investment Catalogue'), which outlines in which industries investments are prohibited, restricted or encouraged (see Appendix 2 for a list of economic areas with foreign ownership restrictions in the current Investment Catalogue). Some of the stalled acquisitions are in formally approved industries, a fact that has taken foreign investors aback. A new round of investment guideline revision is apparently again under way. In addition, a separate, detailed list of industries in which foreign ownership is restricted, and industry-specific M&A policy guidelines are reportedly under preparation by the National Development and Reform Commission (NDRC).

The heated internal debate on the role of foreign and private interests in the Chinese economy is likely to affect several impending laws. For example, the draft anti-monopoly law includes a section on mergers and acquisitions in line with international standards. In so far as enterprise mergers could result in the formation of monopolies they have to be reported to and examined by the authorities. However, according to media reports, a controversial section on administrative monopolies has been watered down. Administrative monopolies are mainly maintained by Chinese companies in collusion with local government, whereas monopolies formed through the market and M&A include many foreign companies.

The view on foreign acquisitions is, however, not uniform within the Chinese government. Given the chorus of concerns raised by foreign governments and media about the new anti-monopoly law targeting foreign firms strong in China, MofCom apparently felt compelled to dispel some of these fears. In an interview with a Chinese newspaper, the director of MofCom's research centre on transnational corporations, Wang Zhile, stated that there are no industries in China where foreign companies have established monopolies; on the contrary, most monopolies are maintained by SOEs. Wang also stressed that foreign investment is welcome and beneficial to the Chinese domestic economy (*Bloomberg*, 25 August 2006).

Nevertheless, the last two years have seen a string of industrial policies that increase restrictions on foreign investors in the Chinese market, which suggests that the government has adopted a more selective attitude towards foreign investments. Commonly, these put limitations on foreign companies buying up a majority stake in a Chinese company operating in the sector, require a higher local content in products or new research centres, or require that foreign investors report and seek approval for their acquisition intentions from Chinese authorities. The new approach to foreign investment was enshrined in a document (Appendix 1, Document 21) produced by the NDRC as part of the 11th five-year plan. The document was published in November 2006, and it is the first time that the government's FDI policy has been included in a five-year plan. Appendix 3 provides brief summaries of industry-specific policy and legal changes that affect foreign ownership in selected major industries.

4 New approach to organising state ownership

China has never embraced privatisation of state-owned enterprises as a central policy goal. While the ownership structure of many smaller SOEs has seen changes over the years and the total number of SOEs has been substantially reduced through mergers, bankruptcies and divesting of small SOEs, from over 250,000 in 1995 to 127,000 in 2005 (Imai 2006, p. 5; *Xinhua* 18 December 2006), in most cases 'privatisation' has involved ownership shifting into the hands of local government officials or company managers, not always in a transparent manner.[9] With regard to the largest and most important companies, the likelihood of any significant privatisation in the foreseeable future is even more remote. Instead, the aim has been to enhance the operations of the state-owned sector of the economy through *corporatisation* (Clarke 2003).

[9] Due to lack of space, management buyouts in state-owned enterprises are not dealt with directly in this paper. Readers are referred to earlier writings by Barry Naughton on this issue (eg Naughton 2005).

The Chinese government was quick to recognise the benefits from corporatisation, ie turning SOEs from directly state-owned into stock companies. The corporatisation reforms started in the late 1980s. By August 1997, some 9,000 SOEs had gone through the process (*Xinhua* 18 December 2006), which allowed them to list partly or wholly on the stock market.[10] But the state was anxious not to lose control of its assets. Consequently, the so-called *split share structure*（股权分值）was set up. This system divided shares into tradable shares openly exchanged on the market, and non-tradable shares held by the state or state-linked legal persons （法人股）and not subject to open trading. Non-tradable shares could, however, be exchanged outside of the market in a number of ways; through agreed sale, indirect takeover, free or judicial transfers, or entrusted shares (Green 2003, pp. 4–5). Until recently, non-tradable shares accounted for up to 2/3 of the market value of all listed companies, which created stock pricing problems and prevented the use of stock-based incentives. Besides the distinction between tradable and non-tradable shares, stocks of Chinese companies are divided into several share classes. A shares are domestically traded shares traded in yuan in Shanghai or Shenzhen and open to domestic investors and select foreign institutional investors. B shares are shares in Chinese companies traded in China but in foreign currency. B shares were initially open only to foreigners, but are now open also to domestic investors with a foreign currency account (on B share restrictions, see Ji 2005, pp. 12–13). H shares are the shares of Chinese companies traded in Hong Kong or listed on foreign stock markets.

More than 80% of the companies listed on the Shanghai and Shenzhen stock exchanges are still state-owned enterprises. Knowing the history of the Chinese stock market and China's economy, this should not surprise anyone. When the stock markets were set up in the early 1990s, practically all Chinese companies were state-owned, with the remainder mainly collectively owned ('township and village enterprises'). Furthermore, the stock markets were set up mainly in order to take some of the burden of financing the massive social obligations of SOEs directly out of state coffers. The CSRC, which has the authority to approve or deny stock listings, has had a bias in favour of SOEs (like the SCBs in lending decisions); most listings approved were of state-owned enterprises, while private enterprises found it difficult to list on the Chinese exchanges. Companies therefore sometimes

[10] Recent official comments suggest that the eventual goal is to make all but a handful of companies shareholding enterprises.

seek a backdoor listing through acquiring a listed company (Green 2003, pp. 4–6). New regulations on stock market listings aim at tackling this problem.

Initially, the government chose to list mainly subsidiaries of SOEs – commonly the best assets – on the market. A model followed in most listed SOEs was to create a separate corporatised subsidiary to the wholly-owned SOE and list the subsidiary on the stock market, with the wholly state-owned parent company retaining a majority of shares as non-tradable shares. In some cases, a number of subsidiaries have also been separately listed. Such a model was applied in the case of Sinopec, presented as an illustrative case study below. SASAC would apparently like to end the practice of listing only subsidiaries and replace it with full listings (整体上市) whenever possible – a practice which has a precedent in the banking sector, where the SCBs have already listed in full rather than in part. Furthermore, SASAC has indicated that it may as early as 2007 assume direct ownership of some listed SOEs.

