State-owned enterprises: From centrally-planned origins to hybrid market competitors
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Some of the largest and most influential businesses in China – and now the world – are controlled by China’s central government, yet this is a model that remains a mystery to the business world outside of China. Most of these State-owned enterprises (SOEs) were originally set up along Soviet lines in the 1950s; over the past 30 years, the Chinese government has been progressively reforming their operation and management.

Today, in many respects these companies look like multinational companies. Some are listed on overseas stock markets, and some feature prominently on lists of the world’s largest corporations. Look a little closer, however, and one can see that these Chinese business giants still maintain traditional SOE characteristics, including how they are managed and led; their corporate objectives; their stakeholders; and their corporate culture and ethos.

This month’s China 360 discusses the unique SOE phenomenon, in particular the centrally-managed SOEs in China and how they compare to international peer companies. We also look at reasons for the longevity of this special business model, and offer insights on how the SOE model may adapt going forward.

State-owned enterprises – the early years

In China, SOEs are wholly or majority-owned by the Chinese central, provincial, county or municipal government. From the 1950s until 1978, China managed and operated SOEs under a centrally planned system: without private enterprise or significant foreign investment, the SOEs were the backbone of the economy. The lion’s share of economic output was directed and controlled by the State, which set production goals, controlled prices, and allocated resources.

To support industrialization, the central government undertook large-scale investments in physical and human capital, primarily through the central-government controlled SOEs. The large SOEs supported massive numbers of people and their families, by providing a lifetime of benefits including but not limited to: housing, canteens, parks, on-site schools and playgrounds, as well as hospitals and clinics. By 1978, nearly three-fourths of industrial production was contributed by centrally-controlled SOEs.

A present version of the past:
Dqing Oilfield Company Ltd. (a subsidiary of China National Petroleum Corporation) still employs the classic SOE model of providing varied social benefits for employees. Such current company-provided facilities and benefits include, but are not limited to: housing, health and medical communities, travel services, food, water, power, gas, nurseries and kindergartens, as well as public transportation and commercial and catering services.
30 years of reform

Since China’s reform and opening up in the late 1970s, the SOEs have undergone a variety of reforms, as China moves away from a planned economy towards a market-driven economy with private and foreign investment in many sectors. This process has been evolutionary, rather than revolutionary.

Phase 1: From 1978 to 1984
Reform concentrated on managerial autonomy to promote profit and growth. Managers were essentially allowed to sell surplus product at market prices for a profit, once planned quotas were met. This was the first introduction of a dual-price system in China. By permitting ‘holes’ in the fabric of the planned economy, the government to some degree began to weaken the link between the State and enterprises.

Phase 2: From 1985 to 1993
Reform focused on separating company ownership and management by introducing a ‘contract responsibility’ system. Managers signed a contract with the relevant government agencies and became legal representatives of the SOE. The idea behind this was to transform SOEs into truly independent economic entities responsible for their own profit and loss, and to establish independent legal entities that shared certain rights and obligations. Measures were also granted to provide SOE managers with financial incentives, and consequently SOE performance improved.

Phase 3: From 1993 to the present day
The government has emphasized the transformation of SOEs into ‘modern corporations’ with clearly defined responsibility and authority, separating government from internal management. The main elements of reform during this period included the 1993 policy of ‘grasping the large and letting go of the small’ [enterprises], which allowed inefficiently run small or medium-sized SOEs to become private entities with mixed ownership (state and non-state). There were still around 300,000 SOEs in 1994; most of these SOEs were small or medium-sized and have been privatized; roughly 1,000 were considered large and designated as needing to remain under the ownership of the State.

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In addition to privatization, becoming a listed entity has also been an important step towards ownership reform. China’s companies are allowed to list on a domestic or foreign stock market and issue three types of shares.

- **A-shares** are a popular choice for SOEs, these are listed in China, denominated in Renminbi, and are accessible to domestic investors or Qualified Foreign Institutional Investors (QFII).
- **B-shares** are also listed in China and denominated in Hong Kong dollars or US dollars. B-shares are now accessible to foreign investors and domestic investors, alike.
- **H-shares** are listed in Hong Kong and available to foreign investors. Shares listed in North America used to be called N-shares, and are now also referred to as H-shares.

At a macroeconomic level, these ongoing SOE reforms can be seen as a strategic adjustment of a formerly-planned economy towards a more market-oriented economy; at the microeconomic level, the reforms are intended to transform the Chinese SOEs into modern corporations with independent decision-makers, clearer legal responsibilities, incentives for performance, and public ownership options.

### ‘Central’ oversight

![Diagram showing 115 SOEs in China](image)

The above 115 companies are some of the largest and most important SOEs in China. They are called ‘Zhòng Yāng Qǐ Yè’ (or ‘Yāngqǐ’ 央企, which means ‘central enterprise’ in Chinese) and they operate in the most strategic industries in China. The State-owned Asset Supervision and Administration Commission of the State Council (SASAC, 国务院国有资产监督管理委员会) is directly responsible for the administration and oversight of the Yangqi. SASAC is organized both centrally, for the control and management of China’s central SOEs and regionally, for the control of local and subsidiary SOEs. Altogether, SASAC is responsible for over 100,000 central, provincial, municipal, and subsidiary entities. Directly above the SASAC is the State Council, which is the chief administrative authority of the People’s Republic of China. It is chaired by the Premier of the State Council, Li Keqiang, and includes the heads of each governmental department and agency.
One of SASAC’s key responsibilities is to appoint the ‘top executives’ in charge of daily operations of the Yangqi (including the Chairman, Vice-Chairman, Chief Accountant, etc). In fact, the top position in 53 Yangqi (refer to the infographic on page 3) is equivalent in rank to a Vice-Minister. This means that the Chairman of the SOE would also serve as ‘The Secretary of the Party Committee’, with their Party role conferred by the Central Organization Department of the Chinese Communist Party, and their Chairman position conferred by SASAC.

