Claiming Profit for the State: SASAC and the Capital Management Budget

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One of the most important economic issues playing out in China today is the control of state enterprise profits. State firms have become very profitable over the last several years, so there is a lot of money on the table. At the same time, control over profit is a central component in a network of interlocking issues, including corporate governance reform, fiscal reform and even social security reform. The State Asset Supervision and Administration Commission (SASAC) has taken major steps in 2006 toward establishing a claim on these profits and advancing its own agenda for reform of the state sector.

Ordinary Politics

Much important policymaking in China is ordinary bureaucratic politicking, taking place primarily behind closed doors. Debates over neoliberalism and market reforms rage in the public media (see *CLM* 17), and do have an effect on the direction and pace of decision making. Thus, during the first half of 2006, the top leadership seemed to be taking some steps to rein in the public criticisms of reform, and temper a general tilt to the left. In March 2006, at the National People's Congress Meeting, first Secretary Hu Jintao explained to the Shanghai delegation that it was crucial to push ahead with reform of the economic system. Later, the campaign to shore up the reputation of reform continued with front-page editorials in the *People's Daily* and other standbys of official propaganda.[1] But at the same time, much of policymaking proceeds under a different kind of momentum, reflecting the interests and ideologies of "insider" policymakers. Successive Communist Party plenums have in recent years become tightly scripted and controlled exercises that produce general policy documents. When they are promulgated, they do not necessarily signal immediate changes of any consequence, but they set the framework for bureaucratic politicking in the following years.

The pattern of a programmatic document setting the subsequent agenda has been much in evidence of the past few years with respect to state enterprise reform. The Third Plenum, in October 2003—the "economic plenum"—laid out a broad but vague and abstract set of reform goals. State enterprises were instructed to focus on the development and consolidation of joint stock corporations; and the proposal was endorsed to adopt a "state capital management budget" (to be discussed below). Whether these general declarations were to make any practical difference was left up to the agency with authority over state firms, the State Asset Supervision and Administration Commission (SASAC). In fact, over the past 18 months, a series of slow but steady changes have been made which cumulatively will have a significant impact on the governance of public firms. The focus of discussion in this paper is the creation of a capital management budget that will give SASAC control over a significant portion of state enterprise profits. A final, formal decision on the precise contours of the capital management budget has still not been made as of this writing, but it is clear that some version of this program will be enacted, given that the most influential groups have reached agreement. The decision process for this important policy fits the overall pattern of cumulative, gradual changes that on occasion are almost imperceptible.

To track this process we must first consider the role of SASAC. As we described earlier (in *CLM* 14, "SASAC Rising"), SASAC is a government body of slightly ambiguous legal provenance, but with a vision of a potential role for itself that is both extremely broad and surprisingly bold. There is an enormous gap between the powers SASAC actually exercises today, and the vision that it holds of its future role. However, SASAC is relatively well positioned to be able to increase its powers, to bring them in line with its vision, so long as it has support at the top of the political system. As it happens, a fundamental feature of Wen Jiabao's administration of the State Council is the high degree of support he gives to bureaucratic agencies and legitimate decision-making processes. As a result, at the end of the day, Wen tends to support SASAC's agenda, and this has gone a long way toward ensuring the steady accumulation of power and influence by SASAC.

The Sources of SASAC's Influence: Ownership, Money, Vision

It is useful to think of SASAC's influence as deriving from three sources:

Ownership. SASAC's basic mission is to exercise the government's power of ownership. SASAC therefore in theory possesses enormous power to speak in the name of the owner of hundred of corporations with a collective worth in the hundreds of billions of dollars. It has the authority, again in theory, to exercise all the rights and responsibilities of public ownership, and to set the strategic orientation of all these companies. The establishment of SASAC coincided with a demarcation between central and local government ownership, so central SASAC exercises ownership of the largest, most powerful and most profitable centrally run corporations.

