Policy Dialogue on Corporate Governance in China

Hosted by

The Shanghai Stock Exchange
and
Organisation for Economic Co-operation and Development (OECD)

Co-organiser: ERI /Development Research Center (DRC)

Shanghai, China
25 - 26 February 2004

"State Equity Ownership and Management in China: Issues and Lessons from International Experience'

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Drawing upon two previous studies,[1] this paper focuses on three issues: mitigating the confusion between regulatory and ownership functions of the State; maximizing the return on State assets (or equity); and ensuring adequate transparency. Considering both the Chinese context and international lessons, Section I develops recommendations for the organization of "first tier" and "second tier" state shareholders. Proceeding from a brief analysis of China's portfolio of state-owned enterprises (SOEs), Section II discusses maximization of returns, transparency through accounting/auditing reform, and the related issues of portfolio management, dividend policy and capital reinvestment, intra-governmental sharing of sales proceeds and liabilities, and risk management.

I. Exercise of State Shareholder Rights

A. Chinese Context

1. The Pre-Reform Regime

Given the size and diversity of the SOE sector, the Chinese state has developed a system of division of labor in exercising ownership rights in SOEs. First, ownership rights are exercised by every level of government, from the national government to provincial, municipal and county governments. Second, ownership rights are shared by a wide range of government and Party agencies. This division of labor is reflected by the concept of "subordinate relation (*li shu guang xi*)". In the pre-reform regime, a SOE being "subordinated (*li shu yu*)" or "supervised (*zhu guan*)" by a particular level of government would typically mean that the government and party committee at this level exercised the following rights:

- *Appoint, monitor, motivate and replace managers*. This was typically done by party committee and its personnel department at the level of government that was supposed to supervise the SOE in question[2]. In line with the political nature of SOEs, their managers were "administrated" as party cadres in the same way as other officials serving in the government bureaucracy, and were ranked in the same system. It was indeed quite common for a SOE manager to be appointed in a government position or the other way around.

- *Make key business decisions*. This was performed by economic departments of the level of government involved. For example, the planning commission would be responsible to formulate overall annual and Five-Year plans, which specified anything from budget funds allocation and investments to prices and quantities of key products of SOEs under its supervision. Planning department was also charged with the authorities to approve capital construction investment projects, or make recommendations to the higher-level government in cases of large investments. The economic commission in collaboration with line bureaus (ministries) was responsible for day-to-day management of SOE businesses. Labor and personnel departments held the power to manage human resources related issues, such as recruitment, wages and salaries, social benefits, etc..

- *Provide finance and claim revenue*. Financial department of the level of government was responsible to collect revenues from and allocate funds to SOEs. Enterprise revenue, in forms of taxes and profit remittance, accounted for roughly ½ of budget revenue in pre-reform China. Related to this function,

[1] W. Mako and C. Zhang, "Exercising Ownership Rights in State-Owned Enterprise Groups: What China Can Learn from International Experience," World Bank background paper, December 2002; and W. Mako and C. Zhang, "Management of China's State-Owned Enterprises Portfolio: Lessons From International Experience," World Bank background paper, September 2003. Full texts are available at www.worldbank.org.cn . In addition to topics covered for this conference, these two papers discuss organization and operation of SOE boards and ownership transformation (or privatization) of SOEs.

[2] When a high rank manager was appointed to a SOE that is supervised by a lower level of government, this particular manager could be "administrated" by the higher level of party committee and personnel department. For example, a minister level manager could be appointed to a provincially supervised SOE. In such cases, this particular manager had to be administrated by the higher authority, the central party committee and personnel department, but other lower rank managers would follow the usual pattern.

it was also responsible to monitoring financial accounting and reporting of SOEs. State owned banks were responsible to collect deposits and provide working capital to SOEs. Bank loans were not an important source of finance for SOEs before the reform.

2. Past Reform Efforts

The SOE reform started in late 1970s has experimented numerous approaches and strategies, initiated by the central government as well as local governments at every level and managers and workers of SOEs. The relationship between the state and SOEs has been the central focus, and most reform measures were designed to change the way the state exercises its ownership rights in SOEs. Conceptually, these reform efforts can be viewed as having followed two strategies, which are often mixed with each other in specific policies and therefore less visible.

The first strategy prevailed during 1978-93 and has remained influential since then. It has two pillars: empowering insiders to improve efficiency on one hand, and strengthening party-government control to contain insider control on the other hand. Managerial autonomy and earning sharing between the state and insiders, i.e., managers and employees, were introduced in an attempt to strengthen incentives and raise efficiency. This empowered insiders and inevitably led to significant degree of insider control with all the negative consequences such as assets stripping. To get insider control under control, the role of party and state organs in appointing, monitoring and supervising SOE managers was strengthened.

The second strategy was officially adopted in the 1993 "3rd Plenum Decisions", which states that "building modern enterprise system is the direction of SOE reform" and calls for "institutional innovation" to replace the previous strategy of "delegating power and conceding profit". The 15th CCP National Congress in 1997 and the 4th Plenum of the CCP 15th Central Committee in 1999 reinforced the strategy by advocating the policies of "grasp the large and let-go the small", "adjust the layout of the state sector with a strategic view", and "withdraw from where the state should withdraw". This strategy is essentially one of corporatization and ownership diversification, expressed in different official jargons in different periods though. Since neither corporatization nor diversification can be possible without reform of the state assets management system, the three tier model of state assets management reform deserves a closer look.

3. The Three-Tier Model

Corporatization as a potential way of reforming SOEs started to be discussed and experimented in mid-1980s[3]. By 1993 when the 3rd Plenum of the 14th CCP Central Committee was held, there had been more than 3000 SOEs corporatized one way or another. One of the most important ideas behind this strategy of corporatization was to reform the institutional framework in which the state exercises its ownership rights by redefining its role in enterprises as a pure shareholder, whose rights and obligations are specified by law.

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[3]The World Bank played a role in advocating this strategy, according to some Chinese reformers such as Wu Jinglian, a leading advisor to the government on reform strategies and policies. In a report published in 1985, the Bank recommended that China may wish to delegate decision making power to a board of directors instead of workers and managers, as was happening at that time. And in order to isolate the board from political intervention as much as possible, a "socialist joint stock ownership" was suggested, which meant to "spread the ownership of each state enterprise among several different institutions", such as banks, pension funds, insurance companies, and other enterprises, in addition to central and local governments. In 1988, a Bank mission visited a number of major industrial cities in China and held extensive discussions with Chinese officials and academics in a workshop in November 1988. One of the key messages of this workshop and a subsequent unpublished report was that "the contracting responsibility system in China should gradually be phased out, and wherever appropriate it should be substituted by the share company system". See Wu Jinglian, *Modern Company and Enterprise Reform*, Tianjin People's Publishing House, 1994, p220-21; p234-38. The World Bank, *China: Long-Term Development Issues and Options*. The John Hopkins University Press, 1985, p166. The World Bank, 1989. *China: Enterprise Management Reform, Issues and Options*. Unpublished report. Report No. 7773-CHA.

To this end, a three-tiers model was developed and widely accepted by policy makers and advisors. The model was characterized by two separations: separation of the ownership function of the state from its other function, and separation of the ownership function from day-to-day operation of state assets. According to some common understanding of this model, the first tier consists of one state agency, under the State Council or even the NPC (the government or the local People's Congress in local levels), charged with the exclusive authority to act as the owner of state owned assets. Ownership function is thus separated from other functions of the state as all other party and government organs are supposed to transfer their ownership functions to this agency. However, this first tier agency is a government organ staffed with civil servants, rather than commercial units. The second tier institutions are designed to perform day-to-day management function of the state assets. These institutions are designed as commercial entities maximizing return on state assets, and most likely wholly owned by the first tier agency. They are supposed to exercise shareholder rights in corporatized SOEs who are found on the third tier, by voting in the shareholders assembly or sitting on their boards. In the Chinese Company Law, this kind of institutions are called "state authorized investment institutions"

Despite its strong influence in reform practices, this model has never been formally accepted by the central government as part of its SOE reform strategy. In particular, the idea of establishing the first tier agency has not been tried at the central government level. In terms of the second tier institutions, however, the central government did take some relevant actions. Many parent companies of SOE groups were "authorized (*shou quan*)" one way or another to act as the representative of state ownership in its subsidiaries. In mid-1990s, three parent companies of large industrial groups were selected for a pilot implementation of the idea of state holding company[4] , which was later substituted by government-led reorganizations in the three relevant sectors before producing any useful results.

A number of local governments went farther by setting up a state assets management committee (SOAMC) on the first tier. Shanghai and Shenzhen were among the most advanced. However, the SOAMC was only "virtual", as is usually called in China. First of all, the members of the committee are all current heads of party and government departments, instead of full time independent professionals. As a result, it has become more and more ceremonial. The gap has been filled by all kinds of party and government organs. In one case, eight party and government bureaus in charge of particular sectors, the Personnel Department of Party Committee, the Auditing Bureau, Supervision Bureau, Municipal Trade Union, and the office of SOAMC all have a role to play in exercising ownership rights in the second tier and third tier companies.

The three-tier model has its own logic. Without a separation of ownership function from other functions of the state on the first tier, the second tier institutions can hardly differ from any other SOEs in terms of their relationship with the government. Not surprisingly, failure of the reform on the first tier has led to failure of commercialization of the second tier. In some places, the second tier institutions are known as "funnel (*lou dou*)", " setter (*er chaun shou*)" of the government, or "quasi-government". Their behavior is widely questioned. Some of these institutions see themselves performing multiple functions including a warehouse of non-performing assets and a guardian of social stability. Some invested in obviously non-profitable projects and enterprises in response to request from the government departments; some created "directly owned subsidiaries" and provided preferential treatment to them at the expense of other subsidiaries; some collected 30% of after tax profits of subsidiaries and could not cover their administrative costs.

The fact that the second tier institutions have failed to become professional owners generated complaints from the third tier companies, which led to a return to the first strategy discussed earlier. Shenzhen government has implemented what is called "authorized operation" in some better-performing large groups, in which the government bypassed the second tier and signed performance contract directly with the management of each group. This is of course only feasible in wholly state owned companies, as was the contract responsibility system in the 1980s.

[4] Involving China Petro-chemical Indutrisal General Corporation (Sino-pec), China Aviation Industrial General Corporation, and China Non-ferro Matel Industrial General Corporation.

4. The Challenge of Exercising Ownership Rights in SOEs

The fact appears to be that China has spent more than two decades to reform the state assets management system and achieved only very limited success. None of the two strategies could turn SOEs into fully commercialized business entities that fits the notion of a modern market economy. Ownership rights are still exercised in a similar way as two decades ago in terms of institutional framework. The most significant change is probably the fact that some control rights have been transferred from the state to SOE management. Overall, the relationship between the state and SOEs is still such that it does not fit the requirement of a modern market economy. It is critical to ask the question of why this has been the case.

In retrospective, one important reason seems to be that the reform in the past two decades have almost exclusively concentrated on the relationship between the state and SOEs, and did very little in terms of the relationship between the original owner, the people as a whole, and the state. This is important because the existing status of the relationship between the people and the state represents a soft budget constraint to the state. Legally speaking, the Chinese people as a whole is the ultimate owner of SOEs, and the state is supposed to manage them on behalf of the people. In this sense, the people-state relationship is comparable with one between the owners of a fund and the fund manager. However, the state faces a much more soft constraint than a fund manager. Mostly notably, there is no contract specifying the obligation of the state in terms of financial return to the assets owned by the people, as is found in the case of commercial assets management.

This soft budget constraint has allowed the state to ignore the cost of state capital and pursue objectives other than maximization of the return on state capital. So long as the state is free to use its ownership function to achieve goals other than maximization of financial returns, two results follow naturally. First, SOEs are inevitably driven by the state to pursue multiple objectives as well, unless the state loses its control over certain SOEs. Second, it is probably the best arrangement for the ownership rights to be shared by various government and party agencies, which perform other functions of the state, because in this way, the ownership function is fully utilized to serve goals of other functions.

The implication is clear: until the ownership function of the state is separated from its other functions and fully commercialized, i.e., maximization of the financial return on state capital is taken as the primary objective of the state as owner, SOEs are not going to become fully commercialized business entities that meet the requirement of a modern market economy integrated with the world market. The fundamental challenge to the next stage of SOE reform is how to make this happen.

B. International Lessons

This section applies experiences from reasonably well-run SOEs in selected countries in Europe and Asia-Pacific to China's "three tier" model.

1. "First Tier" Shareholding

Institutional frameworks for well-run SOEs typically distinguish between the rights and responsibilities of the government to regulate economic activity and control the disposition of state capital and those of the SOE's directors and management toward the SOE itself.

- In Singapore, the Ministry of Finance – which is 100 percent owner – plays a minimal role in Temasek. The ministry appoints the chairman and members of Temasek's board. Every year, Temasek submits audited financial statements to the ministry for review. From time to time, the minister may ask for meetings with Temasek or its GLCs to discuss performance and plans. Otherwise, the ministry of finance gets involved only when an issue – e.g., acquisition, sale, or merger – affects Temasek's shareholding in a GLC.
- In New Zealand, the relationship between the SOE's board and the state is regulated by the SOE Act, while the relationship between the SOE's board and its management follows commercial practice. SOE directors are legally bound to act in the SOE's interest. They report to the two shareholding ministers, who are themselves accountable to parliament. The board appoints the CEO and senior

management of the SOE, determines strategy, takes decisions on large investments and dividend changes, ensures that the Statement of Corporate Intent complies with existing regulations, sets management compensation, and approves financial statements.

- In the case of Statoil, the Norwegian government acts both as regulator and owner. By law, the state owns all oil resources and the Minister of Energy ensures that exploration and production conform with official resource policies. Legally, however, the state has no power over Statoil other than the shareholder rights it exercises at annual general meetings. By law, the directors and chief executive officer (CEO) of Statoil have a fiduciary duty to the company and all shareholders and are individually liable for any damage caused to the company.
- In Sweden, governance of SOEs reflects the division of labor set out in the Swedish Companies Act, with the board responsible for providing oversight and guidance and the managing director in charge of day-to-day administration. Some matters, such as company closures and dividend policy, are considered part of normal administration and within the prerogatives of the government and – by extension – the SOE board. Other matters – such as changes in SOE ownership or capital – would be considered a disposition of state property and require consultation between the government and parliament.

