

## SOE Dividends: How Much and to Whom?

World Bank\*

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China's state-owned enterprises (SOEs) overseen by the central government's State-Owned Assets Supervision and Administration Commission (SASAC) made net profits of RMB 299 billion during the first half of 2005 and RMB 400 billion in 2004. All non-financial SOEs, including those administered by provincial and municipal authorities, earned total profits of RMB 759 billion in 2003, representing 6.5 percent of GDP and equivalent to 35 percent of fiscal revenue.<sup>1</sup> Some large publicly-listed SOEs pay out 20-60 percent of their earnings in dividends (Table 1). Yet, for historical reasons recounted below, no government entity – neither the Ministry of Finance (MOF) nor SASAC – receives any dividends from large centrally-administered SOEs, a pattern that mostly applies as well to local governments and locally-administered SOEs. This is in contrast to arrangements in other countries, where the state, as key shareholder, normally receives dividends, like other shareholder.

Following the establishment of SASACs at the central, provincial, and municipal levels during 2003-04, SOE dividend policy was brought to the government's reform agenda when the annual working conference of SASACs discussed the issue of a "state assets management budget" in January 2005. Central SASAC Chairman Li Rongrong indicated that his Commission would "work closely with the Ministry of Finance to try to start this reform this year following the strategy set by the State Council"<sup>2</sup>.

Why is SOE dividend policy important to China? A dividend policy for a SOE group would divide its after-tax profit into two parts: retained earnings to finance investment in the group and dividends to finance general public spending (consumption or investment in other enterprises and projects) by the government. As such, the rationale for a sound dividend policy is twofold. First, it has the potential to enhance the efficiency of investments financed by retained earnings of SOEs; and second, it would improve the overall allocation of public financial resources.

If one accepts the broad rationale for a reform aiming at a sound dividend policy for Chinese SOEs, several follow-on questions arise:

- First, why are dividend policies needed and how should they be set?
- Second, which government entity should receive SOE dividends?
- Third, what are the implications for the organization of enterprise groups?<sup>3</sup>

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<sup>1</sup> *China Financial Yearbook, 2004; China Statistical Yearbook, 2004.*

<sup>2</sup> <http://www.people.com.cn/GB/jingji/1037/3098445.html>.

<sup>3</sup> While somewhat esoteric, the organization of enterprise groups is an issue because – in many cases – dividend-paying SOEs are spin-offs from larger enterprise groups and dividends are paid to the enterprise group parent company. Typically, despite being 100 percent state-owned, enterprise group parent

## Background

Since the taxation reform in 1994, most SOEs have not paid any significant dividend to the government in China. 1993 was the last year when “revenue from enterprises” was still a component of government budget revenue. In essence, the current issue of SOE dividend policy is a result of an unfinished reform on the financial relationship between the government and SOEs.

The pre-reform system was unified and simple. SOEs were required to submit to the budget any profit they made and received grant funding from the budget to finance all their investments and losses. In 1978, “revenue from enterprises” was the largest source of budget revenue and accounted for more than half of the total<sup>4</sup>.

When the reform started in early 1980s, this system was identified as one of the key weaknesses of the SOE sector, as it led to weak incentives, known as “sharing rice pot”, in that it failed to reward (punish) profit-making (loss-making) SOEs and made it difficult for managers to reward better-performing employees beyond their formal wages, for example, by giving bonuses.

SOE reform in the 1980s started with an increase in managerial autonomy and profit retention. The underlying strategy was to break up the “sharing rice pot”. With profit retention policies, SOEs who made more profit were allowed to retain more. As part of the retained profit could be used to finance “collective welfare” and “employees awards”, the benefit accrued to individual managers and employees, which helped generate profit motives inside SOEs. In addition, employees’ awards, in most cases in the form of bonuses, were determined and distributed by managers. Better-performing employees could be rewarded.

Profit retention, however, gave rise to a difficult issue of dividing SOE profit between the government and the “enterprises”, which mainly meant their managers and employees. As more profit was retained by SOEs, government revenue from enterprises declined sharply in the 1980s, leading to an overall fiscal decline, which did not reach the bottom until 1995 when the taxation reform in 1993-4 began to show results (Figure 1). To secure its revenue from SOEs without weakening profit motives of their managers and employees, the government employed a range of measures from various profit retention formulae in early 1980s to the “contracting responsibility system” in late 1980s, all of which involved one-to-one negotiation on profit division between the government and each SOE. The taxation reform in 1994 marked the end of that approach. The 1994 tax reform provided a clear and non-negotiable division of SOE profit: the part that goes to the government is now fixed as tax at a unified rate, while anything left belongs to the enterprise.

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companies do not in turn pay dividends to the government, but rather retain and use surplus cash as seen fit by parent company management.

<sup>4</sup> China Statistical Yearbook, 2004. P291.

It was, of course, not forgotten that the enterprise itself is owned by the state, and therefore, that the government as sole owner is entitled to all its after-tax profit. However, a decision was taken during taxation reform in 1994 that the government would not collect profit from SOEs for an unspecified period of time. The exact reasons for this decision remain unclear. However, a number of factors may have played a role.

- First, this decision seemed a natural extension of the logic prevailing in SOE reform in 1980s, which emphasized the independence of SOEs from the government.
- Second, the central theme of SOE reform during 1992-1994 was still increasing managerial autonomy and reducing government intervention, as was evident in the State Council “Regulation on Transformation of Management Mechanisms of SOEs” in 1992. Collecting dividends from SOEs would appear naturally as moving in the opposite direction.
- Third, without corporatization and some minimum progress in corporate governance, it would be practically difficult for the government to determine an acceptable rate of dividend without reopening the negotiation with management of each SOE on profit division.
- Fourth, SOEs as a whole were in poor financial situation in early 1990s. What the government could collect was not much, while the need for new capital injection was perceived as urgent and large. In 1994, total profit of industrial SOEs was only 1.8 percent of GDP, which compared with 3.3 percent of GDP in 2003.<sup>5</sup>

### **Why Pay Dividends?**

It is well-known that saving and investment in China are very high in comparison with other countries. It is less well-known that high corporate sector saving—including by SOEs—is a key contributor to China’s high saving and investment. At about 20 percent of GDP—double the share in the US and France—retained earnings finance more than one-half of enterprise investment. Amidst concerns about the efficiency of investment and calls for a larger role of consumption in the economy, it is appropriate to revisit the corporate governance and dividend policies for SOEs.