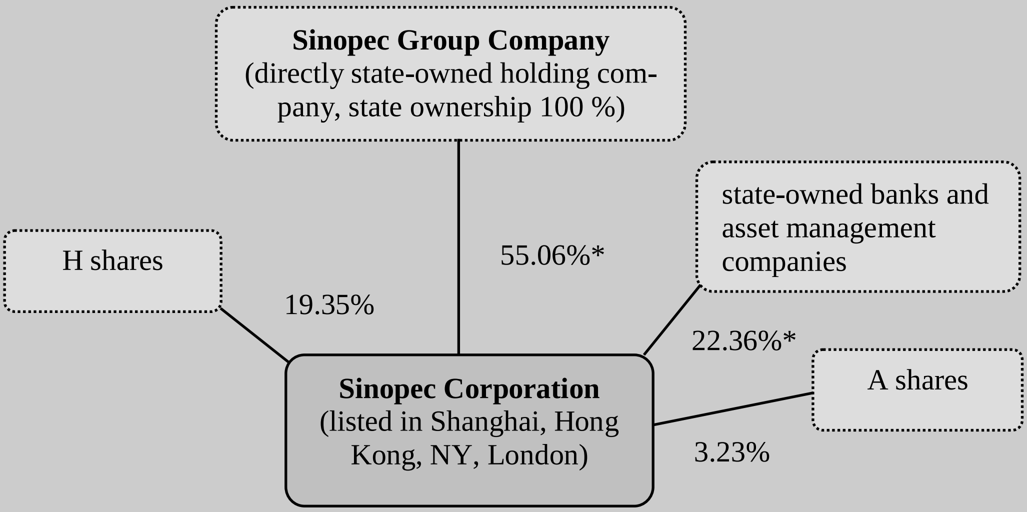
The goal of maintaining state control while raising funds was effectively achieved with the split share structure. However, a dilemma was created. Given the dominance of non-tradable shares on the market, whenever the state aired its intention to sell down its shares in some SOEs, the market slumped due to fears of newly tradable shares flooding the market. The government was forced to abandon two earlier attempts at reform in 1999 and 2001. In order to ameliorate the effects of the current round of share reform, the government decided that the holder of non-tradable shares has to compensate owners of tradable shares by offering them new shares or cash compensation. By making its shares tradable and by diluting its ownership, the share structure reform could be seen as lessening government control of its publicly traded shares. However, as the case below shows, the opposite may in fact occur.

Case: Sinopec and the non-tradable share reform

The ownership control structure previously favoured by the Chinese government in the case of large SOEs was to retain a non-listed traditional SOE as a holding company and parent to a corporatised and listed subsidiary. For example, non-listed Baosteel Group is the parent of listed Baoshan Iron & Steel, while non-listed China Petrochemical Corporation (Sinopec Group) is the parent of listed China Petroleum & Chemical Corporation (Sinopec Corp.). Given the legacy of SOEs as providing numerous welfare benefits to present and former employees as well as their family members, SOEs were saddled with social responsibilities, which were usually left with the non-listed company, while the best productive assets were transferred to the listed subsidiary. Not surprisingly, parent companies are usually loss-making while the subsidiaries are profitable. Parent losses are commonly covered by the profits of listed subsidiaries (Imai 2006, pp. 12–14; Naughton 2006, p. 8).

Sinopec is arguably one of the most important Chinese companies. Whether by revenue, profits, market value or market weight, it is one of the biggest Chinese enterprises. Sinopec Corp. is the fourth largest company and biggest non-financial company on the Shanghai stock exchange. In terms of its structure – a wholly state-owned parent company and a majority state-owned listed subsidiary, with several separately listed subsidiaries – Sinopec is a typical major Chinese SOE, and also a typical company on the Chinese stock markets. Following the Chinese government's determination to implement reforms that would invigorate the languishing local bourses, Sinopec's ownership structure has seen several changes.

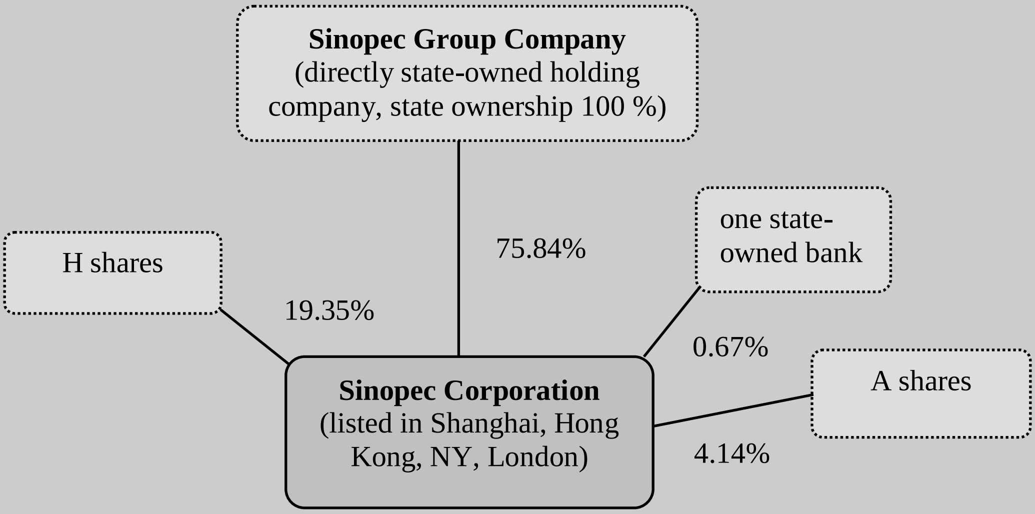
Figure 1. Sinopec Corp.'s ownership structure after all listings



Note: The mark * refers to non-tradable shares.

After the H and A share listings in 2000-01, the state directly held 55.06% of the shares in Sinopec Corp. through Sinopec Group (Figure 1). Together with legal person shares, state-related institutions held 77.42% of all shares. Sinopec Group later acquired some of the shares held by legal persons. In the autumn of 2006, Sinopec Corp. completed its conversion of non-tradable into tradable shares, as one of the last major listed SOEs to do so. In conjunction with the share conversion, Sinopec Group further redeemed almost all remaining legal person shares. To compensate minority shareholders for the conversion, all A-share holders were given 2.8 newly tradable shares for every 10 shares they already held. H-share holders, however, did not receive any compensation. Since 2001, the state-controlled shares owned by the parent company have thus actually increased substantially even following the share compensation scheme, rising from 55.06% to 75.84%. In the process, legal person shares have almost been eliminated, while minority shareholders' ownership in Sinopec Corp. has increased only marginally (Figure 2).

Figure 2. Sinopec Corp.'s ownership structure after the share reform and share redemptions



In conjunction with the share conversion, lock-up periods for newly tradable share sales were imposed and a timetable was mapped out, with 5.67% of shares open for trading one year after the implementation of the reform, a further 5.00% after two years, and the rest of the shares (65.84%) tradable three years after commencement of the implementation phase (Source: Sinopec shareholder notification on share conversion, 28 September 2006). This conforms to a general rule on share sales stipulating that no more than 5% of shares may be sold 1 year after implementation of the reform, another 5% after 2 years, and the rest after 3 years. The timetable effectively imposes a temporary moratorium on actual share sales. Even if the state will eventually sell down its shares in some companies, it will take until 2008–2009 before significant ownership changes can be observed.

Several of the current restructuring issues affecting Sinopec are common to other SOEs, and a legacy of the piecemeal way in which SOE changes and market reforms in general have been pursued in China. The complicated group structure of Sinopec is one such issue. The fact that Sinopec first listed a dozen subsidiaries, in which it usually remained the majority owner, before the mother company itself listed, was probably a combination of the need to raise cash, difficulties in valuing the company as a whole, government fears of losing control of the core of the company, and the perceived need for trial runs before the mother company was listed. The listed parent (Sinopec Corp.) has retained a major influence in its listed subsidiaries, controlling the appointment of management, the board of directors and the supervisory board (Tobin 2003, pp. 7, 15–18). In its 2000 listing prospectus, Sinopec Corp. pledged to gradually consolidate its separately listed subsidiaries into the parent in order to streamline corporate structures and eliminate internal competition. This consolidation process began with the sale of Sinopec Hubei Xinghua to the State Development & Investment Corporation, a SASAC-administered company newly turned into an AMC on a trial basis. The process has gathered pace since 2004, with Sinopec Corp. buying up more than half of its listed subsidiaries and divesting two subsidiaries to other central enterprises (Table 3).

