Achieving Competitive Neutrality in China

Nicholas R. Lardy[1]

The concept of competitive neutrality was first advanced in Australia more than 20 years ago, and the Organization for Economic Cooperation and Development (OECD) began studying and promoting this concept almost a decade ago. Essentially, competitive neutrality means that any action taken by a government should have a similar effect on both private and state enterprises. One OECD study of the concept is summarized under the following points:

· State-owned enterprises (SOEs) providing public services should be given fair and transparent compensation, and commercial operations of SOEs should be separated from their responsibilities for public services.

· State and private firms should enjoy equal tax, supervision, and government procurement treatment.

· The state should not provide implicit or explicit guarantees of SOE borrowing. Exemption from debt repayment is equivalent to a subsidy.

· The state as a shareholder in an SOE should require the same rate of return as it would get on a commercial investment. Injecting state capital into SOEs while not demanding a commercial rate of return is a form of subsidy.[2]

Chinese policy has long emphasized that the state should protect the ownership rights and legal interests of all enterprises, regardless of their ownership

[1] Nicholas R. Lardy is Anthony M. Solomon Senior Fellow, Peterson Institute for International Economics.

[2] Zhang Chunlin. 2018. "Competitive Neutrality for SOEs Can Help China at Home and Abroad." Caixin, October 16.

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status, allowing them equal use of factors of production and to openly and fairly participate in a competitive market. But Chinese practice has fallen short of these ideals. This paper explores some of these shortfalls and suggests policies that would form an essential part of any serious effort to implement competitive neutrality in China.

The first and perhaps most obvious dimension in which China's current economic policy falls short of competitive neutrality is the huge share of loss-making state firms. Data from the Ministry of Finance (Table 1), reveal that over the past decade about two-fifths of all state companies are loss-making, meaning that they can't fully cover their cost of capital. Losses of about RMB500 billion prior to the global financial crisis tripled to about RMB1.5 trillion by 2017. Moreover, in many cases it appears that these money-losing firms are relieved of paying taxes and perhaps contributions to social insurance funds. Their true losses may be larger than shown in Table 1.

Since the losses of state firms roughly tripled between 2008 and 2017 while roughly two-fifths state firms remain loss-making, it seems that a large subset of state firms is persistently losing larger and larger amounts. These loss-making firms continue to operate by borrowing more and more funds to cover their losses and to have the funds to pay the interest on their outstanding borrowings from state banks. These mechanisms violate the competitive neutrality principles of equal treatment in taxation and not guaranteeing borrowing of state firms.

A second dimension in which China's current economic policy falls short of competitive neutrality is that the state as shareholder does not demand that state enterprises earn the same return as it would get on a commercial investment. Figure 1 shows that the return on assets of state industrial firms has since the late 1990s persistently lagged the returns of private firms and that the gap has increased since the global financial crisis. In recent years, the return on assets of private firms has been two-and-a-half to three times the returns earned by state companies. Perhaps some loss-making state firms included in Table 1 are public service firms that are required to provide services at less than cost and receive subsidies that offset the resulting losses.

The situation of state industrial firms (Figure 1) is quite different. Few public service firms operate in this universe; rather, these firms are mostly in manufacturing, where state firms generally are not required to sell at less than cost of production to meet social objectives. Thus, there is a second clear violation of competitive neutrality—the state provides capital to industrial SOEs but does not require these firms to generate a commercial rate of return.

More evidence that conditions of competitive neutrality do not exist in China is reflected in Figures 2 and 3. Figure 2 shows one of the more common metrics of enterprise creditworthiness—the share of a firm's profits is required to pay interest on its outstanding debt. Commercially oriented banks presumably would be less willing to lend and/or would charge higher interest rates to firms in which interest payments absorb a relatively large share of profits. As is clear from Figure 2, the average creditworthiness of state and private industrial firms diverged after the global financial crisis so that by 2017 private firms were more than twice as creditworthy, on average, as state firms.