Enterprise saving shows up as reported profits and depreciation charges, which have increased significantly, including in SOEs. With overall profitability in SOEs having improved in recent years, profits of *industrial* SOEs and collectively owned enterprises have increased from 1.2 percent of GDP in 1998 to 3.7 percent of GDP in 2003 (Table 2). These profit numbers, and the numbers mentioned elsewhere in this note, exclude depreciation (of assets) allowances. While data on depreciation charges of SOEs is difficult to get, data for the industrial sector overall (including the private sector) suggests that depreciation allowances have increased to generous levels in recent years, and are almost as large as reported profits (Table 2).

Large-scale financing of enterprise investment through retained earnings may facilitate industrial expansion due to the readily-accessible source of finance. However, this pattern of financing has disadvantages that become more prominent as the economy

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<sup>5</sup> China Statistical Yearbook, 1995, p403; 2004, p536.

develops and becomes more sophisticated. The critical one is that within-firm allocation of capital does not receive the same scrutiny as channeling via the financial sector, which may affect its efficiency. If the firm's prospects for growth and profitability are good and corporate governance strong, within-firm allocation of at least some of the profits can be optimal and efficient. However, the lower growth and profitability prospects are, and the weaker corporate governance is, the higher is the probability that the within-firm allocation is inefficient and that pay-out of at least some of the profits to its shareholders improves efficiency. For instance, although many steel companies have seen large increases in profitability due to high international prices, given the prospects for oversupply in the sector, it may not be optimal to invest these profits in another steel factory. It may economically be more appropriate to channel these profits via the financial market to investment in other sectors, or to consumption. Lack of scrutiny may also lead to pro-cyclical investment behavior of enterprises, making the economy prone to "boom and bust cycles". These issues are of particular concern in an environment of weak corporate governance.

Strengthening SOE corporate governance and increasing dividend pay-outs should lead to greater scrutiny of the allocation of capital. This would tend to improve the efficiency of capital and shift the trade-off between consumption and investment more towards consumption, in line with the government's objective to increase the role of consumption in the economy (as opposed to investment).

An additional consideration is that the State has borne most of the restructuring costs for enterprises: it has taken on social obligations such as schools and hospitals, and it has taken over much of the responsibility for costs associated with workers' unemployment and early retirement. Indeed, the shedding of these obligations played a big part in the rise in SOE profits — all the more reason for the State to recover some of its costs.

Dividend policy has long been a subject of detailed study in advanced market economies, especially in the United States.<sup>6</sup> Principal-agent considerations provide the main rationale for distribution of surplus cash, through dividends or share buy-backs. Jensen and Meckling (1976) noted that managers of a jointly held public firm could allocate resources to activities (e.g., corporate jets, unjustifiable acquisitions and expansions) that benefit them, but that are not in the shareholders' best interest. In other words, too much cash in the enterprise may result in over-investment. Grossman and Hart (1980), Easterbrook (1984), and Jensen (1986) have suggested that shareholders, by minimizing management's access to cash, can make it more difficult for management to go on (unmonitored) spending sprees. The less discretionary cash accessible by management, the more difficult it is for them to invest in projects with negative net present value.<sup>7</sup> Peter Lynch (1990), one of America's most successful asset managers,<sup>8</sup> has provided an

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<sup>6</sup> For a good summary, see Franklin Allen and Roni Michaely, *Payout Policy*, Wharton, Financial Institutions Center, April 2002. Available at <http://fic.wharton.upenn.edu/fic/papers/01/0121.pdf>

<sup>7</sup> Citations from *ibid*, pp. 61-2.

<sup>8</sup> Peter Lynch managed Fidelity's Magellan Fund from 1977 until 1990. By the time Lynch retired, Magellan Fund had grown to \$9 billion in assets. During Lynch's tenure as fund manager, Magellan posted average annual returns of 29%, which was substantially higher than returns for the S&P500.

anecdotal summary of a decade's worth of "diworseifications" by cash-rich enterprises in the U.S. (Box 1).

Empirical findings lend support to these theoretical suggestions. Several studies show that limiting potential over-investment through cash distributions (e.g., dividends), especially for firms with limited investment opportunities, tends to enhance shareholder wealth.<sup>9</sup>

Lastly, it is worth noting the linkages between dividend payout ratios and corporate governance. La Porta et al (2000) found that firms in countries with better investor protection made higher dividend payouts than did firms in countries with lower investor protection. Moreover, in countries with more legal protection for investors, high-growth firms had lower payout ratios. Thus, it appears that enterprise managers have no inclination to distribute surplus cash to shareholders. Rather, an effective corporate governance system gives shareholders the opportunity to reduce agency costs by forcing enterprise managers to distribute surplus cash, especially when growth prospects are low.<sup>10</sup>

### **How Much to Pay?**

Some studies have looked at how much dividends are paid by companies in the private sector. Among them, a classic 1956 study of dividend behavior made a number of findings that still ring true today. Companies are concerned with the stability of dividends. Rather than setting dividends anew each quarter, firms first consider whether they need to make any changes in the existing dividend. Earnings are the most important determinant of any change in dividends. Most companies have a target payout ratio. Even if earnings show a sudden and unexpected rise, firms adjust dividends slowly. Contrariwise, firms are reluctant to cut dividends. Companies often set dividend policy and then adjust other policies accordingly. For example, if investment opportunities are abundant but the firm lacks sufficient funds *ex-dividend*, the firm will likely borrow. The median dividend target ratio in the 1956 study was around 50 percent of earnings. More recently, in two-thirds of the years between 1972 and 1998, dividends of 122,000 U.S. industrial firms represented between 38 percent and 54 percent of their earnings.<sup>11</sup>

Among individual companies in OECD countries, however, dividend payout ratios vary widely. The portion of earnings paid out as dividends tends to reflect each company's growth prospects.