Thus there is typically a clear distinction between the government's regulatory rights and shareholding rights and a concentration of shareholder rights and responsibilities. The organization of "first tier" state shareholding, however, may vary. In Singapore, for example, the Ministry of Finance is the 100 percent owner in Temasek and relies on Temasek to manage state shares in GLCs. In New Zealand, state shares are divided between the Ministry of Finance and a sector ministry. In South Korea, the treasury bureau of the Ministry of Finance and Economy holds the state's shares in all GIEs. But the authority to exercise the government's shareholder rights – in consultation with the MOFE – may be delegated to a supervisory ministry, e.g., commerce, industry, and energy; construction and tourism.

Institutions for managing state equity may be modest and efficient – especially if the state shareholder implements effective reporting and controls, emphasizes strong boards for its SOEs, and follows best commercial practices.

Sweden's 59 SOEs are estimated to represent about 7 percent of GDP and 5 percent of total employment. The 31 largest SOEs – including holdings in energy, telecoms, armaments, pulp and paper, pharmaceuticals, and transport – are administered by the Ministry of Industry, Employment, and Communications (MoI). State shares in these 31 SOEs are administered by the MoI's State-Owned Enterprises Division. This Division has a staff of 13, including 7 senior investment managers, 3 analysts, 2 assistants, and a director. Responsibility among senior investment managers is divided according to industry sectors in order to encourage focus and understanding of each holding. For example, the senior investment manager responsible for transport holdings maintains contacts with relevant bankers and consultants, tracks global competitors, and is MOI's main liaison with management of the transport SOEs, e.g., the airline SAS and the rail company SJ AB. Senior investment managers also represent the state shareholder as a non-executive director on SOE boards.

The state shareholder completely revamped the boards and management of Swedish SOEs during 1998-2001. More than 85 percent of incumbent non-executive directors, 75 percent of board chairmen, and almost half of SOE CEOs were replaced during the period. The objective was to improve SOE performance by empowering the Non-Executive Board. By Swedish law, the Non-Executive Board is only institution responsible and accountable for development of a corporation – either private or state-owned. To revitalize the Non-Executive Boards of its SOEs, the state shareholder took a number of steps to upgrade board appointments and procedural rules for the Non-Executive Boards of SOEs.

Singapore. Temasek is a "second" rather than a "first tier" shareholder. It is worth noting, however, that Temasek's portfolio management infrastructure – especially relative to the market value of its portfolio – is quite modest. The Temasek financial holding company holds shares in over 20 major GLCs, 12 of which are listed on the Singapore Exchange (SGX). Temasek GLCs represent about 20 percent of SGX market capitalization. Major Temasek companies account for about 12 percent of Singapore's GDP. It is

estimated that Temasek manages about $55 billion of market capitalization at an annual operating cost of less than $30 million – i.e., a 0.05% expense ratio. Temasek's Corporate Stewardship Division, which manages Temasek's GLC portfolio, has a staff of just 53. Temasek is able to get by with such a modest administrative infrastructure by focusing on GLC board appointments and ensuring that its GLCs have high-quality boards.

New Zealand's Crown Companies Monitoring Advisory Unit (CCMAU) supports the two shareholding ministries in overseeing each of New Zealand's 16 SOEs. Set up in 1993, the CCMAU is owned by and administratively linked to the Treasury – for example, the Secretary of the Treasury appoints the CCMAU's executive director. But the CCMAU is operationally independent and functions like a private consulting business. It has separate purchase agreements with each shareholding ministry to consult with the ministry of SOE issues. Many of the CCMAU's consultations are oriented toward balancing SOE profit maximization goals against broader social goals (see Box 1).

Box 1. Outsourcing SOE Oversight: New Zealand's Crown Companies Monitoring Advisory Unit (CCMAU)

The CCMAU prepares an annual outlook letter, which is then sent by the ministry to each SOE, detailing information required for business planning.

The CCMAU reviews SOE Statements of Corporate Intent (SCIs) and provides comments to the shareholding ministries. The CCMAU also monitors SOE performance.

To balance tensions between SOE profit maximization goals and state interests, the CCMAU advises shareholding ministries on SOE objectives; board performance and composition; definition of core businesses; capital structure and dividend policy; commercial assessment of business activity; performance measurement targets; actual performance relative to targets; and the impact of government policies on the SOE's value. More particularly, the CCMAU provides shareholding ministers with comments as to whether a board's proposed performance targets are consistent with relevant statutory requirements; the robustness of the board's proposed strategy and plans for achieving its proposed targets; whether the board's proposals on strategic issues (e.g., scope of business, balance sheet, dividend levels) serve the best interests of shareholders; whether the board is meeting its performance targets; and, if not, what action the shareholding ministries should take to hold the SOE board accountable.

The CCMAU also participates actively in the appointment process for SOE directors, including commentary on skills needed for each SOE board. The CCMAU monitors board vacancies and conducts searches and develops short-lists of board candidates, for final approval by the shareholding ministers.

Source: Butzbach.

Austria. OIAG currently has about 50 staff. This group manages a portfolio of ten companies, some with subsidiaries. As of end-August 2002, the seven listed companies had a market capitalization of $3.6 billion.

Careful development of strategic business plans, cash flow forecasts, and regular reporting are needed for the shareholder's representatives to exercise effective governance and to link management/employee performance and incentive compensation.

Great Britain. British Steel (BSC) regularly submitted to the government detailed plans, both for the upcoming year and the medium-term. These plans were generally on a corporate-wide basis, although the operating budgets also showed details for each of the operating divisions of the corporation. Plans took into account government objectives for the corporation as well as internal targets for performance improvements. Among other things, the plans included projections of BSC funding needs for the upcoming three years. Plans were subject of extended negotiations with government representatives,

during which the plans were modified as appropriate. Monthly results for the corporation and its businesses were reported to the BSC board in the monthly management accounts. Copies were supplied to the Department of Trade and Industry (DTI) and the Treasury, and the results were subsequently discussed at the joint monitoring review meeting. This included detailed reporting on cash expenditures.

South Korea. The 1983 GIE Basic Administration Act streamlined multi-layer controls by technocrats and gave GIE managers greater autonomy. While setting goals for GIEs and rigorously evaluating their performance, the government began to refrain from controlling the means through which these objectives were attained. In addition to streamlining procurement and audit procedures, the 1983 Basic Act entrusted GIEs with the authority to finalize their budget plans, subject only to common budget guidelines. Direct government representation on GIE boards facilitated this change. The Act established the GIE Management Evaluation Council (MEC), a ministerial-level council empowered to coordinate such matters as guidelines for managerial objectives, preparation of GIE budgets, and performance evaluations. Headed by the Prime Minister, the MEC had representatives from supervisory ministries and civilian experts. MEC oversaw enhancement of the GIE performance evaluation system (see Box 2).

Box 2. South Korea: Performance Monitoring of Government Invested Enterprises (GIEs)

The system monitors three categories of performance indicators:

- General indicators include quantitative measures of productivity and qualitative indicators of general management efficiency, such as efforts at responsible management.
- Criteria for carrying out enterprise purposes include a number of enterprise-specific technical measures of operating efficiency. Most of these were evaluated on a performance vs. target basis, with the target based on a multi-year trend analysis. These criteria also allowed for benchmarking against peers.
- Business administration criteria were mostly qualitative indicators such as responsiveness to changing business conditions, efficient operation of the board of directors, appropriateness of internal targets, customer satisfaction, and results from research and development.

It was not uncommon for a GIE to have 30-40 performance indicators. A satisfactory grade for a quantitative indicator was based on past performance, controlled for historical deviations. All indictors were weighted, such that a GIE could receive up to 100 points. The evaluation score for each GIE was linked to a special annual bonus paid to all staff. In 1996, annual special bonuses ranged from 395 percent of monthly salary at KEPCO to 295 percent of monthly salary at Korea Coal Corp. Publication of the *GIE Management Performance Evaluation Report* provided additional incentives. Compared with the special annual bonus, the loss of face resulting from bad publicity may have been a greater concern for top managers at GIEs.

Lim, 2002.

2. "Second tier" Shareholders

Ownership and governance of "second tier" shareholders – e.g., shareholding funds, parent companies of enterprise groups, asset management companies – may follow the pattern that exists between "first tier" shareholders and standalone SOEs. For example, Temasek is subject to standard company law, is expected to earn a reasonable return on its investments, and is governed by a commercially-oriented board of directors. State-owned conglomerates in Brazil, such as CVRD and Petrobras, have relied on normal shareholding meetings, director appointments, and board procedures to exercise governance over large numbers of subsidiaries. The following discussion looks at (i) state funds financial investors; (ii) enterprise group strategic investors; and (iii) asset management companies. The special issues that arise for second tier shareholders have to do with the disposition of state assets and the creation of state liabilities. E.g.:

a. When a state-owned shareholding fund receives dividends from SOEs or proceeds from the sale of SOE shares, should these be returned to the state treasury or reinvested by the fund?
b. What should be the rules for debt or equity investments by a state-owned shareholding fund or state-owned parent company of an enterprise group?
c. How should asset management companies formed to resolve NPLs manage converted equity in distressed SOEs?

Any proposal to allow a <u>state-owned shareholding fund</u> to hold and reinvest cash reserves in enterprises or to lend, borrow, or extend guarantees to provide debt financing for enterprises should be viewed with great caution. Temasek appears, so far, to have been a good steward of the state's cash reserves. Other problem cases, however – such as Austria's OIG and Italy's IRI – highlight potential dangers from allowing state-owned shareholding funds to provide equity and debt financing.

Singapore. Temasek is not in the lending business. GLCs are expected to obtain debt financing on commercial terms from the market. While Temasek's financial results are not made public, there is nothing to indicate that Temasek is not continuing to exercise its relatively passive stewardship of the state's ownership interests in GLCs in a responsible and commercially prudent manner. Recent reports indicate, however, that the Singapore government may shift Temasek's emphasis from passive financial management of GLCs to a more active role. An economic review committee set up to examine how Singapore could become more competitive in the future recommended in May 2002 that Temasek should help GLCs to internationalize their core businesses and grow GLCs into globally-competitive businesses that are anchored in Singapore. Temasek indicates that it will sell businesses that are "no longer relevant or that have no international growth potential." Temasek is also prepared to dilute its stake by issuing shares or through M&A in companies that "have the potential to grow beyond the domestic market" into regional or global markets. However, the government will continue to own "critical resources" such as water, power, and gas utilities and the air and sea ports. Temasek is open to seeing GLCs that have already expanded regionally – such as PSA Corporation and DBS Holdings – partner with other companies or shareholders to regionalize or commercialize where this makes strategic or commercial sense. Temasek indicates it may also invest in new businesses with regional or international potential, especially in new growth sectors entailing high risk, large investments, or long gestation periods where Singapore's private sector is unable or unwilling to assume risks. While it "will exercise its shareholder rights to influence the strategic direction of companies," Temasek will remain hands-off in day-to-day operations.[5]

Austria. The original missions of OIG and (later) OIAG were to detach SOEs from politics and promote flexibility; guarantee continuity in SOE strategy and supervision; impose hard budget constraints; and centralize treasury and other corporate services. Starting in the 1970s, Austria entered a period of economic decline marked by oil crises and increased competition in basic materials from emerging markets. In the mid-1980s, the government responded with management changes both at OIAG and at OIAG-owned companies. The largest companies held by OIAG were split into independent, market-oriented firms. Parliament agreed on OIAG's re-capitalization but forbid any future injection of state capital. The late 1980s then saw an economic upturn. OIAG companies responded with an aggressive policy of debt-financed acquisitions. Economic conditions soured in the early 1990s: steel and aluminum prices were at thirty-year lows and OIAG debt grew to about $1.4 billion in 1992 and $5 billion in 1994. Both to deal with the public debt concerns (exacerbated by OIAG) and to revitalize OIAG portfolio companies, a 1993 law transformed OIAG's mandate. OIAG was directed to reduce its majority shareholdings to a blocking minority and to use share sale proceeds for repayment of debt. Since then, OIAG has raised about $60 billion from share sales that reduced its holdings to blocking minority positions.[6] These proceeds have mostly been used to repay some subsidiary debt prior to sale and to reduce OIAG's debt from Euro 37 billion in 1995 to Euro 4 billion by end-2001. The OIAG Act of 2000 gives the state a mandatory claim to 80 percent of the profits arising from OIAG sales of company shares.

[5] *The Asian Wall Street Journal*, July 4, 2002.
[6] OIAG share sales also accounted for 45 percent of new publicly-traded equity issued during 1992-2000.

Upon repayment of subordinated state debt, the state would have a 100 percent claim on privatization proceeds.

Italy. As noted earlier, the IRI holding company was expected to support the development of Italy's poor southern region and rescue distressed companies. Until 1987, these activities were partly supported through government transfers and endowments. IRI also borrowed from the European Investment Bank and through bond issues. Implicit government guarantees facilitated borrowing at the IRI level, at the sub-holding level, and at the operating company level. IRI extensively used this mechanism, especially after 1984 when government transfers began a rapid decline. The guarantee became explicit when IRI was transformed into a joint stock company 100 percent owned by the Treasury.[7] This principle also held for sub-holding and operating company debt to the extent that there was an explicit guarantee from IRI.[8] As a result, while IRI's losses increased from $540 million in 1991 to $3.4 billion in 1992 and $8.3 billion in 1993, IRI's consolidated debt surged to $58.3 billion by 1992. The government having exhausted its borrowing capacity and the lira having collapsed, IRI's reform became a priority. From 1992-93, IRI's main goal was to repay its debt, the government having agreed with the European Union that IRI would sell assets to reduce its debt/equity from 13:1 to 0.9:1 by 1996. This goals was actually achieved in 1999. During 1992-2000, IRI conducted 160 major asset sales – including of two banks, auto maker SEAT, Rome airport, toll roads, 31 percent of Alitalia, and a majority of aerospace company Finmeccanica[9] – and raised Lira 65 trillion ($53 billion?). IRI was liquidated in 2000 and remaining shares – including in public television RAI, 30 percent of Finmeccanica, and 54 percent of Alitalia – were transferred to the Treasury. While thus a failure in terms of regional development or corporate restructuring or financial management, IRI succeeded in liquidating itself and – like OIAG in Austria – stimulating development of Italy's capital market. Former IRI companies account for 45 percent of Italy's current stock market capitalization.

