
Effective Discipline with Adequate Autonomy: the Direction for Further Reform of China's SOE Dividend Policy

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Abstract

This note explores the desirable direction for further reform of China's SOE dividend policy. It argues that a sound dividend policy must generate effective discipline against insiders and leave adequate managerial autonomy to them in the meantime. In light of China's current situation and relevant international experience, it recommends three actions to deepen the reform started by State Council Document No. 26 of 2007.

The first is to raise the flexibility of SOE dividend ratio by adding a dividend ratio determination mechanism to the existing system of state ownership function. A desirable mechanism could be defined by the following three components: (i) A two-tier structure of dividend ratio, in which each SOE's dividend comprises one fixed component and one variable component. (ii) A sector-specific uniform ratio of the fixed dividend component for each sector. (iii) A four-step process to set the ratio for the variable dividend component for each SOE, i.e., SOE board's proposal of variable dividend ratio target as part of the Responsibility Statement, SOE and SASAC discussion followed by agreement, and SASAC's evaluation.

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The second involves government monitoring and adjustment of the average dividend ratio of all central SOEs. The government can consider one or more of the following three approaches. The first is to accept whatever is turned out by the recommended mechanism of dividend ratio determination. If some degree of planning and targeting with regard to the average dividend ratio of all central SOEs turns out to be justified, the government may then consider other two approaches. It could either carry out an in-depth study to gauge the appropriate level of dividend ratios in various sectors and key SOEs by assessing investment efficiency of SOE profit, or simply set a target in the interval of 20-50 percent in the 12th Five-Year Program, taking into consideration factors such as overall SOE reform strategy and sectorial development program.

The third is to start integrating “state capital management budget (SCMB)” with the general budget. The government could consider two actions in 2010: (i) transferring the first batch of SOE dividend revenue to the general budget, and (ii) incorporating the SCMB into the general budget that is submitted to the National People’s Congress for approval.

1. Introduction

Despite fast expansion of the private sector, China has retained a fairly large sector of state-owned enterprises (SOEs), which was populated with 112,000 nonfinancial SOEs² with a total employment of over 35 million in 2007. Continuous reform and restructuring in the 1990s have led to steady improvement of SOE profitability since 1998, a trend that was not discontinued until the global financial crisis in late 2008. In 1998, for example, nonfinancial SOEs collectively reported 0.3 yuan aggregate profit (defined as total profit net of loss of all nonfinancial SOEs) for every 100 yuan of sales revenue. This ratio rose to 9 yuan in 2007. Similarly, the aggregate profit SOEs earned for every 100 yuan of equity capital jumped from 0.4 yuan to 12.1 yuan in the ten years³.

Improved profitability has given rise to an increasingly powerful role of SOE profit in China's growth and development. In 2007, aggregate profit of nonfinancial SOEs reached 7 percent of GDP, equivalent to 1/6 China's capital formation (Table 1). Had it been completely added to the budget, total government fiscal revenue would have been 1/3 higher. This highlights the potential significance of SOE dividend policy⁴.

² Enterprises that are wholly owned or majority (51% or more) controlled by the central or local governments.

³ MOF: *Financial Yearbook of China 2008*, pp427, 429.

⁴ The use of the term "dividend policy" in this note requires two clarifications. First, while dividend policy is typically a policy of the firm in the literature, it also refers to a policy of the government on SOE dividend in this note, since most SOEs discussed here are wholly state owned or majority controlled by the state and, as a result of state control, dividend policy of the SOE is not distinctive from the policy of the government on SOE dividend. Second, dividend policy is not equivalent to payout policy in the context of publicly held firms in a market economy, where payout can also be made through repurchase. In the case of Chinese SOEs, repurchase of government share is not an option. SOE dividend policy in this note is, therefore, equivalent to payout policy. We use the term of dividend policy instead of payout policy for simplicity in terminology.

Until recently, however, SOE dividend policy was absent in China. A State Council decision in 1994 allowed SOEs to retain all their after-tax profit. While parent companies of SOE conglomerates typically collect dividend from their subsidiaries, they were not required to pay any dividend to the government budget.

This was changed in 2007 when the No. 26 Document of the State Council launched a reform that aims to collect dividend from central SOEs in the portfolio of State Assets Supervision and Administration Commission (SASAC) of the State Council and put it into a State Capital Management Budget (SCMB) on a pilot basis. The pilot was scheduled for three years. In 2008, the first SCMB was formulated and implemented (See Box 1 for details).

Table 1: Profit of nonfinancial SOEs in China, 1998-2007

Year	Profit net of loss			Memo	
	Amount (billion yuan)	As % of GDP	As % of fiscal revenue	Capital formation as % of GDP	Consumption as % of GDP
1998	21.3	0.3	2.2	36.2	59.6
1999	114.5	1.3	10.0	36.2	61.1
2000	283.4	2.9	21.2	35.3	62.3
2001	281.1	2.6	17.2	36.5	61.4
2002	378.6	3.1	20.0	37.9	59.6
2003	476.9	3.5	22.0	41.0	56.8
2004	736.9	4.6	27.9	43.2	54.3
2005	958.0	5.2	30.3	42.7	51.8
2006	1219.4	5.8	31.5	42.6	49.9
2007	1744.2	7.0	34.0	42.3	48.8

Source: Ministry of Finance: *Financial Yearbook of China 2008*; National Bureau of Statistics: *China Statistical Yearbook 2008*.

Box 1: The First State Capital Management Budget

The first SCMB had total revenue of 58.35 billion yuan, of which 13.99 billion yuan was collected in the early pilot in 2007 (against 2006 profit), 44.36 billion yuan was collected in 2008 against 2007 profit (81.22 billion yuan) in accordance with implementation rules set up by Ministry of Finance (MOF) and SASAC following the No. 26 Document of the State Council. The average dividend ratio is 5.6 percent for 2007 net profit. The thrusts of the rules are as follows.

First of all, the rules define four categories of revenues to be collected by SASAC:

- A. After-tax profit of wholly state owned enterprise “to be paid to the state according to relevant regulations”;
- B. Dividends to be paid by enterprises in which the state holds controlling or non-controlling ownership stakes;
- C. Proceeds of transfer of state ownership rights;
- D. Liquidation revenue of enterprises that are wholly or partially state owned.

In the first SCMB, only category A was collected.

Secondly, different policies are applied to different groups of SOEs. The central SOEs in SASAC’s portfolio and China Tobacco General Corporation⁵ are effectively divided into 5 groups:

1. A 10 percent dividend ratio (defined as dividend/net profit) applies to 18 SOEs, including 3 oil companies, 9 electricity and coal, 5 telecommunication companies and 1 tobacco company.
2. 99 SOEs, mostly in sectors of steel, transportation, electronics, trade, and construction, are required to pay a 5 percent dividend.
3. 32 SOEs are given a three-year grace period in which they are not required to pay any dividend. These are primarily SOEs transformed from R&D institutes and SOEs operating in the military sectors.
4. 2 SOEs managing grain and cotton reserves are exempted from paying any dividend.
5. 8 SOEs are left out of the pilot as they are not wholly held by SASAC.

The revenue Category A applies to groups 1-4, as they are all wholly state owned enterprises. It is worth to note that 84.7 percent of the first SCMB revenue was collected from Group 1 SOEs, of which oil, telecom and tobacco are three largest contributing sectors, accounting for 38.5, 18.8 and 14.9 percentage points, respectively.

For Group 5, the relevant category of revenue is B. Since SASAC does not have 100 percent ownership in these enterprises, it has no legal power to dictate a dividend policy. Following the Company Law, MOF and SASAC regulations state that dividends of these enterprises will follow the profit distribution plan adopted by their shareholders general assembly. They have been left out in the ongoing pilot. How to collect dividend in these SOEs remains an open question for SASAC and MOF.

⁵ China Tobacco General Corporation is a central SOE but not in SASAC’s portfolio. It is supervised separately by State Tobacco Monopoly Administration.

Thirdly, the rules clarify that for SOEs that are organized as enterprise groups (conglomerates), it is the consolidated after-tax profit that constitutes the base profit against which dividend ratio is calculated. This implies that losses of subsidiaries of a SOE conglomerate are allowed to be deducted. Furthermore, the rules also allow SOEs to deduct unfunded losses of previous years from the current year base profit.

The first SCMB allocates 57.2 billion yuan of the revenue to finance a range of expenditures. The remainder of 3.2 billion is retained as surplus. The large expenditure items include:

- 13.4 billion yuan (23.4 percent) as state capital injected into three SOEs, including newly created China Commercial Airplane Corporation and National Nuclear Power Technology Corporation, and Telecom Technology Research Academy.
- 13.6 billion (23.8 percent) as additional state capital investment in two oil companies (to compensate their loss caused by price regulation) and two airline companies (to support them in weathering the financial crisis).
- 14.5 billion (25.3 percent) as additional state capital investment in power and telecom SOEs to support their post-disaster (snow storm, earthquake) reconstruction.
- 7.2 billion (12.6 percent) as state capital injection to 5 SOE to support their efforts of taking over, restructuring other SOEs.

The first SCMB is not incorporated in the 2009 national budget.

Source: Ministry of Finance.

Why does China need a sound dividend policy for its SOEs? A dividend policy divides a SOE's after-tax profit into two parts: retained earnings to finance investment by the SOE and dividends to finance general public spending 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. Since SOEs direct most their retained earnings to investment, the previous absence of a dividend policy was equivalent to an implicit acceptance of the assumption that there was no better use of SOE profit other than reinvestment back into SOEs (World Bank, 2005). From this point

of view, the reform mandated by the State Council Document No. 26 and the first SCMB represent a major step toward the right direction.