Money. There is plenty of money being earned these days in SASAC's corporations. After years of painful restructuring, China's state-owned enterprises (SOEs) are much leaner and more efficient than they used to be. Perhaps more important is the fact that three years of superheated economic growth have created excellent conditions in many Chinese firms. Central SASAC firms are especially well positioned to take advantage of current conditions, because they are concentrated in natural resources sectors, energy, power, and telecommunications. These sectors are all booming, and SASAC firms are doing very well. Profit has increased about 40 percent annually for the past three years, and in 2005, SASAC firms earned 628 billion RMB, equal to 3.4 percent of total GDP![2]

Vision. SASAC does possess a vision, but that vision is more complex and nuanced than many market reformers would prefer. SASAC's vision includes efficient, professional management, to be sure. But SASAC's vision also includes the protection and increase of state assets. This is a point of central importance. It means that SASAC's mission is not to privatize state assets, but rather to maximize the value of state holdings. Could this value maximization be achieved through privatization? Some selective privatization is certainly part of this vision, but SASAC's mission of value maximization should not be understood as an absolute objective. Instead, SASAC sees a mission for state ownership in certain sectors such that value maximization must be combined with strategic government objectives. SASAC's official line is that state ownership should "both advance and retreat" in specific sectors in whatever way is necessary to further government steerage of the economy and value maximization. There are certain sectors in which government ownership is appropriate (national defense; natural monopoly; natural resources; key technologically creative enterprises), and others, where, by deduction, government ownership is not ordinarily indicated. But SASAC doesn't want to be pinned down.

Indeed, SASAC wants maneuverability. It does not want to be constrained by a narrow definition of its mission, and it does not want to be tied down to worthless assets that cannot be restructured or liquidated. A key word in this vision is "fluidity" (*liudongxing*). That means that SASAC should be able to operate in efficient capital markets. Those markets would evaluate the performance of corporate managers. In turn, SASAC, either through intermediaries or on its own account, would manage the state's interests. Increasingly sophisticated SASAC portfolio managers would be able to buy and sell. State ownership would be modernized; the public would benefit; and SASAC employees would be highly educated, well-remunerated professionals.

The Huge Gap Between Reality and SASAC's Vision

Despite the undeniable power of SASAC, as things are currently structured it in fact does not exercise either of the two most fundamental attributes of ownership. SASAC does not harvest the profits of state firms, and it does not appoint their managers, either. The second of these attributes is a fundamental corollary of Communist Party rule: the Communist Party manages cadres (managerial personnel) throughout the society, and therefore SASAC doesn't. (This very important issue, along with all the important qualifications and distinctions, will not be discussed further in this brief.) SASAC does not harvest profits from state firms because the Chinese government does not receive profits from state firms, only taxes.

This astonishing reality has been true ever since 1994, when the tax and fiscal system went into operation. At the time, state firms were bleeding red ink, and total profits were extremely small. So, as part of the implementation of the new tax system, it was simply decreed that firms had the right to retain after-tax profits. Thus, if a firm is listed on the Shanghai stock exchange, it pays dividends to individual shareholders and to legal entities (including other state firms and some state agencies) that hold its shares.

However, these dividends never find their way into the state budget. SASAC would like to change this, and become the government agency that receives and reinvests at least a portion of those dividends.[3]

In China's stock market today, most listed companies have parent firms that are also state-owned firms. Those parent firms, typically labeled something like group companies (*jituan gongsi*), or investment companies (*touzi gongsi*), are much less transparent than are the listed companies. These parent companies in the past spun off listed firms but, in most cases, retained controlling ownership stakes. These parent firms *do* harvest profits from their subsidiaries. Also, in similar fashion, some local governments use their local SASACs to harvest profits from local firms (Shenzhen, for example, does this.) There is thus a "middle layer" of companies and organizations in between the fully corporatized and often listed companies, and the national government. Dividends are paid up to this middle layer, which currently has the authority to control and reinvest these funds.