Poland. Poland's fifteen national investment funds (NIFs) have not been particularly successful in increasing the value of the 512 SOEs assigned to NIFs for management (see Box 3). The portfolio of SOEs that these NIFs inherited were relatively distressed and in need of restructuring. Members of the public were NIF shareholders. Perhaps because of this dispersed ownership, the NIFs were not particularly effective in driving the operational restructuring of distressed corporations. Such operational restructuring typically involves painful measures – e.g., sales of non-core assets, discontinuation of unprofitable products/services, plant closures, and workforce reductions – that a public fund or widely-owned fund may find difficult to force through.

Box 3. Poland's National Investment Funds (NIFs)

The NIF scheme involved 512 large SOEs, including those that were deemed in urgent need or restructuring or sale or which had not already been privatized by other means. Each NIF became the lead shareholder in 33 SOEs by receiving 33 percent of shares in 33 of 512 companies assigned to the NIF scheme, while the remaining 27 percent was held by the other 14 NIFs, 25 percent was held by the state treasury, and 15 percent was held by enterprise employees. Management of each NIF was outsourced to professional asset managers based on the results of a public tender. NIFs were able to reorganize the supervisory boards of portfolio companies and took a number of steps to turnaround SOEs in their portfolio: e.g., business plans, additional capitalization, SOE management changes, investor search, and asset sales. Between 1994 – the first full year of NIFs – and 1999, the gross profitability of NIF SOEs declined significantly, especially in comparison with other types of companies:

	1994	1999	Change (points)

[7] Under Italy's Commercial Code, a sole shareholder is jointly and severally liable for the controlled company's obligations.

[8] In many cases, however, some sub-holdings had developed their own credit ratings and independent access to domestic and international credit markets. During periods of financial rationing, bank perceptions of credit risks are lower for operating companies – which are closer to underlying assets – than for holding or sub-holding companies.

[9] Out of strategic interests, the Treasury retained a 30 percent shareholding in Finmeccanica.

Sold to domestic investor	13%	6%	-7
Sold to foreign investor	7%	7%	0
Continuing state ownership	5%	-2%	-7
NIF	4%	-4.5%	-8.5

Source: PricewaterhouseCoopers

Market-based investments, mergers, and acquisitions are more likely than administrative mandates to result in the establishment of successful enterprise groups. Brazil provides useful contrasts. Sidebras, a state-owned steel enterprises group formed in 1973-75, is a good example of a failed administrative approach. At best irrelevant and at worst counterproductive to development of Brazil's steel industry, Sidebras was liquidated by the government in 1990. By contrast, two other Brazilian enterprise groups – CVRD and Petrobras – evolved into successful conglomerates by pursuing market-based diversification over one or two decades.

Brazil. In the late 1960s, a National Steel Plan proposed the formation of a steel sector holding company in order to centralize ownership, standardize management practices, rationalize capacity expansion, and allow firms to reduce costs by dividing markets to reduce transport costs and achieve greater economies of scale. While formally established in 1973, the Sidebras steel group did not receive significant capital and acquire control of all but one of the federal steel companies until 1975. Sidebras never achieved strong control of its subsidiaries, for several reasons:

- It played no part in development of 1972-74 expansion plans.
- It had its own capital, but was constrained in its ability to finance its subsidiaries.
- Sidebras' subs mostly organized their own funding from the Brazilian National Development Bank (BNDES) or international banks.
- Board appointments at subsidiaries were still controlled by the President of Brazil, the Minister of Industry and Commerce, regional elites, and BNDES.
- Economic conditions and external financing constraints hurt operations.
- Starting in 1979, investments, human resource policies, imports, and financing of large SOEs began to be controlled directly by a Special Secretariat for Control of SOEs (SEST), leading its subsidiaries to ignore Sidebras.

In 1990, after putting Sidebras' subsidiaries – including Companhia Siderurgica Nactional (CSN) – up for sale, the government put Sidebras in liquidation.

Although a good idea from an administrative point of view, Sidebras was never able to coordinate and plan the steel sector. In many instances, it only added another layer of bureaucracy, being unable to force its subsidiaries to adopt a unified strategy. Sidebras complicated management due to the duplication of functions. Sidebras created its own management structure, while the administrative and commercial departments of its subsidiaries continued to operate. In several cases, the same matter was dealt with both at the subsidiary and the parent company. The creation of Sidebras also reduced competition among the steel companies while strengthening lobbying, e.g, for financing. Lobbying was further encouraged because Sidebras management was often drafted from its subsidiaries, creating informal channels for lobbying. Before Sidebras, Brazil's steel SOEs generally competed and emulated best practices. With Sidebras' establishment and tighter price controls, rent seeking within the Sidebras group substituted for healthy competition.

By contrast, CVRD provides a successful example of how to "grow" a globally-competitive enterprise group. CVRD was established in 1942 from British-owned iron mines and a railroad that were nationalized by the British government and given to Brazil to run as an SOE. Creating an ocean-shipping subsidiary in the 1960s, CVRD began to integrate vertically into transport, marketing, and iron processing. During the 1970s, it diversified horizontally and by 1985 its 34 subsidiaries and joint ventures were

involved in engineering, geological research, forestry (re-forestation), cellulose, bauxite, aluminum, manganese, iron ore, and steel. In the early 1980s, CVRD bought out US Steel's interest in the Carajas mining complex and connected it by rail to Porto Madeira. In the early 1990s, CVRD bought large shareholdings in Brazilian steel SOEs undergoing privatization – Usiminas, CSN, CST, and Acominas. By 1997, the CVRD system consisted of 65 controlled or associated companies operating in (i) iron, gold, manganese, bauxite, potash, and kaolin mining; (ii) transportation systems consisting of two railways, ports, and 61 ships; (iii) production of iron ore pellets, aluminum, pulp, and paper; (iv) forestry; and (v) significant shareholdings in steel and alloy mills in Brazil, Argentina, France, and the US. In 1995, CVRD's assets and equity had book values of, respectively, $13.9 billion and $10.9 billion. Financing was a mix of state capital contributions; loans from BNDES and international financial institutions, operating cash flows, and trade finance. The government invested $594 million in CVRD and received $714 million in dividends before privatization, and received $5.3 billion in proceeds from two share sales in 1997 and 2002.

Petrobras, established in 1953, was the other Brazilian SOE most active in diversifying and vertically integrating its activities through the creation of subsidiaries over a 9-year period. It created a petrochemical holding company in 1967, an oil derivatives distributor in 1971, an overseas exploration subsidiary in 1972, and a fertilizer holding company in 1976. With an end to its monopoly position in 1997 and increasing de-regulation, Petrobras reorganized itself in 1999-2000. Changes included (i) the creation of functional business segments to improve information and decision-making; (ii) incorporation of rate of return hurdles (similar to EVA) for these business segments; (iii) increased emphasis on integrated energy production that allows the company to participate in all parts of the energy value chain; and (iv) greater management emphasis on flexibility, transparency, results, and accountability. More specifically, Petrobras has created four business segments – upstream, downstream, international, and gas/power – and 40 business units; reduced the number of corporate units to 20; eliminated one level of management; and decentralized half of its head-office activities.

There are many examples of public asset management companies (AMCs) created to resolve non-performing loans (NPLs) and otherwise manage distressed assets, e.g., real estate.

Under special circumstances, such AMCs may be able to play a useful role in financial stabilization and the resolution of some assets, but AMCs are ill-suited for operational corporate restructuring. Recent experience from the East Asia financial crisis (Mako, 2001) and earlier experience (Klingebiel) indicate that the AMC is more likely to succeed if assets taken over are small relative to GDP; if domestic financial markets are broad and deep; and if the asset taken over are relatively homogenous (e.g., mortgages, real estate, cash, and marketable securities). In addition, an AMC is more likely to be successful if tasked with relatively simple tasks, such as bundling and auctioning un-restructured NPLs. Cases of public AMCs having to manage significant volumes of converted corporate equity are few and far between.[10] There is no reason to expect a public AMC to be able to drive the operational restructuring of distressed corporations. Such operational restructuring typically involves painful measures – e.g., sales of non-core assets, discontinuation of unprofitable products/services, plant closures, and workforce reductions – that a public AMC is ill-placed to force through.

Thus, a public AMC should seek to sell assets – e.g., unrestructured NPLs, restructured debt, collateral, converted corporate equity – as soon as possible. If a public AMC acquires significant holdings of corporate equity – e.g., through debt/equity conversions – it should seek to sell these shares as quickly as possible and, in the meanwhile, should insist on exercising its full rights as a shareholder and creditor. AMCs that have moved forward promptly on asset disposals – e.g., the U.S. Resolution Trust Corporation, Sweden's Securum, Korea's KAMCO, Malaysia's Danaharta – are considered to have been most successful.

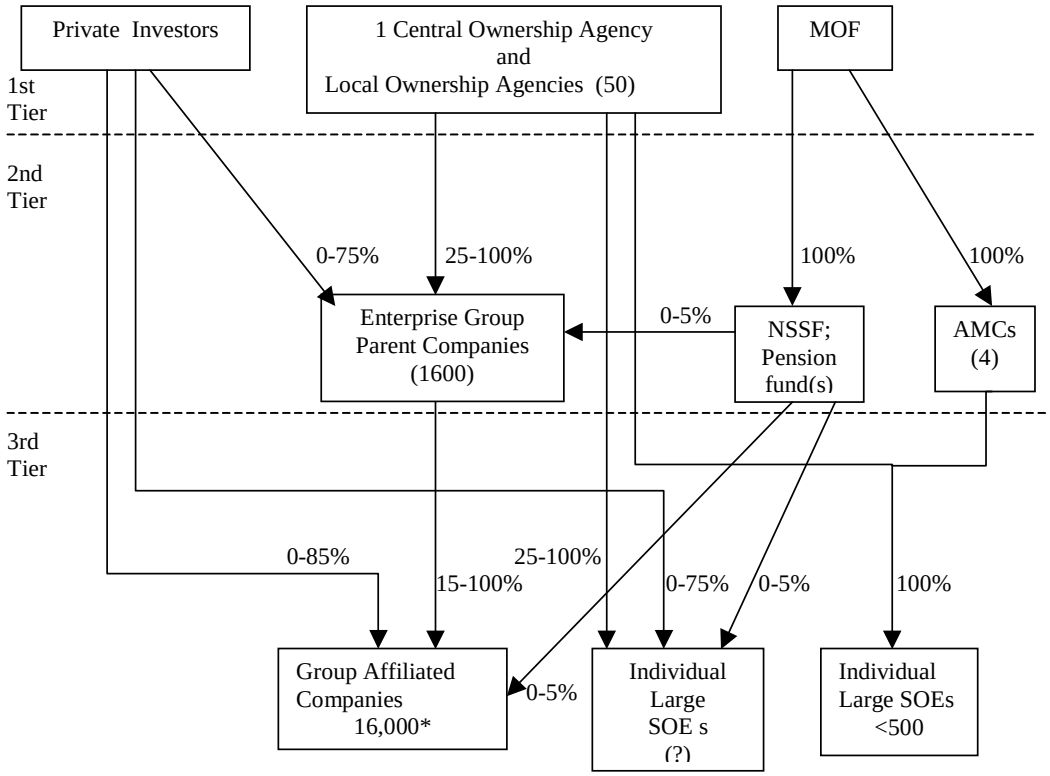
[10] In Malaysia, Danaharta's assets were mostly loans, securities, and real estate. In Indonesia, IBRA's equity management arm has held corporate shares as collateral and sold some shareholdings, but has been unable to exert effective corporate control over these companies. In Korea, KAMCO has minority shareholdings in several Daewoo companies. Another unusual case that may warrant study is that of Germany's Treuhandanstalt.

C. Implications

As small and medium SOEs are "let go," the configuration of China's state asset management system could be streamlined. Box 4 provides a hypothetical example of a more streamlined configuration, which could have the following characteristics:

- The "first tier" of a streamlined configuration would be State Ownership Agencies at the central level of government and at provincial and major sub-provincial levels. Fifty such agencies might suffice. The Ministry of Finance would be the state shareholder in some "second tier" shareholders – the four asset management companies (AMCs) established to resolve NPLs and the National Social Security Fund (NSSF).
- In the "second tier" of a streamlined configuration, there would be no need for new asset management companies below the Ownership Agency. Indeed, with the "letting go" of small/medium SOEs, it might be possible to disestablish some existing second-tier asset managers. Most of the necessary second-tier asset management function could be performed by transforming the parent companies of enterprise groups. To begin to function effectively, these enterprise group parent companies would need to transform their approach to financial management of affiliated companies, internal controls, accounting systems, and human resources skills mix. Transformed parent companies of enterprise groups would be the main second tier agent for governing "third tier" affiliated SOEs. The NSSF and other institutional investors could play a supplemental governance role by appointing directors to the boards of SOEs – enterprise group parent companies, group-affiliated companies, and large unaffiliated companies. Board appointments would presumably be proportional to shareholdings. For risk management purposes, shareholdings by the NSSF or any pension fund should be limited both in terms of each investors capital and shareholdings in any single SOE. By pooling their votes, however, these investors might be able to place one or more directors on the boards of SOEs in which they hold shares.

Box 4. Hypothetical Configuration for State Assets Management System After "Let Go" of Small and Medium SOEs



Assumed shareholdings are shown in percentages. In the case of an enterprise group parent company, for example, it is assumed that an Ownership Agency could hold anywhere from 25-100% of the shares; that private investors could hold up to 75 percent; and that the National Social Security Fund could hold up to 5 percent.