However, the reform is still an experiment and far from completion. As the experiment concludes in 2010, further deepening the reform will entail resolving a number of outstanding issues. First of all, there seems to be a consensus that the dividend ratios of 5 percent and 10 percent are probably too low to go beyond a short phase of pilot, although they may have been quite appropriate to start with. Second, and perhaps more importantly, the approach of setting uniform ratio by the government is questionable. As was argued earlier by the World Bank (2007), if dividend ratio is to be determined to safeguard investment efficiency, it must vary across sectors and firms, implying that a uniform dividend ratio may leave too much cash to some and too little to others. Third, one of the key principles of State Council Document No. 26, namely, the “interconnection (*xianghu xianjie*)” of the SCMB with the general budget, has yet to be implemented, since the first SCMB is not yet integrated with the general budget and there has been no fund flow between the two.

This study represents an effort in exploring the desirable direction for further reform. It is an extension of the previous World Bank studies (World Bank, 2005, 2007) on this subject. It argues that a sound dividend policy must generate effective discipline against insiders and leave adequate managerial autonomy to them in the meantime. Considering China’s current situation in light of relevant international experience, this study recommends three actions for the government to take to deepen the reform. The

first is to raise the flexibility of SOE dividend ratio by adding a dividend ratio determination mechanism to the existing system of state ownership function. The second involves government monitoring and adjustment of the average dividend ratio of all central SOEs. The third is to start integrating SCMB with the general budget.

The rest of the note is organized as follows. Section 2 discusses the nature of the issue and the criteria that a sound dividend policy must meet. Section 3-5 reviews payout practices of private sector firms (mainly publicly held companies but also include privately held firms), non-Chinese SOEs, and Hong Kong listed Chinese SOEs. Section 6 presents recommendations regarding the direction for further reform.

2. Nature of the Issue and the relevance of dividend policy

To better understand the nature of the issue of SOE dividend policy, it is useful to consider a hypothetical private business owner who owns 100 percent of her firm and manages the business to maximize its value. It turns out that at a given point of time when earnings and investment opportunities are all given, dividend policy is a straightforward matter to her. She only needs to decide how much to invest. The net payout is the difference between earnings and investment, and is therefore simply a residual. Needless to say, she has no incentive to invest her money into any project whose expected return falls short of the opportunity cost of her capital, which may be determined by the returns she can expect from alternative usages of her earnings, or the value of consumption that she would have to give up.

If the capital markets are perfect and complete, the issue can be even simpler. Since the owner can costlessly raise capital to finance her investment, how she splits her earnings into investment and dividend simply becomes irrelevant, as it has no impact on the value of her firm. It is her decision of what project to invest, not how to finance the investment, that determines the value of her firm. This is largely the essence of the “irrelevance proposition” of Miller and Modigliani (1961), which states that in perfect and complete capital markets, a firm’s dividend policy does not affect its value. (Allen and Michaely, 2003)

The real world is of course characterized by inherently imperfect and incomplete capital markets, as well as information asymmetry. Capital market imperfection and incompleteness result in significant transaction cost of raising capital. Imperfect and incomplete information gives rise to agency problem in firms where there is a division of “insiders”, who manage the firm and enjoys information advantages, and “outsiders”, who hold equity stakes in the firm and suffer from information disadvantages. Three kinds of firms are particularly prone to agency problem: public company with dispersed ownership; public or private company with concentrated ownership; and SOEs . They are described briefly in Table 2.

Table 2: Three kinds of enterprise with agency problem

Category of the firm	Ownership structure	Insiders or the agent	Outsiders or the principal
Public company with dispersed ownership	Held by a large number of public shareholders in a dispersed manner without a controlling shareholder	The management	shareholders
Public or private company with concentrated ownership	There are one or a few large shareholders who exercise control and involve in management. The company can be privately or publically held	The controlling shareholders and the management	The non-controlling or minority shareholders
State owned enterprises	Wholly or majority owned by the state on behalf of all citizens	The management and the controlling government agency if it involves in management	All the citizens, their representatives and the government in general

Since the interests of insiders and outsiders are inherently misaligned, information asymmetry may lead to expropriation of outsiders by insiders. One form of such expropriation is the retention of free cash flow and investment of it into projects that have negative net present value (NPV) but contribute to private goals of insiders, i.e., to finance overinvestment. When this happens, dividend policy is no longer irrelevant. Stronger power of outsiders in relation to insiders may press them to disgorge more cash in the form of dividend, and therefore reduce the scope of value-destroying overinvestment and enhance the value of the firm (Jenson and Meckling, 1976; Allen

and Michaely, 2003). In this sense, sound dividend policy is the one that generates effective discipline against insiders.

It is however not that the more cash is disgorged, the better. Since it is costly to raise external capital, too much dividend may reduce the value of the firm that has positive NPV project to invest. This would not be a practical concern if outsiders had information that is perfect and complete so as to allow for an adequate evaluation of proposed investment projects and a separation of those that have positive NPV from those that do not, that is, to enable them mimicking the value-maximizing owner-manager of a one-person owned firm. Unfortunately, this is rarely realistic, esp. when the number of relevant outsiders is large and when they are distant from the operation of their firm. Indeed, insiders are engaged to manage the firm exactly because outsiders cannot do it themselves for one reason or another. As a result, for a dividend policy to be sound, it must have sufficient flexibility to allow for adequate managerial autonomy of insiders.

The challenge is therefore to institutionalize the right balance between discipline and autonomy. And the point where the right balance lies appears to be a function of, among other factors, the degree of loyalty of insiders to outsiders, or the extent to which the interests of outsiders and insiders are aligned, as well as insiders' competence. An extremely flexible dividend policy that accepts whatever dividend is proposed by insiders will be the optimal one if insiders have 100 percent loyalty to outsiders and are fully competent. At the other extreme, when insiders are interested in nothing other than expropriation of outsiders, or are extremely incompetent, the strongest dividend

policy that disgorges all earnings will be the best outsiders can do before dismissing the insiders. Bearing this theoretical perspective in mind, the next three sections investigate dividend practice of non-Chinese private firms, SOEs and Hong Kong listed Chinese SOEs.

3. Experience of the Private Sector

Dividend policy has been a subject of detailed empirical study in advanced market economies, especially in the United States, since the publication of a classic paper by Lintner in 1956 (Lintner, 1956) and the establishment of the irrelevance proposition of Miller and Modigliani (1961). Most empirical studies target on publicly held firms in the private sector. Privately held firms have, however, also been covered in some recent studies.

Before moving to further details, it is necessary to clarify the term of dividend in relation to payout and repurchase. Indeed, the Miller-Modigliani framework focuses on payout, i.e., what the company pays to shareholders. While most empirical work measures payout only by the amount of dividends firms pay, payout can also be in the form of repurchase, in which the firm buys back shares from shareholders. Issuance of additional shares is the opposite of repurchase or a negative repurchase. When a firm is acquired by others, its shareholders received a payment that can be viewed as a liquidation (or final) dividend. (Allen and Michaely, 2003)

3.1. Three Basic Facts

How do dividend and payout practices of private sector firms look like? The empirical literature seems to have established the following three basic facts.

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- i. *US industrial firms on average pay out one quarter to one half of their earnings in the form of dividends and repurchases.*

In his classic study in 1956, Lintner interviewed 28 firms' management teams and reported a median target payout ratio of 50 percent of earnings. Despite the very small sample and the fact that the study was conducted half a century ago, the target payout ratio is not far from what can be found in more recent periods of time. (Allen and Michaely, 2003, p11)

Many recent studies have assessed representative samples. In particular, Grullon and Michaely (2002) examined a sample of all U.S. industrial firms on Compustat⁶ over the period of 1972-2000 and provided a fairly representative picture. They investigated the dividend and repurchase policies of established firms, i.e., those firms that have been on the Compustat files over the entire period 1972-2000, the number of which turned out to be 452. Their mean and median dividend payout ratio and the repurchase payout ratio are shown in Table 3. They indicate that during the period of 1980-2000, the average payout (dividend plus repurchase) ratio of U.S. mature and established industrial firms is in the range of 50-60 percent.

⁶ Standard & Poor's Compustat is a database of financial, statistical and market information on active and inactive companies throughout the world. It covers 75,000 global securities, covering 90% of the world's total market capitalization, and provides company data history back nearly 40 years (depending when that company was added to the database). See <http://en.wikipedia.org/wiki/Compustat>.

Table 3: Dividend and repurchase ratios of established U.S. industrial firms, 1972-2000

Period	Dividend/earnings		Repurchase/earnings	
	Mean	Median	Mean	Median
1972-79	26.57	25.59	5.98	0.00
1980-91	36.46	32.56	16.41	3.43
1992-2000	35.15	31.15	22.80	11.48

Note: Dividend is the total dollar amount of dividends declared on the common stock (Compustat item #21). Repurchase is the expenditure on the purchase of common and preferred stocks (Compustat item # 115) minus any reduction in the value (redemption value) of the net number of preferred shares outstanding (Compustat item # 56). Earnings are before extraordinary items (Compustat item #18).

Source: Gullon and Michaely, 2002, Table 3.

It is worth to note that a large fraction of U.S. industrial firms pay no dividend and do not repurchase (see Gullon and Michaely, 2002, Table 2). Adding them to the picture, the average payout ratio of U.S. industrial firms is much lower than that of their established representatives. Using the same sample, Gullon and Michaely (2002) calculated the equal-weighted average payout ratio of all firm-year observations that have positive earnings, and obtained a result as depicted in Figure 1, which points to a rather stable overall payout ratio of 25 percent.

ii. Corporations smooth dividends relative to earnings.