This middle layer of firms is a diverse ecology. At one extreme, there are parent firms that now consist of nothing more than a collection of junk assets that were left over when all the valuable assets were packaged into a firm that could be listed on the stock market. In the petroleum industry, virtually all the valuable oil and gas producing and refining properties were put in the listed vehicles, while most of the money-losing services and welfare firms were put into "successor" (*cunxu*) or "left-behind" firms. For example, after listing, CNOOC (the China National Offshore Oil Corporation) had 1,000 employees in its listed firm, but 16,000 employees in left-behind firms. The former was highly profitable, while the latter were significant loss makers.[4] The parent CNOOC group company used the dividends from the profitable listed company to offset the losses of the left-behind firms. This pattern was common in many sectors.

However, these middle-level firms are not necessarily poor and economically dependent. Quite the contrary: since the middle-level firm still controls both the profitable and unprofitable firms, the middle-level firms often operate with enormous discretion. These firms were carved out of the ministries during early rounds of reform. They have strong networks of cooperating bureaucrats and officials, and they are not very transparent. Particularly following the revival of state sector profitability, some of these organizations are extremely rich and powerful. The state companies under central SASAC's purview include, for example, the State Electricity Grid and the big electric power–generation companies, some of the biggest and least transparent companies in China, and military-linked companies like Baoli and the Nuclear Industry Corporation. These companies have long-standing links to top Communist Party officials. They have power as well as money. This middle layer of the state economy is the least transparent and least reformed part of the state economy.

Reformers would like to see more progress in this tier of the economy. When the 2003 Third Plenum endorsed the development and consolidation of joint stock corporations, the concrete content of this endorsement was ultimately provided by SASAC. It means, on the one hand, improving corporate governance at those joint stock corporations that already exist, by improving boards of directors and appointing independent directors. On the other hand, it means setting up new joint stock corporations with a modicum of transparency in this middle tier of firms. Ultimately, the objective would be to convert the entire state sector into a group of companies working under modern corporate governance procedures. SASAC has been working in this direction for the past couple of years. But the issue of transparency and governance is also entangled with another question: who gets the money?

The Capital Management Budget

The mechanism that SASAC has seized on to transform the situation with respect to SOE profit is a state capital management budget (*guoyou ziben jingying yusuan*). This would be a budget, compiled by SASAC, with revenues derived from state firm profits and asset sales, and expenditures devoted to investment and firm restructuring. SASAC had been mulling the idea of some kind of capital management budget since birth. After the October 2003 Communist Party endorsement, SASAC began to get serious, and spent much of 2004 studying local experiences and developing concrete proposals.[5] At the end of 2004, the Ministry of Finance (MOF) approved in principle the concept of a capital management budget, and the possibility that it might be managed by SASAC, on the condition that the capital budget remained formally a part of the government budget and under the ultimate responsibility of the MOF.[6] Under a state capital management budget, some portion of state enterprise after-tax profits—either decided by the board of directors as distributed profits, or determined by a formula (perhaps 20 percent of profits)—would be remitted to government ownership agencies. This agreement in principle kicked off a prolonged process of bargaining and negotiation about what form such a budget would take. The most important principals were SASAC and MOF, as well as the Finance and Economics Committee of the National People's Congress.

The idea of a capital budget, in one form or another, has been on the table since the 1994 fiscal reforms. Those reforms envisaged a dual-budget system, in which current expenditures and capital expenditures were separated. For several years, such separate budgets were published. But since the capital budget really didn't correspond to actual decision-making processes in the Chinese bureaucracy, it gradually fell into disuse. In recent years, the national government has spent relatively little budget funds on investment, preferring to delegate investment responsibilities to middle-tier companies and to the banking system. Some local governments did collect state enterprise profits and revenues from asset sales, and they would typically use these funds for a fairly broad array of investment-related uses. For example, Shenzhen used the revenues from its firms to build a travel business conglomerate, channeling money through their local SASAC.[7] Other cities used their capital income in a variety of ways.[8]

SASAC understandably pushed for a large share of enterprise after-tax profits, and broad latitude in using those funds. MOF endorses the idea of state firms paying profits to the state, but of course would prefer that those funds be paid directly to them, i.e., directly into the state budget. SASAC, after all, is a special public service unit (*shiye* *danwei*) and not, technically, an arm of government. It therefore doesn't have the legal authority, under the "Budget Law," to compile a fiscal or quasi-fiscal budget.

