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Chinese Government Guidance Funds

A Guide for the Perplexed

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China's government is pouring resources into guidance funds [政府引导基金]. These public-private investment vehicles seek to mobilize massive amounts of capital in support of strategic and emerging technologies, including artificial intelligence (AI). They have attracted enthusiastic support from across China's government—and prompted both concern and skepticism among outside observers.

To understand whether these funds are actually delivering on their ambitious goals, we conducted an in-depth study drawing on hundreds of Chinese-language sources. We found that many guidance funds are indeed poorly conceived and implemented, and that the model as a whole is often inefficient. Nonetheless, we also found that these funds have many advantages over traditional Chinese industrial policy mechanisms, and they are unquestionably helping mobilize money and other resources for emerging and strategic industries. The guidance fund model is no silver bullet, but it should not be casually dismissed.

Our separate report provides in detail an examination of the guidance fund model and how it is working—and not working—based on original Chinese-language sources.[*] This paper presents the essential findings from our aforementioned full-length report. In the following sections, we describe the guidance fund model, explain its intended benefits and observed weaknesses, and assess its prospects for success. We conclude by highlighting several indicators that can help gauge whether guidance funds are trending toward success or failure.

The Guidance Fund Model

Chinese government guidance funds are public-private investment vehicles that aim to both produce financial returns and further the state's industrial policy goals. They raise money from public and

[*] For sources and the full text of the quotations used this paper, see our full-length analysis. Ngor Luong, Zachary Arnold, and Ben Murphy, "Understanding Chinese Government Guidance Funds" (Center for Security and Emerging Technology, March 2021).

private sources and make investments consistent with government priorities, including China's pursuit of leadership in AI and other strategic and emerging technologies.

Government agencies at central, provincial, and local levels establish guidance funds. This typically involves creating the fund, setting a fundraising target, allocating capital to part of the target directly from budget outlays, and raising the rest from other investors, whose contributions are called "social capital." The government sponsor commonly aims to fund 20 to 30 percent of the target, with "social capital" investors providing the rest. As of the first quarter of 2020, Chinese officials had set up 1,741 guidance funds, with a cumulative registered target size of 11 trillion RMB (1.55 trillion USD), but these funds had only raised about 4.76 trillion RMB (672 billion USD).

Guidance funds use the limited partnership structure common in equity finance worldwide. A general partner makes investment decisions and handles day-to-day operations, while limited partners contribute capital and take returns (or losses). A guidance fund's general partner may be a fund management institution established by a government agency, a state-owned investment firm, or a third-party professional fund manager. A guidance fund's limited partners include the "social capital" investors, which many Chinese commenters implicitly or explicitly equate with *private* capital—that is, capital raised from profit-motivated investors not connected to the government. In practice, however, these "social capital" investors are often state-funded entities, such as state-owned enterprises and state-run banks.

A guidance fund may either invest directly in companies or tangible projects, or invest indirectly through a fund-of-funds approach, which allows the fund to invest in other investment funds (including other guidance funds) known as "sub-funds." Each guidance fund has investment priorities and constraints reflecting its policy objectives. For example, some funds only invest in businesses or sub-funds that are located in a particular region or focused on a particular technology.

To entice social capital investors, government sponsors in guidance funds may forgo their own interest payments, assume other investors' losses, or provide other incentives. The government's sizable capital contributions also reduce other investors' exposure and signal the government's commitment to relevant industries.

Guidance funds have developed in three phases. In the first phase, lasting through the early- to mid-2010s, central and local governments set up a number of initial funds and established a supporting legal framework. The second phase experienced a boom in guidance funds between 2015 and 2018, fueled by central government policies, relatively loose regulation, new restrictions on other types of local government spending, and trend-chasing among provincial and local bureaucrats. In the third phase, beginning around 2018, formation and fund-raising slowed down, due in large part to broader economic headwinds in China and tighter regulations.

> *"Since last year, we have established long-term cooperative relations with professional investment institutions. . . . These specialized investment firms . . . [have] a large amount of high-quality resource information and projects in hand [and] connect the guidance funds established by the government with other [investors]. After they [announce these] investment institutions as [their] investment partners, many project institutions will come knocking at the door. The traditional way of attracting investment can't compare with this."*
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> - Wang Jinxiang, director of Weifang City Finance Bureau in Shandong province, in a 2019 interview.

