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THOUGHT LEADERSHIP BRIEF

China's State-owned Enterprises and Competitive Neutrality

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KEY POINTS

- Whether or not China adopts the principles of competitive neutrality in its huge market is important for China and for the rest of the world.
- The advantageous position of SOEs in China results in a poor competitive business environment, with the automotive sector being furthest away from competitive neutrality
- General and sectoral trends point to private firms being unable to leverage as much as SOEs
- A working measure of competitive neutrality could help improve the level playing field for foreign companies in China. The concept could even be introduced in a potential reform of the World Trade Organisation.

ISSUE

Differential treatment of companies operating in China has long been an issue of concern. The powerful role of the state in the production of goods and services in China creates a number of major distortions. This impact is increasingly significant on a global level given China's size and the active overseas expansion of its firms (Garcia Herrero and Xu, 2017; Garcia Herrero and Wolff, 2020). Concerns about the behaviour of Chinese SOEs are rooted in the different legal treatment of state-owned, Chinese private and foreign companies. The close relationship between SOEs and the government make any discussion about an equitable business environment in China very complex.

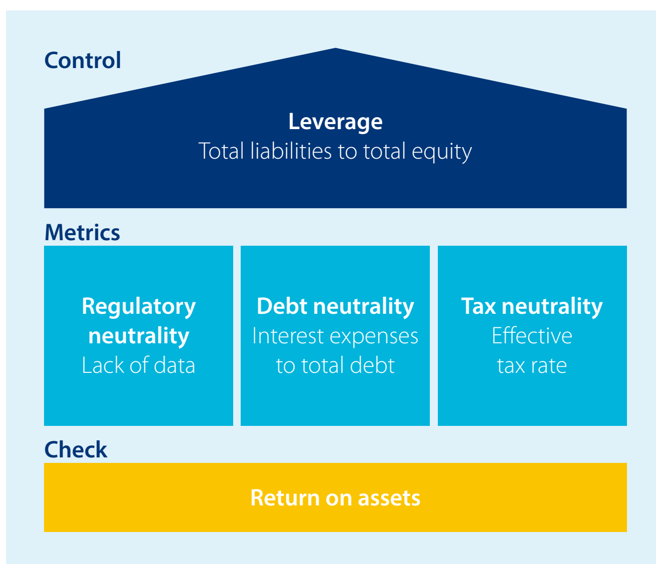
The Organisation for Economic Co-operation and Development (OECD) defines competitive neutrality as the regulatory framework within which public and private enterprises face the same set of rules and where no contact with the state gives competitive advantage to any market participant (OECD, 2009; OECD, 2012). The concept of competitive neutrality is underpinned by the idea that resources need to be used effectively within the economy to achieve growth and development. Policies favouring state-owned enterprises over more efficient private firms make achieving this difficult. Chinese premier Li Keqiang in 2019 said China would implement competitive neutrality so that "enterprises under all forms of ownership will be treated on an equal footing". But since then, no apparent progress has been made.

ASSESSMENT

China's slowing growth due to an aging population and decelerating productivity calls for a more efficient use of resources. The rise in loss-making SOEs, low returns on commercial investment and the misallocation of credit are all signs of the lack of competitive neutrality (Lardy, 2019). The need for SOE reform in China seems clear (Brennan, 2019) and will be globally important considering the increase in overseas revenue.