On numbers of SOEs, at end-2000, the state was majority shareholder in the parent companies of approximately 1600 enterprise groups. Enterprise groups having then an average of ten affiliates, these state-majority enterprise groups had perhaps 16,000 affiliated companies. There being just 9,000 large enterprises, some of these 16,000 enterprise group affiliates must be small/medium SOEs. Some large SOEs operate as standalone companies – i.e., not affiliated with an enterprise group.

This scheme would more narrowly focus the attention of China's state asset managers on 1600 or so enterprise group parent companies plus some modest number of unaffiliated SOEs – perhaps for a total of 2000 or so SOEs. This might mean a requirement for managing 4000 board members.[11]

1. "First Tier" Ownership Agency

Global experience illustrates the importance of insulating SOEs from misdirected bureaucratic and political influence so the SOEs can concentrate on maximizing shareholder value. A clear distinction

[11] Based on the following assumptions: 2000 SOEs; average board size of 7; and average of 3-4 board appointments per qualified director.

between state ownership rights and other economic rights (e.g., regulation) is needed. Creation of a single government agency that specializes in exercising state ownership rights would help separate the ownership function of the state from its other functions. In particular, designation of such a specialized Ownership Agency with the authority and the responsibility for exercising state ownership rights is needed to address the current fragmentation of authority and diffusion of responsibility for SOEs.[12] Thus, efficient use of State capital could not be readily pursued without putting the ownership function into a separate Ownership Agency. Furthermore, exercising ownership with the single objective of capital efficiency requires vastly different expertise from other government functions. Thus, a new emphasis on the efficient use of capital would require a professional approach to the state ownership function. The state would have to exercise its ownership function in a way similar to professional investment agencies in the private sector. This provides further impetus for a separate and specialized Ownership Agency.

Establishment of an Ownership Agency will require decisions on the following issues: (1) legal form; (2) scope of portfolio; (3) mandate; (4) appropriate exercise of ownership rights; (5) authority; and (6) financial management.

1) *The Ownership Agency should be commercially-focused and professional.* It may be easier to cultivate these qualities if the Ownership Agency is organized as a "public service unit" (PSU), which reports to the State Council and whose work is reported to the annual National People's Congress for its evaluation. The Ownership Agency should be staffed with full-time professionals whose compensation is market-based. Full-time staff are needed to ensure that the Ownership Agency is "real," rather than "virtual" as in some localities. Ownership Agency staff 's compensation should be market-based in order to attract staff with the necessary skill sets. Ownership Agency staff should have the business training and/or experience to be able to make integrative assessments of an SOE's marketing, production, financing, and other business plans and results. Such general management skills are more readily available in the non-state sector. To obtain a sufficient supply of necessary general business management skills, the Ownership Agency should have the ability and the readiness to match non-state salaries.

2) *The Ownership Agency's portfolio should include only for-profit, non-financial SOEs.* Establishing effective state ownership over China's large number of for-profit non-financial SOEs would be a huge challenge. Assigning non-profit organizations, state assets in government departments, and "public service units" to an Ownership Agency would distract the Ownership Agency from establishing effective governance over non-financial SOEs. While some 1st tier shareholders elsewhere oversee other types of organizations,[13] this seems inappropriate for China's circumstances. As for financial SOEs, it would be a mistake to assign these to an Ownership Agency for non-financial SOEs. Assigning non-financial SOEs and financial SOEs to the same Ownership Agency would create or increase conflicts of interest – e.g., pressures for directed lending, avoidance of enterprise restructuring.[14] It may be useful to develop some criteria for deciding whether to assign SOEs to a Local Ownership Agency (LOA) instead of the Central Ownership Agency (COA). SOEs that are very large, strategic, or involved in nationwide infrastructure networks would presumably be assigned to the COA, while most large SOEs and all small/medium SOEs would presumably be assigned to a LOA.

3) *The Ownership Agency's mandate should include both management of state shares and, as appropriate, sale of state shares (equity).* In performing its share management function, the Ownership Agency would ultimately be responsible for the value of State shares in SOEs. In

[12] As noted in Section I, a variety of official entities (e.g., Ministry of Finance, State Development and Planning Commission, CCP Central Committee Enterprise Working Committee) perform multiple functions of social and political as well as an economic nature.

[13] In New Zealand, for example, the Crown Corporations Monitoring Unit oversees 18 non-SOE entities, including research institutes, airports, mass media, text book publication, and property valuation.

[14] State-owned commercial banks and other financial institutions should be corporatized and assigned to a different shareholder.

organizing sales of state shares (equity), the Ownership Agency's goals would include maximization of sale proceeds. There is no inconsistency between the share management and share sale functions. Indeed, since maximizing the value of state shares would help maximize the proceeds from any share sale, it makes sense to link these two functions.[15] Assuming that small/medium SOEs are assigned to LOAs and that the 4th Plenum Decision to "let go" is fully and expeditiously implemented, the LOAs would assume major responsibility for the sale of small/medium SOEs.

4) *State shareholder interests should be exercised through normal means, i.e., annual shareholder meetings and SOE board appointments.* "Shareholder interests" include seeing that the company's business plan, capital investment, financing, financial performance, risk management, key management appointments, staffing, compensation, and other business practices combine to produce positive EVA and a sufficiently robust balance sheet. To give company management sufficient space to operate, the shareholder's right to pursue these shareholder interests is normally exercised through annual shareholder meetings and board appointments. This should also be the pattern for China's SOEs. The Government's other non-shareholder interests (e.g., SOE fulfillment of contractual obligations or SOE compliance with health, safety, labor, competition, or environmental regulations) should be pursued through the appropriate commercial or administrative law channels. The "normal" exercise of shareholder rights will require the Ownership Agency to focus on making good appointments to SOE boards and on monitoring development/implementation of SOE business plans. A corporate form may be inappropriate for small/medium SOEs, but these should be "let go" in any case.

5) *The Ownership Agency should have broad authority to perform its share management and share sale functions and should have sole authority to vote the State's shares at SOE annual shareholder meetings and to make SOE director appointments (proportional to the State's shareholding).* This would be consistent with a non-political, commercial, and professional approach to the efficient use of state capital. The Ownership Agency director would be responsible for liaising with the government and maintaining political support for the Ownership Agency's share management/sale mandate. The government would presumably provide financial performance targets and other guidelines (e.g., on appointments, conflicts, risk management) for the Ownership Agency. As long as it conforms with these guidelines, the Ownership Agency should have substantial autonomy to carry out its share management/sale mandate in pursuit of agreed financial targets.[16] Consolidation of shareholder rights and responsibilities in an Ownership Agency is a major change. The Ownership Agency must have sufficient authority to perform its mandate in order to be effective.

6) *While seeking to maximize the efficient use of state capital, the Ownership Agency should implement financial management procedures that provide transparency and minimize risk.* The Ownership Agency's financial goals would presumably include both dividend payments from 2nd tier shareholders and 3rd tier SOEs as well as increases in the value of SOE equity. The Premier (or local equivalent) and the Ownership Agency would need to agree on "dividend policy" to guide SOE board decisions on whether SOE profits should be reinvested or paid as dividends to the 1st or 2nd tier shareholder. Measurement of SOE equity value should be as objective as possible – e.g., market value for listed companies, book value, EVA, or a valuation based on a multiple of dividend yield or cash flow. The Ownership Agency should have the authority to make additional equity investments in portfolio companies, but it should be prohibited from providing, guaranteeing, or directing debt financing for 2nd tier shareholders or 3rd tier SOEs. International experience (e.g., Italy's IRI and Austria's OIAG) show how dangerous it can be for a state shareholding fund or state shareholder to provide or facilitate SOE debt financing. Lastly, the Ownership Agency should not invest in or operate any other businesses. The Ownership Agency's sole mandate should be to manage or sell shares in SOEs assigned to it. In thinking about financial flows from the 2nd and 3rd tier to the Ownership Agency,

[15] Share management and share sale functions are linked in other countries, e.g., Austria's OIAG, Singapore's Temasek, Sweden, and Norway.

[16] In the case of particularly large share sales, the government may wish to retain authority to review and approve.

linkages between the Ownership Agency to the Ministry of Finance (or bureau), and financial reporting for all three tiers, it would be useful to study New Zealand and other well-regarded cases.

The Ownership Agency would focus on monitoring the performance of its SOEs and SOE boards and on board appointments and the development of SOE boards. South Korea approach to SOE performance monitoring may warrant consideration and adaptation to Chinese circumstances.

The SOE governance framework outlined in this policy note will require a substantially higher degree of transparency in order to work – especially given the emphasis on more efficient use of state capital. Under the existing system, financial statements of non-listed SOEs are treated as secret and available to only a few government departments. The mind-set behind this regime need to be changed. While listed companies are ones that are owned by a large number of public shareholders, SOEs are owned by all Chinese citizens. The Chinese citizens should be treated by SOEs in the same way as listed companies treat their public shareholders in terms of information disclosure and transparency. This is the case in many countries such as Sweden where SOEs are relatively well-managed.

All large SOEs should be required to adopt the accounting and disclosure standards applied to listed companies in a specified period of time, say three years. Annual reports of large SOEs should be made available in the public domain. All "second tier" shareholders (e.g., AMCs and the NSSF) should also make their consolidated financial statement available to the public. The Ownership Agency or the NPC may wish to mobilize outside professionals such as investment bankers and accountants to publicly evaluate the performance of certain SOEs and second tier shareholders in terms of efficiency of their use of capital. Higher degree of transparency achieved through means such as this would greatly help the Ownership Agency in its monitoring the performance of SOEs.

Approaches used by the Swedish government and Singapore's Temasek to monitor SOE board performance and fill board vacancies likewise warrant consideration.

Lastly, the Ownership Agency should remain a lean organization – minimizing its staff size in order to avoid becoming another large bureaucracy. Focusing on working through SOE boards and on monitoring and high-quality board appointments should help. In addition, the *Ownership Agency* could emphasize a commercial approach to its operations and out-source SOE monitoring/advisory functions as much as possible. The Crown Corporations Monitoring Unit that assists New Zealand's Treasury provides one such model for consideration.

2. Second Tier Shareholders

Assuming implementation of the 4th Plenum decision to "let go" small and medium SOEs, it should be possible to organize second tier shareholding by empowering the parent companies of enterprise groups; the National Social Security Fund, pension funds, insurance companies, and any similar "fiduciary institution investors"; and the four asset management companies (AMCs). Comments on each of these groups follow.

The management and board of <u>enterprise group parent companies</u> will face continual decisions on whether to merge or acquire new businesses; on whether to support capital investments by affiliated companies; on whether to divest businesses and dispose of non-core assets. These transactions may generate cash reserves or absorb cash reserves or require debt and/or equity financing. Investment and financing proposals by parent company management and board decisions should focus on projections of economic value added (EVA). Merger and acquisition (M&A) transactions should be commercially motivated, not administratively mandated. If parent company cash reserves cannot be invested in a manner likely to generate positive EVA, capital should be returned to shareholders through cash dividends.

<u>Institutional investors</u> could include the National Social Security Fund (NSSF), other pension funds, insurance companies, and investment funds. While corporate governance and restructuring can be an intermediate goal, the ultimate goal of institutional investors should be to meet future obligations to their

beneficiaries or investors. At present, it appears that equity holdings by institutional investors are modest and that institutional investors play no significant role in SOE governance. By providing a different perspective, directors appointed by such institutional investors could provide useful diversity on SOE boards. But prudent diversification by institutional investors – for example, limiting investment in a company's equity to 2 percent of institutional assets – may limit opportunities for institutional investors to claim director seats on SOE boards. Thus, it may be useful for China's nascent institutional investors to vote together in order to gain greater representation on SOE boards.

Especially in cases where the asset management company (AMC) has become a majority shareholder in the SOE as a result of a debt/equity conversion, the AMC may be called upon to function as an active "strategic investor" in turning around a distressed SOE, searching for strategic or financial buyers, monitoring the SOE's performance, and appointing SOE directors. Unfortunately, there are no examples of state AMCs successfully taking over, turning around, and successfully governing large numbers of distressed companies. In cases where an AMC(s) holds only a minority shareholding in an SOE, it could not be expected to function as more than a passive "financial investor." Global experience shows, however, that public AMCs are not well-suited either for managing corporate equity or for turning around distressed enterprises. Thus, China's AMCs should seek to sell their assets – corporate equity as well as unrestructured NPLs – as soon as possible to investors better-positioned to create value. But in the interim, while the AMC still holds corporate equity, its rights as a shareholder in exercising corporate governance over the SOE should be commensurate with its shareholding.

II. Management of State Equity

Over the past two decades, China has steadily moved to implement a modern enterprise system. The goal has been to improve the competitiveness of China's enterprises. Somewhat analogously, the preservation and enhancement of State capital will require implementation of a modern capital management system through (a) more widespread accounting and auditing reforms; (b) a segmented approach to the management of SOE portfolios; (c) a systematic approach to SOE dividend policy and capital re-investment; (d) agreement between central and local governments on sharing of SOE gains and losses; and (e) enhanced risk management, including hard budget constraints on SOEs. For each of these topics, this section compares what is known about current practice in China with international best practices. Discussion of these reforms follows a brief overview of China's portfolio of SOEs

A. China's SOE Portfolio

Between 1997 and end-2001, the number of SOEs decreased by 88,000 – from 262,000 to 174,000 (Table 1). This decrease has largely been driven by administrative actions: privatizations, "capital structure optimization program" bankruptcies, and mergers or acquisitions (M&A). Local governments have continued to administer about 90% of China's SOEs. During this period, SOE assets have grown significantly – especially among centrally-administered SOEs. The average asset size of centrally-administered SOEs has more than doubled since 1997. Almost all of the overall growth in SOE assets is due to increases in fixed assets and current assets (e.g., receivables, inventory). Some significant part of these increases may be due to SOE M&A transactions.

Table 1. SOEs and SOE Assets, 1997 and 2001
Amounts in RMB millions

	SOEs			Assets			Average Assets	
	Central	Local	Total	Central	Local	Total	Central	Local
1997			262,000					

	26,000	236,000		4,862,440	7,635,080	12,497,520	187	32
2001	17,000	157,000	174,000	7,321,100	9,349,860	16,670,960	431	60

Source: *Financial Yearbook of China 2002*.