Intended Benefits

As an industrial policy tool, guidance funds have several potential advantages.

- ***Guidance funds help Chinese policymakers leverage market discipline and expertise.*** By bringing the profit motive into industrial policy, the guidance fund model could reduce the inefficiency and corruption associated with subsidy schemes and other traditional policy tools.

Policymakers in China hope that professional fund managers and profit-oriented "social capital" investors will discipline the guidance funds in which they participate, and bring in capital, information, contacts, and expert judgment beyond what the government can provide.

- ***Guidance funds offer patient capital, a critical resource for emerging technologies.*** Most investors tend to favor areas with short investment periods and quick returns, rather than nationally strategic technologies that require long-term financial support. Even promising startups may struggle to cross the "valley of death," an in-between stage before scaling-up and commercialization, when initial capital runs dry. Guidance funds can fill in the gap by supplying stable, long-term investment capital to technology startups, helping them move from discovery to commercialization of high-quality technologies.

> *"'Give me a lever long enough and a fulcrum on which to place it, and I shall move the world.' The words of Archimedes, an ancient Greek philosopher, leap from the pen. Is Haihe Industry Fund not a fulcrum? It will leverage the 478 square kilometers of land resources . . . and it will guide investment institutions, listed companies, outstanding talents, high-quality projects and other factors in gathering and bouncing off one another, energizing this homeland of innovation and entrepreneurship."*
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> - Commentary in *Tianjin Daily*, an official newspaper, in 2020.

- ***Guidance funds can complement and amplify other industrial policy measures, producing robust, holistic support for emerging and high-tech businesses.*** To attract high-quality targets, many guidance fund institutions provide or coordinate other industrial policy measures, such as state-sponsored technology parks, research and development incentives, and talent recruitment plans, making them more effective as a whole. Ideally, these diverse resources could form comprehensive ecosystems of support, fostering local economies of scale and helping emerging and strategic businesses take off.

Observed Weaknesses

In practice, however, most guidance funds fail to live up to their ambitions, weakened by unrealistic goals, incompetent management, bureaucracy, and a lack of market discipline.

- ***Guidance funds often raise much less money than planned.*** New funds routinely plan to raise hundreds of millions or even billions of yuan, but struggle to raise money from both public sponsors and "social capital" investors. Major causes include local debt burdens, broader economic headwinds, and stricter regulations.

- ***Much of the money they do raise is never actually invested in projects.*** Funds that do raise money may not find suitable investment targets. Risk-averse government sponsors may further narrow the pool of targets by restricting investment to specific industries or geographies.

- ***There are too many guidance funds.*** By the first half of 2019, local governments had already set up 1,300 guidance funds alone, many of which had overlapping policy objectives, leading to an overcrowded and inefficient investment market. Local funds often unnecessarily duplicate the state's efforts and end up competing with each other for scarce capital and managerial talent.

> *"A biotech and pharmaceutical industry cannot be developed in every province, but every province is blindly trying to create such an industry through [guidance] funds. Investment is cyclical. In the beginning, everybody wants in. It's 'national strategic industry' this, 'emerging industry' that. However, if every province is investing in [these industries], we will have excess capacity within three years. . . . Government guidance funds have entered an era of wild growth and we must get to the root of the problem."*
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> -An anonymous financial official, speaking to the *China Economic Times* in 2016.

- ***Many guidance funds are poorly managed.*** Local governments often rely on inexperienced bureaucrats to manage their guidance funds, leading to bad investment decisions. Some local governments have begun using professional fund managers, but unrealistic evaluation criteria and bureaucratic hurdles can interfere with effective management and drive managerial talent away from guidance funds.

- ***Guidance funds have wasted capital.*** Instead of investing in high-quality, strategic projects, some funds serve as vehicles for nonstrategic, wasteful or even unauthorized activities. These include subsidizing local companies that are already well-resourced and facilitating unauthorized borrowing by local governments. New regulations and tighter budgets, however, may help reduce these practices in the future.