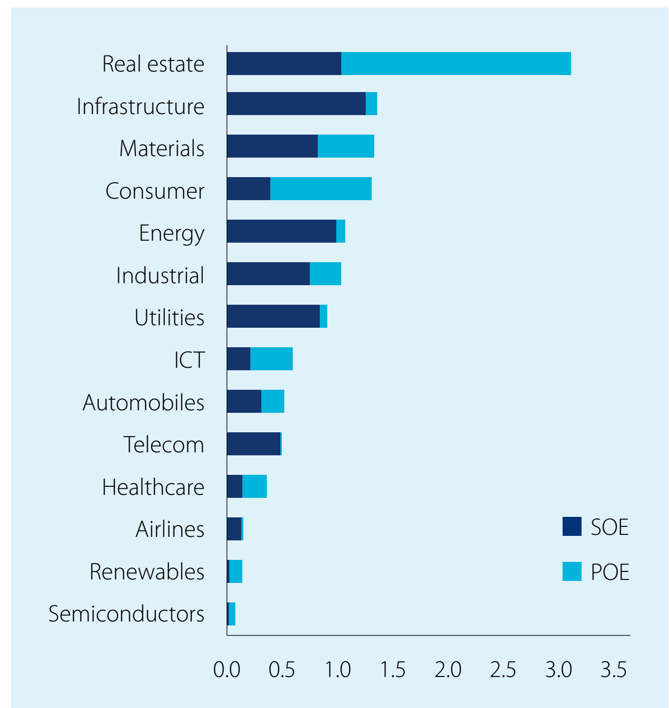
We developed a data-rich approach to measure whether there is competitive neutrality in monetary and fiscal support between SOEs and privately-owned enterprises (POEs) (Figure 1). We used leverage as a control measure to show the divergence in leverage for SOEs and private companies. The three key metrics are regulatory, debt and tax neutrality. It is difficult to quantify regulations, therefore we focus on debt and tax neutrality measured by interest expense-to-total debt and the effective tax rate.

Figure 1. Analysing Competitive Neutrality



Source: Bruegel.

Figure 2. Asset Size by Sector and Ownership, $ Trillions, 2019



Source: Bruegel based on financial statements, Bloomberg. Note: Chinese listed companies.

Using WIND, a financial data platform from China, and classification from Bloomberg, we categorised companies by ownership and sectors and divided firms into 14 key industries. General trends could be affected by different sectoral distribution of SOEs and POEs, coupled by different risk perceptions per sector. To adjust for these differences, we calculated the financial metrics for different sectors and removed the sectors in which SOEs are fully dominant to ensure our selected sectors represent competitive environments for private firms. Thus airlines, energy, infrastructure, telecoms and utilities were excluded from the analysis (Figure 2).

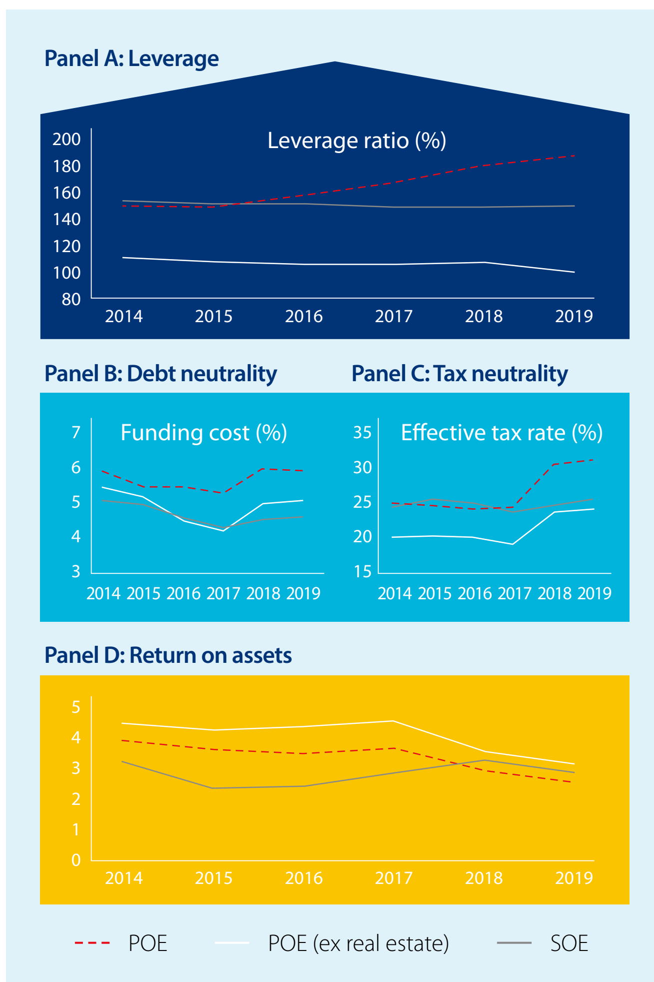
We used 2014 to 2019 data to calculate leverage ratios, effective tax ratios and average funding costs, and return on assets by ownership and sector. The leverage ratio is defined as total liabilities over total equity. The effective tax rate is calculated as income tax expense to pre-tax income. The average funding cost is the ratio of interest payments to total debt. We then compared the average of each of the ratios for SOEs and POEs in each sector. Signs of the absence of competitive neutrality are lower effective tax ratios for SOEs and lower funding costs per unit of debt. In most cases, we calculated an adjusted ratio for POEs excluding real estate. The lack of investment options together with lax mortgage rules have created large property developers in China. Such rapid development has helped local governments secure tax revenues from land sales. In other words, while real estate companies are generally POEs, local governments in particular might consider them strategic, and this skews the overall result.