Negotiations and preparatory work went on through much of 2005. By the end of the year, the various parties were in enough general agreement that the proposal was more or less officially released.[9] Other influential policymakers, including central bank governor Zhou Xiaochuan, announced their support for the idea that state firms should pay dividends to the government.[10] In early 2006, there were many reports that SASAC was compiling the first ever capital management budget for use in 2006. Moreover, these reports repeatedly said that the MOF would have broad authority over a general capital management budget, but the SASAC would compile a more detailed budget for central enterprises under its authority. This would give SASAC de facto control over the actual revenues, while maintaining MOF's ultimate authority over the budget.[11] Indeed, SASAC hoped to present this year's capital management budget for approval at the National People's Congress meeting in March 2006. However, it was not to be. The other agencies, reportedly including the MOF in the first rank, still objected to SASAC's concrete proposals, and in fact, no formal announcement was made. Premier Wen Jiabao's Government Work Report had a single phrase referring to the "completion of the system of capital management budgets," thereby creating the misleading implication that such a system already existed.[12]

Toward Resolution

At the end of May 2006 came a report that agreement had finally been reached between SASAC and MOF.[13] Although this agreement had not been officially confirmed as of this writing, the specificity of the outcome and the outlines of the bargaining solution appear authoritative. According to the report, SASAC gained the authority to be the lead agency in drawing up the state capital management budget, which would be overseen by MOF and incorporated into the overall budget under MOF's control. In return, SASAC had to surrender control of part of the revenues. According to this negotiated outcome, SASAC would receive a portion of revenues for state enterprise restructuring and investment, while MOF would receive a portion for social security and other public finance needs.

This outcome illustrates the complex forces affecting this policy decision. First, since there is a great deal of money on the table, entrenched interest groups are naturally fighting hard over this policy. The MOF-SASAC competition is more exposed to the daylight, because both these agencies have strong and legitimate public interests on their side. Less visible are the interest groups maneuvering to block the proposal because they simply do not wish to lose control over large sums of money.

Second, the economic health of state enterprises still varies widely. While some SOEs are flush with cash, others have little revenue to spare. It is inconceivable that SASAC would suddenly take over profits from all of these. Inevitably, the program will start with the richest firms, and those that are most susceptible to SASAC's influence. In practice, this means energy and telecom. These firms have the money and are reasonably well run, and their profits are highly sensitive to government regulation and policy. They therefore have little choice but to comply with the new system. In turn, SASAC has been forced to accept the fact that this year, implementation of the budget will be only partial and experimental, limited to these few firms, and differentiated according to monopoly and competitive sectors. Public utilities will likely be exempted altogether.[14] Of course, distributed profits are paid to the owners of a firm only if the board of directors votes to distribute dividends, which will not automatically occur. But if the board of a state firm votes to distribute, after the adoption of the capital budget, some of the distribution will go to the capital budget, and to the MOF. Moreover, perhaps some influential guidelines would be adopted, influencing directors to pay dividends.