For example, companies with relatively slow and dependable growth can typically support a dividend payout ratio of about 50 percent of earnings (Table 3). Because their earnings are often more predictable, regulated utilities may comfortably support an even higher payout ratio (Table 4).

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<sup>9</sup> Allen and Michaely, *Payout Policy*, pp. 78-80.

<sup>10</sup> *Ibid*, p. 81.

<sup>11</sup> J. Lintner, "Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes," *American Economic Review*, 1956, 46(2), summarized in Allen and Michaely, pp. 10-12, 132.

For companies in cyclical industries, such as basic materials, dividends may reach or exceed 100 percent of earnings during cyclical downturns (Table 5). Companies can do this because cash flows typically exceed net income (see Table 6 for examples).<sup>12</sup> Cash flows (basically pre-depreciation earnings) tend to be higher for companies with high capital investment and high depreciation charges. Especially in setting dividends for companies in cyclical industries, it makes sense to consider projected cash flows over the entire business cycle.

High-growth or high-tech companies may pay little or no dividend (Table 7), on the assumption that reinvestment in the company is the best use for surplus cash. But it is important to review such assumptions periodically, since an extended period of high growth may more or less exhaust a company's growth prospects. A good example of this is Microsoft, which used to be a fast-grower that paid no dividends. Over the past five years, however, Microsoft's annual earnings growth has slowed to 6 percent. Having accumulated cash reserves of \$49 billion by mid-2003, Microsoft began to pay dividends. During the past year, Microsoft has paid out 29 percent of its earnings in dividends.

Because SOEs represent a public trust, several officials from OECD countries suggest a higher standard for SOE retention of surplus cash. For instance, in the view of one senior official from Scandinavia, "a reasonable dividend policy in a 100 percent state-owned company would be to give the total profit as dividend unless the company in question can present investment opportunities that promise a reasonable reward, considering the risk."

Actual SOE dividend policies vary among OECD countries. In New Zealand, SOE boards set dividend policies, in consultation with the shareholding ministries, based on such factors as the SOE's capital structure, proposed capital investments, and profitability. SOE boards in Denmark, Finland, Norway, and Sweden set multi-year payout targets – for example, 33 percent, 50 percent, or 67 percent of earnings *projected over an entire business cycle* (Table 8). In Singapore, SOE payouts are based on cash flow (i.e., pre-depreciation earnings). In Sweden and Norway, SOEs have occasionally returned capital to the state in the form of a special (one-time) dividend in order to reduce SOE capital (equity) and achieve a higher rate of return on capital invested (equity).

### **Who to Pay?**

SASAC as the shareholder agency of the government would obviously be the direct recipient of SOE dividends. However, what is next is not as obvious. For instance, if SASAC collects SOE dividends, should these be submitted to MOF or should they be managed by SASAC as part of a "state assets management budget?"

Before entering into concrete discussion of alternative arrangements, however, it is important to clarify one principle, that SOE profit and privatization proceeds are all

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<sup>12</sup> For three of the four cyclical companies shown in Table 6 – in paper, aluminum, and steel – dividend/earnings ratios ranged from 20 to 300+ percent over the last ten years. During the same time, however, dividend/cash flow ratios varied much less, 11-24 percent.

public financial revenue and should be managed as such. In other words, nobody has the legal power to decide on their spending without approval of the National People's Congress (NPC) through the budgeting process. This is critical because better prioritization of public spending across sectors requires an integrated budgeting process in which all available public financial resources are allocated according to one set of criteria to meet public needs.

The current dividend policy (or absence of a dividend policy), whereby SOE groups retain virtually all after-tax profit to finance reinvestment, seems to have an implicit assumption that there is no better use of SOE profit other than reinvestment back into SOEs. This is obviously questionable. Indeed, China now faces the urgent challenge of refocusing its public spending to improve equity and efficiency of the delivery of key social services, such as education and health, which are considered critical to achieve national development goals<sup>13</sup>. And the isolation of SOE profit from normal budgeting process is hardly justified.

Take education as an example. In 2002, 159,000 non-financial SOEs made a total profit of RMB558.9<sup>14</sup>, while primary and junior secondary schools collected RMB27 billion fees<sup>15</sup>. In other words, a 4.8 percent dividend payout would have enabled the government to waive all school fees for children under compulsory education in 2002. Suppose the government had intended to subsidize less developed provinces to ensure that per student expenditure in every province in the three sub-sectors of basic education, namely, regular primary, regular junior secondary and regular senior secondary, is not lower than the level of Shandong province in 2002, the additional financial requirement (around RMB30 billion<sup>16</sup>) would be met with 5.4 percent of SOE profit. If 50 percent of SOE profits, estimated at 6.5 percent of GDP in 2004, were distributed to the budget and spent on education and health, this would allow an 85 percent increase in government spending on education and health.

Moving from the domestic needs to international best practices, it appears that the norm is for SOE dividends to go to the finance ministry for general public uses, regardless of which agency acts as the state shareholder. This is (or has been) the case, for instance, in Denmark, Finland, France, Germany, New Zealand, Norway, South Korea, and Sweden (Table 8).

A few OECD countries have created separate state shareholding funds: for example, Austria's OIAG fund, the Czech Republic's National Property Fund (NPF), and Singapore's Temasek. Of these, it appears that only Temasek operates as a self-perpetuating fund that reinvests dividends and privatization proceeds. Even so, dividend payments by Temasek to Singapore's finance ministry have averaged 7 percent of the market value of Temasek's shareholdings over the past 30 years. At Austria's OIAG, 90

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<sup>13</sup> World Bank, 2005, *China: Deepening Public Service Unit Reform to Improve Service Delivery*. CITIC Publishing House. P142.