Our results support the argument that China's competitive environment is poor as conditions favor SOEs. General and sectoral trends point to private firms being unable to leverage as much as SOEs. Despite POEs having a lower leverage ratio on average, they bear higher funding costs. When the real estate sector is excluded, the leverage ratio for POEs falls from 108% in 2014 to 100% in 2019 while it remains largely stable for SOEs at 151% in 2019 (Figure 3, Panel A).

The interest rate on the cost of debt is higher for POEs than SOEs (Figure 3, panel B). Between 2015 and 2017, funding costs fell sharply for all firms as the government tried to support growth, but these lax liquidity conditions have not been reflected equally for SOEs and POEs. The latter have suffered from widening funding costs.

Real estate developers are being heavily taxed, leading to an increase in the overall tax burden for private firms. If we exclude real estate, the effective tax rate has been consistently lower for private firms than for SOEs (Figure 3, panel C). However, on a sectoral level, SOEs pay lower effective tax rates than private firms, with consumer goods and semiconductors being the two exceptions (Figure 4).

Figure 3. Results for SOEs and POEs

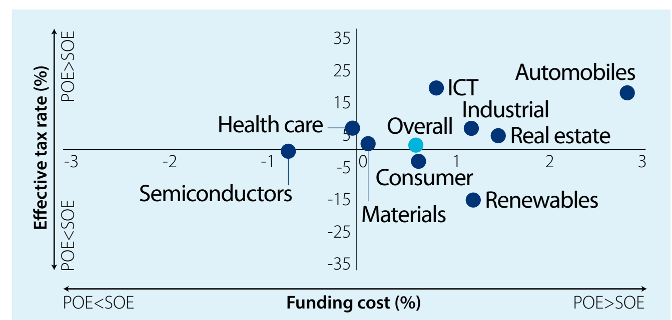


Source: Bruegel based on financial statements, Bloomberg. Notes: Leverage ratio is computed by dividing total liabilities by total equities. Funding cost = interest expense over total debt.

The return on assets (ROA) is higher for private firms until recently (Figure 3, panel D). This improvement for SOE could be an indicator of a more centralised approach to resource allocation with a stronger focus on SOEs. When analysing the different sectors, ROA is lower for private firms in most sectors but marginally better than SOEs in the renewables, industrial and materials sectors. A slower growth environment, with sharp declines in POE returns on assets, has made it difficult for POEs to compete with SOEs in most sectors, with the exception of the consumer and renewable sectors. The fact that these sectors have higher levels of private ownership shows that a lesser presence of state-owned players can enhance competitive neutrality (Figure 5).