Table 3. Sinopec Corp.'s de-listings and acquisitions of its listed subsidiaries

Name of listed subsidiary	Ownership share before	Current ownership	Time of delisting
Sinopec Hubei Xinghua	57.58%	0%	2002
Sinopec Beijing Yanhua	70.01%	100%	2004
Sinopec Wuhan Phoenix *	40.72%	0%	2004
Sinopec Zhenhai Refining & Chemical	71.32%	100%	2005
Sinopec Qilu Petrochemical	82.05%	100%	2006
Sinopec Yangzi Petrochemical	84.98%	100%	2006
Sinopec Zhongyuan Petroleum	70.85%	100%	2006
Sinopec Shengli Oilfield Dynamic group	26.33%	100%	2006
Sinopec Wuhan Petroleum Corp.**	46.25%	(0%)	in progress
Sinopec Shijiazhuang Refining Chemical**	79.73%	(0%)	in progress
Sinopec Shandong Taishan Petroleum	38.68%	38.68%	-
Sinopec Shanghai Petrochemical	55.56%	55.56%	-
Sinopec Yizheng Chemical Fibre Co.	42.00%	42.00%	-

Data sources: Company annual reports, Sinopec website, Shanghai stock exchange, Xinhua, China Daily, Netease stock information.

* Sinopec Corp. swapped its ownership stake in Sinopec Wuhan Phoenix for petrochemical assets from Guodian Group (a central SASAC enterprise) and Qingjiang Water Power Investment.

** Sinopec Corp. signed an agreement to sell its stake in Wuhan Petroleum to an investment company seeking a backdoor listing, but simultaneously bought up all Wuhan's assets. Shijiazhuang Refining will similarly sell all its assets to Sinopec Corp. while the company shell is used for a backdoor listing.

Buying up subsidiaries and related companies is not a trend confined to Sinopec, although Sinopec's case is the most prominent. SASAC has encouraged the internal consolidation of big enterprise groups, the integration of upstream and downstream companies into the same group, and the comprehensive listing of related assets on stock markets. For example, PetroChina has also similarly acquired and de-listed its subsidiaries, while Chalco (Aluminium Corp. of China) has integrated its upstream and downstream production chains. If SASAC's wish is fully carried out, the Chinese stock markets will see major changes in the near future. At the end of March 2006, only about half of the central enterprises (87) had listed parts on the stock market with A shares. However, these enterprises held as many as 186 separately listed entities (*Zhongguo zhengjuan bao* 22 March 2006).

In the case of Sinopec, the legal person share redemptions and subsidiary acquisitions so far more than outweigh the state share dilution that occurred as an immediate consequence of the share reform. At least until now, the state's ownership control (through Sinopec Group) of Sinopec's productive assets has been considerably enhanced in recent years, rather than reduced. This also gives the state stronger control of tremendous cash flows that can be used to finance government priorities. Together with PetroChina and CNOOC, the three oil giants stand for about 40% all SOE profits (see Figure 3 and Table 5). Following the publication of the list of strategic industries, it is highly unlikely that the state will sell down its stake in any of these companies.

When analysing the share reform, we should keep in mind the distinction between converting shares from non-tradable to tradable on paper, and actually selling them on the market. When the government announced plans for its share reform, much news reporting assumed this meant that the state aimed to sell down its ownership, or even privatise listed SOEs. While it is likely that the state will sell a part of its massive shareholdings, it is by no means certain that even a significant part of newly tradable shares will be sold.

Policy guidelines jointly issued in August 2005 by several government agencies (Appendix 1, Document 14) unequivocally state that the objective of the share reform is *not* to reduce state holdings, only to make non-tradable shares tradable, and that at the moment the state has no plan to use state share sales to raise capital on the market. These guidelines, as well as SASAC's own guidelines on the share reform (Appendix 1, Document 15) also indicate that controlling shareholders, ie the state-owned parents, have to propose a minimum ownership stake they have to retain in accordance with the strategic layout of the state-owned economy and objectives for its' restructuring. This proposal, as well as all state share sales, has to be approved by SASAC. Similarly, when an enterprise board proposes the details of its plan to transform non-tradable shares into tradable ones, the board's proposal needs to be approved in each individual case by SASAC. The dual nature of SASAC is evident here, as SASAC itself ultimately represents the biggest owner of most major SOEs (the state) at the same time as it is the regulator of state asset sales.

Furthermore, the regulations state that central government should retain controlling interests in companies in 'pivotal industries' that are key to national security, without specifying which industries and companies it has in mind. The later released list of strategic and pillar industries, however, gives strong indications of which industries this refers to. While limited in numbers, the companies on this list have a disproportionate weight on the stock market. Furthermore, the guidelines also demand that the government has to secure control of key industries and sectors, if necessary by the holders of state-owned shares *increasing* their share holdings through market transactions. Interestingly, in conjunction with the release of the list of strategic industries, it was also mentioned that the state should increase the share of state assets in these industries.

Comments from high-ranking SASAC and CSRC officials provide further evidence of the state's intention to maintain or even strengthen control of major parts of the state-owned economy and only sell stakes very gradually, precluding any large-scale privatisation. Li Rongrong has said that the state needs to 'both advance and retreat' at the same time. This would seem to imply that the state is going to sell-down its ownership in non-core assets, while using the funds to increase its ownership in enterprises deemed strategic. Similarly, China's top securities regulator, Shang Fulin, chairman of the CSRC, said in a statement issued at the onset of the share reform that '[t]he country still needs to hold enough shares to absolutely or comparatively control pivotal companies after making all shares tradable' and that state shares will only be sold very gradually (*Bloomberg* 27 June 2005). These statements are consistent with the reform strategy coined in the 'grasp the big, let go of the small' phrase incorporated in the 9th five-year plan. However, neither the conditions nor the specific policies for withdrawal from ownership have yet been specified (Chen 2005, p. 104), at least publicly.

Judging from these statements, and contrary to what some observers seem to believe (eg *Business Week* 21 July 2006), it is erroneous to talk of any general privatisation programme in China. More appropriate perhaps would be to characterise the central government agenda with regard to its ownership interests as *portfolio rationalisation*. Recurring themes in official comments are, on one hand, the diversification of ownership, and, on the other hand, the continuing leading role of state ownership in the Chinese economy. The goal appears to be to find the optimum mix between retaining control of strategic parts of the state-owned economy and maximising the raising of cash through selling non-core assets and minority shares in core assets, as well as 'normalising' the operation of the Chinese stock markets.[11] SASAC is now encouraging SOEs that have previously listed on foreign markets to list domestically (including in Hong Kong).

In terms of the specific modes of maintaining its control of these 'pivotal' enterprises, the government has previously favoured simply retaining a clear majority of shares in those of its companies that have been converted into shareholding corporations. In Sino-foreign joint ventures, the 50/50 ownership principle has been favoured by the authorities, and many sectoral liberalisation debates (see Investment Catalogue in Appendix 2) have earlier revolved around whether and when this requirement would be loosened. Government-linked scholars have argued that the state does not necessarily need to retain an absolute share majority in order to maintain control over SOEs; it could rather use a relative majority in a situation of highly diversified ownership (Zhang 2002, pp. 174–175) or golden shares (Chen 2005, p. 106) to achieve the same aim. In principle, the Company Law allows for the creation of golden shares, as it only states that shares *within* the same class shall enjoy the same rights (Appendix 1, Document 1, Art. 126–133). However, so far the Chinese government has regarded ownership exceeding 50% as a sturdier defence of its ownership control. In conjunction with the release of the list of strategic industries, Li Rongrong mentioned the possibility of using *conditional* relative controlling stakes in some enterprises, which may indicate a more diversified arsenal of means to maintain state control in key enterprises.