One of the central findings of Lintner (1956) is that corporations appear to smooth dividends relative to earnings. In his sample, 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. (World Bank, 2005)

Lintner's observation remains largely true half a century later. Empirical evidence suggests that firms usually increase dividends gradually and rarely cut them (Allen and Michaely, 2002, pp11-12). In a recent study based on survey of 384 financial executives and in depth interview with an additional 23 conducted in 2003, Brav et al (2005) find that 90 percent of firms strongly or very strongly agree that it is true that they smooth dividends from year to year. 94 percent of dividend-payers strongly or very strongly agree that it is true that they try to avoid reducing dividends. As smooth dividend payout is given priority, dividends are not the residual cash flow as the Miller and Modigliani (1961) theorem implies they should be. Indeed, 65 percent of dividend-payers in the survey strongly or very strongly agree that external funds would be raised before cutting dividends. The most significant difference with Lintner's findings in 1950s is that the importance of targeting the payout ratio has declined. Most firms report that they consider the level of dividends per share in recent quarters when choosing today's dividend policy.

The primary reason for firms to smooth dividend is that the market usually reacts to announcement of increases in payouts and negatively to announcements of dividend decreases. Moreover, the market has an asymmetric response to dividend increases and decreases (and for initiation and omission). Using a comprehensive sample of dividend

changes of at least 10 percent over the period 1967-1993, Grullon, Michaely, and Swaminathan (2002) found that the average abnormal return to dividend increases was 1.34 percent (a median of 0.95 percent) and the average abnormal market reaction to dividend decreases was 3.71 percent (a median of 2.05 percent). In particular, the market never greeted positively to a cut of dividend made by a board when there are good investments (Allen and Michaely, 2003, p64). In their survey and interview, Brav et al (2005) find that managers perceive a substantial asymmetry between dividend increases and decreases: there is not much reward for increasing dividends but there is perceived to be a large penalty for reducing dividends. Nearly $\frac{3}{4}$ of the interviewed executives expressed this viewpoint.

The fact that firms smooth dividend to avoid negative market reaction to dividend decrease points to the disciplinary role of dividend policy. Indeed, one theory of dividend policy, labeled as “outcome model” by La Porta et al (2000), states that dividends are the result of effective pressure by minority shareholders to force corporate insiders to disgorge cash. And the study has found empirical support to this model. Examining data of firms from 33 countries, La Porta et al (2000) finds that firms operating in countries with better protection of minority shareholders pay higher dividends. The gap in dividend ratio is substantial: between 36.3 percent for common law countries and 27.7 percent for civil law countries. It is worth to note that in some countries, regulators choose to force companies to pay dividends by mandatory dividend rules. Weak corporate governance in terms of protection of outsiders appears to be the plausible reason (La Porta et al, 2000, p14).

The linkage between dividend smoothing and outsiders discipline against insiders is evident in a recent empirical study as well. Using a dataset extracted from a database of U.K. private and public firms, Machaely and Roberts (2007) examine the difference between private and public firms. They identify a group of “wholly owned” firms, i.e., privately held firms with few, often only one, shareholders that are intimately involved in the operations and management of the firm through positions on the board of directors, through financing arrangements, or even through managerial positions. Compared with publicly held firms, they find (pp2-4) that wholly owned firms do not smooth dividends as much as publicly held firms, and show the highest sensitivity of dividends to investment. In other words, their dividends policies most closely resemble the residual financing decision predicted by Miller and Modigliani (1961).

iii. Share repurchase has become an increasingly important form of payout in the U.S. since mid-1980s.

Figure 1 has shown this trend clearly. Moreover, the rather stable payout ratio suggests that repurchases may have been substitutes for dividends. The evolution of dividend yield (total dividends over market value of equity), repurchase yield (repurchases over market value of equity) and payout yield (dividends plus repurchases over market value of equity) since the early 1970s (Figure 2) calculated for the same sample points to a similar trend. In particular, firms’ average total yield remained more or less constant in the 1990s while the dividend yield declined and the repurchase yield increased.

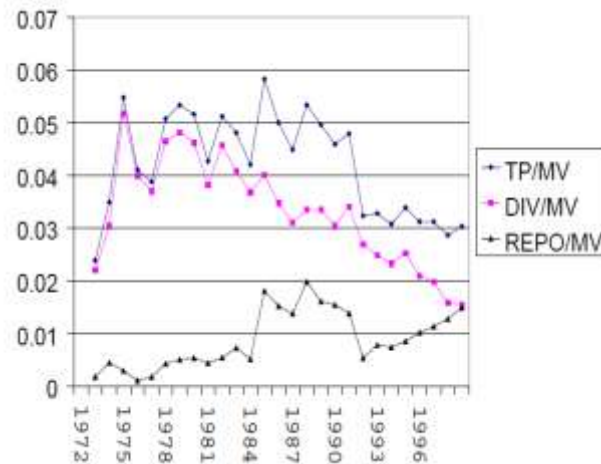
Prior to the 1980's U.S. firms that initiated a cash payment usually did so with dividends. But since the beginning of the 1980s, most firms have initiated cash payments with repurchases. Defining a cash distribution initiation as the first time after 1972 that a firm pays dividends and/or repurchases shares, Figure 3 shows that the proportion of U.S. industrial firms that initiated a cash distribution by using only share repurchases increased from less than 27 percent in 1974 to more than 81 percent in 1998. Share repurchase programs have now become the preferred method of payout among firms initiating cash distributions to their equity holders. (Allen and Michaely, 2003, p8)

Figure 1: Average payout ratio of U.S. industrial firms, 1972-99



Source: Grullon and Michaely, 2002, Figure 1.

Figure 2: Dividend, repurchase and payout yields of U.S. industrial firms, 1972-1999



Note: The data sample contains 121,973 firm-year observations and excludes banks, utilities, and insurance companies. TP = total payout; DIV = dividend; Repo = repurchase; MV = market value.
Source: Allen and Michaely 2003, Figure 1, based on data from Grullon and Machaely 2002.

Figure 3: Payout methods of U.S. industrial firms that initiated a cash distribution, 1972-1999



Source: Grullon and Michaely, 2003, Figure 2.

Why do U.S. firms substitute repurchases for dividends? The first factor is regulation. Historically, regulatory bodies in many countries frowned on this practice, since it might make it possible for corporations to manipulate the price of their shares. In the U.S., share repurchase activity is governed by the anti-manipulative provisions of the Securities Exchange Act of 1934. These provisions exposed repurchasing firms to the possibility of triggering an SEC investigation and being charged with illegal market manipulation. This risk seemed to deter firms from purchasing their shares. As part of the deregulation wave of the early 1980s, the SEC approved a legislation to regulate open market share repurchases. In 1982, the SEC adopted Rule 10b-18, which provides a safe-harbor for repurchasing firms against the anti-manipulative provisions of the Securities Exchange Act of 1934. (Allen and Michaely, 2003, p92) This presumably paved the way for the rise of repurchase as a payout method.

Tax may have played its role too. In the U.S., dividends are taxed as ordinary income, share repurchases are taxed on a capital gains basis. Since the tax rate on capital gains has usually been lower than the tax rate on ordinary income, investors had an advantage if firms repurchased, rather than paid dividends. (Allen and Michaely, 2003, p9)

In addition to the roles of regulation and tax, the empirical evidence indicates that repurchase activity is motivated by several other factors. Firms with more cash than they need for operation (excess cash) are more likely to repurchase their shares. Lower-

growth firms are more likely to repurchase shares, because their investment opportunities shrink. (Allen and Michaely, 2003, p107)

However, views of financial executives expressed in the survey and interview of Brav et al (2005) has a strong implication that it may well be the flexibility of repurchase as a method of payout that matters the most. Managers clearly value the flexibility of repurchases and dislike the rigidity of dividends. Survey evidence indicates that dividend choices are made simultaneously with (or perhaps a bit sooner than) investment decisions, but repurchase decisions are made later and treated as residuals of investment as implied by Miller and Modgiliani (1961). The interviewed managers state that the flexibility of repurchases (relative to dividends) is one of the main reasons that repurchases have increased. As to the role of tax, executives indicate that differential taxes were a consideration, but not a first-order concern in payout decisions.

Another possible explanation is that firms use dividends and repurchases for different purposes. Dividends are more of a permanent commitment than are share repurchases. Hence, dividends are more likely to be paid out of permanent earnings and repurchases are more likely to be used as a way to distribute temporary cash flows. This is supported by empirical evidence. Using a large sample of repurchase and dividend change events, Jagannathan, Stephens and Weisbach (1999) found that firms that repurchased their share had a higher variability of operating income relative to firms that only increased dividends, or to firms that increased their dividend and repurchased their shares. (Allen and Michaely, 2003)

3.2. *Implications for Chinese SOEs*

To summarize, the experience of private sector firms in the U.S. and other advanced economies seems to have three implications for Chinese SOEs. First, a “smoothed” dividend ratio, i.e., a dividend ratio that hardly declines over time, can be a useful instrument to prevent insiders’ expropriation of outsiders by pressing insiders to disgorge free cash flow. The associated cost is that dividend is then unlikely to be a residual of investment as implied by Miller and Modigliani (1961), which is presumably associated with potential efficiency loss in firms that have positive NPV projects to invest.

Second, repurchase is an instrument with the advantage of flexibility and sensitivity to investment. While wholly owned SOEs cannot repurchase shares from the government, it could make one-off cash transfer to the government, the effect of which is equivalent to repurchase in the private sector.

Third, corporate governance and variability of earnings are two factors that determine the desirability of rigid and smooth dividend policy. The lower are the degree of insiders’ loyalty to outsiders and variability of earnings of a firm, the higher is the desirability of rigid and smooth dividend policy. On the other hand, the desirability of repurchase is higher in firms where insiders’ loyalty to outsiders is higher and/or variability of earnings over time is higher.

4. Experience of Non-Chinese SOEs

Dividends data of SOEs are much scarcer than that of private listed firms. However, it is still possible to collect information for a significant amount of cases to generate a rough picture of how SOEs dividend policy in other countries looks like. This section summarizes practices of 5 countries and present results obtained by investigating a dataset of 49 non-Chinese SOEs.