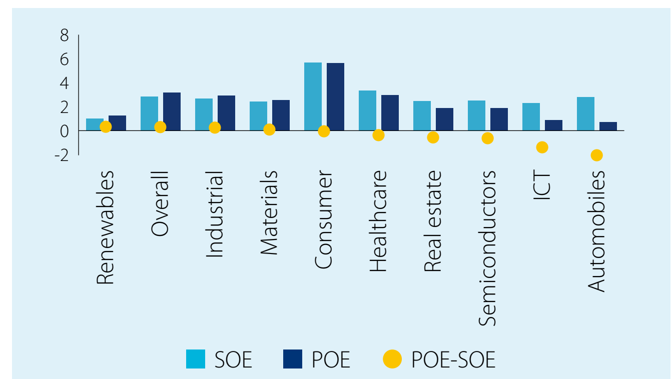
The lack of competitive neutrality in China has significant consequences for companies operating globally. Most Chinese companies on the Fortune 500 list are SOEs, and the proportion is even higher for financial companies compared to non-financial corporations. Chinese firms in the ICT, industrial and auto sectors earn relatively high proportions of their revenues overseas. We find that these sectors are among those that lack competitive neutrality the most..This is important as a highly uncompetitive environment in favour of state-owned automakers must be damaging for foreign competitors.

Figure 4. SOEs, POEs, Divergence in Effective Tax Rates and Interest Rates (Values of POE-SOE, 2019)



Source: Bruegel.

Figure 5. Chinese Listed Firms, Return on Assets by Sector and Ownership (%)



Source: Bruegel based on financial statements, Bloomberg.

RECOMMENDATION

Various measures could be put in place to improve the competitive environment in China without the need to resort to privatisation. Above all, it is important to identify the sectors that suffer from competitive neutrality issues and those that should be characterised as natural monopolies/oligopolies. Once the subgroup of sectors is identified, both *ex-ante* and *ex-post* measures are needed to ensure a level playing field for different companies. Fundamental *ex-ante* concepts include tax, debt and regulatory neutrality. For the first two, the ability to calculate the implicit subsidy and to make it known through appropriate disclosure rules is key. For regulatory neutrality, China's ultimate goal of socialism with Chinese characteristics might make legal and regulatory equalisation particularly difficult to achieve. This means that ensuring competitive neutrality in tax and debt becomes even more important.

China's lack of a competitive environment is exported overseas via foreign direct investment. Unless this improves, foreign governments may decide to use their own trade policies to protect the competitive environment in their own market and overseas. Therefore, China's adoption of competitive neutrality principles would improve the competitive environment globally. The most obvious avenue is the World Trade Organization (WTO), but would require major stakeholders to work on a reform so that WTO members would have an obligation to create a level-playing field. Beyond the WTO, competitive neutrality may return to the forefront of negotiations between the US and China, and in the deal in principle between the EU and China on the Comprehensive Agreement on Investment. By becoming a member of the OECD and adhering to its principles of corporate governance and competitive neutrality, China could achieve the right result without the impression that it has been subject to foreign pressure.

In any event, China would be the main beneficiary of improvements to its competitive environment, especially given the clearly stated objectives of ensuring technology upgrading and self-reliance, as stated in the Fifth Plenum of the 19th Central Committee of the Chinese Communist Party (CCP). The two objectives tend to be mutually exclusive unless a very competitive environment is guaranteed. Otherwise, incumbents will be protected, making it harder to move up the technology ladder in a cost-effective way.

All in all, implementing the concept of competitive neutrality seems like a relatively easy solution to China's long-standing competition problems, which have dampened down potential growth.

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Reference:

Alicia Garcia-Herrero and Gary Ng. *China's state-owned enterprises and competitive neutrality.* Bruegel Policy Contribution. https://www.bruegel.org/2021/02/chinas-state-owned-enterprises-and-competitive-neutrality/

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