Finally, regarding the future modes of strategic management and restructuring of state ownership, SASAC is also experimenting with new models. In December 2006, Li stated that China is considering creating new asset management companies to deal with SOEs, and that SASAC would assume direct ownership over some central enterprises as soon as 2007. However, if all central enterprises in China were subjected to the same AMC, that would create a tremendous concentration of assets in the Chinese economy, with combined assets on a par with the world's biggest bank, Citigroup. It is therefore more likely that SASAC will set up several AMCs as in the financial sector, where Central Huijin Investment performs similar owner and asset oversight roles as SASAC, while four AMCs take care of the practical work of managing and disposing of distressed assets. As a trial exercise, two central enterprises have already been converted into AMCs – State De-

[11] So far at least the share reform looks like a success. Without the state having sold any of its shares (apart from those it gave away as compensation), the Chinese stock exchanges appear to have been revitalised. Having fallen almost continuously for 18 months, the Shanghai composite index began rising shortly after the share reform began in April 2005. Since July 2005, the broad index has risen by more than 150%.

velopment & Investment Corp. (SDIC) and China Chengtong Group. On its website, Chengtong appears to envision its role mainly as restructuring the non-core and bad assets of the central enterprises in order to maximize the returns on state assets (*Chengtong Group website*). SASAC has also indicated that some other central enterprises may follow suit, while other AMCs may be specifically created for the purpose. Nevertheless, international experiences of using AMCs to perform corporate restructuring are not favourable. World Bank economists have therefore advised that they should be used with caution, limiting their role mainly to financial stabilization (Mako and Zhang 2004, p. 12).

With the reform of the share structure, the aim of 'comprehensively listing' SOEs, and apparent government dissatisfaction with the investment decisions of the SOE holding companies, it would thus appear a distinct possibility that SASAC, with the assistance of AMCs, would assume many of the powers of the current directly state-owned holding companies, thereby making these holding companies redundant in the long run.[12]

5 Enhancing financial control over state-invested enterprises

Mainstream Western views on the relative advantages of the market versus the state in allocating investments efficiently holds that a market-oriented financial system, in general, is more efficient in allocating capital than a state-dominated financial system, despite occasional market failures. The Chinese government has throughout the reform period had a preference for active economic management, perhaps as a legacy of the planned economy. This active management has been particularly evident in macroeconomic policy and in bank lending. Based on the Chinese case, some scholars have even recently challenged the prevailing view that a centrally managed finance system is necessarily less efficient than a market-based one (Allen et al. 2004).

One of the conspicuous features of China's decades long economic growth spurt is the very high ratio of investment to GDP, even compared with Japan, South Korea and Taiwan at a similar stage of economic development (Kwan 2004). While some economists disagree with the contention that China as a whole over-invests, the mainstream view among scholars appears to be that the investment allocation system in China does not function well, as numerous cases of over-investment in various sectors of the economy indicate.[13] Research has shown that Chinese domestic capital flows – especially capital based on loans from government-linked financial institutions – tend to favour relatively non-productive SOE-heavy areas (Boyreau-Debray and Wei 2005, pp. 17–20; Phillips and Shen 2005). A major share of bank loans are still directed to wholly or partly state-owned enterprises SOEs linked to local governments, for political rather than commercial reasons, with private enterprises receiving only 27% or loans (Farrell and Lund 2006, p. 6).

Much of the discussion on China's overheating economy has focused on the high personal savings rate as an explanation for the country's high investment rates. Less noted is that China's corporate savings are also exceptionally high in international comparison, currently standing at around 33% of all bank deposits, and over 60% of GDP (calculated from People's Bank of China and PRC National Bureau of Statistics data). More importantly, with all the focus on bank lending as a cause of the overheating of the economy, it has been less widely recognised that bank lending actually funds only a relatively small proportion of new investment. Domestically raised loans funded only 18.8% of fixed asset investment (FAI) in 2005. A bigger reason for China's supernormal investment rates than bank lending behaviour are companies that reinvest most of their (and other companies) earnings in new investment projects, rather than distributing earnings as dividends or using the cash to strengthen their balance sheets. According to World Bank scholars, retained corporate earnings finance almost 75% of corporate investment and amount to around 20% of China's GDP (Kuijs 2006, pp. 9-11; International Monetary Fund 2005, p. 25).

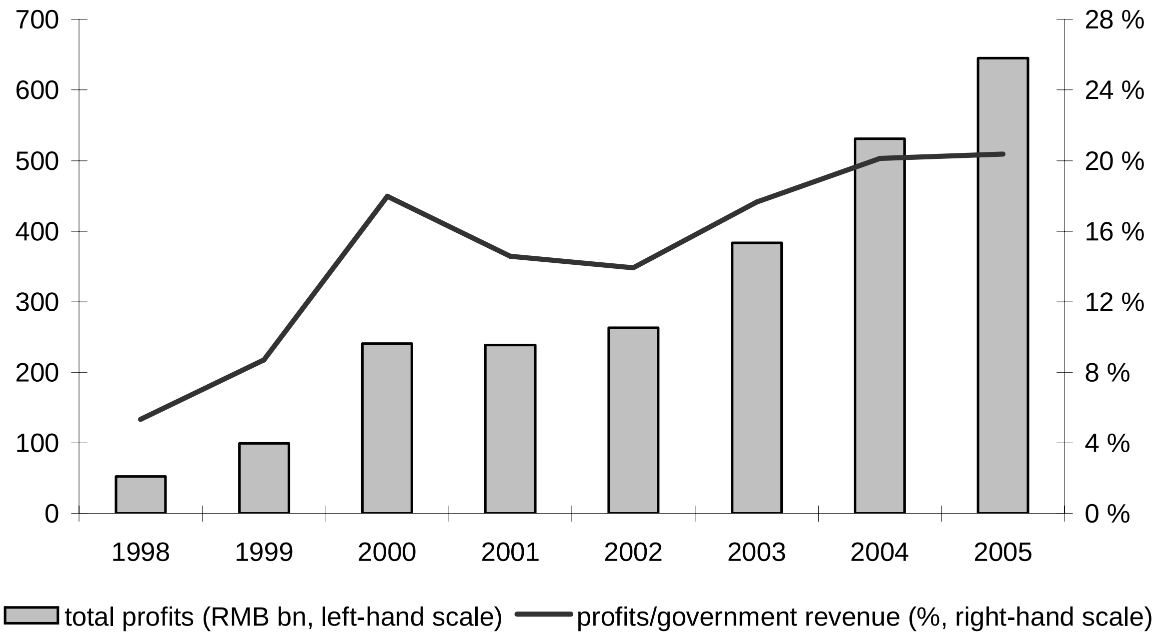
One of the main drivers of investment in recent years has been a triangular relationship between state-owned companies with semi-monopolistic features enabling windfall profits, central government hesitancy towards imposing hard budget constraints on SOEs and collecting dividends from them, and local governments locked in heated competition for GDP growth and prone to local protectionism. While there are still many loss-making SOEs, the state-owned part of the economy has, on the whole, been producing solid profits in recent years, with SOE profits multiplying both in absolute terms and relative to the size

[12] Recently, non-listed Shenyang Neusoft Group listed all its assets on the stock exchange through a share swap with its listed subsidiary Neusoft Co, in the process liquidating itself.