4.1. *Practice of Five Countries*

i. New Zealand

In New Zealand, the relationship between the SOE's board and the state is regulated by the SOE Act. SOE directors are legally bound to act in the SOE's interest. They report to two shareholding ministers, namely, the Treasury and a sector ministry, who are themselves accountable to parliament. Dividend policy is set by boards, in consultation with shareholding ministries. The Treasury and the Crown Company Monitoring Advisory Unit (CCMAU) advise sector ministries on dividend policy, based on such factors as the company's capital structure, proposed capital investments, and profitability. (World Bank, 2002, 2005)

All SOEs are expected to add to shareholder value in their operation over the longer term and also meet short- term financial targets specified in a special Statement of Corporate Intent (SCI) developed by the board. The net profits for the year ending 30 June 2008 were NZ \$598 million of which NZ \$420 or 70 percent was turned in to the

state as dividends. The high dividend ratio comes from the fact that some companies were running at a loss. (Cederlund, 2009)

ii. Norway

The Norwegian government ministries manage the state's ownership stakes in a total of 80 companies, which are divided into four categories in terms of their objectives. Most of the companies where the main objective of state ownership is commercial operation are managed by the Department of Ownership in the Ministry of Trade and Industry.

The Norwegian government stated the following positions on SOE dividends: The state expects that each company will formulate a clear dividend strategy. An active ownership policy includes putting forth commercial demands for dividends and returns, such that this builds up over the company's long-term maximisation of value and industrial development. In order for companies to remain competitive over time they must consider more than just short-term gain. Companies must adequately invest in both R&D, and in developing competence in the work force so that in the long run the company will be able to initiate any necessary adjustments due to market competition.

As a result of the activities in 2007 the state got 34.2 billion NOK in dividends in 2008, an increase by 18 percent from the previous year. For the listed companies dividends of last five years was 20- 53 percent of profit generated, if the loss-making airline Scandinavian Airlines System (SAS) was not taken into account. (Cederlund, 2009)

iii. Sweden

The Division for State Owned Enterprises of Ministry of Enterprise, Energy and Communication is responsible for most of the Swedish SOEs as well as for the ownership policy. All companies have financial targets and are in many cases asked to deliver a dividend policy. The policy is established in conjunction with the Division and decided at a shareholders meeting.

Dividend targets are documented, although the targets and definitions used in each particular company can vary. The difference depends, among other things, on the sector in which the company operates, the structure of its business activities, the company's financial situation and where the company is in its life cycle.

In all companies, the owner and the company should take a discussion on the particular company's need of capital and capital structure. The company should be as efficiently capitalized as possible in order to be able to carry out its business activity. Future capital requirements must also be taken into consideration. There is no reason for the owner/the state to have more capital tied up in the activity than is needed. A parliament decision is required in order for dividends of some SOEs to be used for capital contributions to other state-owned companies by "earmarking".

In 2006 and 2007, dividends received by the Swedish government from SOEs represent 67 percent and 58 percent of their net profit, respectively. The higher rate in 2006 reflects proceeds of divestments of shares.

iv. Finland

State ownership in companies is mainly managed by the Ownership Steering Department of the Prime Minister's Office in Finland since 2007. At the end of 2008, the State Ownership Steering Department in the Prime Minister's Office was responsible for ownership steering in respect of 29 market-based, profit-seeking companies operating in a competitive environment. Additionally, the Department was responsible for the ownership steering of one special assignment company, Solidium Oy. Outside the centralized steering system, ownership steering in respect of a total of 15 companies performing certain special functions is handled by a number of ministries.⁷

According to the Department of Ownership Steering, the average payout ratio in 2007 for the state shareholdings in listed companies was 60 percent. Based on the dividends to be paid for 2008, the average payout ratio for the companies included in the state portfolio, including companies owned by Solidium Oy, was 69 percent. The listed companies in the state portfolio paid a higher average dividend than companies operating in the same sector in general⁸.

7

http://www.valtionomistus.fi/documents/Julkaisut/2008_Annual_Report_of_the_Ownership_Steering_Department_in_the_Prime_Ministers_Office.pdf

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http://www.valtionomistus.fi/documents/Julkaisut/2008_Annual_Report_of_the_Ownership_Steering_Department_in_the_Prime_Ministers_Office.pdf

v. France

France established Government Shareholding Agency (Agence des Participations de l'État, APE) in 2004. APE devotes itself to “identify clearly the Government’s functions as a shareholder within the French administration, and to defend the State's assets on a more professional basis”. The agency manages a highly diversified portfolio, comprising undertakings that differ greatly in nature and size, some listed, others non-listed, corporations and public undertakings, etc. In 2007, the portfolio included 51 entities.⁹

APE collaborates with the sector ministries and the office of the president in handling the portfolio. There is no general postulate on dividend policies. Dividends in most companies are decided after proposal from the board. APE overlooks the value creation and the profitability of all the companies.

In 2007, the dividends received by the state represent 40.3 percent of net profit generated by the entities. In 2006, the ratio is 37 percent.

4.2. Dividend Ratio of 49 Non-Chinese SOEs

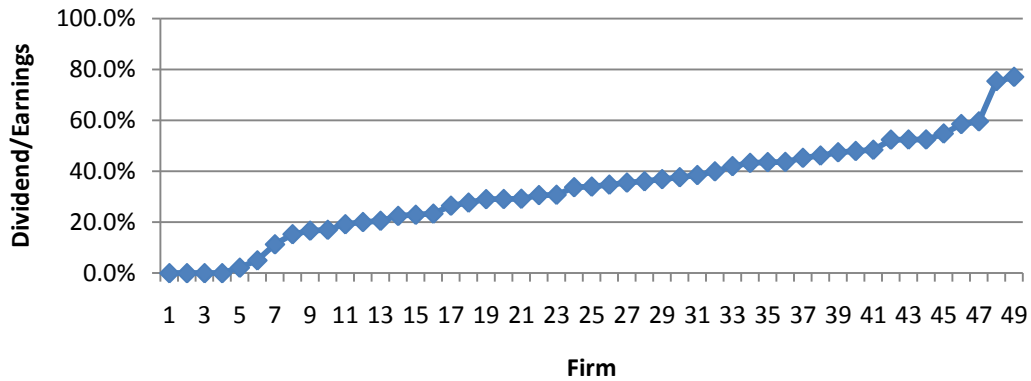
To further investigate how much dividend SOEs in other countries pay, this study collects data for 49 SOEs of 16 advanced economies (see Appendix 1), for which dividend payout data for 2000-8 are available. With the dataset, we first calculate each SOE’s average of reported dividend ratios over the period of 2000-8 that fall in the range of 0-1, and find a mean ratio of 33 percent and median ratio of 33.9 percent. Figure 4

⁹

http://www.ape.minefi.gouv.fr/sections/rapports_sur_l_etat/annual_reports_on_go/downloadFile/attachedFile_1/2008_Report_on_the_Government_as_a_shareholder.pdf?nocache=1243250217.11

summarizes the results. It is easy to note that 20-50 percent is the range where most firms find their average ratios.

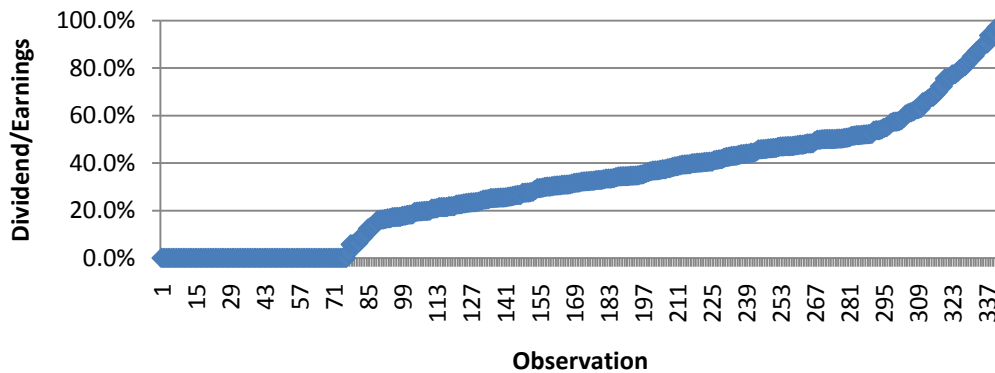
Figure 4: Average Dividend ratio of 49 Non-Chinese SOEs, 2000-8



Source: “Trade Policy Review” Report by the Secretariat of European Communities (WT/TPR/S/214, March 2009), (http://www.europarl.europa.eu/meetdocs/2004_2009/documents/dv/s214-05_/s214-05_en.pdf), P173-186; Bloomberg firm database; Author’s calculations.

Secondly, we examine firm-year observations of dividend ratios of the dataset, again, excluding those that are negative or greater than 1. There are 344 such observations in total. Their mean and median are all 32.1 percent. Figure 5 shows the overall picture. Again, most observations lie in the interval of 20-50 percent.

Figure 5: Dividend Ratios of 344 Firm-Year Observations of 49 N on-Chinese SOEs, 2000-8



Source: Bloomberg firm database; Author’s calculations.

Table 4 is a summary of the firm-year observations from a sectorial perspective. With the exception of airline industry SOEs, which did not pay dividend in 31 of the 52 firm-years, the average levels of dividend ratio in all other industries are 30-45 percent. There is no incident of positive repurchase in the dataset.