The distinction here between centrally and locally-administered SOEs has somewhat been overtaken by events. It has recently been announced that the central SASAC would oversee the governance of 196 SOEs with combined assets shown at RMB 2.5 trillion.[17] Most of these SOEs are quite large and have a substantial number of subsidiaries or affiliated enterprises. Other SOEs would presumably be governed by local SASACs. Despite this recent change, the distinctions made here in terms of enterprise size, performance and financial strength – as well as the implications for portfolio management – remain valid.

Data on SOE financial performance and position present significant methodological issues (see Section II.C). However, it appears that SOE profitability has increased since 1998-1999. Net profitability has roughly doubled to 3.7% and the proportion of loss-making SOEs has been reduced from about two-thirds to about half (Table 2). Economic growth, debt/equity conversions by AMCs, and other decreases in interest expense have presumably contributed to improved profitability. But SOE privatizations, mergers, and bankruptcies may have been more important. Notably, the 84,000 decrease in loss-making SOEs since 1997 almost equals the 88,000 decrease in total SOEs. However, 51% of SOEs were still loss-making in 2001. For 2001, China's SOEs showed RMB 281 billion in overall profit, with profitable SOEs contributing RMB 480 billion and loss-making SOEs destroying RMB 199 billion in value. In addition, a high and increasing level of current assets-to-sales indicates an SOE liquidity problem. Current assets have increased to 313-325 days of sales since 1997. Unless SOEs are maintaining large cash balances, which seems unlikely, this suggests that increasing amounts of working capital are tied up in possibly un-collectible receivables and un-saleable inventory.

Table 2. SOE Profitability and Liquidity, 1997-2001

Amounts in RMB millions

	1997	**1998**	**1999**	**2000**	**2001**
Sales revenue	6,813,200	6,468,510	6,913,660	7,508,190	7,635,550
SOE profits	n.a.	328,020	329,070	467,980	480,470
SOE losses	n.a.	-306,650	-214,490	-184,600	-199,360
Net profit	79,120	21,370	114,580	283,380	281,120
Net profitability	1.20%	0.30%	1.70%	3.70%	3.70%
Percentage loss-making	65.90%	68.70%	53.50%	50.70%	51.20%
Profitable SOEs	89,000	74,000	101,000	94,000	85,000
Loss-making SOEs	173,000	164,000	116,000	97,000	89,000
Total SOEs	262,000	238,000	217,000	191,000	174,000
Current assets	5,369,850	5,575,110	5,935,170	6,682,560	6,678,560
Current asset-days 1/	288	315	313	325	319

Source: *Financial Yearbook of China 2002*.

[17] http://www.people.com.cn/GB/jinji/31/179/20030522/998247.html

1/ Represented as days of sales.

SOE profitability varies by locality. In 2001, over 60% of SOEs in Beijing and Shanghai were profitable. By contrast, over 60% of SOEs were unprofitable in the northeast provinces of Liaoning and Jilin; the central provinces of Anhui, Henan, and Hubei; the southwestern provinces of Guangxi, Hainan, Chongqing, Sichuan, and Yunnan; and the northwestern province of Gansu.

The most-distressed SOE sectors are building materials, chemicals, forestry, food processing, textiles, machinery, urban utilities, construction, transportation/storage, and commerce. In 2001, these sectors showed province-wide losses in more than half of China's provinces. Returns on equity were worse than *negative* 20 percent in about 1/3 of China's provinces in the case of textiles and commerce. In many cases, it appears that SOEs have been de-capitalized as a result of ongoing losses and – presumably sustained by outside bank, vendor, or government financing – are just hemorrhaging cash.[18] Even in the case of less distressed sectors, sector-wide averages may mask deep distress among individual SOEs.

Sector data show that overall liabilities/equity for China's SOEs was about 1.6:1 at end-2001 (i.e., a liabilities/assets ratio of 0.61) Aggregate data for 1997-2001 show that China's locally-administered SOEs have remained more highly indebted, with liabilities/equity of about 220% (0.69 liabilities/assets) versus 125% (0.56 liabilities/assets) for centrally-administered SOEs. A number of sectors, however, are highly leveraged with liabilities/equity in excess of 2:1.[19] These include building materials, chemicals, wood processing, food processing, textiles, machinery, defense, and other industrial production, as well as construction, commerce, real estate, and the small health/welfare sector. These activities accounted for 50% of the end-2001 liabilities of China's SOEs. High leverage probably means an inability to meet obligations to lenders, vendors, etc.

As noted earlier, a rising ratio of current assets/sales revenue suggests increasing liquidity problems for SOEs. Indeed, there has been an attempt to identify "unhealthy" assets (e.g., outmoded fixed assets, un-collectible receivables, un-saleable inventory):

- Unhealthy assets are minimal (i.e., less than 10% of total assets) in a few locales: Beijing, Shanghai, Zhejiang, and Fujian.
- However, unhealthy assets represent more than 20% of assets in ten provinces: Liaoning, Jilin, Heilongjiang, Jiangxi, Hubei, Hunan, Guangdong, Chongqing, Shaanxi, and Xingjiang.
- With no adjustment for unhealthy assets, only seven provinces show liabilities/equity worse than 200% (i.e., liabilities/assets worse than 0.67): Jilin, Heilongjiang, Jiangxi, Henan, Hubei, Shaanxi, and Xinjiang.
- With adjustment, all but four provinces (Beijing, Shanghai, Zhejiang, Tibet) show liabilities/equity worse than 300% (i.e., liabilities/assets worse than 0.75).
- Moreover, with adjustment, the SOE sector in five provinces (Jilin, Heilongjiang, Jiangxi, Hubei, and Shaanxi) would be insolvent (i.e., negative equity). In these provinces, liabilities exceed adjusted assets by RMB 90 billion.
- Adjusting for unhealthy assets reduces equity in locally-administered SOEs by more than half, from RMB 2.9 trillion to RMB 1.4 trillion. Overall liabilities/equity go from 252% to 632% (i.e., to 0.86 liabilities/assets).

As serious as these figures are, it is not clear whether there has been adequate accounting for SOE liabilities. For example, if SOE accruals for interest expense and worker pensions have been inadequate, full accounting for these liabilities would further raise liabilities/equity ratios.

[18] Enterprise de-capitalization presumably explains some very high negative ROEs for specific sector-provincial pairs: e.g., -638% for chemicals in Hainan; -708% for power in Ningxia; and –2089% for commerce in Xinjiang.
[19] Liabilities/equity of 2:1 was considered a risk threshold in South Korea, where the financial supervisor required over-indebted *chaebols* to reduce liabilities/equity to 2:1 within a 2-year period. It would be preferable to use other indicators of financial resiliency, such as interest coverage ratios. But the data available on China's SOEs do not support such calculations.

The foregoing problems notwithstanding, a small top tier of Chinese enterprises has shown strong financial performance as well as reasonable disclosure and governance. For example, Chinese companies with shares listed in Hong Kong generally showed a strong 2001 performance in terms of returns on equity. These companies show adjustments to their Chinese-statutory accounting for international and U.S. accounting standards; retain Big 4 auditors who follow Hong Kong auditing standards; limit and disclose related party transactions in conformity with Hong Kong regulations; retain international investment banks to value major acquisitions; and – while still majority state-owned – include one or more director-representatives from strategic/financial investors on their boards.[20]

The split nature of China's SOE portfolio – some reasonably profitable large SOEs and many distressed SOEs of all sizes, but mostly small or medium – has important implications for implementation of the state asset management reforms mandated by the 16th CPC Congress and the 10th National People's Congress:

- Additional reforms are needed to facilitate not just more efficient use of State capital, but its actual preservation.
- Up to 150,000 small and medium SOEs should be "let go" within the next five years – a huge task that will require efficient approaches to ownership transformation and restructuring or liquidation.
- Resolution of large numbers of distressed SOEs will require market-based allocations of losses plus more capacity to do operational and financial restructuring.
- While central SASAC may be able to focus on SOE governance, local SASACs will need to focus more on SOE ownership transformation and restructuring.

China's SOEs pose two issues for the management of State capital. First, what should be done with the cash generated through dividends or sales proceeds from relatively good SOEs? The second is less pleasant – i.e., how to contain and share operating losses, losses on sale, and restructuring losses from China's many bad SOEs?

Historically, China's SOE sector has overwhelmingly emphasized jobs preservation over the efficient use of capital. This is clear from such indicators as the maintenance of 89,000 loss-makers in the SOE portfolio, the progressive de-capitalization of at least ten sectors, and the insolvency of five provincial SOE portfolios. From the earlier description of locally-administered SOEs, there appears to be a significant "localization of benefits" (e.g., preservation of jobs, "leaking out" personal gains) leading to a "nationalization of liabilities." These national liabilities are almost certain to include *additional* requirements for the eventual re-capitalization of state banks, to cover losses from non-performing loans (NPLs) to SOEs, and for the National Social Security Fund (NSSF) to cover local social insurance shortfalls for workers.

Thus, the most urgent task is preservation of State capital. The prompt sale of small/medium SOEs is likely to be the most obvious way of mitigating the risk of "localization of benefits – nationalization of liabilities." Also urgent is the restructuring or liquidation of distressed or non-viable SOEs. The process of selling or restructuring SOEs, however, will precipitate the recognition of losses from excess claims and require some resolution.

Dividends and sales proceeds from good SOEs will provide some financial resources to cover claims. In at least some provinces, however, local financial resources will probably not suffice to cover claims.[21] Thus, it will be important for the central and local authorities to work out arrangements for sharing of gains and losses as well as appropriate financial management systems. The central SASAC should be in a

[20] For example, see China Petroleum and Chemical Corporation (Sinopec), *Annual Report and Accounts 2001*, pp. 55-57; China Mobile and Rothschild, "Major Transaction and Connected Transactions," 27 May 2002; and Huaneng Power International and JPMorgan, "Connected Transaction," 22 November 2002. In 2001, Sinopec's board included directors from Exxon Mobil and Cinda AMC.

[21] This applies both to privatization and liquidation. Most often, claims on an enterprise are paid out of sale proceeds or enterprise assets. Excess pools of financial resources – e.g, to satisfy financial institution creditors and social insurance obligations – are unlikely to be available at the municipal or provincial level in most cases.

leading position to work with the local SASACs and liaise with other national authorities (e.g., the state banks, NSSF, and Ministry of Finance) to facilitate SOE ownership transformation and restructuring and to make arrangements for the sharing of gains and losses.

To make sound decisions on dividend policy, enterprise valuations, and enterprise restructuring, SASAC staff will need better accounting data. As suggested earlier, there is no cause for confidence that current data on the financial performance and position of China's SOE portfolio is materially correct. Finally, to address the "localization of benefits – nationalization of liabilities" issue, the authorities (especially central SASAC) will need to give serious attention to risk management.

Small and medium enterprises (SMEs) do not belong in China's SOE portfolio. The data suggest that small/medium SOEs diminish rather than enhance State capital. Small/medium SOEs tend to be perpetual loss-makers. In addition, because their finances are especially non-transparent, small/medium SOEs pose high risks of additional liabilities. While individually insignificant, the large numbers of SMEs represent a collectively large claim on the attention of officials and a distraction from the potentially more rewarding enhancement of large SOE governance.

While full and rapid implementation of the 1999 4th Plenum Decision to "let go" small SOEs and "grasp" large SOEs makes more sense than ever, this would precipitate a huge number of transactions. Leaving aside small/medium SOEs that may be affiliated with enterprise groups, as many as 150,000 small/medium SOEs should be "let go." Profitability and solvency data suggest that perhaps half of these could be sold as viable businesses while asset sales would be more appropriate for the other half.

B. Maximizing Returns on State Capital

The best SOEs in the world focus on financial performance, especially on returns on capital.

Sweden. The SOE shareholder – typically the Ministry of Industry – expects each SOE to do more than earn a profit based on standard financial accounting. Each SOE is expected to provide "economic value-added" (EVA), by earning more than its cost of debt and equity capital (see Box 5). In Sweden, the emphasis on EVA has been endorsed by the labor union representatives of SOE workers on the assumption that there is only room for efficient companies – either private or state-owned – in a globally competitive market. The state shareholder has encouraged SOE boards to introduce value-based systems, such as EVA, to communicate the importance and effects of an efficient capital structure and to link employee and management compensation to EVA results. According to one estimate, the value of Swedish SOEs grew by more than 12 percent during 1998-2001, while the Stockholm Exchange's overall market capitalization showed just 6 percent growth (Detter, 2002)

Box 5. Economic Value-Added (EVA)

Academic research shows that accounting measures (e.g., earnings per share) are only coincidentally related to stock prices. More significant is the cash, adjusted for time and risk, that investors can expect to get back over the life of the business. This raises the question of how to link discounted cash flow – which is the most analytically respectable approach to valuation – with actual financial management of the enterprise?

Management should focus on maximizing *economic value-added* (EVA), which is operating profits less the cost of all the capital employed to produce those earnings. EVA will increase if operating profits can be made to grow without tying up any more capital, if new capital can be invested in projects that will earn more than the full cost of the capital, and if capital can be diverted or liquidated from business activities that do not provide adequate returns. EVA is the only performance measure that is entirely consistent with the standard capital budgeting rule: Accept all positive and reject all negative present value investments. (Earnings per share, on the other hand, will increase so long as new capital investments earn anything more than the after-tax cost of borrowing.)

The rate of return on total capital is the return that should be used to assess corporate performance. The required rate of return for a particular enterprise should increase with the enterprise's operational risk and financial risk. Performance should be measured against total capital – both debt and equity. Net operating profits in excess of total capital times required rate of return is considered economic value added (EVA).

Stewart, 1994.

Norway. Soon after Statoil's founding in 1972, the state shareholder established commercial targets for the company. The shareholder's decision in 1999 to proceed with an initial public offering (IPO) of 19 percent of Statoil's shares – in order to induce continuous market evaluation, facilitate benchmarking vis-à-vis competitors, and sharpen the distinction between enterprise governance and management – coincided with efforts to reduce costs of labor and capital. Labor reductions were agreed with the enterprise's unions and, as part of its 2001 IPO, Statoil's equity was reduced by 24 percent and capital was returned to the ministry of finance (MOF). This return of capital was financed through the issuance of new equity to public shareholders, transfers of cash and assets to the MOF, and additional debt.