Figure 3 shows that in the early years of this decade, private firms, indeed, received a much larger share of bank credit than state firms, consistent with the hypothesis that commercially oriented banks would lend larger amounts to more creditworthy firms. But after 2013, with no improvement in their creditworthiness, the share of new bank loans going to state firms soared, and bank lending to private firms collapsed. It appears that the state began to provide at least an implicit guarantee of borrowings by state companies from state banks, again another violation of the principle of competitive neutrality.

To offset their loss of access to bank credit, private firms turned increasingly to shadow banks. This involved two violations of competitive neutrality. First, since interest rates charged by nonbank financial institutions are typically several times those charged by state banks, private firms were no longer able to compete with state firms on a level playing field. Second, starting in 2017, the authorities sought to slow the growth of credit to reduce the financial risks associated with a high level of debt relative to GDP. And they focused their efforts on shadow banking, the less well-regulated portion of China's financial system. While this made sense from a macroprudential perspective, the collateral damage is that private firms were increasingly squeezed out as the growth of shadow bank lending slowed and then shrank in absolute terms (Figure 4). Again, government action had a differential effect on private and state firms, a clear violation of the principle of competitive neutrality.

Figure 5 further underscores the preferential access of state firms to credit, showing that the number of state-controlled firms continues to expand while, as their access to bank and non-bank credit collapsed, the number of private limited liability companies grew more slowly in 2016 and then fell noticeably in 2017.[3] Despite the large number of loss-making state companies, exit via bankruptcy is limited. In 2017, Chinese courts adjudicated fewer than 7,000 bankruptcies.[4] Even if all these cases involve state-owned firms, the share of loss-making state firms subject to bankruptcy is less than 5 percent annually. The absence of significant exit plus the formation of some new state firms means the universe of state-owned firms continues to expand.

Similarly, money-losing state-owned firms are not required to either sell assets to offset their losses or be acquired by another firm that could potentially make more productive use of the state firm's resources. As Table 2 shows, only around 7,000 merger and acquisition transactions occurred in each of the past two years. In value terms these transactions are tiny. The assets of state nonfinancial firms at the end of 2017 stood at RMB185 trillion.[5] If all of the merger and acquisition transactions involve takeovers of state firms, the magnitude of the assets involved is only about one-half of one percent of the assets of state nonfinancial firms.

Figure 6 reflects another dimension in which competitive neutrality is absent—while entry by private firms into manufacturing has long been relatively liberalized, substantial regulatory barriers remain to entry of private firms in services. The share of investment by state firms in services is relatively

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3 The focus here is on private firms organized as limited liability companies. Undoubtedly thousands of small startup, registered private companies fail and go out of business simply by exiting. With no formal creditors involved there is no need for a legal bankruptcy process when these firms exit. Private firms organized as limited liability companies are much larger. For example, these firms account for only a little over one-tenth of all private firms but a disproportionately large share of the profits of private firms. Thus, they are more likely to have formal creditors.

4 Supreme People's Court of China. 2018. "Press Conference Briefings on the Adjudication of Enterprise Bankruptcy." March 6.

5 Ministry of Finance. 2019. 2018 China Fiscal Yearbook China State Finance Magazine, p. 356. Beijing.

elevated and shows no downward trend, meaning the state has not liberalized the terms of entry for private firms for almost a decade. Private investment in services is concentrated in traditional services such as wholesale and retailing, restaurants, and hotels, all domains that the state opened to private investment decades ago. Investment by private firms in financial services and information transmission, software, and information technology is far more limited. The restrictions on access of private firms reduce competition and likely contribute to the very low return on assets of state firms in services (see Figure 1).

Discussion by Chinese leaders of adopting the principle of competitive neutrality is an encouraging sign. If implemented it likely would put China on a path to higher growth, near its potential of 8 percent a year, or slightly more.[6] Achieving competitive neutrality would be challenging and require:

· market-oriented allocation of financial resources, meaning at a minimum ending the implicit state guarantee of borrowing by state companies,

· imposition of hard budget constraints on state enterprises,

· elimination of obstacles to merger and acquisition activity,

· facilitation of bankruptcy for chronic money-losing companies, and

· liberalization of access of private firms to service industries.