<sup>14</sup> China Fiscal Yearbook 2003.

<sup>15</sup> World Bank staff calculation based on data in *China Educational Finance Statistics 2003*.

<sup>16</sup> World Bank staff calculation based on data in *China Educational Finance Statistics 2003*.

percent of its ordinary earnings for 2004 were paid to the finance ministry in dividends. In addition, OIAG is now required to pay 100 percent of any extra-ordinary privatization proceeds to the finance ministry. Payments over the years by the Czech Republic's NPF to various government agencies, projects, and subsidy programs seem more or less to have equaled NPF's earnings and privatization proceeds.

Thus, both theory and international best practices would suggest that while SASAC acts as the state shareholder, SOE dividends and privatization proceeds should go to the MOF and be subject to standard budget processes. This may cause concerns about SASAC's capacity in making "structural adjustment" in the SOE sector: how will SASAC's financing needs in structural reform be financed? Structural adjustment may involve a range of actions such as corporatization, privatization, financial restructuring, merger, liquidation, technological upgrading, investment in new business line or new firm, and exits from expensive social service burdens.<sup>17</sup> This is a legitimate question, but the answer should be simple. SASAC's all expenditures should be funded by the budget in the same way as any other central government department. The key point here is prioritization. By going through standard budget processes, SASAC's expenditure requests are assessed and weighed against other competing spending requests by the government and People's Congress, which is supposed to reflect the value judgment of the people.

While this simple model is the most straightforward and can be taken as the "base-case," real-world circumstances compel consideration of alternative models. The most important consideration is SASAC's incentive to oversee SOE dividend policies. Will SASAC's incentive to insist on regular dividends from SOEs be materially weakened if all of the dividends flow to the MOF, leaving SASAC to depend on standard budget processes and allocations from MOF for its own funding? Will SASAC's legitimate needs for fund be assured in the budget process? The relevance of these considerations decreases as the standard of public governance rises. In an environment characterized by sound public governance, these should not be problems. Collecting dividends for the budget is part of the job of SASAC, and the budget process is sound enough to prioritize among all legitimate needs. It is rather natural for all government departments to be subject to budget constraint.

However, imperfection in public governance might warrant an alternative model – the implementation of a "dividend policy" for SASAC itself. Dividends from SASAC to MOF could be based, for example, on a fixed percentage of the dividends that SASAC itself receives, or a percentage of the capital employed by the SOEs in SASAC's portfolio (which might encourage a more efficient use of capital), or some combination of the two.

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<sup>17</sup> For instance, SASAC would be a likely candidate to pay at least part of the cost for centrally-administered SOEs in Northeast China to exit from expensive social service burdens. In 2002, centrally-administered SOEs in Northeast China maintained 1,667 social service organs (e.g., schools, clinics), which employed 140,000 staff and cost RMB 6.8 billion. Shao Ning, "The Reform and Transformation of Central SOEs in Northeast China," International Conference on Revitalizing Northeast China, Dalian, 25 September 2004.



There is also a third alternative – the transformation of SASAC into a Temasek-like fund that would manage dividend/privatization receipts, re-invest, and perhaps borrow. This would be a radical departure for China. The success of Temasek and its allure notwithstanding, worldwide experience shows that attempts to create state-controlled “super-holding” companies are likely to end in financial disaster. A less risky (but by no means risk-free) approach to the development of internationally-competitive enterprise groups would be to rely on the highly-qualified management and boards of SOEs to make investments based on their best commercial judgments, backed by “normal” shareholder oversight and incentives, and free from bureaucratic interventions or interference.<sup>18</sup>

Whichever alternative model is adopted, SASAC’s budget and resources should be subject to the same NPC scrutiny as any other fiscal resources. This should include cash transfers from SASAC to the general budget whenever considered appropriate by the State Council and NPC.

Further debate on the nature of a “state assets management budget” is warranted. The concept of a state assets management budget is, as yet, completely undefined. There is no particular reason, however, why it should be broadly defined to include SASAC’s retention of all dividends, reinvestment of dividends, and (perhaps) borrowing. The concept could just as reasonably be narrowly defined to cover SASAC’s costs of portfolio management. International experience indicates that portfolio management costs should be quite modest.<sup>19</sup>

Similarly, the role of SASAC(s) in financing structural reform needs clarification. What, if any, structural adjustment costs should be covered by SASAC’s budget? For instance, if a centrally-owned SOE in Northeast China is liquidated and workers are owed for severance and health/pension benefits, what should be the source of funds to settle workers’ claims – the SOE’s assets? SASAC’s budget? MOF directly? or a new employee insurance scheme? Suppose an investment into a new project by the government is justified and approved. Should it be SASAC or some other agency who gets the money from MOF and carry out the investment? Questions like this must be addressed in view of the proper role of SASAC as a shareholder agency.

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<sup>18</sup> In Italy, for instance, a lack of financial discipline and muddled goals led to financial collapse of the IRI holding company in 1992, and its transformation into a privatization fund until its liquidation in 2000. In Austria, ballooning debt at OIAG and its portfolio companies led to a change of OIAG’s mandate in 1993 to a privatization fund that would hold “blocking minority” (about 25 percent) shares of “strategic” companies. In Brazil, an unsuccessful effort in the early 1970s to create a state steel enterprises holding company (Sidebras) eventually led to the privatization of subsidiary companies and the liquidation of Sidebras in 1990. By contrast, by following a commercial approach to corporate governance and investment, the formerly state-owned CVRD conglomerate proved far more successful. W. Mako and C. Zhang, “Exercising Ownership Rights in State-Owned Enterprise Groups: What China Can Learn from International Experience,” December 2002, pp. 14, 27-30, [www.worldbank.org/cn/english/content/soe/pdf](http://www.worldbank.org/cn/english/content/soe/pdf).