Singapore. Temasek expects those "government-linked corporations" (GLCs) in which it holds shares to (i) be world class and compete internationally, in order to attract talent; (ii) have a high-quality board; (iii) focus on core competencies; (iv) pay competitive wages; and (v) maximize financial performance in terms of EVA, return on assets (ROA), and return on equity (ROE). GLC operations may be benchmarked to international standards. To encourage each GLC to focus on core competencies, any diversification must be agreed beforehand by Temasek. Singapore GLCs compare favorably, in terms of returns on equity, with international private-sector peers (see Table 3).

Table 3. Returns on Equity:
Singapore GLCs vs. International Private-Sector Peers

Sector/Company	Temasek Ownership	2001	2000	1999
Telecoms:				
Singtel	68%	24.9%	30.3%	25.6%
AT&T	-	13.5%	4.5%	4.3%
British Telecom	-	15.5%	14.4%	22.6%
Banking:				
DBS	13%	7.4%	13.2%	9.9%
UOB	-	7.3%%	13.5%	12.3%
OCBC	-	9.0%	10.3%	9.5%
Airlines:				
SIA	57%	16.3%	10.6%	n.a.
British	-	3.2%	-0.7%	n.a.

Source: Tay and Ma

South Korea. With its Public Enterprise Reform Act of 1983, South Korea began systematic efforts to improve performance at "government invested enterprises" (GIEs). Performance monitoring and incentives emphasized quantitative productivity measures (e.g., public profit divided by fixed operating capital); enterprise-specific technical indicators of operating efficiency; and qualitative indicators of performance in such areas as administration, research and development, and service. Initially, standard financial ratios – such as returns on equity – were not considered appropriate for public enterprises. In recent years, however, the government has increasingly included economic value added (EVA) as a performance indicator. Among Korea's thirty largest enterprises in 2001, both state-owned and private, returns on equity averaged 5.2 percent at the state-owned versus 4.1 percent at the private.

Financial and other business goals are sometimes supplemented by explicit statements of social goals.

New Zealand is a good example. Under the SOE act of 1986, SOEs should meet three goals: (i) be as profitable and efficient as comparable businesses in the private sector; (ii) be a "good employer;" and (3) show social responsibility by paying attention to local communities' needs and interests. An annual Statement of Corporate Intent (SCI) is used to guide and monitor each SOE in New Zealand. In order to ensure that New Zealand SOEs achieve their objectives of profitability, efficiency, and social responsibility, the government established a framework that included state monitoring, control, and incentives. The two state shareholders – i.e., the ministry of finance and relevant line ministry – monitor and control the results and operations of the SOE and verify its compliance with an annual Statement of Corporate Intent (SCI) that covers the following:

- Nature and scope of business activities to be pursued by the SOE;
- Performance targets for the next three years;
- Level of dividends to be paid;
- Employees' safety, compensation, job security, and equal opportunity;
- Adherence to long-term contracts with suppliers of goods and services;
- Compliance with legal and regulatory obligations; and
- Compliance with regulatory obligations

Excessive SOE emphasis on social goals, however – such as the rescue of distressed companies or development of lagging regions – can destroy value for the state shareholder. The dangers from mixing business and social goals are clear in the case of the former state holding company in Italy. *L'Instituto per la Ricostruzione Industriale* (IRI) was set up in 1933 to take over heavily indebted companies in all sectors. After World War II, IRI played a key role in financing highways, telephone networks, steel, electricity, and engineering companies. In the 1960s and 1970s, IRI was assigned two non-commercial missions: (i) to rescue ailing companies, especially those hurt by oil shocks; and (ii) to dedicate 40 percent of its investment to developing Italy's poor southern region. IRI's management also became increasingly politicized during the 1970s, with management and board appointments, investments, and restructuring strategies fought over by political parties. By 1992, IRI had majority shares in 550 companies and minority shares in 280 companies. IRI's losses grew from $540 million in 1991 to $3.4 billion in 1992 and $8.3 billion in 1993. IRI's consolidated debt grew to $58.3 billion by 1992.

While it is natural for the Chinese state to pursue different political and social objectives, in exercising its ownership in large SOEs, the State shareholder should focus on maximizing returns on capital (which is best measured by EVA). In general, this focus would serve the interests of Chinese citizens – the ultimate owners of State capital. Moreover, a shift in focus to maximizing returns on capital paves the way for SOEs to be fully commercialized and in preparation for post-WTO competition. As illustrated in Section I.A, pursuit of multiple and non-commercial objectives by multiple representatives of the Government and Party does not support the commercialization of SOEs.

More specifically, a focus on efficient use of capital by SOEs would discourage self-defeating business practices. For example, proposed capital investments, merger and acquisition transactions, and major changes in capital structure would be expected to clear designated "hurdle rates" and provide positive EVA. Such capital discipline would discourage administratively-mandated M&A transactions – e.g., forcing profitable SOEs to take over loss-making SOEs – that, in the past, have diminished state capital. A focus on efficient use of capital would also discourage practices such as administratively-mandated debt/equity conversions as the preferred response to an SOE's inability to service its debt. While a debt/equity conversion would reduce interest expense, it also represents a major opportunity cost in the use of state capital. Because an equity investment is generally riskier than a credit investment, the state should earn more on its equity investments in SOEs. Such a disciplined approach to the deployment of state capital would encourage greater emphasis on operational restructuring, rather than superficial financial restructuring. Greater emphasis on operational restructuring would, in turn, enhance the global competitiveness of China's SOEs.

While foremost emphasis on efficient use of state capital is recommended to enhance the competitiveness of China's SOEs (and, perhaps, to reverse past mis-deployments of state capital), it is entirely reasonable to expect SOEs to achieve other goals as well. Some of the other goals are not in conflict with the commercial nature of SOEs. For example, as in the case of New Zealand's SOEs, these other goals could include being a good employer, showing social responsibility to the local community, treating suppliers and customers fairly, and complying with environmental and other governmental regulations. These are the goals that even good private companies pursue. There can be, of course, non-commercial goals that the state may wish SOEs to fulfill, for example, providing poor farmers in remote areas with access to telephone by telecom company, which is commercially non-profitable. Even is such cases, however, a single-minded state owner is preferable, because it would generate more transparent measurement of the cost of such non-commercial activities. If, after recognizing the true cost, the state decides to proceed with its plan, it could still implement the plan by providing adequate compensation to the SOEs involved. Such compensation does not reduce the total wealth of the state at all, but it allows SOEs to operate on full commercial basis and therefore in a better position to compete with their private sector counterparts in the market.

To implement a new state ownership function centered with efficiency of use of capital, two instruments can be important. The first is the concept of EVA. All large SOEs should be required to improve their accounting practice so that agencies that exercise ownership rights on behalf of the state can calculate EVA for each large SOE and evaluate their performance accordingly. This has been the experience of Sweden. The second is an annual statement of SOE approved their board that specifies goals to be achieved in the coming 1-3 years. This would help facilitating SOE performance monitoring and evaluation by the representative of the state shareholder. As in New Zealand, the annual statement for each SOE could specify the nature and scope of activities to be pursued; returns on state capital (e.g., return on equity, economic value-added) and other performance targets for the next three years; expected dividends; treatment of workers and suppliers; and compliance with regulatory obligations.

C. Accounting and Auditing

Accounting and auditing reforms should cover individual SOEs and enterprise groups as well as the SOE portfolios of the central SASAC and each local SASAC.

1. SOE and enterprise group accounting

Accurate financial statements are essential for investors to make realistic decisions on enterprise performance, valuation, sale, restructuring, or re-investment. Accounting standards now applied to listed companies and foreign-invested enterprises should also be applied to all medium/large SOEs. Listed SOEs (i.e., about 1000 enterprises) as well as foreign-invested enterprises (FIEs) are obliged to follow the new Accounting Systems for Business Enterprises (ASBE). ASBE standards, where they have been developed, are reasonably close to International Accounting Standards (IAS). Problems arise from the fact, however, that the great majority of SOEs continue to follow older accounting regulations which are sometimes much less conservative than IAS and sometimes much more strict (see Table 4).

Table 4. New vs. Old Accounting Standards for Chinese Enterprises: Selected Accounting Items

Accounting Item	Joint Stock Companies and Foreign-Invested Enterprises	Other State-Owned Enterprises
Short-term investments	• Short- vs. long-term based on management's intention • Shown at lower of cost or market value • Impairment provision in case of	• No guidance on classification • Shown at cost

	a permanent impairment of value	
Accounts receivable	• Provision for bad debts should be based on management's experience and judgment. May be applied to specific balances, as a % of overall balance, or by applying different % to different receivables age brackets	• Provision for bad debt may not exceed 0.3-0.5% of accounts receivable balance
Inventories	• Carried at lower of cost or net realizable value • Impairment treated as general and administrative expense	• Carried at cost. Provision for diminution in value generally not allowed without approval from authorities • Impairment treated as a selling cost
Long-term investments	• Carried at cost unless there is a permanent diminution in value. Then an impairment provision should be made for the difference • Accounted for using equity method if investment >20% of investee voting rights or able to control investee	• Carried at cost • If investment >20% of investee equity and significant influence can be demonstrated, investor has option to use equity method
Consolidated financial statements	• Required if company holds >50% of another entity's equity or with smaller ownership has the ability to exercise control	• Focuses on percentage of ownership; not control
Fixed assets - depreciation	• Useful life of asset based on management's judgement • Depreciation method is based on management experience and judgement • Depreciation method may be straight-line or accelerated	• Useful life determined by government; may not be realistic • Depreciation method set by government • Straight-line depreciation generally prescribed
Fixed assets - impairment	• Impairment provision required in case fixed asset is damaged; not in use and not expected to be used in foreseeable future; technically obsolete; used to produce sub-standard products; or no longer beneficial to company	• Not addressed
Finance leases	• Liability and asset shown	• Only lease expense is shown
Construction in progress	• Carried at cost unless impaired, in which case provision similar to other fixed assets impairment	• Carried at cost; impairment not addressed
Land use rights	• If not idle ("intangible asset") or recent construction ("construction in progress"), shown as separate LUR line item	• Shown in separate LUR line item

Foreseeable liabilities	• A provision should be made for foreseeable liabilities, such as restructuring costs, redundancy costs, or warranty costs	• Not addressed; some of these costs could be accrued in "other liabilities"

Source: accounting industry. See also Nicholas R. Lardy, *China's Unfinished Economic Revolution*, Brookings, 1998, pp. 33-47.

Thus, old-style non-ASBE accounts can vary from modern ASBE accounts in the following important ways:

- Short-term and long-term investments valued at cost may be over-valued if there has been a decline in market value. This could also lead to an overstatement of income and equity.
- Accounts receivable are almost certainly overvalued, since bad debts are always more than the 0.5% permitted by regulation. This would cause income and equity to be overstated.
- Inventories (along with income and equity) may be overstated if there is a lot of inventory that is obsolete or sub-standard and cannot be sold.
- There may be an under-consolidation of accounts, which could result in overstatements of revenues, income, and equity as a result of related party transactions.
- Fixed assets may be over-stated, due to too-slow depreciation, or overstated due to a failure to show effects of impairment from damage, obsolescence, or non-use.
- Fixed assets and liabilities may be understated from failure to account for financial leases.
- Fixed assets will be understated if there has been inadequate accounting for the market value of land use rights.
- Failure to account for foreseeable liabilities – e.g., restructuring costs, redundancy costs – would cause an overstatement of income and equity.

Some simple examples in just one of these areas – accounts receivable – illustrates the potential impact from adoption of new international standards, i.e., ASBE. The switch to realistic bad debt accounting from a statutory maximum of 0.5% can require a major 1-time provision that would reduce income and equity. Companies listed on the Hong Kong Stock Exchange, for example, have already made this adjustment. By comparing actual reported receivables with what would have been reported net of a 0.5% bad debt allowance, it appears that just this switch to ASBE accounting for receivables could cause a 1-time reduction in net income (and retained earnings) of at least 20-25%.[22] Other old-style treatment of items, especially land use rights, may tend to understate SOE accounts. But in the great majority of differences, old-style accounting is likely to overstate SOE income, equity, and assets and to understate SOE liabilities.

In the case of affiliated SOEs – for example, in many of China's state-majority enterprise groups, it appears that there is no proper consolidation of accounts except in the case of listed SOEs. In most cases, the accounts of multiple affiliated SOEs (including the effects of cross-affiliate sales) may be simply combined rather than consolidated to eliminate the effects of inter-affiliate transactions. This would tend to overstate revenues, income, and equity within enterprise groups.

2. Portfolio accounting

Similarly, periodic financial statements for each SASAC portfolio will be needed to assess each SASAC's management of its assigned portion of State capital. Austria's OIAG state shareholding fund

[22] The 20-25% figure is based on an analysis of SOEs listed on the Hong Kong and New York Stock Exchanges. These are among China's best companies. Thus, the impact of a switch to ASBE receivables accounting for other less-good companies would almost certainly be more severe.

is probably the most complete example of accounting for an SOE portfolio.[23] OIAG's annual financial statements provide a public accounting for portfolio assets, liabilities, and income (Box 6).

Box 6. Accounting Practices at Austria's OIAG SOE Fund

As of end-2001, OIAG's holdings included 7 publicly-traded companies (or subsidiaries) and 7 non-public companies, including 100% of Austria Post. These holdings, some investment securities, and cash represent most of OIAG's assets.

Market values are available for the publicly-traded companies. OIAG typically values all holdings at cost (book value), however. Holdings are depreciated at annual rates of 20-33%. Any long-term impairment in the value of a holding is accounted for by an extraordinary depreciation charge.

OIAG's mandate includes sale of State shares in SOEs. At the time of sale, a holding is "written up" if actual market value exceeds its cost basis. This write-up appears as operating income on OIAG's income statement. OIAG shares 80% of the profits from any sale of a holding with Austria's Ministry of Finance. Such profit-sharing is treated as an operating expense.