Table 4: Summary of Dividend Ratio Observations of 49 Non-Chinese SOEs, 2000-8, by Sector

Sector	No. of SOEs	Total No. of Observations	Observations of Dividend Ratio in the Range of 0-100%				No. of Observations of		
			Number	Mean	Min	Max	Negative Dividend Ratio	Zero Dividend	Dividend Ratio Greater than 100%
Airlines	6	52	49	10.5	0.0	30.6	2	31	1
Energy	5	44	41	35.1	22.5	52.4	0	1	2
Manufacturing	9	68	56	29.9	15.3	52.4	4	7	5
Media	3	22	18	31.5	5.0	54.8	3	5	2
Telecommunications	9	78	63	44.6	20.5	75.3	6	5	9
Transport and postal	8	59	56	30.5	0.0	52.4	2	19	1
Utility	9	64	61	40.9	17.0	77.0	3	8	3
Total	49	387	344	33.0	0.0	77.0	20	76	23

Source: Bloomberg firm database; Author's calculations.

4.3. Implications for Chinese SOEs

The strong role of SOE board in determining dividend ratio in the reviewed countries deserves special attention. It seems uncommon for the government to set uniform dividend ratio for SOEs in advanced economies with a substantial SOE sector. Instead, dividend strategy and ratio are often proposed by SOE board and discussed and agreed with government ownership agencies. Discussion and agreement on board proposal seems to be the mechanism that balances discipline and autonomy. As to the level of

dividend ratios, similar to the situation of US publicly listed firms, 25-50 percent appear to be the interval where SOE dividend ratios most likely to fall.

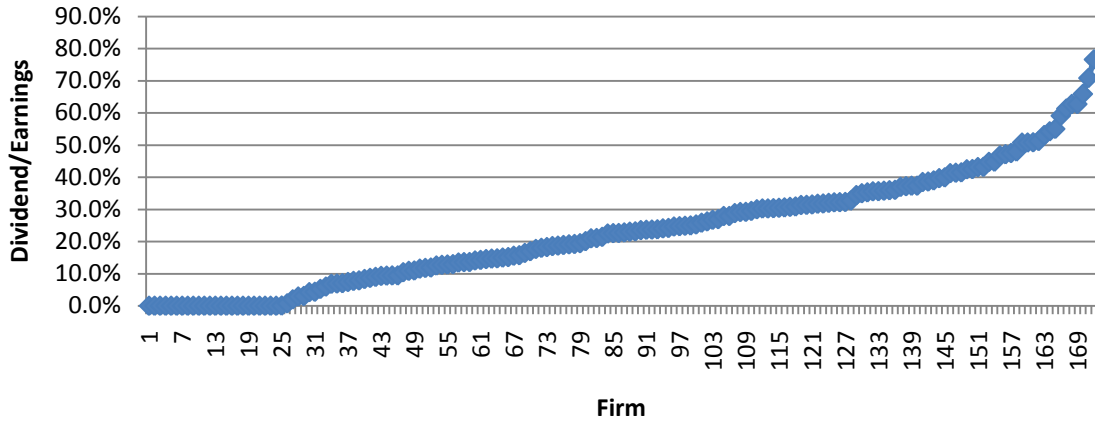
5. Dividend ratio of Chinese SOEs Listed in Hong Kong

While Chinese SOEs did not pay dividend to the government during 1994-2007, many of them are listed in overseas markets and follow international common practice in their dividend policies. For the purpose of this study, we collected dividend data of 172 Chinese enterprises (see Appendix 2) that are listed in Hong Kong Stock Exchange and appear to be held directly or indirectly by the Chinese government¹⁰. First of all, as we did in the case of non-Chinese SOEs in the last section, we calculated each firm's average dividend ratio over the period of 2000-8, excluding those firm-years in which the dividend ratios are negative or greater than 1. The result is presented in Figure 6, where the mean is 23.2 percent and the median is 22.7 percent.

Secondly, we also look at all the firm-year observations, which total 1227 excluding those that are negative or greater than 1. They are depicted in Figure 7, which has a mean of 22.9 percent and a median of 21.5 percent. From a sectorial perspective, the dataset can be summarized in Table 5.

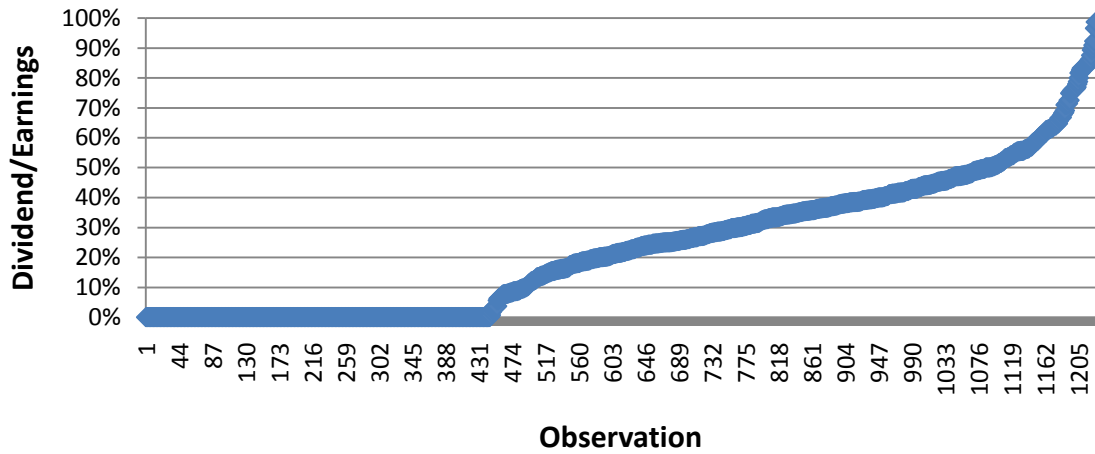
¹⁰ There is no publicly disclosed information regarding the share of state ownership in these firms. We made our judgment on state ownership by viewing the names of their key shareholders on a case-by-case basis.

Figure 6: Average Dividend ratio of 172 Hong Kong Listed Chinese SOEs, 2000-8



Source: Bloomberg firm database; Author's calculations.

Figure 7: Dividend Ratios of 1227 Firm-Year Observations of 172 Hong Kong Listed Chinese SOEs, 2000-8



Source: Bloomberg firm database; Author's calculations.

Table 5: Summary of Dividend Ratio Observations of 172 Hong Kong listed Chinese SOEs, 2000-8, by Sector

Sector	No. of SOEs	No. of Observations	Observations of Dividend Ratio in the range of 0-100%				No. of observations of		
			No.	Mean	Min	Max	Positive Dividend with Negative Earnings	Zero Dividend	Dividend Ratio Greater than 1
Aerospace/Defense	3	27	26	10.1	0.0	30.2	1	20	0
Airlines	3	21	20	7.1	2.9	11.5	0	14	1
Automobile	6	45	43	23.2	7.9	61.3	0	12	2
Consumer product	8	59	56	27.0	0.0	65.9	1	25	2
Diversified	11	97	97	18.7	0.0	38.6	0	38	0
Electrical	6	49	48	8.2	0.0	20.1	0	32	1
Energy	5	35	35	23.2	0.0	30.4	0	11	0
Engineering&Construction	5	26	26	7.7	0.0	15.7	0	18	0
Financial	14	89	85	32.1	11.8	62.7	1	20	3
Logistics	9	50	50	26.2	0.0	43.2	0	12	0
Machinery	7	46	45	17.6	4.2	31.7	0	20	1
Materials	17	125	123	21.0	0.0	50.7	0	39	2
Media	1	6	6	16.4	16.4	16.4	0	3	0
Mining	8	42	40	22.4	0.7	51.2	1	21	1

Oil&Gas	6	50	50	29.3	22.6	44.8	0	0	0
Pharmaceuticals	4	36	35	34.1	17.7	46.8	0	5	1
Real Estate	8	69	64	23.9	0.0	38.5	0	17	5
Retail	4	20	19	40.8	30.6	50.8	0	3	1
Technology	15	113	107	13.2	0.0	39.0	3	74	3
Telecommunications	9	70	69	16.0	5.2	26.9	0	31	1
Transportation	15	126	125	38.7	5.9	76.6	0	17	1
Utilities	8	63	58	27.2	4.3	55.0	1	12	4
Total	172	1264	1227	23.2	0.0	76.6	8	444	29

Source: Bloomberg firm database; Author's calculations.

Comparing Figures 6-7 and Table 5 with Figures 4-5 and Table 4, it can be noted that Hong Kong listed Chinese SOEs on average pay less dividend. Their firm-year observations are less concentrated in the interval of 20-50 percent. Out of the 1264 total firm-year observations of Chinese SOEs, 444 or 35 percent are zero dividends. In contrast, this percentage is 20 percent for the 49 non-Chinese SOEs. Chinese SOEs rarely pay dividend when earnings are negative: 8 out of the 1264 observations, or with a likelihood of 0.6 percent. In the case of the 49 non-Chinese SOEs, this happens with a likelihood of 5 percent. Airline SOEs also pay the lowest dividend in the Chinese SOE dataset. However, sectorial variation is much greater here than in the case of the 49 non-Chinese SOEs.

6. Direction for Further Reform in China

If the target to pursue is a sound SOE dividend policy with effective discipline over insiders and sufficient flexibility to allow for adequate managerial autonomy, what could China do in deepening the reform that was launched in 2007 after the conclusion of the three-year pilot? Considering China's current situation in light of relevant international experience, this study recommends three actions. The first is to raise the flexibility of SOE dividend ratio by adding a dividend ratio determination mechanism into the existing system with which the state exercises its ownership function. The second involves government monitoring and adjustment of the average dividend ratio of all central SOEs. The third is to start integrating SCMB with the general budget.