[13] Reliable assessments of the efficiency of Chinese domestic investment allocations are hampered by the fact that there are as yet very few publicly available quantitative assessments on the efficiency of the Chinese capital market (Boyreau-Debray and Wei 2005, p. 1).

of the economy and government revenue (Figure 3).[14] Some corners of the state-owned economy are awash with cash and with every incentive to reinvest their profits (even if unprofitably), but often with inadequate procedures for reaching sound re-investment decisions. As a consequence, profits have often been ploughed into unprofitable and duplicatory investments.

Figure 3 State-owned or -controlled industrial enterprises' profit development



Data source: NBS.

Many among the mass of smaller SOEs are still loss-making or barely break even. The bulk of SOE profits are made in a handful of big SOEs, almost all of which are central enterprises. The biggest industrial profits in China, both absolutely and in relative terms, are currently made in sectors of the economy that are dominated by state-owned enterprises, such as the oil and petrochemical, energy and metal industries. Several of these industries retain semi-monopolistic features, dominated as they are by a handful of SOEs and often shielded from competition by administrative and legal measures. The steel industry is different in this respect. While the biggest companies in the steel industry, too, are SOEs, the industry also has numerous smaller players, and profit margins are therefore thinner. Table

[14] One observer from the private equity community disagrees with the officially published profitability figures, arguing that they are artificially inflated by several accounting peculiarities (Shan 2006, pp. 29–32).

4 shows the cumulative profits of the most profitable industrial sectors in the period 2000–2005, as well as the proportion of state ownership in China within each sector.

Table 4 Cumulative industrial profits in the 15 most profitable industries in China 2000–2005, and state ownership share of industry revenue*

Industry	*Billion yuan (cum.)*	*State ownership*
Petroleum and natural gas extraction	893.7	95.5%
Electricity, gas and water	382.4	99.3%
Electronic, computers and telecom equipment	366.4	13.5%
Smelting and pressing of ferrous metals	332.2	49.4%
Transport equipment	315.1	52.5%
Raw chemical materials	289.9	31.6%
Electric machinery and equipment	218.1	11.2%
Ordinary machinery	171.4	23.7%
Tobacco processing	159.7	98.8%
Non-metal mineral products	147.1	13.7%
Textiles	140.4	7.6%
Medical and pharmaceutical	137.0	27.7%
Coal mining	112.4	71.4%
Smelting and pressing of non-ferrous metals	105.8	36.2%
Metal products	98.1	7.8%
All other industries	932.0	-

Sources: CEIC database, NBS China Statistical Yearbook 2006.

* State ownership refers to the combined revenues of state-owned enterprises as a share of industry total revenue. Figures are for the year 2005.

In 2005, the entire state-owned sector made a net profit of 644.7 billion yuan, according to the PRC National Bureau of Statistics figures. This figure is very close to the total profits recorded by central enterprises, 627.7 billion yuan (754.7 billion in 2006). The concentration of profits goes further. Among the central enterprises, the forty most profitable firms account for 95% of all profits, while the twelve most profitable firms made 78.8% of all central enterprise profits in 2005 (Table 5). Not surprisingly, in the SOE dividend debate, too, the focus has been on central enterprise dividends.

Table 5. The most profitable central enterprises in 2005 (total profits)

Rank	*Company*	*Industry*	*Ownership category*	*profits* (billion yuan)
1	PetroChina	petrochemical	Strategic	175.6
2	China Mobile	telecom	Strategic	78.2
3	Sinopec	petrochemical	Strategic	55.2
4	CNOOC	petrochemical	Strategic	35.8
5	China Telecom	telecom	Strategic	33.9
6	Shenhua	energy	Strategic	22.1
7	Baosteel	steel	Pillar	22.1
8	COSCO	shipping	Strategic	20.0
9	Chalco	aluminium	Pillar	15.0
10	State Grid	energy	Strategic	14.4
11	Anshan Steel	steel	Pillar	10.5
12	China Shipping	shipping	Strategic	10.0

Source: The profit figures were reported on an official website *China.org.cn* 11 July 2006, citing a SASAC study.

The torrid pace of China's economic growth has led Chinese policymakers to the conclusion that investment levels are too high. Central enterprises made a total of 1 trillion yuan (EUR 100 bn) in investments in the year 2004, accounting for almost 20% of all FAI in that year. In the first 11 months of 2006 the figure reached 1.005 trillion yuan.[15] Thus, while the number of central SOEs is limited, they account for a large share of investments, and also still enjoy a major share of loans extended by the SCBs. More importantly, since they are now under the direct management of SASAC with a mandate from the State Council, it should be easier for central government to influence the investments of this sector of the economy than either the foreign-invested sector or the privately invested sector, which receive little financing from state-owned lenders. As a consequence of a long series of administrative, corporate and fiscal reforms involving the SOEs, central government has lost many of the tools to directly guide the economy, while most investment decisions are taken in the interaction between corporations and local government. One motivation for central government in introducing the state assets management budget is to rein in duplication of investment projects, a practice that has been rampant in China.

[15] Fixed asset investments by state-owned and state shareholding companies in 2005 totalled more than EUR 400 billion. NBS, China Monthly Statistics 1/2006, p. 19; *Xinhua*, 7 January 2007.

If companies have adequate internal systems in place to evaluate the profitability of future investment projects, re-investment of profits or raising of funds for investment should not be a cause for government concern. But while the quality of management and corporate governance have improved over the years, many SOEs still make investments that are either ill-advised in terms of their corporate focus, unprofitable, or downright corrupt. The high profitability enjoyed by some central enterprises is often converted into new investment, as enterprises are able to retain a larger part of their profits than their peers in the West would, given that the Chinese government currently does not collect dividends on post-tax profits. Furthermore, given soft budget constraints,[16] companies often have ample incentives to reinvest profits. Investment is therefore kept at an abnormally high level.

Chinese central government appears to have lost faith in the ability of SOEs to re-invest profits prudently. SASAC appears to harbour the idea that they can do a better job in guiding state investment than company management can, at least at the strategic level. Consequently, a few years back SASAC set about developing a comprehensive framework for guiding SOE capital allocation decisions, in particular as regards investments and dividends. However, the specifics of the project released to the public have come in a long trickle with substantial uncertainties still remaining. A decision to collect dividends from SOEs was apparently already made in 2005. Some provincial and municipal SASAC offices, including at least Beijing, Shanghai and Shenzhen, have already gained operational control over local SOE budgets and profits as a pilot exercise prior to extending the same practice to the national level. In December 2006, the Finance Minister announced that in 2007 directly state-controlled central enterprises as well as local enterprises would begin to compile the state assets management budget on a trial basis. Eventually, the system will also cover state-invested financial institutions, including the SCBs.

However, the decision to start collecting dividends gave rise to strong disputes due to conflicts of interest. The principal protagonists were SASAC, which originally wanted control over all or most SOE dividends, the Ministry of Finance, which wanted the proceeds included in the regular state budget, and SOE managers who more or less opposed the whole idea (Naughton 2006, p. 12). In the intra-bureaucracy wrangling, the MoF bargaining position would appear to be stronger, as SASAC decisions still need to be countersigned by the MoF in order to take legal effect (Naughton 2005, p. 8).