OIAG's liabilities include provisions for severance payments, pensions, all identifiable risks, and un-quantifiable liabilities. OIAG segments some of its earnings in several reserve funds. The sale of a holding may precipitate a provisions cancellation and/or reserves release, which would count as operating income.

OIAG's net profit for 2001 was ATS 341 million. OIAG's supervisory board concurred with management's recommendation to carry this amount forward as retained profit.

For 2001, OIAG's accounts were audited by the local affiliate of Ernst & Young (E&Y), an international accounting firm. E&Y certified that OIAG's "accounts and annual financial statements comply with the relevant legal provisions" and that OIAG's financial statements "observe the principles of adequate and orderly accounting and to the maximum extent possible present a true and fair view of the company's assets, financial situation and profitability."

Source: OIAG, *Annual Report 2001*.

Periodic financial statements for each SASAC portfolio should similarly reflect international accounting standards. China's ASBE standards already provide a starting point for SASAC portfolio accounting. According to ASBE, short-term equity investments should be carried at the "lower of cost or market." For long-term investments where a SASAC owns 20% or more of the enterprise's equity – or can otherwise exert control or significant influence – the "equity method" of accounting should apply. Under the equity method, which would likely apply to most of the medium/large SOEs in SASAC portfolios, SOE profits would increase the SASAC's investment balance and investment income; SOE losses would decrease the SASAC's investment balance and investment income; and SOE dividends would increase the SASAC's cash balance while reducing its investment balance. For either long- or short-term equity investments, any permanent reduction in value should be reflected in a provision to the SASAC's investment balance and a realized loss of investment income.

[23] New Zealand has recently improved government accounting for SOEs. Before July 2002, the government's financial statements showed a consolidated net surplus for all SOEs in the government's operating balance (income statement) and a consolidated net investment value for all SOEs in the government's balance sheet. Since July 2002, the government's financial statements and forecasts show consolidated revenues, expenses, surplus, assets, liabilities, and equity for all SOEs. R. Hamilton, New Zealand accounting policies on SOEs, correspondence, July 29, 2003. Singapore's Temasek SOE fund does not make public its financial statements.

In overseeing the implementation of improvements in financial reporting for SASAC portfolios, it would be useful for the central SASAC to seek advice from a qualified international accounting firm. It may be necessary to address additional accounting issues not yet covered by ASBE. In addition, while implementing international accounting standards, careful consideration should be given to the unique circumstances of China's SOE portfolios (e.g., large numbers of non-marketable shares, significant minority shareholdings, insolvent provincial portfolios). Lastly, it would be a good idea to resolve valuation issues (e.g., "unhealthy" SOE assets) before establishing initial balance sheets for central and local SASAC portfolios. Any international accounting firm that has had a major presence in China over the past 1-2 decades could usefully advise central SASAC on these matters. Any such international firm would also be able to advise and assist SASACs in improving their management information systems and identifying appropriate performance goals (e.g., returns on equity). These additional steps are also necessary to support the effective management of State capital.

3. Auditing

The material accuracy of financial statements should be independently audited according to international audit standards. All countries have some financial mis-reporting. China is no exception. An official investigation of almost 200 Chinese companies found that 54 percent mis-reported profits in 2001.24/ Independent audits conducted according to international audit standards are an important deterrent to financial mis-reporting The effective implementation of *adequate* audit standards also depends on the SOE's board of directors and external auditors. The board of directors should be responsible for the integrity of financial statements prepared by management and for overseeing external auditors. External auditors should be responsible for validating the SOE's financial statements and the adequacy of other information disclosures.

D. Portfolio Segmentation and Management

Other countries with large SOE portfolios that include a significant number of distressed SOEs have segmented the portfolio and applied an appropriate method(s) to each segment of the portfolio. As indicated in Section II, about half of China's SOEs are unprofitable and likely in moderate-to-severe distress. This is not dissimilar to past situations facing the SOE portfolios of other transition or OECD countries:

- In Italy, the IRI state holding company's portfolio was highly distressed by 1992-9: annual losses were $8.3 billion and consolidated debt was $58 billion. Per Italy's agreement with the European Union to repay these debts and reduce its debt/equity ratio to about 1:1. During 1992-2000, IRI conducted 160 major asset sales – e.g., two banks, auto maker SEAT, Rome airport, toll roads, 31 percent of Alitalia airline, and most of the Finmeccanica aerospace company – for Lira 65 trillion (about $53 billion). IRI itself was liquidated in 2000. Its remaining shareholdings – public television RAI, 30 percent of Finmeccanica, and 54 percent of Alitalia – were transferred to the Italian Treasury. While a failure at financial management and enterprise restructuring, IRI succeeded in liquidating itself and – like OIAG in Austria – stimulating development of Italy's capital market. Former IRI companies account for 45 percent of Italy's current stock market capitalization.
- In East Germany, the Treuhandanstalt transformed over 12,000 SOEs. Of these, 53 percent were sold, 30 percent were liquidated, and 17 percent were transformed through restitution or other means.
- In Poland, between 1990 and end-1996, about 40 percent of 8,441 medium/large SOEs entered ownership transformation through a liquidation or insolvency process.

Thus, depending upon the size and condition of any particular SOE in a SASAC portfolio, any of the following may be most appropriate: sale as a "going concern," asset sale or liquidation, operational and/or financial restructuring, or normal corporate governance.

[24] *China Daily*, January 10, 2003.

It would be useful for the central SASAC to develop some guidelines for segmenting local SASAC portfolios (as well as its own portfolio) and managing portfolio segments accordingly. Segmentation should reflect SOE size plus financial performance and condition. It makes sense to sell small/medium SOEs, either as "going concerns" or through asset sales/liquidations. Many medium-sized SOEs, however, may need "operational restructuring and/or "financial restructuring" before they could be sold. Similarly, some large SOEs destined to remain in the State portfolio may need operational and/or financial restructuring. Ultimately, some medium/large SOEs may be non-viable because of basic business flaws and would better be liquidated. Company cash flows are a good preliminary indicator of the health or distress of individual enterprises. The need for accurate cash flow reporting reinforces the need for more widespread implementation of accounting reforms.

E. Dividend Policy and Capital Reinvestment

Dividend payments, by those companies that pay dividends, are usually regular (e.g., quarterly) and somewhat predictable. Occasionally, a company may make a special one-off dividend payment, especially if it has a large cash balance that cannot be invested at an adequate expected return. A key measure is the "dividend payout ratio" – the ratio of dividends to net income. The appropriate dividend payout ratio for a particular company will depend on its growth prospects, capital structure, and investment opportunities.

China's best SOEs, such as those listed on the Hong Kong and New York Stock Exchanges, seem to follow international best practices in terms of dividend policy and the payment of dividends (see Box 7).

Box 7. Dividend Policy at a Major SOE

Dividend policy for for one SOE listed on the Hong Kong and New York stock exchanges is subject to approval by the company's Board of Directors. Up to 35 percent of net income can be paid out as dividends. Actual dividend payments in 2001 and 2002 were at this maximum dividend payout ratio.

Each year's dividend payment is proposed by company management. It must then be approved by the Board and finally approved at the annual general meeting (AGM) of shareholders.

In making its dividend decisions, the Board's Strategic Committee and company management jointly review cash projections, debt/equity structure, and capital expenditure (CAPEX) needs. Any proposed CAPEX should clear a specified "hurdle rate" (14 percent return on capital invested) in order to be approved.

It appears, however, that the great majority of China's medium/large SOEs take a much less formal approach to dividend policy and in fact do not pay dividends. This may reflect a widespread attitude that SOE managements have a "management right" to decide themselves on the use of excess cash. This informality may lead to the accumulation of large cash balances and the opportunistic and un-disciplined investment of these cash balances. For example, some major Chinese SOEs have acquired or sought significant stakes in the initial public offerings (IPOs) of completely non-related businesses. Chinese SOEs also make private equity investments in unrelated non-core businesses.[25]

[25] For example, World Bank staff are familiar with one capital goods company that has maintained long-term equity investments in such unrelated businesses as securities, mineral water, traditional Chinese medicine, and advertising. This is in spite of the fact that this company does not pay dividends, allegedly needs additional funds for CAPEX, and is in increasing arrears on debt service to creditors.

Internationally, dividend payout ratios tend to reflect the growth prospects of each company. For example, companies with relatively slow and dependable growth can typically support a dividend payout ratio of about 50%. (Table 5) American securities analysts regard a payout ratio of 50 percent or less as reasonably secure and "defensible." Companies with strong cash flows (e.g., Pfizer) may maintain high payout ratios despite high R&D costs and high returns on equity (ROE).

Table 5. Dividend Payout Ratios: Slow-Growth Companies, 2003

Sector	Company	Country	Market capitalization ($ millions)	Return on equity (ROE)	Earnings per share (EPS)	Dividends per share	Payout ratio
Appliances	Electrolux	Sweden	6,880	11%	2.59	1.24	48%
Pharmaceuticals	Pfizer	US	271,600	45%	1.51	0.6	40%
	Novo Nordisk	Denmark	12,200	n.a.	1.9	0.38	20%
Diversified	3M	US	50,900	32%	5.12	2.64	52%
	GE	US	292,500	24%	1.48	0.76	51%
	Siemens	Germany	46,400	8%	2.33	0.85	36%
	United Technology	US	33,900	26%	4.5	1.08	24%
Food Processing	ADM	US	8,600	7%	0.72	0.24	33%
	ConAgra	US	12,600	18%	1.58	0.99	63%
Oil integrated	Statoil	Norway	18,300	32%	1.1	0.37	34%
	Repsol YPF	Spain	19,500	n.a.	2.33	0.42	18%
	Petrobras	Brazil	22,200	25%	2.19	0.17	8%
	Eni	Italy	60,400	18%	6.81	3.31	49%
	Royal Dutch	Netherlands	96,900	20%	3.59	1.42	40%
	Total	France	154,200	18%	2.97	1.47	49%
	BP	UK	154,200	16%	2.97	1.47	49%
	Exxon Mobil	US	240,800	21%	2.29	1	44%
Consumer Goods	Colgate	US	31,200	n.m.	2.26	0.96	42%
	Gillette	US	33,600	54%	1.19	0.65	55%

Source: Yahoo Finance, company profiles, July 7, 2003.

Regulated utilities may comfortably support an even higher dividend payout ratio. Among foreign companies, payout ratios may reach 70 percent for highly-regulated utilities with relatively regular demand and relatively predictable cash flows and CAPEX requirements, such as local phone service and power distribution (Table 6). Lightly regulated infrastructure companies with more variable demand and significant capital costs, such as railroads, may only be able to support lower payout ratios.

Table 6. Dividend Payout Ratios:Utilities/Infrastructure Companies, 2003

Sector	Company	Country	Market capitalization ($ millions)	Return on equity (ROE)	Earnings per share (EPS)	Dividends per share	Payout ratio
Communications	AT&T	US	15,700	3%	1.36	0.75	55%
	Verizon	US	110,100	20%	2.29	1.54	67%
	British Telecom	UK	28,600	n.m.	7.87	1.08	14%
Electric Utilities	Consolidated Edison	US	9,220	11%	3.06	2.24	73%
	Scottish Power	UK	11,300	14%	2.32	1.83	79%
Railroads	CP	Canada	3,680	14%	2.15	0.35	16%
	CSX	US	6,680	7%	2.06	0.4	19%

Source: Yahoo Finance, company profiles, July 7, 2003.

For companies in cyclical industries, dividends may reach or exceed 100 percent of earnings during cyclical downturns. Recent experience provides plenty such examples (Table 7). Indeed, companies may continue to pay dividends despite a loss-making year in order to satisfy shareholder demands for regular and predictable interest payments.[26] Shareholders disgruntled by a disruption in regular dividend payments may massively sell company shares, thereby punishing the company's share price.[27] Cyclical companies often accumulate cash reserves during cyclical upturns and draw down cash reserves during cyclical downturns. Many of the cyclical companies shown below are notable for their relatively low returns on equity (e.g., ROE <15%).

Table 7. Dividend Payout Ratios: Cyclical Companies, 2003

Sector	Company	Country	Market capitalization ($ millions)	Return on equity (ROE)	Earnings per share (EPS)	Dividends per share	Payout ratio
Aerospace	Boeing	US	28,000	14%	1.55	0.68	44%
Autos/components	Daimler	Germany	37,200	7%	3.14	1.61	51%
	Ford	US	20,400	16%	0.63	0.4	63%
	GM	US	20,100	20%	5.43	2	37%
	Johnson Controls	US	7,780	18%	6.74	1.44	21%
Chemicals	NL Industries	US	849	11%	0.82	0.8	98%
	Monsanto	US	5,860	2%	0.43	0.52	121%
	BASF	Germany	25,500	8%	2.74	1.25	46%
	Dow	US	28,600	-4%	-0.4	1.34	-335%
	Dupont	US	42,000	18%	1.92	1.4	73%
Steel	Posco	South Korea	8,980	10%	2.81	0.59	21%
	Nucor	US	3,910	7%	2.04	0.8	39%
	Siderurgica	Brazil	1,760	51%	6	2.45	41%
	US Steel	US	1,630	6%	1.09	0.2	18%
Mining	Alcoa	US	21,700	5%	0.6	0.6	100%

[26] Some of the dividend amounts in this table are "indicative" – i.e., amounts now expected for the current quarter based on communications from management.

[27] For example, when Ford omitted its regular dividend in 1982, shareholder sales drove Ford's share price down to a 25-year low.

	Alcan	Canada	11,000	3%	0.83	0.6	72%
	BHP Billiton	Australia	22,400	11%	0.44	0.29	66%
	Pechiney	France	3,770	-1%	-0.22	0.48	-218%
	Rio Tinto	UK	27,400	6%	1.32	2.4	182%
Capital Goods	Milacron	US	162	-6%	-0.57	0.04	-7%
	Hitachi	Japan	17,900	1%	0.69	0.43	62%

Source: Yahoo Finance, company profiles, July 7, 2003.