6.1. *Making dividend ratio more flexible*

The key weakness of the dividend policy that is currently under experiment is the lack of flexibility in determination of dividend ratios. The two flat ratios set by the government have little potential to reflect firm variation in investment opportunity, innovation potential and growth perspective. It takes some new mechanism to overcome this weakness. Indeed, such a new mechanism does not have to be created from scratch. It can simply be inserted into the existing institutional framework of SOE management of SASAC¹¹ as an additional sub-system. A desirable mechanism could be one that is defined by the following three components:

- 1) *A two-tier structure of dividend ratio, in which each SOE's dividend comprises one fixed component and one variable component.* The fixed component would be the instrument for the state owner to exercise discipline, while the variable component can be used to ensure flexibility. The relative weight of the two components should be managed in light of sector characteristics. In particular, the variable component should be greater the higher is the variability of earnings of the sector. This can be adjusted by setting the ratio of the fixed component, as discussed below.
- 2) *A sector-specific uniform ratio of the fixed dividend component for each sector.* This can be done by a review of historical dividend and earnings data of Chinese and international listed companies of the same sector.

¹¹ Again, China Tobacco General Corporation should be treated separately as a special case.

3) *A four-step process to set the ratio for the variable dividend component for each SOE.* This is designed as an addition to the existing performance evaluation system run by SASAC. The four steps are proposal, discussion, agreement, and evaluation. Specifically, they are

- Step 1: the board (or management where a functioning board with external directors has not been in place) of a SOE proposes a target dividend ratio in the Responsibility Statement (RS) that they submit to SASAC, covering the same time period as the RS does.
- Step 2: SASAC holds discussion with the board of the SOEs on the proposed target dividend ratio in view of the SOE's capital structure, growth and innovation strategy and investment proposals on one hand, and the government's strategy of "state sector restructuring", which sets priority areas of state ownership, on the other hand. In areas the state has decided to withdraw, SASAC should use variable dividend component as an instrument of divestiture. It is worth to note that this should not be a negotiation but a discussion between professionals on both sides. SASAC has to build up the necessary competence in the views of the SOEs to run the discussion.
- Step 3: SASAC and the SOE board agree on a target dividend ratio and record it in the final RS, which is then signed by both sides.
- Step 4: SASAC incorporate the realization of dividend ratio target into its existing process of annual and term performance evaluations.

The role of SOE board needs to be emphasized. The management is giving the calculations, budgets etc., and the board should be responsible for the fulfillment of the dividend policy.

The common concern about this recommended approach is the potential administrative cost entailed by the one-to-one negotiation between SASAC and SOE management. There are however two reasons why this is less a serious concern than it appears. First, under the existing system of performance evaluation, SASAC is already supposed to discuss a set of performance targets with the management before a RS is signed. Dividend ratio would be no more than just one more performance target. Indeed, adding dividend ratio to the list of performance targets can strengthen the evaluation system as well.

Box 2: China's Performance Evaluation System for Managers of Central SOEs

Starting in 2003, SASAC, in its capacity of shareholder, monitors and evaluates the performance of top three managers (typically, chairman, CEO, chief accountant, including deputies) of its portfolio SOEs.

Managers' performance is evaluated based on the *annual results* and *term results*, both of which are summarized by a number of *general indicators* and *specific indicators* stipulated in the "Responsibility Statement" (RS) agreed between the SASAC and the firm's management. For annual results, general indicators include "annual profit" and "return on equity"; for term results, there are "rate of state assets appreciation" and "3-year average annual growth rate of core business". The key idea is to focus on return on capital. Depending on the sector, SASAC will also look at a number of specific indicators, which are chosen to reflect the firm's capacity of technology innovation, energy-saving, sustainability and core competitiveness.

The evaluation process has the following seven steps. (i) Before year-end, the relevant manager proposes a RS to SASAC Chairman. (ii) SASAC Chairman or his designee holds conversation with the manager to discuss and agree on a final version of the RS. (iii) Both sides sign the RS. (iv) The manager reports progress to SASAC every half-year. (v) By end-April, the manager submits to SASAC audited financial statements of the SOE. (vi) SASAC analyzes the data, holds consultation with other stakeholders, and comes up with a proposed score and personnel action plan. The score is fed back to the determination of the

manager's "performance-based" salary and decision of promotion. (vii) SASAC communicates the results back to the manager and hears his/her response before finalizing its decision.

A manager's total compensation comprises a base salary and performance salary. 40 percent of the performance salary withheld until one year after the manager is re-appointed or leaves his position. Performance salary is calculated using the following formula: Performance salary = a co-efficient (p) * base salary, where $0 < p < 3$. The coefficient p is a function of scores of annual results, which are divided into five bands, namely, A-E, where the score is E when $p=0$, D when $0 < p < 1$, C when $1 < p < 1.5$, B when $1.5 < p < 2$, and A when $2 < p < 3$.

For managers who scores A, B or C in term results evaluation, full amount of the withheld 40 percent performance salary will be paid plus some extra bonus. For those who score D or E in term results evaluation, the consequence will be a reduced rate of payment (according to specific formulae) plus conversation, dismissal or de-promotion, etc.

Source: SASAC, "Tentative Guidelines for Management Performance Evaluation of Central SOEs", revised on Dec. 31, 2006. See <http://www.sasac.gov.cn/n1180/n1566/n257060/n257203/1705022.html>

Second, the number of SOEs that SASAC would need to discuss with is not as large as it appears. This is not only because SASAC is working to reduce the number of SOEs in its portfolio to around 100, but also because the number of major dividend contributors is very limited. For example, there are only 18 SOEs in the four most profitable sectors, namely, oil (3), electricity and coal (9), telecommunication (5) and tobacco (1), which are defined as Group 1 SOEs (see Box 1). In 2007, they jointly accounted for 66.5 percent of the total net profit all SOEs that are covered by the pilot collection of dividend (that is, SOEs under SASAC supervision plus China Tobacco General Corporation, minus Group 5 SOEs as defined in Box 1), of which the one tobacco company alone contributed 11.6 percent points. In contrast, the 99 SOEs in Group 2 only have a share of 29.6 percent¹².

¹² Data are from Ministry of Finance.

To reduce administrative cost, the government may consider starting with these 18 SOEs and expanding the exercise to the Group 2 SOEs gradually in three years.

6.2. Targeting on a higher overall level of dividend ratio

It is clear that the overall level of dividend ratio of central SOEs needs to be raised from the current level, which is 5.6 percent against 2007 earnings. The practical question is by how much. Or in more general terms, what is the “right” level of average dividend ratio for Chinese central SOEs (i.e., *total* dividend revenue collected from central SOEs as percentage of their *total* net profit) that the government should target on? This is necessarily a question that has to be addressed in designing the next step of reform. However, a definite and scientific answer to it is difficult, if not possible. To deepen the reform, the government can consider one or more of the following three approaches.

The first is to accept whatever is turned out by the recommended mechanism of dividend ratio determination. If the recommended mechanism works well, the average dividend ratio resulted from individual dividend ratios can be trusted as being fairly close to the “right” level. However, since there are always factors that hamper the functioning of this mechanism, such as lack of information and knowledge on the government side, and the time it takes to institutionalize sound board governance in SOEs, some degree of planning and targeting with regard to the average dividend ratio of all central SOEs may well be justified. The government may then consider other two approaches.

Firstly, an in-depth study can be carried out to gauge the appropriate level of dividend ratios in various sectors and key SOEs. Based on the theoretical framework presented in Section 2, such a study could analyze firm-level data of relevant SOEs to determine the return to investments financed by retained earnings, followed by an evaluation of the return against the opportunity cost of the funds, i.e, the benefit that would have accrued to Chinese citizens had the profit been allocated differently.

Secondly, the government could consider targeting on an average dividend ratio of all central SOEs in the interval of 20-50 percent in light of the payout practice of international firms and Hong Kong listed Chinese firms as reviewed earlier. The specific target can be set in the 12th Five-Year Program incorporating other considerations such as overall SOE reform strategy, sectorial development program.

There can a number of concerns that question the soundness of this recommendation. The first is about its timing. Since the SOE sector has been hit hard by the global crisis, some might argue that this is not the right time to raise dividend ratio. However, from a perspective of implementation, dividend ratio is easier to be raised when profitability of SOEs remains low and their net profits are insignificant or negative, since many of them would end up with little or no dividend payment despite higher dividend ratio.

The second is that most SOEs are not profitable, and they need finance to grow. The alleged low profitability, leaving alone its truthfulness, is clearly not a reason to justify a position that the state owner should simply give up its rights in collecting dividends from SOEs. As to SOEs' need for funding to grow, it is indeed about the relative merits of

internal and external financing of SOEs. While internal financing through retained earnings saves transaction cost and is often a more appropriate instrument to support risky investment in R&Ds, external financing through bank borrowing and bond issuance may contribute to sound corporate governance as banks and bondholders could play a useful role in supplementing SASAC in SOE performance monitoring. Again, the right level of retained earnings is a function of the balance between discipline and autonomy.

The third relates to the potential impact on incentives of SOEs to truthfully report their profit. While higher dividend ratio would certainly strengthen incentives of under reporting of profit, it should be noted that there are counter balancing factors at work. For example, there are also factors that generate incentives for over reporting by SOE managers. Most importantly, the ongoing reform of introducing EVA(economic value added)-based performance evaluation system has the potential, if implemented effectively, to significantly discourage SOEs to expand their capital base.

6.3. Starting integrating SCMB with the general budget

The spending of the dividend revenue is not discussed in this note because arguments made by the World Bank in its 2005 policy note (World Bank, 2005) remain relevant and valid, and the recommended approach deserves a reiteration.

The bottom line is that SOE dividends and privatization revenue are 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. It was also indicated that in terms of international practice, 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, World Bank 2005).

As shown in Box 1, there has been no transfer of SOE dividend to the general budget in China so far, and the first SCMB is not part of the government budget that is submitted to the NPC. Since the integration of SCMB with the general budget has been mandated by the State Council Document No. 26 and can be done fairly easily within the jurisdiction of MOF, the government is well advised to start the integration process in 2010 by (i) transferring the first batch of SOE dividend revenue (those collected from the tobacco industry and oil industry, for example) to the general budget, and (ii) incorporating the SCMB into the general budget that is submitted to the NPC for approval.