[16] In the definition by Kornai and Weibull, soft budget constraints implied a state that would semi-automatically step in and rescue loss-making firms unwilling to shoulder the cost of their failure. See discussion in Colombo and Valentinyi (2002, pp. 2–3).

In June 2006, Chinese newspapers reported that a general agreement had been reached between SASAC and the MoF, whereby the MoF would continue to have overall control over SOE finances, while central SASAC would get control of the proceeds from central-level enterprise dividends and asset sales. However, as recently as September 2006, MoF and SASAC officials' statements on the issue appeared to contradict each other. Li Rongrong has nevertheless revealed that in order to ensure consistency in state budgeting and some oversight of SASAC's use of funds, the MoF will be responsible for approving SASAC's budget for state assets, which will then form a part of the general central government budget. It has also been announced that the general principles on SOE dividends will be published soon, with detailed regulations to follow later.

As for the amount of dividends to be collected, there is no certainty as yet. Chinese state media has repeatedly reported that a ratio of 20% of net profits has been applied in the trial locations Beijing and Shanghai in 2006. Fujian provincial media have also reported the figure of 20% of distributable profits. However, this was said to be a *minimum* level for dividends, the precise amount being determined in each instance by the provincial SASAC based on general state asset restructuring needs and the specific circumstances of each enterprise (*Fujian ribao* 1 January 2007). Assuming a 20% general dividend rate were also to be applied to central enterprises, that would give SASAC ample ammunition to tackle industrial restructuring, providing at least EUR 10 billion annually, at current profitability levels. However, an oil company executive was recently quoted as saying that SASAC would collect only 5–8% of the profits of the main oil companies (*Forbes* 1 December 2006). Li Rongrong recently mentioned that different dividend levels will be determined and applied based on enterprise categorisations (分类收取). Dividend ratios will most likely be determined according to specific circumstances.

Judging from the dividend debate so far, the decision on which institution gains control over the dividends, and to what extent, will have an effect on the state's future spending priorities. The MoF appears to be favouring using the bulk of the dividend income to fund the National Council for Social Security Fund (NCSSF) created in 2000, while SASAC would rather spend the money on its own priority areas, namely restructuring domestic industries, investing in new strategic investment priorities and funding public works projects. It had earlier been reported that 10% of government-held shares in listed SOEs would be transferred to the NCSSF, thereby allowing the Fund to collect dividends directly, and central SASAC had instructed local SASACs to study the possibility. Nevertheless, SASAC appears to have concluded that this plan is not the best option. SASAC recently announced that it does not support transferring shares directly to the NCSSF, as this may endanger its goal of maintaining absolute state control in certain industries. Instead, SASAC would prefer making cash contributions to the NCSSF from the dividend earnings it receives. Meanwhile, SASAC's encouragement of full stock market listings and its intention to assume direct ownership in some listed SOEs may be a way to allow central government to collect dividends directly from the profitable listed SOEs, rather than indirectly through their non-listed parent companies.

SASAC has grouped central enterprises into various categories and defined 'core industries' for each company. Beginning in 2004, SASAC has released this information in five batches, with some 22 companies still being uncategorised at the time of writing (Table 5). SASAC restricts core business areas, even in the case of large enterprises, to a maximum of three. If implemented according to SASAC's orders, the exercise will potentially have several practical implications. When the state assets management budget is in full use, side-business investments will be strictly controlled, with SASAC reserving to itself the right to deny enterprise investments when these are deemed as not serving the strategic objectives of the core business. According to related regulations, side-business investments have to be reviewed and *approved* by SASAC, while core business investment only needs to be *reported* to SASAC (Appendix 1, Document 4). Thus, the rules on investments and business definitions are designed to directly tackle the central enterprises' widespread practice of using their surplus cash to diversify into businesses that have no relation to the core business. However, according to SASAC, side-business investments only accounted for 3–4% of all central enterprise investments in 2005, so the impact of these regulations on overall corporate investment levels should be limited.

In addition, in conjunction with SASAC's goal of listing related businesses within an enterprise comprehensively on the market, companies with separately listed subsidiaries that do not fall within the core business areas will probably be pressed to divest these non-core subsidiaries, as Sinopec has already done in some cases.

Table 6 Central enterprise categorisations by SASAC

Batch (number of companies)	**SASAC characterisation**	**Core businesses**	**Company examples**
First (49)	Core businesses are related to national security and other industries key to the lifeline of the national economy	Petroleum, electricity, steel and colour metals, heavy machinery, auto, airlines, telecom, military, shipping	Sinopec, CNOOC, State Grid, Dongfeng Motor, Minmetals, Baosteel, China Airlines, China Telecom, China Mobile, COSCO
Second (13)	Core businesses are related to national security and other industries key to the lifeline of the national economy	Railway equipment, real estate, infrastructure, diversified, chemicals	Sinochem, State Grain Reserves, China Merchants Logistics
Third (35)	Mostly relatively large companies with well-defined main businesses	Real estate, construction, infrastructure, environmental engineering, tourism, chemicals, textiles	Sinomach, China Railway Engineering, Chengtong Group, China International Travel Service (CITS)
Fourth (16)	---	Light industry (textiles, food, handicrafts) and various service industries (real estate development, tourism, trading)	China Travel Service (CTS), China Satcom, Chinatex
Fifth (25)	---	Industrial research and design	Central Iron & Steel Research Institute (CISRI), China Coal Research Institute, China Electronics Engineering Design Institute

Note: At the time of writing, 22 companies were still uncategorised and one company was listed in two batches.

In the spring of 2006, SASAC director Li Rongrong stated with regard to defining core businesses that, in the future, state assets would be concentrated in four economic areas: in those industries that are related to national security and key to the lifeline of the economy; in those areas that possess competitive advantages or may develop into future leading industries; on big internationally competitive industrial groups and companies; and on the core businesses of central enterprises. The first of these criteria uses word for word the same expression as the characterisation of the companies in the first two batches in Table 6, and the same definition as was used for the strategic industries. This, of course, is no coincidence. This characterisation was already stipulated during the 15th Party Congress (1997), which decided that the state has to retain control of sectors that concern national security, the national economic lifeline, basic infrastructure, key resources and strategic high-tech fields (Chen 2005, p. 105).

If SASAC gets control over a major part of SOE dividends and asset divestment proceeds, then it appears that these will be concentrated on strengthening the already strong among the SOEs, focusing on a small group of major companies and channelling support to them.[17] SASAC officials have repeatedly stated that central enterprises need to merge in order to achieve a scale at which they can compete globally. The vision SASAC appears to hold for the future management of central enterprises looks remarkably similar to Singapore's new vision for Finance Ministry-owned Temasek and the companies linked to it. According to Mako and Zhang (2004, p. 9), a Singaporean economic review committee in May 2002 recommended that Temasek (which SASAC officials repeatedly refer to as an example) should help Singapore's government-linked companies to internationalise their core businesses and grow into globally competitive companies anchored in Singapore. Furthermore, the government should continue to own 'critical resources', while selling stakes in less important companies.

To date, the number of central enterprises has been reduced from an original 196 to 159. However, SASAC officials are not content with this pace. In October 2004, SASAC director Li Rongrong stated that companies would need to grow to being among the three largest companies in their fields in the Chinese market. If they could not achieve this goal within three years, SASAC would find a partner for them, effectively merging companies by decree. The most likely candidates for companies that would form the core of these future Chinese mega-companies are those listed in the first batch in SASAC's own categorisation framework defining enterprise core businesses, and operating in the industries defined as strategic or pillar industries. Among these are almost all the largest, most competitive and most profitable Chinese firms, with notable exceptions being some electronics and IT companies.

