Testimony before the U.S.-China Economic and Security Review Commission on "Chinese State-Owned and State-Controlled Enterprises"

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Introduction

Good morning and thank you for inviting me to testify today. My name is Adam Hersh and I am an Economist at the Center for American Progress Action Fund.

You have asked me to talk about the role of state-owned enterprises in China's economy. More than 30 years since beginning economic reform, China's fundamental economic institutions today are dramatically different than the system of central planning operating during the Mao era. But despite sweeping reforms, government control over China's economy remains pervasive, including through direct ownership of virtually all of the formal financial system and much of the economy's productive assets.

The still evolving nexus of political and legal institutions, corporate structures, and economic relationships in China resulting from these reforms is complex and opaque. This has led to several common misconceptions about how China's economy works. Today I will try to clarify three.

First, Beijing neither controls nor coordinates everything in the Chinese economy. While government involvement in China's economy is extensive, most of the action aimed at developing individual companies happens at the local government level. Local officials make their own decisions in their own interests, often without the knowledge or support of Beijing. Local officials are integral to many of the entrepreneurial decisions that have led to China's remarkable economic success. The investment resources under local government control vastly exceed those used by the central government to support its own state-owned enterprises as well as private sources of financing.

Second, there is often no clear distinction between "privately owned" and "government-owned" enterprises in terms of government support—national, provincial, or local—for economic development. Corporate-governance reforms beginning in the mid-1990s transformed many once distinctly government-owned companies into an array of seemingly private, shareholding, or joint-venture ownership forms. But the various government institutions that support the development of government-owned companies are just as readily applied to other ownership forms, as well. There is often a revolving door between top leadership in business and key government economic positions. And beyond this system of local government-led industrial policy, Communist Party infrastructure is expanding within private firms even as business leaders are expanding their reach within the Communist Party hierarchy.

Third, China's economic success is not due exclusively to cheating on international economic agreements. Many of China's development strategies make profound economic sense for building a productive and competitive economy. These include:

- Solving market failures common to all economies that create disincentives for private investments in factories, scientific research and development, and development of new markets and products
- Regulating the financial structure to supply capital for productive investments in the manufacturing sector
- Investing in 21st century education and infrastructure that make workers and businesses more productive
- Committing to employment-targeted macroeconomic policies that promote development of a middle class—and deepening of markets for businesses.

U.S. policymakers certainly must take strong action to investigate and remediate China's economic policies that violate international agreements or give Chinese companies unfair advantages—including violations of worker rights and environmental rights. But there are also clear lessons in China's economic success that U.S. policymakers can apply here in United States. U.S. policymakers also have the power to pursue these economic strategies today—if we so choose. What's more, these policies are consistent with American economic principles and America's own economic history.

But let me begin with the importance of local governments in China's economy today and going back several decades.

Origins and powers of local government industrial policy

Local government officials occupy a key position within China's economic structure giving them considerable power over economic affairs, finance, productive industry, and the everyday affairs of people under their jurisdiction. The structure of state power in Chinese society is much different than in the United States. A long-time U.S. diplomat and China hand explained the distinction to me this way: "In the United States you can do whatever you want unless the government says you can't. In China you can only do what the government permits you to do."

This social structure has profound consequences for how power is distributed within the economy and the ability of local government officials to exercise authority beyond just the property rights conveyed by direct ownership of productive assets. Economists call this kind of power "first-mover advantage," and it endows local government officials with power in setting the terms of contracts for workers, enterprise managers, people who lease lands or assets from the government, and really, for all who are subject to the regulatory discretion of officials, including privately owned businesses. So even businesses not owned by the government must dance to the tune of government officials, to an extent.

But local governments do also own significant portions of China's economy, and they also command tremendous financial resources that can be used for economic-development purposes. Political and economic reforms that steered China away from the Mao era centrally planned economy devolved considerable power and resources to local government entities. The system of local government-managed industrial policy that emerged can be seen most clearly in the experience of China's rural township and village enterprises, or TVEs. The authority and autonomy of local governments I describe were not limited just to TVEs or rural governments—it was replicated in local governments throughout the country.

TVEs as an enterprise form evolved from pre-reform era rural-agricultural collectives and were organized under the authority of local government officials. Prior to reform rural-industrial enterprises existed in modest concentrations under rural-production brigades, though, like most of the Mao-era economy, they were typically highly inefficient and undercapitalized with antiquated technology. Reforms vastly transformed the incentives and opportunities for local governments to pursue industrial development. In a relatively short time period, these companies developed tremendous economic importance. In the 1980s TVEs accounted for 30 percent of China's growth in manufacturing and service sectors.[1] By the mid-1990s literally millions of TVEs accounted for a combined 40 percent of China's total exports.[2] Economic analyses find that these TVEs achieved levels of efficiency that rivaled or surpassed privately owned and even foreign-invested companies.[3]