The common concern that often leads to skeptics of or disagreement upon this recommendation is the need of the state sector, represented by SASAC, for fund to cover costs of reform and restructuring. This is largely unfunded. First of all, most of the items of “SOE reform costs” such as bad debt write-off and settlement of laid-off workers, which used to be financed outside the budget in the 1990s, are now covered by general budget in most cases. Secondly, nothing prevents SASAC from applying and

receiving budgetary allocation to cover its legitimate expenditure in the same way as any other central government ministries. 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 (World Bank, 2005).

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Appendix 1: Summary Information of 49 Non-Chinese SOEs

No.	Firm	Country	Sector	State Ownership (%)	No. years of positive dividend ratio	Average positive dividend ratio	No. of years of negative dividend ratio
1	Air France KLM	France	Airlines	15.7	7	11.3	0
2	Air NZL	New Zealand	Airlines	75.4	4	19.2	0
3	Alitalia spa	Italy	Airlines	49.4	0	0.0	0
4	Austrian Airlines AG	Austria	Airlines	42.8	1	2.1	0
5	Finnair plc.	Finland	Airlines	55.8	6	30.6	2
6	SAS AB	Sweden	Airlines	21.4	0	0.0	0
7	Areva	France	Energy	84.2	6	52.4	1
8	Korea Electric Power C.	Korea	Energy	51.0	8	22.5	0
9	Korea Gas C.	Korea	Energy	51.0	9	43.6	0
10	OMV AG	Austria	Energy	31.5	9	23.3	0
11	StatoilHydro	Norway	Energy	70.9	8	33.7	0
12	Aker Solutions	Norway	Manufacturing	30.0	4	29.0	0
13	Kemira	Finland	Manufacturing	16.5	7	52.4	1
14	Metso	Finland	Manufacturing	11.1	6	38.5	1
15	Norsk Hydro	Norway	Manufacturing	43.8	8	27.7	0
16	Outokumpu	Finland	Manufacturing	31.0	7	29.1	2
17	Renault	France	Manufacturing	15.0	8	22.9	0
18	Ruukki	Finland	Manufacturing	39.7	1	16.7	0
19	Safran Group	France	Manufacturing	30.4	4	37.6	3
20	Yara International	Norway	Manufacturing	36.2	4	15.3	0

21	Korea Broadcasting system	Korea	Media	30.0	8	34.7	0
22	Television NZL	New Zealand	Media	43.7	4	54.8	0
23	Thomson SA	France	Media	9.1	1	5.0	2
24	Belgacom Group	Belgium	Telecommunications	53.5	7	58.5	0
25	Deutsche Telekom AG	Germany	Telecommunications	31.7	3	36.9	1
26	France Télécom	France	Telecommunications	26.7	6	43.6	1
27	NTT C.	Japan	Telecommunications	33.7	8	20.5	1
28	Swisscom AG	Switzerland	Telecommunications	55.2	8	42.0	0
29	Telekom Austria AG	Austria	Telecommunications	27.4	5	59.5	1
30	Telenor ASA	Norway	Telecommunications	54.0	7	29.2	1
31	TeliaSonera AB	Sweden	Telecommunications	37.5	7	36.1	1
32	Telstra C.L.	Australia	Telecommunications	10.9	7	75.3	0
33	Aéroports de Paris	France	Transport and postal	68.4	3	52.4	0
34	Copenhagen Airports A/S (Københavns Lufthavne)	Denmark	Transport and postal	39.5	8	47.9	0
35	Deutsche Post World Net	Germany	Transport and postal	30.5	8	43.3	1
36	Fraport AG (Frankfurt Airport)	Germany	Transport and postal	51.8	7	46.1	0
37	German Railways (Deutsche Bahn AG)	Germany	Transport and postal	100.0	0	0.0	0
38	Korea Airports C.	Korea	Transport and postal	59.5	8	20.1	1
39	Österreichische Post AG	Austria	Transport and postal	51.0	3	33.9	0
40	PSA	Singapore	Transport and postal	100.0	0	0.0	0
41	British Energy	UK	Utility	35.2	1	26.5	0
42	DONG Energy A/S	Denmark	Utility	73.0	3	17.0	0

43	Electricité de France (EDF)	France	Utility	84.9	4	30.8	0
44	Enel spa	Italy	Utility	21.1	7	77.0	0
45	ENI spa	Italy	Utility	20.3	9	47.4	0
46	Fortum Oyj	Finland	Utility	50.9	8	48.4	0
47	Gaz de France SUEZ	France	Utility	35.7	4	45.2	0
48	Vattenfall AB	Sweden	Utility	100.0	8	35.5	0
49	Verbund (Österreichische Elektrizitätswirtschafts-AG)	Austria	Utility	51.0	9	39.9	0

Appendix 2: Summary Information of 172 Hong Kong Listed Chinese SOEs

No.	Code	Firm (short name)	Sector	State Ownership (%)	No. years of positive dividend ratio	Average positive dividend ratio (%)	No. of years of negative dividend ratio
1	31	CHINA AEROSPACE	Aerospace/Defense	44.5	0	0.0	0
2	161	CATIC SHENZ-H	Aerospace/Defense	58.8	6	30.2	1
3	232	AVIC INTL HLDGS	Aerospace/Defense	39.9	0	0.0	0
4	670	CHINA EAST AIR-H	Airlines	74.7	3	11.5	0
5	753	AIR CHINA LTD-H	Airlines	50.7	2	7.0	0
6	1055	CHINA SOUTH A-H	Airlines	50.2	1	2.9	0
7	203	DENWAY MOTORS	Automobile	37.9	8	24.9	0
8	489	DONGFENG MOTOR-H	Automobile	66.9	4	21.0	0
9	1114	BRILLIANCE CHINA	Automobile	55.4	5	11.0	0
10	1122	QINGLING MOTOR-H	Automobile	50.1	7	61.3	0
11	2338	WEICHAJ POWER-H	Automobile	22.4	5	13.6	0
12	2357	AVICHINA INDUS-H	Automobile	61.1	2	7.9	0

13	1058	GUANGDONG TANNER	Consumer product	69.8	0	0.0	0
14	308	CHINA TRAVEL HK	Consumer product	52.6	8	50.7	1
15	2006	SHANGHAI JIN J-H	Consumer product	69.5	3	19.4	0
16	168	TSINGTAO BREW-H	Consumer product	30.7	7	65.9	0
17	506	CHINA FOODS LTD	Consumer product	68.9	9	35.6	0
18	828	DYNASTY FINE WIN	Consumer product	44.8	4	44.7	0
19	438	IRICO GROUP EL-H	Consumer product	75.0	0	0.0	0
20	921	HISENSE ELEC-H	Consumer product	30.8	0	0.0	0
21	217	CHINA CHENGTONG	Diversified	29.6	0	0.0	0
22	257	CHINA EVERBR INT	Diversified	55.9	5	11.9	0
23	270	GUANGDONG INVEST	Diversified	60.6	5	21.0	0
24	291	CHINA RES ENT	Diversified	51.6	9	32.7	0
25	363	SHANG INDUS HLDG	Diversified	50.8	9	37.3	0
26	392	BEIJING ENTERPRI	Diversified	50.6	9	35.6	0
27	455	YUNNAN ENTERPR	Diversified	50.9	0	0.0	0
28	604	SHENZHEN INVEST	Diversified	43.2	9	38.6	0
29	882	TIANJIN DEV HLDG	Diversified	53.4	9	19.1	0

30	1203	GUANGNAN HLDGS	Diversified	59.3	4	9.4	0
31	1205	CITIC RESOURCES	Diversified	54.0	0	0.0	0
32	42	NORTHEAST ELEC-H	Electrical	24.3	0	0.0	0
33	521	SHOUGANG TECH	Electrical	20.0	0	0.0	0
34	1072	DONGFANG ELECT-H	Electrical	50.1	5	10.4	0
35	1133	HARBIN POWER-H	Electrical	50.9	8	20.1	0
36	1202	CHENGDU PUTIAN-H	Electrical	60.0	0	0.0	0
37	3898	ZHUZHOU CSR	Electrical	54.4	3	18.6	0
38	1071	HUADIAN POWER-H	Energy	62.5	8	30.2	0
39	1088	CHINA SHENHUA -H	Energy	73.9	5	30.4	0
40	1171	YANZHOU COAL-H	Energy	52.9	9	26.2	0
41	1185	CHINA ENERGINE	Energy	73.1	0	0.0	0
42	1898	CHINA COAL ENERG	Energy	57.6	2	29.1	0
43	230	MINMETALS LAND	Engineering&Construction	45.0	0	0.0	0
44	390	CHINA RAIL GRP-H	Engineering&Construction	58.3	0	0.0	0
45	1186	CHINA RAIL CON-H	Engineering&Construction	63.3	1	7.7	0
46	1800	CHINA COM CONS-H	Engineering&Construction	70.1	3	15.7	0

47	3311	CHINA STATE CONS	Engineering&Construction	62.8	4	15.1	0
48	165	CHINA EVER LTD	Financial	54.5	5	12.8	1
49	183	CITIC INTL FINAN	Financial	69.7	7	41.2	0
50	218	SHENYIN WANGUO	Financial	50.9	8	35.3	0
51	349	IND & COMM BANK	Financial	71.3	9	53.1	0
52	405	GZI REIT	Financial	35.6	1	62.7	0
53	939	CHINA CONST BA-H	Financial	48.2	4	23.8	0
54	966	CHINA TAIPING IN	Financial	41.2	5	14.5	0
55	998	CHINA CITIC BK-H	Financial	77.3	2	24.2	0
56	1398	IND & COMM BK -H	Financial	70.7	4	24.7	0
57	2328	PICC PROPERTY &	Financial	69.0	2	15.0	0
58	2388	BOC HONG KONG HO	Financial	65.8	6	59.1	0
59	2628	CHINA LIFE-H	Financial	68.4	4	11.8	0
60	3328	BANK OF COMMUN-H	Financial	26.5	5	31.8	0
61	3988	BANK OF CHINA-H	Financial	67.5	3	39.9	0
62	152	SHENZ INTL HLDG	Logistics	40.7	6	13.4	0
63	357	HAINAN MEILAN-H	Logistics	50.2	6	42.5	0