Third, there is a great deal of concern that this control of money could be used by SASAC to create too much control over firms, effectively rolling back the achievements of almost 30 years of expanding enterprise autonomy. The reported outcome of the SASAC-MOF bargain reflects these concerns. If SASAC were given undivided control over revenues, there are fears that SASAC would simply turn itself into a super-agency, launching all kinds of new initiatives. Local SASACs do not feel particularly constrained in spending the profits they harvest, and often spend them for new investment. In Chongqing, at the beginning of 2005, the local SASAC used its revenues to purchase shares in a series of companies linked to the bankrupt private Delong group. Chongqing SASAC argued that this was a wise move preventing ripple effects from a local bankruptcy, but critics argued that it was an unwarranted expansion of power and public ownership.[15]

Concerns about expanding the power of the government bureaucracy are legitimate, but the fact is that it is hard to see any other way forward to the comprehensive restructuring of the state sector in China. In the current political climate, large-scale privatization of large, centrally controlled firms is simply not an option. If profits are bottled up within the group companies, they will be invested in lower- (or zero-) return projects by the group companies, and funds will be lacking for the restructuring of worthless firms and the resettlement of displaced workers. It is essential to move forward with the restructuring of the middle tier of state firms. Those firms need to be subject to the discipline and transparency of an improved corporate governance system. But actually doing this involves a complex mix of giving (putting in resources to restructure or close down firms) and taking (gaining control over revenue streams). SASAC's approach to the issue is not perfect, but it is the most feasible under current conditions.

SASAC would like to see a system in which all of the assets of state-owned companies are included in joint stock companies, and preferably listed on China's stock market. This formula is called "comprehensive listing" (*zhengti shangshi*), in contrast to the partial listing of just some higher-quality assets that characterized earlier stock market development. China's state-owned banks have all followed a practice of comprehensive listing, and all pay dividends to their state "owner," the Huijin Corporation. In this, the Huijin Corporation is like SASAC in the financial sector, but it operates according to a set of procedures to which SASAC, at this point, can only aspire. A system of comprehensive listing would be a big step forward. It would reduce the scope for insider transactions on the Chinese stock market. It would bring some sunlight into the middle tier of Chinese state firms. It would also give SASAC a much more “fluid” market for capital, giving it new resources and many new options for carrying out continuous restructuring of the state sector. In the process, of course, it would make SASAC a much stronger and more influential organization.

Conclusion: The Role of SASAC

When SASAC was established, in 2003, it developed a five-year plan to make itself into a modern organization to exercise state ownership. If the practice of state enterprises paying dividends to a government agency is established in 2006, this five-year plan will be more or less on schedule. Where will SASAC go from here?

If there is a single model for SASAC, it is Temasek, the Singapore government’s state holding company. Rather than a single state holding company, SASAC would prefer to create a tier of investment companies under its aegis. These companies would have to themselves be joint stock companies with substantial transparency from the beginning. Like Temasek, each of these holding companies would hire professional managers and be responsible for managing their holdings in such a way as to maximize their market value. Down the road, these holding companies could perhaps themselves sell shares to the public, allowing their own managers’ performance to be evaluated by their own share price. In this way, China could move to a modern and professionally managed system of public ownership, according to SASAC. Moreover, managerial compensation schemes could be adapted to include stock options and other links to share prices, aligning managers’ incentives with those of the state owners, without thereby giving managers excessive independent control over their firms.

The success of SASAC’s mission is by no means assured. It is unclear whether SASAC will prevail in its attempt to exert direct control over the middle tier of state firms. On a day-to-day basis, SASAC still often finds itself in the position of trying to track down the true value of state firms and their undertakings. A set of modern regulations and accounting procedures will not be enough to regulate the sprawling government sector in China. It will take substantial political will to really bring these interest groups into a new alignment. But this is one area where real change is happening through the bureaucratic process. That change is incremental, slow, contested, and sometimes invisible. However, the outcome of this process will have a large impact on how China’s modern economy functions in future years.

Notes

[1] Zhong Xuanli, “Unwaveringly hold to the reform direction,” *People’s Daily*, 5 June 2006, http://www.southcn.com/nflr/shelunsp/200606050238.htm.