<sup>19</sup> It is estimated that Temasek’s annual operating cost in 2001 was less than \$30 million. Against a market value of \$55 billion for its shareholdings, this represents about a 0.05 percent expense ratio. *Ibid*, p. 16.

## **Whither (Wither?) Enterprise Groups?**

No discussion of SOE dividends is really complete without consideration of a final question of what to do with state-controlled enterprise groups. Group subsidiaries (including many publicly-listed companies) may pay dividends to the 100 percent state-owned enterprise group parent company, which then retains the cash for its own purposes rather than forwarding it to the government (e.g., MOF and/or SASAC).

Many enterprise groups have a troubling history. During the peak period of initial public offerings (IPOs) in the mid- and late-1990s, up to 1100 enterprise groups went through the process of “packaging” good assets for IPOs. Bad assets, unprofitable business operations, excess debt, pensions and other liabilities typically remained in the group company or other subsidiaries.

Unfortunately, “packaging for listing” created a corporate governance mess. The enterprise group parent might use IPO proceeds and ongoing earnings (e.g., dividends from publicly-listed subsidiaries) to fund intra-group structural reform. Or, these new funds might be used for ill-advised investments in core businesses, investments in non-core businesses (e.g., speculation in commercial real estate), or worse. Enterprise group parent companies often used control over listed subsidiaries to extract cash through various connected transactions.<sup>20</sup>

Such exploitation of listed subsidiaries (and public shareholders) having become an increasingly notorious problem, the authorities responded with three main initiatives. First, opportunities for new “packaged” IPOs have been curtailed. Second, regulatory changes have strengthened the responsibility and authority of independent directors and shareholders to review and approve connected transactions. Third, on a pilot basis, a few different efforts at equity restructuring have attempted to disentangle parent-sub finances and ownership. For instance, Hunan Television’s parent company transferred its shares in a listed subsidiary to the subsidiary in repayment of debt owed to the subsidiary, while TCL Group used the proceeds from a public offering of Group shares to buy out the public shareholders of a Group subsidiary.

More such equity restructuring would improve financial transparency, regularize corporate governance, and enhance credibility with equity market investors. Disentanglement of listed companies from enterprise groups should also serve to streamline the flow of dividends from SOEs to the designated government recipient. In cases where the enterprise group is highly distressed – for instance, due to excessive bank debt and/or pension liabilities, non-viable core businesses, or ill-advised investments in new ventures – liquidation (with preservation of any viable business segments) would be the preferred course.

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<sup>20</sup> As illustrated in Figure 2, enterprise group parent companies have relied on various fees and borrowings to extract cash from listed subsidiaries. In a 2002 survey of 71 listed companies, loans to the largest shareholder averaged 46 percent of the listed company’s equity. Most borrowers expected to take 2-3 years or more to repay, and did not plan to repay in cash.

**Table 1. Dividend Payout Ratios by Major Chinese SOEs On American Depository Receipts (ADRs)**

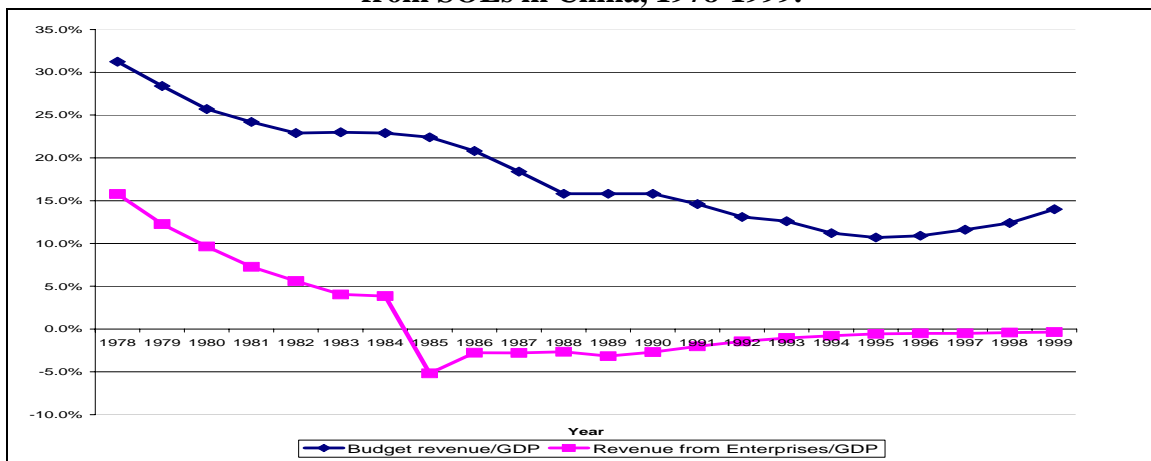
	<u>Dividends Per Share</u>	<u>Earnings Per Share</u>	<u>Dividend Payout Ratio</u>	<u>Market Capitalization</u>
Petrochina	2.37	7.59	31%	156,890
China Mobile	0.13	1.41	9%	79,570
Sinopec	1.45	5.91	25%	37,640
China Telecom	0.83	4.02	21%	31,120
China Unicom	0.12	0.39	31%	11,310
Huaneng Power	1.21	2.14	57%	6,580
Aluminum Corporation of China	2.13	7.40	29%	6,420
Yazhou Coal Mining	1.57	6.36	25%	4,050
Guangshen Railway	0.71	0.85	84%	1,510
China Eastern Airlines	0.48	1.15	42%	823

Source: [www.finance.yahoo.com](http://www.finance.yahoo.com) on 1 August 2005.

Note:

Per share data for trailing twelve months (TTM) and expressed in US\$ per share.  
Market capitalization is in millions of US \$.

**Figure 1. The Decline of Budget Revenue and Revenue from SOEs in China, 1978-1999.**



Note: revenue from enterprises is the government revenue from SOEs net of loss subsidies.

