OPINION

The SOE Irritant in U.S.-China Relations

By Andrew Batson

When leaders from China and the U.S. gather for talks in Washington this week, they will not be able to avoid the thorny issue of state capitalism. Defenders of this distinctive economic model argue that China's huge collection of state-owned enterprises is an indispensable tool for the nation's growth. For the U.S., state capitalism has emerged as the dominant issue in its economic relationship with China. Yet critics often lack an understanding of how China's state-owned enterprises (SOEs) really work.

There is little evidence that China's state-owned enterprises are able to turn power into profits.

Outside of China, the debate over the country's state capitalism is driven by two perceived problems. First, China's SOEs have become increasingly profitable and economically dominant since the 2008 global financial crisis. Second, their profits and power come from their ability to bypass market competition and extract subsidies and other favorable policies from the government. As these state firms expand their global presence, their unseemly profitability and unfair market power undermine the competitiveness of U.S. companies.

The U.S. and other like-minded countries have been searching for ways to redress this imbalance. The simplest remedy is to take away some of the SOEs' profits. One of the main accomplishments of the 2012 Strategic and Economic Dialogue for the U.S. was China's agreement to require more state firms to pay higher dividends. Getting China to reduce subsidies to SOEs is tricky, but the U.S. has stepped up its use of trade remedies to fight against subsidy policies. It wants to incorporate restrictions on SOE aid into the Trans-Pacific Partnership and other new trade deals under negotiation.

These are not necessarily bad policies, but their popularity appears to be based on a mistaken understanding of how SOEs actually function. Simply put, the real problem is not that China's state firms are too profitable or too subsidized, but that they are too inefficient. Most SOEs are not globe-straddling colossi flush with cash–they are parochial, poorly performing companies. As the Chinese government cools down the rapid credit growth that many SOEs rely on, the real condition of its state sector will become increasingly clear.

The idea that SOEs' fortunes have improved since 2008, thanks to waves of government cash flowing through Chinese economy, does not stand up to scrutiny. In fact SOEs in general have done poorly in the years since the crisis, proving less nimble than private-sector firms at adapting to a slower-growing China. According to the Ministry of Finance, China's state firms have made a combined return on assets of barely 3% since 2008. Their financial performance in recent years is heavily driven by big increases in debt, rather than improvements in underlying profitability. The size of SOE profits relative to China's annual GDP peaked at 6.6% in 2007 and has hovered between 4% and 5% since 2008.


Reuters/Stringer
A Sinopec natural gas transmission facility in Sichuan.

While a few large and profitable firms like PetroChina and China Mobile dominate public perceptions of SOEs, most state firms are much smaller and financially weaker. China has more than 100,000 state enterprises, most of them controlled by local authorities rather than Beijing, and belonging not to high-profile strategic sectors like energy and telecommunication. The average SOE has annual revenues of less than $45 million.

It's certainly reasonable to ask the most profitable SOEs to pay much of their profits back to the government as dividends, as state firms in other countries do. But most of China's SOEs would struggle to generate enough profit to even attract the attention of dividend-collectors in Beijing.

While the government clearly allows some state firms to occupy profitable niches, the ability of SOEs to sway government policy to their own benefit is often overstated. For example, state energy firms may have a monopoly on extracting oil and gas, but they have to sell the resulting gasoline, diesel and other fuels at state-set prices that frequently leave little room for profit. For every Chinese SOE that is granted a lucrative franchise, there is another that has to endure low margins in order to meet the government's political goals.

Even in sectors where law or custom gives SOEs a favored position, there is little evidence that they are able to translate that power into enormous economic returns. China's state-owned tobacco firms, for instance, make a high 17% return on equity—but publicly-traded tobacco firms outside China make even higher returns, around 23%. The same pattern holds true for other industries dominated by SOEs, such as telecom, electric power and transportation. So even with a monopoly or other advantages, Chinese SOEs tend to make lower returns than non-state companies in competitive markets.

Both the defenders and the critics of Chinese SOEs tend to overstate their accomplishments and financial success. The last round of state-enterprise reforms in China, which happened from 1998 to 2003, resulted in real achievements. They shuttered thousands of unprofitable companies and forced the rest to face the discipline of the market.

But many of those gains have been undone in recent years, as slow economic growth renewed political pressure on state firms, making them spend and hire more in order to keep GDP figures high. Burdened by poor investment decisions, state-owned firms are falling further and further behind China's vibrant private-sector firms.

Both the U.S. and China should therefore favor a revival of the principles embraced by the previous generation of Chinese reformers: holding SOEs to high global standards of performance and transparency, and closing down or selling off chronic poor performers. Such a program would address U.S. concerns about lack of fair competition in state capitalism. And with China now settling into a slower economic trajectory after the past decade's boom, its leaders should be eager to remove the poorly performing SOEs' drag on growth.

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