

Zhou Xiaochuan: Capital return of state-owned enterprises

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the 2005 Annual Meeting of China Enterprises' Leaders & the 20th Anniversary of <China Entrepreneurs>, Beijing, 11 December 2005.

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Ladies and Gentlemen, fellow participants,

Good afternoon.

It is my great honor to discuss issues of common interest with many entrepreneurs in this gathering. In the same gathering two year ago, I expressed my hope to have more dialogues with entrepreneurs. I regret that I couldn't attend yesterday and this morning's discussions and listen to your marvelous speeches, since I just came back from a business trip. Today, I would like to take this opportunity to share with you my opinions on capital returns of enterprises.

Nowadays, it is already natural for private enterprises to distribute dividends. But are state-owned enterprises willing to pay dividends? Should the state accept dividends? Those questions draw attentions from many and are worthy of discussion. Here, I also wish to exchange my personal views with you.

1. Background of the issue

Economic development has produced different backgrounds for the issue.

Background one: Many state-owned enterprises including state-holding companies have more profits than before. Some enterprises have even higher profits due to high energy prices, particularly oil prices.

Background two: To promote reform process, government needs huge amount of funds to dissolve historical burdens. In the aftermath of Asian financial crisis, sources of fund were needed to help enterprises in distress, establish a safety net and to relieve enterprises off social functions.

Background three has a lot to do with public companies. Many people criticized listed companies because they seldom paid dividends. As listed companies, I think they should reward their investors after raising funds in the capital market.

Background four: reform of state-owned commercial banks. Currently, China Construction Bank, Bank of China and the Industrial and Commercial Bank of China have undergone financial restructuring and recapitalization. Furthermore, China Construction Bank has become a listed company. As their holding company, the Central Safe Investment Co. Ltd. has made it clear that it expects dividends. However, since 1994, state-owned enterprises have never paid dividends to their investors. People will ask why there are such differences.

2. Dividend distribution or not: my personal view

I think owners have the right to receive dividends. First, in terms of corporate governance, this will set a clear operational target for management of the company and protect shareholders' interests. Management should earn profits for shareholders, and accordingly shareholders ought to require dividends.

Second, the property rights structure must be clear. A rewardless investment is the result of unclear property rights structure and could give rise to insider controls and other problems.

Third, we should consider the efficiency of resource allocation. Are resources efficiently allocated? If even the investors don't consider dividends, how could we measure the return on investment?

Some people may argue that, in principle a company should pay dividends to its shareholders, but it needs to take good care of itself in order to have self-development capacity before paying dividends to its shareholders. I think this argument only touches the surface.

In a book I wrote in 1992, I mentioned that the many distortions in our system restrained enterprises' real costs and distorted the relation between cost and profit. Also, enterprises took over

responsibilities that should not have been theirs. As a result, enterprises had exaggerated profits or had difficulties in paying dividends or submitting profits.

If we all agree that state-owned enterprises and state-holding companies should pay dividends to the state, great efforts should be made to correct those distortions. Otherwise, reform will be damaged by those distortions.

Enterprise reform has always been a crucial part in our institutional reform. In the 1980s and 1990s, enterprise reform was taken as both the starting point and the basis of the whole reform program. But recently, I feel the voice for enterprise reform has been a bit muffled. I wonder if this is because enterprise reform has achieved a lot. But in my view, many tasks are yet to be accomplished, many questions are to be answered and many reform measures need to be taken. Only by doing so, can we strengthen our micro-economy and enhance competitiveness.

In order to promote enterprise and relevant supporting reforms, establish a clear operational target, clarify ownership structures and improve capital resource efficiency, I think we should put forward such a proposition, i.e. state-owned enterprises and state-holding companies should pay dividends to their owners. Accordingly, owners should have the rights to decide whether to distribute dividends and by how much.

3. Some supporting reforms are crucial.

It will not be easy to resolve the above mentioned proposition without implementing a series of supporting reforms. Therefore, we should not neglect their importance in this process.

First, distortions in the relation between cost and profit in enterprises' financial statement need to be tackled. A lot of works are still waiting ahead, though after many years' efforts great progress has been achieved in raising accounting standards and amending accounting rules since the Asian financial turmoil.

In the end of 1980's and early 1990's, serious distortions in enterprises' costs and profits propelled the launching of financial accounting reform in 1993 and adoption of new accounting standards and general financial rules. Comparing the profit margin of Chinese enterprises with their international counterparts, we would notice that, profit margin of Chinese enterprises was much higher than the average 5 percent of the top 500 enterprises in the world. You can check the detailed data of Chinese enterprises at that time for yourself. Such comparison doesn't mean higher profitability of Chinese enterprises, as a large amount of costs was not reflected in cost, but in profit. For instance, bonus, employees' pensions, health, R&D and advertisement expenditures should have been cost items, but they were covered by profits. If such artificially high profits of enterprises were paid out as dividends, enterprises could not survive and develop.

Therefore, resolving distortions in cost and profit should be the first task in a series of supporting reforms. This involves upgrading accounting standards. In recent years, continued progress has been made in this regard, for instance, adoption of many practices. Further international comparison may help us detect the remaining problems.

Financial treatments of complicated operations are also involved in the fundamental issue of cost and profit classification, such as risk provisioning, loss write-off and accounting rules on derivatives. Without a clear classification, there will be serious disputes and complaints from enterprises when distorted profits are used as a basis to pay dividends. Some entrepreneurs think it is a difficult problem. We can look at it from the perspective of distorted relationship between profit and cost.