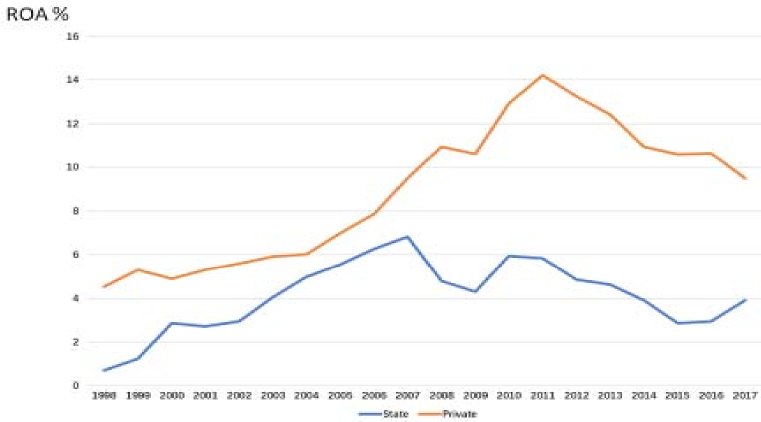
Table 1. Huge Share of Loss-Making State Firms, 2008–17

Year	Loss-making share (percent)	Number of Loss-making Enterprises (Hu)	Losses: Amount (billions of RMB)	Losses: As a share of GDP (percent)
2008	39.5	43,500	507	1.6
2009	37.1	41,200	394	1.1
2010	35	39,900	392	1.0
2011	35.1	47,700	613	1.3
2012	35.5	52,200	855	1.6
2013	35.6	55,200	860	1.5
2014	36.1	58,100	1,086	1.7
2015	37.2	62,100	1,342	2.0
2016	37.1	64,600	1,466	2.0
2017	36.9	69,000	1,445	1.8

Source: Ministry of Finance.

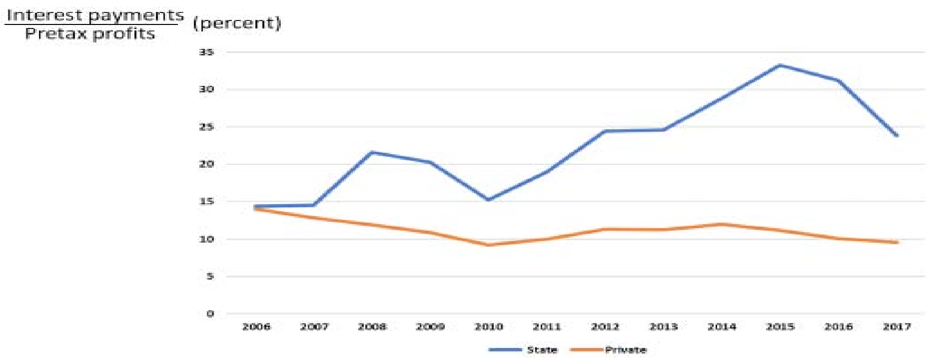
[6] Nicholas R. Lardy. 2019. The State Strikes Back: The End of Economic Reform in China? Washington: Peterson Institute.

Figure 1. Diverging Returns of State and Private Industrial Enterprises After 2007



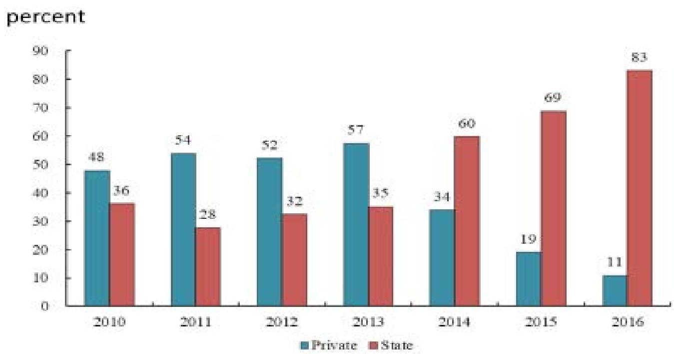
Source: National Bureau of Statistics.

