China's Industrial State-owned Enterprises

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**CHINA'S INDUSTRIAL STATE-OWNED ENTERPRISES
BETWEEN PROFITABILITY AND BANKRUPTCY**

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To Thomas P. Lyons

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Preface

The fate of China's industrial state-owned enterprises (SOEs) has occupied the minds of economists inside as well as outside China for the past two decades. The data certainly look grim. Between 1978 and 1997, losses in industrial SOEs rose twentyfold. By 1998, approximately 20% of all industrial SOEs had partly or fully stopped production. Capacity utilization in more than half of all industrial SOEs was below 60%. One-third of all employees in industrial SOEs had been made redundant. While in 1990 industrial SOEs in only three of the thirty major industrial sectors were running aggregate losses, by 1997 there were aggregate losses in fully 25 of the then 39 sectors. Yet by 2001, the number of industrial sectors in which SOEs were running aggregate losses was down to four.

These facts raise a number of questions. First, why did the profitability of industrial SOEs decline so drastically during the first two decades of China's economic reforms? Did competition drive down profitability, was labor remuneration excessive, or was a high liability-asset ratio to blame? What can we learn about the causes of the decline from industrial SOEs' profit and loss account? Once we know the causes of the decline in industrial SOE profitability over the past more than two decades, what are the implications for industrial SOE profitability in the future?

Second, how do industrial SOEs compare with industrial non-SOEs? Is profitability in industrial non-SOEs so much higher than in industrial SOEs that a change in the ownership form of industrial SOEs is called for? What explains the difference in industrial SOE vs. non-SOE profitability? Are differences in profitability the outcome of continued differential government policies or of systemic deficiencies in SOEs?

Third, are profit rates equal across all industrial SOEs, or do we need to distinguish between specific groups of industrial SOEs, or even individual

enterprises? Does sector, location, size, or ownership level matter? If profit rates are not equal, why not, and what are the implications of unequal profit rates for industrial SOE reform?

Finally, what has the Chinese government done to improve industrial SOE profitability? In 1998, the central government initiated a three-year SOE reform program. Has it achieved its objectives? Which government reform policies succeeded, and which did not? What are the current impasses in industrial SOE reform, and what are the prospects for their resolution?

Understanding the determinants and characteristics of industrial SOE profitability is important, because profitability matters. Profitability matters, because in the long run it determines the economic viability of an enterprise. Industrial SOE profitability also affects employment, government finances, and the health of the banking system. In as far as low industrial SOE profitability triggers industrial SOE reform measures, which in turn are intricately linked to other reforms ranging from social security reform to financial sector reforms, industrial SOE profitability ultimately has implications for the entire transition process.

Carsten A. Holz
December 2002

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