Source: *China Statistical Yearbook*, various years.

Table 2

Table. Profits state-owned and collective industrial enterprises							
	1998	1999	2000	2001	2002	2003	2004
	(in percent of GDP)						
Profits industrial enterprises							
Total	1.9	2.8	4.9	4.9	5.5	7.1	8.3
State owned and holding	0.7	1.2	2.7	2.5	2.5	3.3	...
Collectively owned	0.5	0.6	0.5	0.4	0.4	0.4	...
<i>memorandum items:</i>							
Depreciation 1/							
Percent of GDP	6.9	2.3	5.0	4.9	6.2	6.5	...
As share of net fixed assets			9.1	9.1	11.5	12.5	...
Source: CEIC							
1/ for industrial enterprises overall.							

### **Box 1. Avoid “Diworseifications”**

Instead of buying back shares or raising dividends, profitable companies often prefer to blow the money on foolish acquisitions. The dedicated diworseifier seeks out merchandise that is (1) overpriced, and (2) completely beyond his or her realm of understanding. This ensures that losses will be maximized.

Every second decade, corporations seem to alternate between rampant diworseification (when billions are spent on exciting acquisitions) and rampant restructuring (when those no-longer-exciting acquisitions are sold off for less than their original purchase price).

There are so many examples of diworseification I hardly know where to begin. Mobil Oil once diworseified by buying... a retailer in an unfamiliar business that plagued Mobil for years....Mobil blew more millions by paying too much for Superior Oil. Since the 1980 peak in oil prices, Mobil stock has risen 10 percent, while Exxon has doubled. Beyond a couple of relatively small acquisitions, such as Reliance Electric and an ill-fated capital venture subsidiary, Exxon resisted diworseification and stuck to its own business. Its excess cash went into buying back its own stock. The shareholders of Exxon have done much better than the shareholders of Mobil, although new management is turning Mobil around.

Gillette had a spectacularly profitable razor business, which it gradually reduced in relative size as it acquired less profitable operations. If the company had regularly bought back its shares and raised its dividend instead of diverting its capital to cosmetics, toiletries, ballpoint pens, cigarette lighters, curlers, blenders, office products, toothbrushes, hair care, digital watches, and lots of other diversions, the stock might well be worth over \$100 instead of the current \$35....Gillette, too, has made major reforms and lately mended its ways.

General Mills owned Chinese restaurants, Italian restaurants, steak houses, toys, shirts, travel companies, camping goods stores, and footwear.

That’s not to say it’s always foolish to make acquisitions....We would never have heard of Warren Buffet if Buffet had stuck to textiles....The trick is that you have to know how to make the right acquisitions and then manage them successfully.

If a company must acquire something, I’d prefer it to be a related business, but acquisitions in general make me nervous. There’s a strong feeling for companies that are flush with cash and feeling powerful to overpay for acquisitions, expect too much from them, and then mismanage them. I’d rather see a vigorous buyback of shares.

Source: Peter Lynch, *One Up on Wall Street*, (Penguin, 1990), pp. 139, 146-150.

**Table 3. Dividend Payout Ratios: Slow-Growth Companies, 2003**

<u>Sector</u>	<u>Company</u>	<u>Country</u>	<u>Market</u> capitalization <u>(\$ millions)</u>	<u>Return</u> <u>on equity</u> <u>(ROE)</u>	<u>Earnings</u> <u>per share</u> <u>(EPS)</u>	<u>Dividends</u> <u>per share</u>	<u>Payout</u> <u>ratio</u>
Appliances	Electrolux	Sweden	6,880	11%	2.59	1.24	48%
Pharmaceuticals	Pfizer	US	271,600	45%	1.51	0.6	40%
Diversified	Novo Nordisk	Denmark	12,200	n.a.	1.9	0.38	20%
	3M	US	50,900	32%	5.12	2.64	52%
	GE	US	292,500	24%	1.48	0.76	51%
	Siemens	Germany	46,400	8%	2.33	0.85	36%
Food Processing	United Technology	US	33,900	26%	4.5	1.08	24%
	ADM	US	8,600	7%	0.72	0.24	33%
	ConAgra	US	12,600	18%	1.58	0.99	63%
Oil integrated	Statoil	Norway	18,300	32%	1.1	0.37	34%
	Repsol YPF	Spain	19,500	n.a.	2.33	0.42	18%
	Petrobras	Brazil	22,200	25%	2.19	0.17	8%
	Eni	Italy	60,400	18%	6.81	3.31	49%
	Royal Dutch	Netherlands	96,900	20%	3.59	1.42	40%
	Total	France	154,200	18%	2.97	1.47	49%
	BP	UK	154,200	16%	2.97	1.47	49%
	Exxon Mobil	US	240,800	21%	2.29	1	44%
Consumer Goods	Colgate	US	31,200	n.m.	2.26	0.96	42%
	Gillette	US	33,600	54%	1.19	0.65	55%

Source: Yahoo Finance, company profiles, July 7, 2003.

**Table 4. Dividend Payout Ratios: Utilities/Infrastructure Companies, 2003**

<u>Sector</u>	<u>Company</u>	<u>Country</u>	<u>Market</u> capitalization <u>(\$ millions)</u>	<u>Return</u> <u>on equity</u> <u>(ROE)</u>	<u>Earnings</u> <u>per share</u> <u>(EPS)</u>	<u>Dividends</u> <u>per share</u>	<u>Payout</u> <u>ratio</u>
Communications	AT&T	US	15,700	3%	1.36	0.75	55%
	Verizon	US	110,100	20%	2.29	1.54	67%
	British Telecom	UK	28,600	n.m.	7.87	1.08	14%
Electric Utilities	Consolidated Edison	US	9,220	11%	3.06	2.24	73%
	Scottish Power	UK	11,300	14%	2.32	1.83	79%
Railroads	CP	Canada	3,680	14%	2.15	0.35	16%
	CSX	US	6,680	7%	2.06	0.4	19%

Source: Yahoo Finance, company profiles, July 7, 2003.