Figure 2. Private Industrial Firms Are More Creditworthy



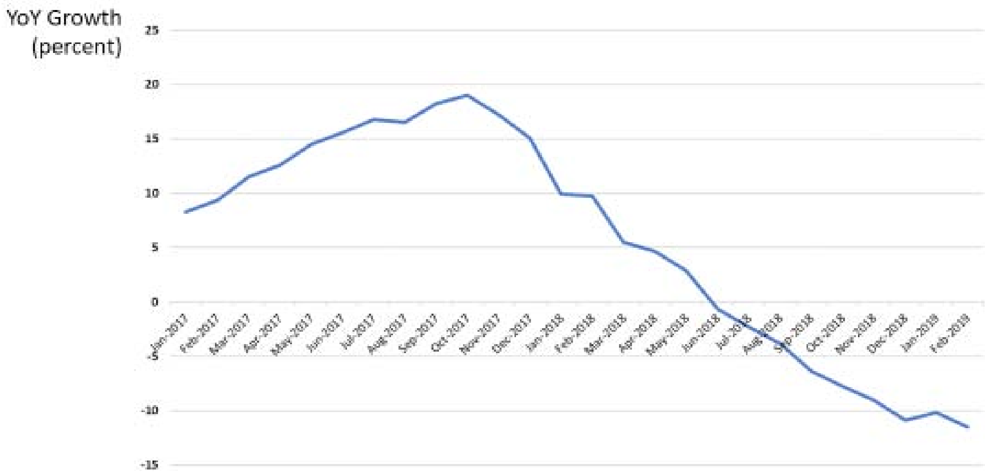
Source: National Bureau of Statistics.

Figure 3. Misallocation of Loans to Nonfinancial Enterprises After 2013



Source: China Banking Society.

Figure 4. Collapse of Shadow Finance Further Squeezes Private Firms, January 2017–February 2019



Note: Shadow finance = sum of entrusted loans, trust loans and bankers' acceptances.
Source: People's Bank of China.

Figure 5. Only Private LLCs are Subject to Financial Discipline

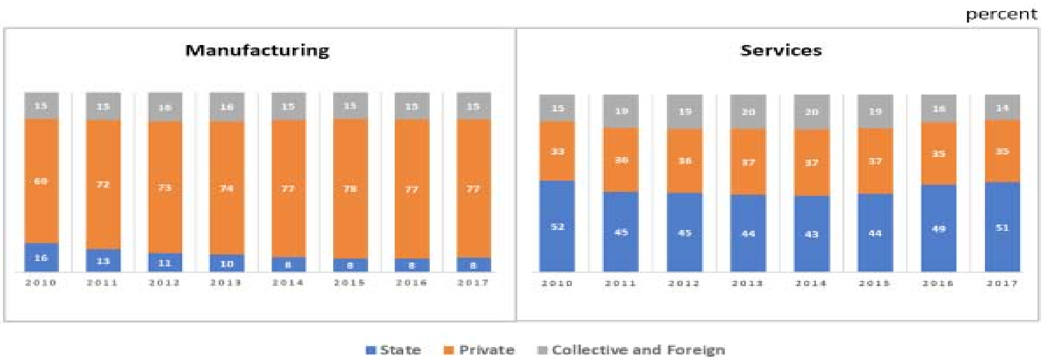
LLCs = limited liability companies
Source: National Bureau of Statistics.

Table 2. Limited Domestic Mergers and Acquisitions, 2007–18

Year	Number of transactions	Value (billions of RMB)
2007	1,078	326
2008	1,668	519
2009	1,559	577
2010	1,797	663
2011	2,063	725
2012	1,079	506
2013	1,583	480
2014	1,915	871
2015	2,887	1,547
2016	2,938	1,490
2017	6,689	1,568
2018	7,234	1,362

Source: Wind Financial Information.

Figure 6. Continued State Domination of Services Investment, 2010–17



Source: National Bureau of Statistics.