In the late 1990s and early 2000s TVEs and other local government-owned enterprises underwent corporate-governance reforms that resulted in a proliferation of ownership forms ranging from continued government ownership, to worker-owned cooperatives, to ostensibly private and foreign-invested companies. Although legal ownership status for many of these companies may have changed, the relationships and channels of influence between local governments and industry remain, including through the supply of capital for investment. Local government officials often concurrently serve as government executives, party secretaries, and directors of local enterprises.[4] In a 2002 nationally representative survey of local government leaders, 39 percent of party secretaries surveyed and 38 percent of village heads reported previous experience as enterprise managers; in half of localities either one or the other brought such experience into governance.[5] But officials also exercised power with a scope well beyond industry "over almost all aspects of social, political, and economic life" in local communities, according to World Bank Chief Economist Justin Lin and co-authors.[6] Little takes place in local economies without the explicit or tacit blessing of local officials.

Investment in China, under all property-ownership classifications, is subject to extensive state influence through regulatory channels and through control of the financial system. Despite emergence of new ownership forms and private property rights, the extent of state influence over investment can be seen in persistent patterns of investment over time. Economist Thomas Rawski observes that even late into the economic-reform process, China's investment cycles have not changed substantially from those seen under the centrally planned economy. The consistent pattern indicates that the main determinants of investment—that is to say, government decision-making authority–also persisted through economic reforms.[7] MIT

economist Huang Yasheng goes so far as to argue that the ability of local governments to raise funds for investment projects and to influence key production decisions "has been considerably enhanced" during the reform period.[8]

Professor Huang describes an extensive government structure for monitoring and overseeing fixed-asset investments: "[investment] activities went through a government scrutiny process that required a bureaucratic paper trail."[9] And this bureaucratic trail is overwhelmingly local: In 1995, 70 percent of fixed-asset investment was supervised under the jurisdiction of local governments; by 2008 local governments held jurisdiction over 83 percent of investment.[10] In 2008 only 6 percent of fixed investment occurred outside the jurisdiction of local or central governments.

How local governments fund economic development

Early reforms devolved much fiscal authority to local governments, altering the way they collect and remit taxes to higher levels of government. Prior to reform local officials would remit collected taxes and then receive some revenue-sharing allotment back from higher levels of government. This arrangement gave local officials little incentive to collect taxes or utilize revenues efficiently.

Fiscal reforms reversed this structure, in essence giving local officials a "property right" in the taxes they collect. In particular, taxes collected on industrial and commercial activities, and a range of miscellaneous fines and fees, would be retained at the local level as "extrabudgetary" revenues that local officials could use at their discretion. As much as two-thirds of all off-budget government revenues derived directly from the business activities of TVEs, though local governments also derived revenues from enterprises in other ownership categories.[11] In some provinces, extrabudgetary revenues accounted for as much as 60 percent of total fixed-asset investment.[12]

To put the scale of local government resources in perspective, we can look at how sources of financing for fixed-asset investment in China have evolved over time, from 1996 to 2009.[13] (see Figure 1) First, consider the primary sources of financial resources available to state-owned enterprises, or SOEs, under the control of Beijing and higher levels of government: domestic-bank loans and funds allocated from the state budget. Over the past 15 years combined capital resources provided by the central government budget and domestic bank loans amounted ranged from 19 percent to 27 percent of total national investment. Today, state budget resources for investment represent a very small portion of overall investment, roughly 5 percent, down from nearly 30 percent in 1980. And not all domestic-bank credit is used to support SOEs on a noncommercial basis. World Bank economists Robert Cull and Collin Xu find that firms receiving bank loans in China tend to be of higher productivity.[14] But the key point is that fully three-quarters to four-fifths of all fixed investment in China is not derived from capital sources over which the central government in Beijing holds direct control.

Foreign investment, to which many observers and analysts ascribe China's economic success, accounts for a relatively minor and diminishing portion of overall investment in China. In the

time since China's WTO accession in December 2001, foreign investment averaged only 3.7 percent of national investment, and less than 2 percent in 2009. Even these figures overstate the impact of foreign investment. Much of what is recorded in statistics as foreign direct investment actually originates from domestic capital sources "round-tripped" through Hong Kong in order to receive preferential tax treatment. Estimates suggest one-quarter to one-half of all registered foreign direct investment actually originates from domestic sources.[15] Similarly, China's capital markets supply only a marginal share of total investment, on average less than 3 percent annually since WTO accession.

The vast majority of resources for investment seen in Figure 1 fall into the all-encompassing "other" category, overwhelmingly the largest source of funds for investment in China. This amalgam includes (a) extrabudgetary revenues and other resources provided by local governments, (b) retained earnings of firms, and (c) funds raised through private finance. Private finance occurs mainly through informal, unregulated channels also sometimes called the "curb market." Although research suggests informal finance is widespread, it is concentrated in relatively small-scale, low-productivity entities. In the words of Professor Huang, truly private entrepreneurship is "a poor man's affair" in China.[16] Moreover, much informal finance is not used for business investment, but rather for household consumption purposes or to finance migration or weddings.