It is especially important to update policies on dividends and capital investment for high-growth or high-technology companies. Such companies usually – but not always – do not pay a dividend. If a company can earn returns on equity of 25 percent or more and needs additional capital for expansion or modernization (e.g., Nokia, Adobe, Oracle), it makes sense for the company to re-invest all of its earnings in the business rather than pay dividends. (Table 8). Of course, some re-investments (e.g., biotechnology companies) have uncertain prospects and may take a long time to pay off. In addition – as the post-1999 performance of Motorola, Ericsson, Nortel, and Corning illustrate – a company may be both high-technology and cyclical. In such cases, it is especially important for the company's management and board to consider the likely effect of additional CAPEX on long-term competitiveness. Finally, an extended period of high growth may more or less exhaust a company's future prospects for high growth. It may make sense for such companies to begin paying dividends. Microsoft is a good example of this. Given the slowdown in Microsoft's growth to 9 percent over the past five years and the accumulation of $49 billion in cash reserves (as of mid-2003), Microsoft recently decided to begin paying a modest dividend. As these examples illustrate, it is especially important periodically to re-examine assumptions about growth and future returns on capital invested (ROCI) for companies classified as high-growth or high-technology.

Table 8. Dividend Payout Ratios: High-Growth/Technology Companies, 2003

Sector	Company	Country	Market capitalization ($ millions)	Return on equity (ROE)	Earnings per share (EPS)	Dividends per share	Payout ratio
Aerospace	Aviall	US	231	10%	1.02		- 0%
	Flir	US	1,070	29%	1.18		- 0%
Pharmaceuticals	Biogen	US	6,150	12%	1.25		- 0%
	Amgen	US	88,900	-10%	-1.02		- 0%
Technology	Cisco	US	127,900	12%	0.46		- 0%
	Nokia	Finland	84,700	27%	0.83	0.26	31%
	Motorola	US	23,200	-16%	-0.82	0.16	-20%
	Ericsson	Sweden	18,200	-27%	-1.86		- 0%
	Nortel	Canada	11,400	-90%	-0.7		- 0%
	Corning	US	9,540	-41%	-1.81		- 0%
Software	Peoplesoft	US	5,700	9%	0.56		- 0%
	Satyam	India	1,530	20%	0.5	0.11	22%
	Adobe	US	8,030	27%	0.86	0.05	6%
	SAP	Germany	37,800	22%	0.56	0.14	25%
	Oracle	US	65,800	40%	0.43		- 0%
	Microsoft	US	294,400	18%	0.88	0.08	9%

Source: Yahoo Finance, company profiles, July 7, 2003.

While regular dividends are more the norm, a 1-time dividend or return of capital may be appropriate if the enterprise cannot expect to earn an adequate return from the re-investment of its cash reserves. During preparations for an IPO of shares in Norway's Statoil, for example, a financial review concluded that the company had too much equity – more than it could efficiently use. As a result, Statoil's IPO coincided with a 1-time return of Statoil capital to the State treasury.[28] New Zealand companies may also pay a special one-time dividend (Box 8).

Box 8. Dividend Policy for New Zealand SOEs

Successive governments have taken a close interest in the potential dividends that may be derived from SOEs. Although it is natural to expect that SOEs may be perceived as "cash cows," a constructive but conservative approach has been taken with regard to dividend policies. Although the basis for an SOE's balance sheet aims toward a 60/40 debt/equity ratio, agreement on each SOE's balance sheet reflects its individual circumstances. This also applies to each SOE's dividend policy. However, in general, the state shareholder will seek the maximum possible dividend consistent with the SOE's ability to meet its future financial needs. Where an SOE is perceived to have a higher level of financial resources than is necessary for the business, a special dividend may be paid. Frequently, this is at the initiative of the SOE.

R. Hamilton, Crown Companies Monitoring Unit (CCMAU), "State Owned Enterprises Dividend Policy," correspondence, July23, 2003.

The return of surplus cash to shareholders is far preferable to bad diversification. Recent international experience offers many examples of bad diversification.

- One of America's most successful and famous fund managers has provided a pungent exegesis of ill-considered corporate diversifications, which he refers to as "di-worse-ifications." [29] More recent examples include Worldcom and Tyco. These experiences have encouraged renewed interest of American shareholders in dividends on the grounds that it is better for a company to return surplus cash to its shareholders than to re-invest it poorly in the business.[30]
- European examples of ill-considered diversification include France Telecom's debt-financed acquisition of UK mobile phone operator Orange at a very high price, and Vivendi, whose diversification from a predictable but unglamorous water utility to a highly-indebted multi-media empire destroyed shareholder value and nearly bankrupted the company.
- In South Korea, ill-considered debt-financed diversification into highly-competitive and cyclical sectors led to many famous chaebols into distress or bankruptcy: e.g., the Daewoo companies, Kia, Samsung Motors, Hynix, and Hyundai Engineering & Construction.

In all these cases, the return of surplus cash to company shareholders could have seemed preferable to its use by company management to finance "di-worse-ification."

China's large SOEs should each have a formal dividend policy that makes a realistic assessment of alternative uses for surplus cash. China's Hong Kong/New York-listed companies, such as Chalco, seem a good model in terms of process for making decisions on the adoption and implementation of a dividend policy. Ultimately, decisions on dividends should be based on realistic assessments by company directors about the company's business prospects, cash flow projections, debt service capacity, and CAPEX requirements and opportunities. This involves both analysis and business judgment. *Company cash surpluses on which management cannot expect to earn an adequate risk-adjusted return should be*

[28] Ongoing dividend payments are governed by Statoil's dividend policy, which includes an item that dividends will not be paid if the company's equity falls below a certain percentage of total assets. Olivier Butzbach, background note on Statoil, June 23, 2002, mimeo.

[29] These comments are from Peter Lynch, who managed Fidelity's Magellan Fund from 1977 until 1990. By the time Lynch retired , Magellan Fund had grown to $9 billion in assets. During Lynch's management, Magellan posted average annual returns of 29 %, which was substantially higher than returns for the S&P500.

[30] In the US, dividends paid on post-tax earnings are additionally taxed as ordinary income. Recent proposals to lessen this "double taxation" of dividend income has further heightened investor interest in dividends.

distributed to company shareholders. As a starting point for a more formal approach to dividend policy, China's large SOEs could adopt the working assumption that 100 percent of year-end cash should be returned to shareholders *unless management can demonstrate that the cash is needed to support ongoing business operations or that re-investment of the cash in the business is expected to generate ROCI in excess of some pre-specified "hurdle rate."*

F. Sharing of Sales Proceeds and Liabilities

Some SOE sales will generate sales proceeds. Given that local SASACs are managing local SOE equity on behalf of the entire Chinese people, what sharing of sales proceeds between the local government and the central government might be appropriate? Conversely, proceeds from the sale of some SOEs will not be sufficient to settle all claims on the enterprise – e.g., bank debt, pensions.[31] Thus, should there also be standard arrangements for sharing liabilities between the central and local governments?

Analogous to the broader issue of the sharing of tax revenues and budgetary costs between central and local governments,[32] these issues are beyond the scope of this background paper. But it is useful (i) to comment on appropriate purposes for the use of enterprise sales proceeds and (ii) to highlight the need to address the "localization of benefits-nationalization of liabilities" issue discussed in Section II.

1. Sales proceeds

While OECD experiences have varied, it probably makes sense for China to dedicate enterprise sales proceeds to the reduction of debt or the funding of pension liabilities. The use of privatization proceeds has varied across OECD countries.

- In some countries such as the UK, Sweden, and Denmark the privatization proceeds have not been ear-marked for any specific purpose and have in effect flowed into the general revenue fund.
- In Germany while privatization proceeds basically flow into the general revenue fund of the budget the proceeds gained through privatization of Deutsche Telekom AG and Deutsche Post AG are earmarked for a limited time (until 2003) to reduce the public debt, provided that they are not needed for financing the pension fund of the public servants working for these companies or the former monopoly Deutsche Budespost.
- In Poland, privatization proceeds have made a significant contribution to implementation of Social Security Reform.
- Similarly in the Czech and Slovak Republics privatization proceeds have been earmarked for specific uses.
- In Greece, the proceeds from privatization have been dedicated to reducing public debt and funding adjustment policies for the affected employees.
- In Italy, the revenues from privatization are set aside in a special Fund and used to purchase government bonds in circulation or their redemption at maturity, thus contributing to the reduction of the debt/GDP ratio.
- In Turkey, the government has used the proceeds for several purposes, including loan repayments, credits for companies, and funding for social assistance supplements.
- In Mexico privatization proceeds were largely used to pay off public debt and also to a lesser extent to fund public expenditure.
- Finally in some cases the proceeds from the sale of stakes, or new share issues have flowed to the state-owned enterprise to pay for its investments and acquisition of assets.[33] (OECD, 47).

2. *Control of growth in liabilities*

[31] This case refers to an asset sale, not to sale a "going concern" sale in which the new owner assumes all of the enterprise's debts.

[32] World Bank, *China: National Development and Sub-National Finance: A Review of Provincial Expenditures*, Report No. 22951-CHA, April 9, 2002, C. Wong et al.

[33] OECD, *Privatizing State-Owned Enterprises in the OECD Area: An Overview of Policies and Practices*, Directorate for Financial, Fiscal, and Enterprise Affairs, September 2002, p. 47.

The central government, including SASAC, should explicitly consider approaches to curtailing possible growth in the liabilities that locally-administered SOEs could impose on central institutions. The sale, restructuring, or liquidation of a distressed SOE may force the immediate recognition of outside claims on the SOE – e.g., from workers, trade vendors, utilities, tax authorities, financial institution creditors, pension plans. In many cases, sale proceeds, future cash flows, or assets may not suffice to satisfy these claims. Global experience in corporate restructuring suggests that some claims are more likely than others to be satisfied (or dropped) – e.g., worker severance, trade payables, utilities, and tax liabilities.

Incomplete payment of financial institution credits and pension liabilities is more likely. This, in turn, may create follow-on liabilities for central institutions. For instance, non-payment of bank loans reduces bank capital and may necessitate additional re-capitalization by the Ministry of Finance (MOF). If pension liabilities cannot be fully funded at the local level, the deficit may become a claim on the National Social Security Fund (NSSF). Data are not available to support any detailed analysis.

It appears that the central government faces the following dilemma: either allow local SOE losses to continue and follow-on liabilities to increase <u>or</u> force immediate recognition of all claims on local SOEs through more expeditious sales, restructurings, and liquidations. Central authorities – especially the central SASAC, MOF, largest banks, China Banking Reform Commission, and NSSF – should focus on this issue, conduct appropriate empirical analyses, and develop approaches to control the "localization of benefits-nationalization of liabilities."

G. Risk Management

The purpose of risk management is to make it difficult or impossible for a company to take actions – or fail to take actions – that could lead to the destruction of shareholder value or create unacceptable liabilities for shareholders.

Recent corporate disasters around the world illustrate the need for China's remaining large SOEs to each implement a risk management program appropriate to its line of business and special circumstances. Corporate experience in the U.S., Europe, and Asia over the past five years provides numerous examples of actions that can jeopardize a company's very existence. Examples include the use of commodity trading or financial derivatives for speculative purposes rather than hedging; investment of cash reserves in speculative equity investments; misappropriation of cash; self-dealing in company stock by corporate insiders; related party transactions, including loans to corporate insiders; use of fraudulent accounting to hide problems; ill-conceived direct equity investments; parent company guarantees on debt repayment by new subsidiaries; and inadequate insurance. A complete risk management program would need to consider a wide range of risks: e.g.,

- Natural hazards;
- Contracting/legal issues;
- Financial operations;
- Misconduct, negligence, or criminality;
- Environmental protection;
- Government regulation;
- Economic conditions;
- Dependence on outside suppliers or vendors;
- Property loss;
- Technology; and
- Workforce

Each SOE's board of directors should be responsible for ensuring that the SOE is protected, to the extent possible, from excessive risk. Risk management is a specialized area. It would make sense for the board of each large SOE to solicit professional advice on development of an appropriate risk management process.

Compared with non-state companies and private shareholders, SOEs probably pose greater risks to state shareholders around the world. Any lack of precision about corporate goals (e.g., return on capital vs. preservation of jobs), lack of creditor recourse to court-supervised reorganization or liquidation, or lack of strong corporate governance would make it easier for SOEs to maintain non-viable businesses or non-sustainable debt through non-payment of claims by trade vendors, financial institution creditors, utilities, and the tax authorities. Thus, SOEs may have greater opportunities to create additional liabilities than could a private enterprise in a similar situation. Other transition governments have attempted to counter this risk through the imposition of "hard budget constraints" – including requirements for SOEs to repay creditors, pay taxes on time, and remain current on utilities payments.

Careful attention should be given to the imposition of "hard budget constraints" on SOEs as well as private enterprises. Under a hard budget constraint, enterprises must remain current on all payments to workers, suppliers, financial institutions, tax authorities, and utilities. The effectiveness of hard budget constraints depends on the availability of effective remedies (e.g., foreclosure, liquidation, receivership, court-supervised reorganization) for non-payment, on the readiness of all creditors to use available remedies, and on the effective regulation and supervision of financial institutions. The experience of transition countries highlights both the difficulty and importance of hard budget constraints. On the one hand, many efforts by transition governments to impose hard budget constraints have not been particularly effective. On the other hand, ownership transformation may – by itself – not be a sufficient reform. Indeed, experience shows that ownership tranformation without hard budget constraints may result in ongoing asset stripping by new owners.34 Thus, effective programs for the governance of large SOEs and the ownership transformation of small/medium SOEs will require adequate creditor rights/insolvency systems and adequate supervision of financial institutions.

[34] See William L. Megginson and Jeffrey Nutter, "From State to Market: A Study of Empirical Studies on Privatization," *Journal of Economic Literature*, June 2001, p. 9, citing studies by Kornai (2000), Berglof and Roland (1998), and Frydman, Gray, Hessel, and Rapaczynski (2000) on difficulty of hard budget constraints. See Edward S. Steinfeld, *Forging Reform in China*, (Cambridge: 1998) pp. 23-38 for examples on the post-transformation importance of hard budget constraints.

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