**Table 5. Dividend Payout Ratios: Cyclical Companies, 2003**

<u>Sector</u>	<u>Company</u>	<u>Country</u>	<u>Market</u> capitalization (\$ millions)	<u>Return</u> on equity (ROE)	<u>Earnings</u> per share (EPS)	<u>Dividends</u> per share	<u>Payout</u> ratio
Aerospace	Boeing	US	28,000	14%	1.55	0.68	44%
Autos/components	Daimler	Germany	37,200	7%	3.14	1.61	51%
	Ford	US	20,400	16%	0.63	0.4	63%
Chemicals	GM	US	20,100	20%	5.43	2	37%
	Johnson Controls	US	7,780	18%	6.74	1.44	21%
	NL Industries	US	849	11%	0.82	0.8	98%
	Monsanto	US	5,860	2%	0.43	0.52	121%
	BASF	Germany	25,500	8%	2.74	1.25	46%
	Dow	US	28,600	-4%	-0.4	1.34	-335%
	Dupont	US	42,000	18%	1.92	1.4	73%
Steel	Posco	South Korea	8,980	10%	2.81	0.59	21%
	Nucor	US	3,910	7%	2.04	0.8	39%
	Siderurgica	Brazil	1,760	51%	6	2.45	41%
Mining	US Steel	US	1,630	6%	1.09	0.2	18%
	Alcoa	US	21,700	5%	0.6	0.6	100%
	Alcan	Canada	11,000	3%	0.83	0.6	72%
	BHP Billiton	Australia	22,400	11%	0.44	0.29	66%
	Pechiney	France	3,770	-1%	-0.22	0.48	-218%
	Rio Tinto	UK	27,400	6%	1.32	2.4	182%
Capital Goods	Milacron	US	162	-6%	-0.57	0.04	-7%
	Hitachi	Japan	17,900	1%	0.69	0.43	62%

Source: Yahoo Finance, company profiles, July 7, 2003.

**Table 6. Effects of Earnings Volatility and Capital Investment  
On Payout Ratios, Selected Cases from North America**

(\$ per share, except as noted)

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
<b>International Paper</b>										
Dividends	0.92	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Earnings	4.50	1.49	1.03	1.00	1.33	2.16	0.44	1.12	0.80	1.30
Capital investment	5.82	4.64	3.68	3.42	2.75	2.79	2.18	2.11	2.42	2.59
Cash Flow	8.37	5.42	5.19	4.86	5.00	5.96	4.33	4.44	4.21	4.51
Dividends/earnings	20%	67%	97%	100%	75%	46%	227%	89%	125%	77%
Dividends/cash flow	11%	18%	19%	21%	20%	17%	23%	23%	24%	22%
<b>Alcan (aluminum)</b>										
Dividends	0.45	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
Earnings	2.26	1.74	1.99	1.67	1.66	2.52	1.65	1.51	0.76	1.75
Capital investment	1.73	2.13	2.82	3.56	5.35	4.69	3.46	2.26	2.43	3.48
Cash Flow	4.24	3.64	3.91	3.68	3.85	3.53	4.21	4.18	3.20	5.34
Dividends/earnings	20%	34%	30%	36%	36%	24%	36%	40%	79%	34%
Dividends/cash flow	11%	16%	15%	16%	16%	17%	14%	14%	19%	11%
<b>Dow Chemical</b>										
Dividends	0.93	1.00	1.12	1.16	1.16	1.16	1.30	1.34	1.34	1.34
Earnings	2.76	2.57	2.60	2.04	2.07	2.22	0.52	0.33	1.38	2.72
Capital investment	1.88	1.86	1.77	2.34	2.11	1.99	1.75	1.78	1.19	1.40
Cash Flow	4.86	4.42	4.57	4.18	4.24	4.36	2.49	2.33	3.43	4.92
Dividends/earnings	34%	39%	43%	57%	56%	52%	250%	406%	97%	49%
Dividends/cash flow	19%	23%	25%	28%	27%	27%	52%	58%	39%	27%
<b>Dofasco (steel)</b>										
Dividends	0.80	0.85	1.00	1.00	1.00	1.04	1.08	1.08	1.17	1.26
Earnings	1.98	2.12	2.12	2.04	2.85	2.42	0.35	3.13	1.87	4.90
Capital investment	2.57	3.71	1.41	3.02	2.37	2.88	2.72	1.85	2.14	4.12
Cash Flow	4.40	4.79	5.10	4.96	6.23	5.88	3.73	6.79	5.21	7.95
Dividends/earnings	40%	40%	47%	49%	35%	43%	309%	35%	63%	26%
Dividends/cash flow	18%	18%	20%	20%	16%	18%	29%	16%	22%	16%



**Table 7. Dividend Payout Ratios: High-Growth/Technology Companies, 2003**

<u>Sector</u>	<u>Company</u>	<u>Country</u>	<u>Market</u> <u>capitalization</u> <u>(\$ millions)</u>	<u>Return</u> <u>on equity</u> <u>(ROE)</u>	<u>Earnings</u> <u>per share</u> <u>(EPS)</u>	<u>Dividends</u> <u>per share</u>	<u>Payout</u> <u>ratio</u>
Aerospace	Aviall	US	231	10%	1.02	-	0%
	Flir	US	1,070	29%	1.18	-	0%
Pharmaceuticals	Biogen	US	6,150	12%	1.25	-	0%
	Amgen	US	88,900	-10%	-1.02	-	0%
Technology	Cisco	US	127,900	12%	0.46	-	0%
	Nokia	Finland	84,700	27%	0.83	0.26	31%
	Motorola	US	23,200	-16%	-0.82	0.16	-20%
	Ericsson	Sweden	18,200	-27%	-1.86	-	0%
	Nortel	Canada	11,400	-90%	-0.7	-	0%
	Corning	US	9,540	-41%	-1.81	-	0%
	Software	Peoplesoft	US	5,700	9%	0.56	-
Satyam		India	1,530	20%	0.5	0.11	22%
Adobe		US	8,030	27%	0.86	0.05	6%
SAP		Germany	37,800	22%	0.56	0.14	25%
Oracle		US	65,800	40%	0.43	-	0%
Microsoft		US	294,400	18%	0.88	0.08	9%

Source: Yahoo Finance, company profiles, July 7, 2003.