64	694	BEIJING CAP AI-H	Logistics	56.6	8	43.2	0
65	2880	DALIAN PORT PD-H	Logistics	62.1	3	32.1	0
66	3378	XIAMEN PORT-H	Logistics	61.8	3	24.1	0
67	3382	TIANJIN PORT DEV	Logistics	65.6	3	31.3	0
68	3399	GD NAN YU LOGI-H	Logistics	57.2	4	18.2	0
69	8217	CHANGAN MINSHE-H	Logistics	24.1	5	30.7	0
70	8348	TIANJIN BINHAI-H	Logistics	77.9	0	0.0	0
71	38	FIRST TRACTOR-H	Machinery	52.5	2	8.3	0
72	187	BEIREN PRINT-H	Machinery	52.8	5	31.7	0
73	300	SHENJI GROUP-H	Machinery	36.2	2	6.8	0
74	350	JINGWEI TEXTIL-H	Machinery	33.8	9	25.8	0
75	1893	CHINA NATL MAT-H	Machinery	59.5	1	4.2	0
76	2345	SHANGHAI PRIME-H	Machinery	47.2	3	23.6	0
77	2727	SHANGHAI ELECT-H	Machinery	59.2	3	22.8	0
78	103	SHOUGANG CONCORD	Materials	46.0	4	12.9	0
79	323	MAANSHAN IRON-H	Materials	50.5	7	43.1	0
80	347	ANGANG STEEL-H	Materials	67.3	9	50.7	0

81	358	JIANGXI COPPER-H	Materials	42.4	9	31.5	0
82	697	SHOUGANG INTL EN	Materials	38.8	3	10.8	0
83	1053	CHONGQING IRON-H	Materials	48.8	9	31.4	0
84	1812	SHANDONG CHEN- H	Materials	19.3	3	25.3	0
85	2600	ALUMINUM CORP-H	Materials	41.8	7	26.7	0
86	914	ANHUI CONCH-H	Materials	52.0	8	18.0	0
87	1108	LUOYANG GLASS-H	Materials	35.8	0	0.0	0
88	3323	CHINA NATL BDG-H	Materials	44.1	4	12.5	0
89	297	SINOFERT HOLDING	Materials	52.7	4	8.7	0
90	338	SINOPEC SHANG-H	Materials	55.6	7	30.9	0
91	549	JILIN QIFENG-H	Materials	50.0	1	9.0	0
92	1033	SINOPEC YIZ-H	Materials	60.0	5	25.0	0
93	3983	CHINA BLUECHEM-H	Materials	61.0	3	18.7	0
94	8258	SHAANXI NEW TE-H	Materials	67.0	1	2.0	0
95	1000	BEIJING MEDIA -H	Media	63.3	3	16.4	0
96	629	YUE DA MINING	Mining	36.9	1	0.7	0
97	1208	MINMETALS RESOUR	Mining	58.6	3	23.0	0

98	1818	ZHAOJIN MINING-H	Mining	37.3	2	9.4	0
99	2626	HUNAN NON-FERR-H	Mining	53.1	5	51.2	0
100	2899	ZIJIN MINING GRP	Mining	29.0	3	14.6	0
101	3330	LINGBAO GOLD-H	Mining	48.5	2	41.3	0
102	3833	XINXIN MINING-H	Mining	40.1	2	36.0	0
103	3993	CHINA MOLYBDENUM	Mining	36.8	1	3.0	1
104	135	CNPC HONG KG LTD	Oil&Gas	56.6	9	30.0	0
105	386	CHINA PETROLEU-H	Oil&Gas	75.8	9	44.8	0
106	857	PETROCHINA CO-H	Oil&Gas	86.4	8	27.9	0
107	883	CNOOC LTD	Oil&Gas	64.4	9	22.6	0
108	934	SINOPEC KANTONS	Oil&Gas	72.3	7	22.6	0
109	2883	CHINA OILFIELD-H	Oil&Gas	54.7	8	27.9	0
110	719	SHANDONG XINHU-H	Pharmaceuticals	35.7	7	37.2	0
111	874	GUANGZHOU PHAR-H	Pharmaceuticals	48.2	9	35.0	0
112	1093	CHINA PHARMACEUT	Pharmaceuticals	51.0	5	17.7	0
113	8069	TONG REN TANG-H	Pharmaceuticals	51.0	9	46.8	0
114	119	POLY HONG KONG I	Real Estate	51.9	6	21.4	0

115	171	SILVER GRANT INT	Real Estate	30.5	8	32.0	0
116	281	RIVERA (HLDG)	Real Estate	29.9	3	14.7	0
117	588	BEIJING NORTH ST	Real Estate	34.5	8	23.7	0
118	688	CHINA OVERSEAS	Real Estate	51.7	8	38.5	0
119	730	SHOUGANG GRAND	Real Estate	37.4	0	0.0	0
120	1109	CHINA RES LAND	Real Estate	43.8	8	28.8	0
121	2868	BEIJING CAPITAL	Real Estate	47.2	6	32.3	0
122	811	SICHUAN XINHUA-H	Retail	52.2	2	50.8	0
123	814	BEIJING JINGKELO	Retail	47.1	3	30.6	0
124	980	LIANHUA SUPERM-H	Retail	55.2	6	34.4	0
125	8277	WUMART STORES	Retail	40.8	5	47.5	0
126	74	GREAT WALL T-H	Technology	62.1	4	7.4	0
127	154	BEIJING DEV.(HK)	Technology	40.7	0	0.0	0
128	241	CITIC 21CN CO LT	Technology	21.7	0	0.0	0
129	418	FOUNDER HOLDINGS	Technology	32.5	0	0.0	0
130	597	CHINA RES MICRO	Technology	60.6	1	0.1	1
131	618	EC-FOUNDER HOLDI	Technology	41.3	0	0.0	0

132	696	TRAVELSKY TECH	Technology	57.9	8	37.3	0
133	840	XINJIANG TIANY-H	Technology	38.9	4	35.9	0
134	861	DIGITAL CHINA	Technology	17.8	7	29.2	0
135	981	SEMICONDUCTOR MA	Technology	24.8	0	0.0	0
136	992	LENOVO GROUP LTD	Technology	45.3	6	35.8	1
137	8102	SHANGHAI FUDAN-H	Technology	35.1	0	0.0	0
138	8157	CAPINFO CO LTD-H	Technology	63.3	2	12.7	0
139	8231	SHANGHAI FUDAN-H	Technology	62.3	0	0.0	0
140	8235	CCID CONSULTIN-H	Technology	69.4	1	39.0	1
141	85	CHINA ELECTRONIC	Telecommunications	75.0	2	9.3	0
142	552	CHINA COMM SER-H	Telecommunications	61.4	2	14.2	0
143	553	NANJING PANDA-H	Telecommunications	51.1	1	5.2	0
144	728	CHINA TELECOM-H	Telecommunications	70.9	6	22.4	0
145	762	CHINA UNICOM HON	Telecommunications	40.9	7	23.1	0
146	763	ZTE CORP-H	Telecommunications	35.5	7	18.9	0
147	906	CHINA NETCOM GR	Telecommunications	69.6	4	14.1	0
148	941	CHINA MOBILE	Telecommunications	74.2	7	26.9	0

149	1045	APT SATELLITE HL	Telecommunications	51.8	2	9.4	0
150	107	SICHUAN EXP-H	Transportation	52.7	7	32.2	0
151	177	JIANGSU EXPRES-H	Transportation	66.1	8	76.6	0
152	317	GUANGZHOU SHIP-H	Transportation	35.7	2	5.9	0
153	517	COSCO INTERNATIO	Transportation	58.7	5	6.9	0
154	525	GUANGSHEN RAIL-H	Transportation	41.0	9	70.8	0
155	548	SHENZ EXPRESS-H	Transportation	50.0	9	54.2	0
156	560	CHU KONG SHIPPIN	Transportation	68.6	9	42.4	0
157	576	ZHEJIANG EXPRESS	Transportation	67.0	9	62.7	0
158	598	SINOTRANS LTD-H	Transportation	57.9	6	29.5	0
159	995	ANHUI EXPRESS-H	Transportation	52.2	9	41.5	0
160	1052	GZI TRANSPORT	Transportation	70.4	9	37.0	0
161	1138	CHINA SHIP-H	Transportation	46.4	9	39.7	0
162	1199	COSCO PAC LTD	Transportation	59.4	9	48.0	0
163	1919	CHINA COSCO HO-H	Transportation	53.8	4	13.6	0
164	2866	CHINA SHIPPING-H	Transportation	47.9	4	19.2	0
165	836	CHINA RES POWER	Utilities	64.8	5	17.0	0

166	902	HUANENG POWER-H	Utilities	51.0	8	55.0	1
167	991	DATANG INTL PO-H	Utilities	68.4	7	47.1	0
168	1065	TIANJIN CAP-H	Utilities	54.2	7	30.3	0
169	1193	CHINA RES GAS GR	Utilities	68.9	7	15.5	0
170	2380	CHINA POWER INTE	Utilities	55.4	4	23.5	0
171	3928	ZHENGZHOU GAS CO	Utilities	43.2	7	24.6	0
172	8290	TIANJIN TIANLI-H	Utilities	32.4	1	4.3	0