SASAC appoints and removes the top executives of the supervised enterprises, and evaluates their performances through legal procedures and either grants rewards or inflicts punishments based on their performances; establishes corporate executives’ selection system in accordance with the requirements of the socialist market economy system and modern enterprise system, and improves incentives and restraints system for corporate management.

The Yangqi SOEs

Yangqi have been critical to the success of China. They mainly operate in ‘strategic’ market sectors of China, including: natural resources, food security, defense, energy and power, and telecommunications. Strategic market sectors closely correlate to the ongoing advancement of China's infrastructure, economy, and the daily lives of the Chinese people. In addition to developing these sectors to benefit China, collectively the Yangqi are responsible for a large portion of the overall economy and labor force.

The Yangqi tend not to operate in what is termed the ‘competitive’ market sector. This sector includes businesses related to personal services, or consumer goods. These activities are essential to improving the living standards of Chinese citizens and expanding the middle class; market participants include SOEs (usually non-Yangqi) as well as privately owned enterprises and foreign invested enterprises.
Yangqi versus international comparators

Yangqi are a hybrid of centrally controlled divisions of government agencies and market-oriented multinationals. There are many similarities between Yangqi and international companies. For example, most Yangqi are traded on the Shanghai or a global stock exchange, and many have international operations (some very extensive); Yangqi have been growing and producing substantial economic results for the last 10 or more years; they tend to have strong balance sheets, and many are among the top companies in their sector globally.

The primary differences between Yangqi and multinational corporations are that Yangqi top management officials are not chosen by an outside board of directors but instead are supervised, promoted, and disciplined by the central government. Their decision-making process differs from that of international competitors: they must address the needs of multiple stakeholders, and balance commercial interests with national priorities. On the other hand, Yangqi clearly have advantages through access to central government leadership, financing, talent and other opportunities, by virtue of their status as Yangqi, but also due to their leading position and scale in their respective industries.

Social benefits

For the centrally-managed SOEs, their duties are to contribute to the aggregate growth of China, which according to SASAC means “to provide protection for the development of the national economy and enhance peoples’ lives.” They do this by contributing to the ever-growing infrastructure in China and by ensuring that Chinese consumers can afford basic necessities like water, energy, telecommunications, and natural resources.9

In a reversal from 20 years ago, when many of China’s workers aspired to work for MNCs, now the Yangqi are highly regarded employers in China, with large SOEs seen as the most desirable places to work. In a survey of the 50 best employers in China, 18 listings were from foreign companies and the rest were Chinese companies – mostly SOEs. Four of the top 10 were large SOEs, with China Mobile taking top spot as the most desirable company.10

SOEs, and particularly Yangqi are popular not only because of their size and reputation as national champions, they are also thought to weather economic downturns without incurring massive layoffs, and in fact some offer higher pay and benefits than international companies located in China.

Where do SOEs go from here?

Today, government officials\textsuperscript{11} describe China as a socialist-market economy: the government accepts and allows the use of free market forces in a number of areas to help grow the economy, but the government still plays a vital role in managing the country’s economic development. Since China’s reform in the late 1970s, more than 90 percent of State-owned enterprises have become corporations and some of them have been restructured to become shareholding companies.\textsuperscript{12} Thus reform is an ongoing and continuously changing process.

The question that begs to be asked is: what will the future of SOEs look like? Have they outlived their usefulness, or are they likely to thrive and adapt? For the past 50 years, SOEs have been part of China’s DNA, and although the number of SOEs, as well as their share in China’s economy continues to decline, SOEs and the Yangqi in particular still dominate a number of important economic sectors.

For now, it is a safe bet that the government will wish to continue to have direct oversight of the strategic SOEs, yet there are two key drivers that will undoubtedly influence the course of development of the Yangqi over the next few years:

- On one hand, the government will want to continue to take proactive steps toward maximizing efficiency of these organizations, which has already included supporting the strong SOEs while privatizing the weak or underperforming SOEs, and keeping the Yangqi close, both in terms of continued state ownership as well as ensuring the Yangqi align with national policies and priorities.

- On the other hand, the Yangqi will need to continue to adapt and evolve if they are to maintain their competitive edge in international markets, where they compete outside of their ‘home territory’ against other global leaders. In addition, close linkage to the government has been a double-edged sword in some cases, where SOEs have faced barriers to investment.\textsuperscript{13}

On the whole, we expect the process to be an evolutionary one, where reforms and efficiencies are introduced gradually, while maintaining the basic operating model that has, to this point, served China’s leaders well.

\textsuperscript{http://www.fas.org/sgp/crs/row/RL33534.pdf}

\textsuperscript{12} ‘Chinese SOEs Submit 5 to 20 Percent of Equity Income to Government’. Xinhuanet  
\textsuperscript{http://news.xinhuanet.com/english/business/2012-10/25/c_131930698.htm}

\textsuperscript{13} ‘Not Just Tiltting at Windmills’. The Economist  
\textsuperscript{http://www.economist.com/node/21564235}
For more information, contact:

### Thomas Stanley
COO, Global China Practice  
KPMG China  
Email: thomas.stanley@kpmg.com  
Tel.: +86 21 2212 3884

### Robert Ritacca
Research Manager, Global China Practice  
KPMG China  
Email: robert.ritacca@kpmg.com  
Tel.: +86 10 8508 5109

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