Second, there are deficiencies in the tax system. Our tax system should be rational and with few distortions. Yet, this is not easily achievable for countries in transition and emerging markets and usually takes a long time. The first is tax category. Improper tax categories affect the amount of profits before anything else, thus causing problems.

The second is tax base. Right now, reform of tax base is underway in China. The value-added tax (VAT) will be shifted from production-based to consumption-based. One of the issues involved is how to apportion equipment investment and whether such input should be taken as costs. Some large state-owned enterprises also face problems in taxable salary, depreciation of fixed assets and others that I just mentioned, such as R&D expenditure, advertisement expenditure, risk provisioning and loss write-off etc. If those items could be reflected accurately in the tax base, the profits will also be accurate too.

Third, there is the problem of enterprises' undertaking social functions. We have a very clear direction of relieving enterprises of their social functions. But things are not that simple. In fact, enterprises are still responsible, to varying degrees, for some social functions and working to preserve stability. It is feasible to transfer the function of providing employment, pensioning, and health cares from enterprises if we could have clearly defined responsibilities. Otherwise, "responsibility vacuum" is really troublesome if no social entities take over those social functions. This is potentially possible since reform of social institutions needs much time to complete.

Fourth, it is related to many public companies. Their legacy companies coexist with them and their relations need to be tackled. Some enterprises underwent cosmetic restructuring to get listed in the stock market simply to raise funds, thus it is unnecessary to keep the legacy company. In most cases, there are differences within an enterprise group. Some are growing while others are on the decline; some are well managed and work really hard while others owe it to themselves for the bad performance. At the time of going to the capital market and structural design, consideration should be given to an effective incentive mechanism, moral hazards and striking a balance between the rich and poor. To solve these problems, enterprises have a part to play; at the same time, it has something to do with the state's obligations and historical reasons.

My personal preference is quite clear. I don't think we should underestimate those supporting measures. Only with concerted efforts to promote enterprise reform and take supporting measures can we smoothly solve the problem of returns on state investment.

4. Who should be paid dividends?

There is no doubt to whom the state-owned enterprises and state holding companies should pay dividends. Clear definition of property rights can be found in *the Company Law*, differing from the traditional definition of absolute and relative ownership in the contract-based responsibility system.

Compared with some advanced countries and emerging market economies, where the share of state-owned enterprises in the GDP is 2 percent or 5 percent only, ours is much larger. Accordingly, it is necessary to have multi-leveled operational management. Should each level have capital operation rights? We can find a clear answer in corporate governance structure and *the Company Law*.

Centralized management will not be suitable in China, since we have a sizable presence of three-level state ownership. Great Britain once ruled over India, Australia and some other places. A story was told that, the British government delivered heating radiators to schools in colonial India where electronic fans were actually needed, for officials in London thought India might be as cold a place. For China with a complex and large capital system, we could not imagine that a highly centralized approach could work without a layered management mechanism featuring clear responsibilities and adequate capital operational capacities.

Under such circumstances, owner-agent relationship of state-owned capitals thus became crucial. Since Chinese people are the real owners in essence, how could we realize such ownership? To whom to consign responsibilities? Through what kind of organizational structures, corporate governance structure, checks and balances, including competitive and incentive mechanism? Establishing holding company looks like a good solution. Different holding companies may compare their performances, thus resulting in different incentives. Holding companies could have diverse capital structures and go public to improve efficiencies through public monitor. From this point of view, the establishment of holding companies is an inevitable choice.

As an integral part of SOE reforms, the reform of state-owned commercial banks adopted the holding company model after studying international and Chinese enterprises' reform experiences. Of course, it has to be tested in practice.

Finally, how to pay dividends should be decided by the board of directors and the shareholders' meeting. The board of directors decides whether and how much to pay, and all shareholders rather part of shareholders should be paid. In summary, who should be paid dividends depends on a clear property right structure. There is no need to complicate this matter.

5. Conclusions

In my personal view, to clarify property right and improve corporate governance, we should make efforts to reach consensus through discussion of dividends distribution by state-owned enterprises and investment returns of state owned shares in enterprises with mixed ownerships. In line with such a

spirit, we have carefully studied and discussed property right reform for Bank of China, China Construction Bank and the Industrial and Commercial Bank of China, hoping to avoid the co-existence of both listed companies and the legacy companies like before. All three conducted complete financial restructuring. Among them, China Construction Bank has less than 10 percent of capital invested by the China Jiayin Investment Co. Ltd. which is responsible for providing trust loans on behalf of fiscal authority. And the China Jiayin Investment Co. Ltd. is not a legacy company. The China Construction Bank reform is still complete restructuring. To sum up, property right has become clearer as a result of this approach.

In fact, many of the problems we had to cope with in the process of reform are from supporting measures. That is to say, the problem with return on capital is related to a series of issues, including the systematic reform of enterprises and others that are yet to be properly resolved. As a result, I think we should stress the importance of enterprises' reform under current conditions, and not neglect it since it has been ongoing for many years.

Owners of a company have the right to enjoy its profits through decisions made by the board of directors and shareholders' meeting in line with corporate governance. In a high-growth environment, many enterprises will find themselves lacking of capital. If a company distributes all its profits, how can it continue development when it lack of capitals? In fact, these are two different matters. On one hand, investment should have returns. On the other hand, a company should have other financing channel to supplement capitals in addition to profits. Without financing channel, companies may worry about dividends distribution since they cannot obtain additional funds for future growth. As a result, capital market should be further developed by resolving the non-tradable shares problem. I believe, with our efforts, we will make more progress in the reforms.

I hope my speech will contribute to the discussion. Your comments and criticisms are warmly welcome.

Thank you.