<b>Table 8. Dividend Policy for State-Owned Enterprises And State Shareholding Funds, Selected Cases</b>					
<u>Country</u>	<u>Entity</u>	<u>Sector</u>	<u>State ownership</u>	<u>Dividend Policy</u>	<u>Dividend recipient for state shares</u>
<i>Selected State-Owned Enterprises (SOEs)</i>					
Austria	OMV	oil refining	32%	27% and 20% of post-tax profits, respectively, in 2003 and 2004.	OIAG Fund
Czech Republic	CEZ	power	68%	Articles require 5% of profit to be reserved until reserve fund reaches 20% of registered capital. 2003 dividends amounted to 45% of net income.	National Property Fund
Denmark	CPH	airport	37%	Board proposes to AGM to set stable payout ratio, of 50% of earnings for 2004.	Ministry of Finance
Finland	Finnair	airline	58%	Board proposes to AGM to pay, on average, at least 2/3 of earnings per share during complete economic cycle, taking into account earnings trend and outlook, financial situation, and capital investment needs	Ministry of Finance
Finland	Outokumpu	steel	49%	Board proposes to AGM a dividend policy whereby at least 1/3 of group's profits will be paid as dividends over a business cycle, taking into account investment and development needs.	Ministry of Finance
France	France Telecom	telecoms	31%	During profitable years of 2000, 2003, & 2004 dividends were 16-43% of earnings, on a per share basis. FT paid no dividend in 2002, a year of heavy losses. Future dividends will depend on FT's "ability to generate profits, its financial position, and any other factor deemed relevant by the board of directors." FT "wishes to bring its distribution policy nearer that of other European telecommunications companies."	General budget and state pension fund
Germany	Deutsche Telekom	telecoms	38%	2004 dividend was 56% of earnings, on a per share basis. Following losses in 2001 & 2002, DT paid no dividend in 2002 & 2003. The board recommends a dividend, subject to AGM approval. Dividends may be paid only from distributable balance sheet profits, i.e., as adjusted for prior gains/losses or transfers	Ministry of Economy

				to/from retained earnings. Future dividends depends on earnings, financial condition, cash requirements, and tax, regulatory, and legal considerations.	
India	ICICI Bank	financial services	17%	2004 dividend was 88% of earnings, on a per share basis. Subject to AGM approval, board recommends dividends based on revenues, cash flow, financial condition, and central bank regulations	Mostly state-owned insurance companies
New Zealand	various	e.g., airports, post, rail, media, power, forestry	100%	Dividend policy is set by boards, in consultation with shareholding ministries (SMs). Treasury & CCMAU advise SMs on dividend policy, based on such factors as the company's capital structure, proposed capital investments, and profitability.	Treasury (MOF)
New Zealand	Air New Zealand	airline	81%	Set by boards. Calculation based on stock exchange information indicates payout ratio now about 15% of earnings	Treasury (MOF)
New Zealand	Telecom New Zealand	telecoms	0% (ex-SOE)	For 2005, minimum payout ratio is 85% of post-tax profits, plus amortization and non-cash working capital items. Dividends during first 3 quarters are each about 10% of projected total for year. 4Q dividend is set to reflect payout ratio for full year	NA
Norway	Statoil	oil	81%	Company seeks to payout 45-50% of net profits, measured as an average over several years, taking into account business cycles. To maintain financial flexibility, dividends may vary depending on cash flows, financing requirements, and investment plans.	Ministry of Finance
Norway	Posten	postal services	100%	Per parliamentary resolution, 30% of 2003-2005 net profits are paid as dividends. Starting in 2006, dividends will be calculated as the State's borrowing rate x Posten's equity, but limited to 75% of net profit.	Ministry of Finance
Singapore	PSA	ports	100%	2003 dividends represented 61% of pre-tax cash from operations, with cash from operations being higher than earnings due to high (non-cash) depreciation charges.	Temasek Fund
South Korea	KT&G	tobacco products	100% until 1999; 0% by	During 2000-2002, the final years of state-ownership, dividends were ranged from 60-80% of earnings, on a per share basis. During at least	Ministry of Finance and Economy

			end-2002	2001, dividends to minority (i.e., public) shareholders were 133% of those paid to the majority (i.e., state) shareholder.	
Sweden	SJ	railroad	100%?	Ordinary dividend should be at least 1/3 of net profit, once the target equity/assets ratio of 50% has been achieved. A special dividend shall be paid to achieve an effective capital structure	Ministry of Finance
Sweden	Vattenfall	Power		To maintain a stable dividend over long-term, normally 1/3 of net profits.	Ministry of Finance
<i>Major State Shareholding Funds</i>					
Austria	OIAG fund	“stratetgic”	100%	90% of 2004 earnings paid as dividends. 100% of any privatization proceeds now must also be paid to the State (i.e., MOF)	Ministry of Finance
Czech Republic	National Property Fund	“strategic” & “portfolio”	100%	A review of the Fund’s accounts suggests that perhaps 100% of earnings have been paid to various state entities in the form of budget support and subsidies.	Various government funds
Singapore	Temasek fund	“strategic” & “portfolio”	100%	Over past 30 years, dividends to MOF have averaged 7% of the value of State holdings	Ministry of Finance

Sources: Company and fund web sites; correspondence with selected officials.

**Figure 2: Issues posed by SOE Enterprise Groups**