[2] Zhao Hongmei, "The era in which state enterprises eat the cake themselves is over; but how to divide the feast is still troublesome," *Zhongguo jingji shibao* (*China economic times*) 3 March 2006, at http://www.ce.cn/macro/gnbd/yqdt/200603/03/t20060303_6255353.shtml.

[3] Zhao Yunqi, "State capital management budget would control enterprise lifelines," *Zhongguo caijingbao* (*China finance daily*), 23 September 2005, at http://www.cfen.cn/loginCt/pageprocess?pageurl=bzbm/2005-09/23/content_166542.jsp; Cheng Mingxia, "State capital management budget elicits strategic behavior on all sides; SASAC and MOF still have disputes," *Jingji guanchabao* (*Economic observer*), 20 February 2005, at http://finance.sina.com.cn/g/20050220/10431368996.shtml; Zhang Yuzhe, "SASAC and the big firms maneuver strategically; 400 billion in central enterprise profits may be redistributed," *Caijing shibao* (*Finance daily*). 25 January 2005, at http://media.163.com/05/0125/15/1AUV61930014184H.html.

[4]Xinhua Agency Online, "Making bad assets good—a veritable record of how CNOOC revitalized its successor companies," 22 August 2005, at http://www.sasac.gov.cn/2005ysy/ysy05/200508230199.htm.

[5] Zhao Yunqi, "State capital management budget"; Cheng Mingxia, "State capital management budget elicits strategic behavior."

[6] Yunnan SASAC, "The disposition of dividends on state-owned capital is still awaiting new ideas," 11 November 2005, at http://www.yngzw.gov.cn/wwwroot/gzyw/804.aspx.

[7] "Shenzhen Hospitality Industry has a new force; Jinjiang Hotel Group establishes Southern China Bureau," at http://www3.shenzhenair.com/IndustryNews/showTopicDetail.sh?topid=3914.

[8] Zhu Liangjun, "Five cities each have exceptional experiences to report," *Shenzhen Tequbao* (*Shenzhen Special Zone Reporter*), 15 July 2005, at http://www.sasac.gov.cn/gzyj2/200507150022.htm.

[9]Duan Xiaoyan, "SASAC will compile state capital budget; requiring central enterprises to remit dividends," *21 shiji jingji baodao* (21st century economic herald), 31 December 2005, at http://www.southcn.com/finance/nfcm/21sjjjbd/200512310055.htm.

[10]Zhou Xiaochuan, "The return to capital in state-owned enterprises," 11 December 2005 talk at the conference on the twentieth anniversary of *China Entrepreneur* magazine. Accessed at http://www.sasac.gov.cn/gzyj2/200601130130.htm.

[11] Liu Xiaowu, "Many experts debate whether the beginning of a state capital budget can truly end the period of excess profits of state firms," *Zhongguo jingyingbao* (*China management*) 19 February 2006, accessed at http://finance.sina.com.cn/g/20060219/12372354455.shtml; "Li Rongrong says state capital income will primarily be used to offset the costs of state enterprise reform," *Dongfang zaobao (Shanghai)* (*Eastern Morning News*) 25 January 2006, http://finance.163.com/06/0125/06/289TR01F00251GR3.html; Zhao Hongmei, "The era in which state enterprises eat the cake themselves is over."

[12] Wen Jiabao, Government Work Report, 5 March 2006, http://news.xinhuanet.com/misc/2006-03/15/content_4305660.htm p. 19 (Section 6: Push Reform and Opening a Step Further).

[13] Liu Xiaowu, "The payment of dividends by state firms is nearing resolution; SASAC and MOF have reached agreement," *Zhongguo jingyingbao* (*China management*), 28 May 2006, at http://news.hexun.com/1693_1661127A.shtml.

[14] Ibid.

[15]Xia Feng, "Chongqing SASAC buys back shares of two subsidies of Xianghuozhu,: *Diyi caijing ribao* [*No. 1 finance daily*] 17 January 2005, at http://finance.sina.com.cn/stock/s/20050117/02561297916.shtml.