[17] *Jingji cankao bao* 28 February 2006 and *Zhongguo zhengjuan bao* 14 March 2006.

6 Conclusions

This paper has reviewed recent policy and regulatory developments with regard to central government control over the central enterprises. While several key developments have still not been finally settled, enough data exists to draw some tentative conclusions as to the direction of the Chinese central government's ownership policy.

The long process of loosening the ties between SOEs and central government that started with the onset of China's economic reforms appears to have reached a turning point. While most of the previous reform efforts resulted in enhanced managerial and/or local government control over enterprise management and financial decisions, several recent initiatives by SASAC specifically and central government more generally appear aimed at re-establishing central government authority over the *crème de la crème* of SOEs. In some ways, these efforts are only giving teeth to a strategic direction stipulated already in the mid-1990s on letting go of the small, while grasping the large SOEs.

The documents reviewed for this paper clearly suggest that central government is strengthening its control of a handful of the biggest and most profitable Chinese companies. One of the first steps in this development was centralising the ownership and supervision of 196 SOEs under central SASAC. SASAC has taken on an increasingly active role in the strategic management and restructuring of these companies, with a stated aim of reducing their number to 30–50 globally competitive companies, by forced mergers if necessary, and by channelling state resources into strengthening the global competitiveness of these companies. This is in line with China's new five-year plan published last year, which put heavy emphasis on developing indigenous Chinese technological and innovation capabilities (Appendix 1, documents 19 and 21). SASAC itself will also apparently soon begin assuming direct ownership of some listed SOEs, possibly indicating that it intends to take over some of the powers from the wholly state-owned parent companies, thereby getting closer to the actual source of SOE earnings.

A second step has been stipulating clearer demarcations on which industries the government considers strategic. The recently released shortlist of seven strategic industries implies that at least 40–50 companies on the central enterprise list will be indefinitely off limits to foreign or private control, as will probably also be the 70 companies operating in industries characterised as 'pillar' industries. Companies operating in the strategic industries tend to be the largest among the central enterprises. Intriguingly, almost all the profits among central enterprises and most of the profits in the state-owned sector of the economy as a whole are currently made by the top forty central enterprises. A number of indicators therefore suggest that central government has concluded that less is more. By controlling tightly a small fraction of all SOEs, the state can maintain disproportionate control over profits, investments and the national economy, thus enabling it to let go of many small SOEs without sacrificing much control.

However, there is an inherent paradox. SASAC directors continually emphasize that they are in the process of separating the functions of government and corporation. While this may be true with regard to the entire state-invested economy – especially if the government begins actively selling off non-core companies – it is dubious with regard to the central enterprises reviewed in this paper. If anything, the government's recent actions and numerous policy papers and statements on strengthening the state's hold of strategic industries and channelling state assets to these sectors, provides fuel to critics who argue that big Chinese state-owned enterprises have a dual role as both corporations and arms of the state machinery. A tit-for-tat on foreign acquisitions following CNOOC's failed Unocal acquisition may result in the Chinese government interpreting national and economic security more broadly than is common, thus effectively putting a brake on foreign investments in many industries.

Finally, while central government has clearly signalled its determination to get tighter control over SOE profits and investments, the question of who gets control over SOE profits has succumbed to prolonged intra-bureaucracy wrangling. There still appear to be differences in the positions of the MoF and SASAC even after years of negotiations. In order for SASAC to be able to implement the ambitious SOE restructuring agenda it has set for itself, it will need both effective ownership control of the central enterprises and a significant share of the earnings generated as dividends and divestment proceeds. Judging by its officials' statements, SASAC itself appears to believe it will eventually get operational control of most of the funds generated from Chinese state assets. Were this to happen, SASAC would become one of the biggest and most powerful organisations for government-sanctioned industrial restructuring in recent history.

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Appendix 1 Laws and administrative directives reviewed for this paper[18]

Laws and law-like administrative directives[19]

1) 公司法 Company law, new version (*law*, took effect 1/2006)
2) 公司法 Company law, old version (*law*, 1999)
3) 反垄断法 Anti-monopoly law (*law draft*, under review)
4) 中央企业投资监督管理暂行办法 Central enterprises investment supervision and management (*temporary directive*, 7/2006)
5) 上海市国有资产收益收缴管理试行办法 Trial directive on Shanghai city state assets revenue and dividend management (*trial directive*, 11/2005)
6) 上市公司股权分置改革管理办法 Directive on listed companies' share structure reform (*directive*, 2005)
7) 上市公司收购管理办法 Directive on the takeover of listed companies (*directive*, 9/2006)
8) 地方国有资产监管工作指导监督暂行办法 Temporary directive on the guidance and supervision of local state assets management work (*temporary directive*, 5/2006)
9) 企业国有资产监督管理暂行条例 Interim regulations on the management of enterprise state-owned assets (*regulation*, 5/2003)

Other administrative regulations

10) 国有资产监督管理委员会令 State assets supervision and management committee (*order*, 4/2006)
11) 国务院关于试行国有资本经营预算的意见 State Council opinion on the trial State Assets Management Budget (*opinion*, not yet published)
12) 外国投资者并购境内企业暂行规定 Regulations on foreign mergers and acquisitions (*temporary stipulation*, 9/2006)
13) 国务院关于机构设置的通知 State Council circular on organisational set-up (*circular*, 3/2003)
14) 关于上市公司股权分置改革的指导意见 Guiding opinions on the share reform of listed enterprises (*opinion*, 8/2005)

[18] In some cases, the law was only in draft form, or the document has not been publicly available. In this case several secondary sources were relied on.
[19] The Chinese administrative system has an elaborate hierarchic classification of the documents it produces. Apart from regular laws that usually take very long to pass and law-like administrative directives, there is a hierarchy of administrative documents. Following Lieberthal (1995, p. 177), this hierarchy – in descending order of bindingness – is *order*（命令), *instruction* (指示), *circular* (通知) and *opinion*（意见). In the list above, the nature of the document and month of publication or taking effect can be found in brackets.

15) 关于上市公司股权分置改革中国有股股权管理有关问题的通知 Circular on some issues related to the management of state-held shares in the reform of listed enterprises' non-tradable shares (*circular*, 9/2005)
16) 行政单位国有资产管理暂行办法 Provisional measures on the management of administrative organs' state assets (5/2006)
17) 外国投资者并购境内企业暂行规定 Provisional measures on mergers and acquisitions of domestic enterprises by foreign investors (*temporary stipulation*, 4/2003)
18) 关于推进国有资本调整和国有企业重组的指导意见 Guiding opinion on encouraging transformation and restructuring of the state-owned capital (*opinion*, 12/2006)
19) 关于企业国有产权转让有关事项的通知 Circular on matters relating to the enterprises' transfers of state-assets (*circular*, 12/2006)
20) 外商投资产业指导目录 Catalogue for the guidance of foreign investment industries (*order*, 11/2004)