> *"[Guidance funds] have not attracted much social capital. Take the National Integrated Circuit Industry Investment Fund Co., as an example: In addition to the Ministry of Finance (25.95%) and China Development Bank Capital Corporation (CDB Capital) (23.07%), state-owned enterprises such as China National Tobacco Corporation (14.42%), Beijing E-Town International Investment and Development Co., Ltd. (7.21%) and China Mobile Communications Corporation (7.21%) all own shares. No private capital participated [in the fund's first phase] at all."*
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> - Jiang Liang, "Government Guidance Funds: A 12 Trillion RMB Predicament and Contradiction", *Sina News*, December 15, 2018.

- ***Guidance funds do not invest in early-stage companies as intended.*** Many funds are meant to support early-stage ventures, but government-affiliated fund managers are typically risk-averse and favor mature companies instead. Even when guidance funds want to invest in early-stage companies, high-quality targets can be hard to find, especially for funds that focus on a particular industry or geographical region or lack management expertise.

- ***Guidance funds often fail to attract truly private capital, and in some cases may even crowd private capital out of the market.*** Many "social capital" investors in guidance funds are also state-backed and presumably less likely than private investors to discipline the funds in which they participate. Meanwhile, guidance funds can crowd truly private capital out of the market, weakening the market as a whole.

Trends and Assessment

Guidance funds' weaknesses are real. Many of these flaws are rooted in basic issues of institutional capacity and contradictions in the model—between Chinese Communist Party aims and the profit motive, and between national visions for advanced technology and local, shorter-term economic development interests.

> *"It is more and more difficult and unsustainable to rely on preferential policies related to land and taxation to achieve leapfrog development . . . Because capital is the best 'selector,' 'amplifier' and 'accelerator' of the project, not only can it fulfill urgent requirements for funding, technology and talent, it also completely accords with current regulatory requirements, and has become the preferred way to attract investment. . . . The traditional way of attracting investment cannot compare with this."*
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> - Wang Jinxiang, director of Weifang city's Finance Bureau, in a 2019 interview with the *Economic Observer.*

Although these funds may never meet their sky-high ambitions, they could still aid China's pursuit of global technological leadership. The more disciplined, market-oriented funds have successfully raised and deployed large amounts of capital. Many funds have also shown an ability to self-govern and learn from experience, including by terminating inefficient funds, improving evaluation systems, and hiring professional fund managers with the right expertise. Recent policy reforms may also strengthen the mechanism—for example by relaxing investment restrictions and tightening selection standards for fund managers.

The progress these funds are making appears localized and uneven, but even with its problems, the guidance fund mechanism is probably better than the deeply flawed traditional policy tools, such as direct government ownership or cash handouts to state-favored companies, the Chinese government might otherwise use to support strategic industries.

Performance Indicators

Guidance funds have many possible futures as the model continues to develop, individual funds and investments begin to pan out (or not), and regulators, investors, and fund managers gain the right experience. Regardless, the Chinese government continues to invest, financially and politically, in these funds, and we expect they will continue to be a pillar of China's development strategy. The United States and its allies should closely monitor these funds. As a starting point, they can use these indicators to gauge guidance funds' success or failure over the coming years:

- **Fundraising**: Are guidance funds proposing to raise more money, or less? Are funds raising as much money as they planned? Are "social capital" investors truly private, or state-backed? Are funds attracting foreign investors, or only Chinese nationals?

- **Investment:** Are guidance funds investing in early-stage companies, or sticking to well-established firms? Are funds deploying the capital they have raised? Do funds report strong financial returns? Are governments regularly intervening in the day-to-day investment decisions, or instead delegating authority to professional fund managers?

- **Operation and Management:** Are governments setting up fewer guidance funds in saturated or underdeveloped markets and regions? Are they cleaning up ineffective funds, or continuing to support them? Do government audits continue to identify funds deviating from applicable regulations? Are funds disclosing meaningful information about their activities? Are they leveraging economies of scale by collaborating with other guidance funds? Are funds using an effective, standardized management evaluation system, or vague, unrealistic criteria?

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