Policy papers

21) 国民经济和社会发展第十一个五年规划纲要（草案）Guidelines for the 11th five-year plan (3/2006)
22) 中国利用外资‘十一五’规划 The 11th five-year plan for China's use of FDI (11/2006)
23) 钢铁产业发展政策 Steel industry policy (2005)
24) 船舶工业中长期发展规划 Shipping industry plan (2006; details not yet published)
25) 国务院关于加快振兴装备制造业的若干意见 Proposals for equipment manufacturing industry (6/2006)

Appendix 2 Economic areas with foreign ownership restrictions in the current Investment Catalogue[20]

Economic areas where the Chinese partner must hold a majority of shares
Design and manufacture of civil planes, civil helicopters, aeroplane engines, civil airborne equipment, civil carrier rockets and civil satellites, and manufacture of civil satellites' effective payload
Construction and management of nuclear-power plants, grid of national trunk railways, metro and city light rail
Development and production of grain (including potatoes), cotton and oilseed
Exploring and mining of special and rare kinds of coal
Printing of publications (except printing of package decoration)
Production of material medicines for addictive narcotics and psychoactive drugs
Railway passenger transportation companies
General aviation companies engaging in photographing, prospecting and industry
Construction and operation of cinemas
Production and publication of broadcasting and TV programmes and film-making
Mapping companies
Air transportation companies
Economic areas where only equity joint or contractual joint ventures are allowed
Exploration and exploitation of gold mines with low quality or difficult to exploit
Prospecting and exploitation of copper ores, plumbum ores, zinc ores and aluminium ores (WFOE are permitted in the western regions)
Project based on the mode of integration of forest and paper with an annual production capacity of over 300 thousand tons of chemical wood pulp or an annual production capacity of over 100 thousand tons of chemical mechanical wood pulp
Production of high-quality paper and cardboard
Smelting of gold mines with low quality or difficult to exploit (WFOE are permitted in the western regions)
Power equipment: manufacture of super-critical units of over 600,000 kW, large gas turbines, gas-steam combined cycle power equipment of over 100,000 kW, coal gasification combined cycle technique and equipment (IGCC), pressure boost fluidised bed (PFBC), large scale air cooling generating units of over 600,000 kW, large scale cycle fluidised bed (CFB) boilers
Hydropower plant equipment: manufacture of large pump-storage power units of 150,000 kW and over, large tubular turbine units of 150,000 kW or over

[20] Information extracted from the *Catalogue for the Guidance of Foreign Investment Industries* (2004).

Nuclear-power plant equipment: manufacture of power units of 600,000 kW or over Power transmitting and transforming equipment: manufacture of super high voltage DC power transmitting and transforming equipment of 500 kW or over Manufacture of receiving equipment for satellite navigation and key components Manufacture of equipment for air traffic control systems Construction and management of feeder railways, local railways and related bridges, tunnels and ferry facilities General aviation companies for agriculture, forestry and fisheries Higher education institutes Processing the logs of precious varieties of tree Exploring and mining of minerals such as wolfram, tin, antimony, molybdenum, barite, fluorite Smelting and separation of rare earth metals Manufacture of truck cranes of less than 50 tons Development of pieces of land Market research Medical treatment establishments Education establishments for senior high school students
Economic areas where the Chinese counterpart must hold a relative majority of shares
Production of ethylene with an annual production capacity of 600 thousand tons or over Repair, design and manufacture of special vessels, high-performance vessels Design and manufacture of equipment and accessories for high-speed diesel engines, auxiliary engines, radio communication and navigation for vessels Construction and management of key water control projects for comprehensive utilization Construction and management of civil airports

Appendix 3 New industry-specific policy developments related to foreign M&As

Steel industry

In 2005, China published a steel policy paper banning foreign control – defined as owning a majority of shares – of Chinese steel makers. No such restrictions were included in the Investment Catalogue currently in effect. The steel industry is also reportedly included in a list being drawn up by the Chinese authorities of industries where foreign control is to be forbidden.

Machinery industry

In June 2006, the National Development and Reform Commission (NDRC) issued guidelines for the development of the domestic heavy equipment manufacturing industry (Appendix 1, Document 25). The guidelines define the machinery industry as an important 'pillar industry' and encourage state-owned enterprises to drive industry restructuring through mergers and acquisitions, ensuring that the government's ownership control of the industry is maintained. Furthermore, key enterprises within the sector now need to seek approval from the State Council before transferring ownership control.

Shipbuilding industry

In September 2006, the NDRC and the Ministry of Defence released a new industry development plan. According to this, foreign companies can participate in industry restructuring and funding of shipbuilding enterprises, medium- and low-speed ship diesel engine manufacturing enterprises and crankshaft manufacturing, as long as they do not hold above 49% of the shares. M&As involving overseas enterprises, overseas-funded enterprises in China, or a foreign-controlled JV merging with a domestic company are to be treated as newly created joint ventures. In addition, JVs also have to set up a technical centre with the purpose of absorbing technologies transferred by foreign investors to China. In the Investment Catalogue, foreign participation in shipbuilding of ordinary vessels is not explicitly restricted (implying that it is allowed).

Car industry

The 2004 Car Industry Policy confirmed a 50/50 ownership requirement, against the expectation of a loosening of ownership restrictions on foreign car producers. The same policy paper further restricted the market access of foreign companies by limiting the number of ventures they were allowed to establish and by forcing the localisation of component production (Borgonjon 2006, pp. 49–50). In a policy paper on foreign investment released as part of the 11th five-year plan, further foreign investments in the car industry were encouraged in so far as they brought in R&D and design capacities (Appendix 1, Document 21).

Paper industry

In the paper industry, the government in 2005 changed the earlier rule that allowed fine paper and board mills to operate without a Chinese joint venture partner, so that new ventures now require a local partner.

Appendix 4 The main powers of the agencies involved in approving foreign M&As

Ministry of Commerce (MofCom)

According to the new guidelines on foreign acquisitions that took effect on 8 September 2006, MofCom (in cooperation with the SAIC) is the key government organ in approving or denying foreign mergers and acquisitions of Chinese state-owned as well as private enterprises. Acquiring enterprises need to report their plans to MofCom in a wide variety of circumstances, and the regulations give MofCom considerable discretion to deny acquisitions. MofCom has announced that it will in the future more closely supervise foreign acquisitions of China's 'backbone' enterprises.

State-owned Assets Supervision and Administration Commission (SASAC)

SASAC is tasked with protecting the value of state assets, including SOEs. SASAC evaluates and advises MofCom on foreign acquisitions of SOEs, in particular as to whether the acquisition adheres to appropriate procedures and whether the price received from the asset sale is to be considered 'fair', a fair price implying a minimum of 90% of the net asset value of the acquired company.

China Securities Regulatory Commission (CSRC)

CSRC makes rules on acquisitions of companies listed on the Chinese stock exchanges. It examines acquisitions if the target company is a publicly listed company and undertakes studies of the financial strength and debt levels of the acquiring company. CSRC also scrutinises management buy-outs.

China Banking Regulatory Commission (CBRC)

CBRC has to ratify acquisitions or strategic investments in Chinese banks by foreign financial institutions.

National Development and Reform Commission (NDRC)

Together with MofCom, the NDRC needs to approve foreign investment project applications. It also supervises the restructuring of SOEs. NDRC has issued several policy papers and guidelines pertaining to the development of Chinese industries and the involvement of foreign enterprises in these, and was probably involved in drafting the new rules on foreign acquisitions.

Special agency in the future?

A specialised ministerial-level agency below the State Council has been proposed to examine future mergers and acquisitions.

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