Overall, "other" sources of funds climbed from 66 percent of total investment in 1996 to 77 percent in 2009. The "other" category is not exclusive to extrabudgetary revenues of local governments. Depending on the year, roughly half of "other" funds for investment can be attributed to extrabudgetary revenues—still considerably larger than any other single source of investment financing in China. Though it is not possible to pinpoint with accuracy the remaining contributing sources of funds to this category, it is clear that within this category are other sources under the domain of local government officials, including retained earnings of firms under local control and the forced savings of workers who are routinely required to post "employment-performance bonds," putting substantial capital at the disposal of firm management as a condition of securing a job. Thus, the overwhelming majority of funds for fixed-asset investment in China are under the control of local governments.

More recently, under China's 2009 and 2010 fiscal and monetary stimulus plan, local governments also borrowed substantial sums for investment from banks through what are called local government-financing platforms. We are still learning many of the details of how this financial instrument worked and the scale of its use. But, in short, local governments created investment companies that borrowed money from banks and used this capital for local-investment projects. In theory this borrowing would be accounted for under the domestic bank loans category presented in Figure 1. Use of this new financing vehicle does not change the story of how development strategies are financed in China, but serves to highlight the key roles played by local governments in development.

The entrepreneurial role of local government officials

The institutional arrangement of local government industrial-financing policy established a virtuous circle of incentives for local officials. The more that the local economy developed, the more extrabudgetary revenues officials collected and could reinvest in economic development: extrabudgetary revenues and local industry developed hand in hand. The financial resources and economic assets under the authority of local officials certainly created ample opportunities for corruption, and anecdotal and journalistic accounts of corruption abound.

Yet local government-led industries also faced a significant disciplining effect in the form of rampant competition among the multitudes of localities pursuing development strategies—they competed against each other in domestic markets, and they competed against each other and high-productivity companies from around the world in global export markets. Competition in markets helped drive local government enterprises to efficiency, but so did competition for political advancement, premised in large part on achieving economic and export growth targets set from above in the political hierarchy. In essence the political advancement of local officials was linked to their entrepreneurial skills.[17]

Funneling large sums of financing to inefficient companies over extended periods of time does not yield sustained, rapid development over three decades by itself. Local officials must be doing something economically right with these funds. In addition to the incentives for growth and efficiency that evolved since 1978 through successive economic reforms, local governments directed funds toward economically efficient uses that expanded companies' and the overall economy's technological and productive capacity and diversified production into new and increasingly more sophisticated manufacturing activities.

Recent economic research shows the critical importance of the manufacturing sector for accelerations and sustained strong levels of economic growth.[18] While manufacturing is important for growth and technological deepening, expansion of economic activities into new and more sophisticated areas are fraught with market failures, or what economists refer to more broadly as "coordination failures." These failures result when potentially profitable or welfare-enhancing opportunities exist, but are not taken by individuals or companies for a variety of reasons.[19]

In terms of growing new industries and adopting and developing new technologies—the foundations of economic growth—the key market-failure problems tend to stem from (a) information spillovers, (b) difficulty in coordinating complementary investments needed to make some individual investments profitable, and (c) risks specific to startup companies and small businesses that make financing difficult. It is costly and risky for firms to invest in discovering new products, new markets, new technologies, and new ways to do business. Once such an investment is made, the information about what can be profitable to do is readily available to other potential entrepreneurs. As a result, the discoverer of this information will not be able to recoup the benefits of making investments to discover this information. Such issues with information spillovers will lead to an inefficient undersupply of such investment as well as research and development activities.

In the case of coordination problems, a potential investment opportunity may only be profitable if other complementary investments—public or private—are also made at the same time. For most firms making the combined necessary investments is often beyond the means, scope of expertise, or risk appetite of an individual investor. Moreover, cooperation of multiple individual investors is difficult due to incomplete information among the parties and conflicts over how to divide the profits created from the complementing investments. Lastly, difficulty of small and new firms accessing investment capital is a problem faced by businesses even in advanced countries with highly developed financial systems.

Public interventions to resolve all three coordination problems can be both general-welfare and economic-growth enhancing. Policies in the United States have served to remedy these challenges to growth through a variety of means: direct funding and tax subsidies for scientific research and development; coordinating development of new technologies through DARPA and SEMATECH; the Small Business Administration, the Small Business Innovation Research program, and the manufacturing-extension program; efforts of state and municipal governments to develop regional economic clusters; and more. But in recent years funding for such endeavors at the federal government level and from cash-strapped states have waned and the programs have come under repeated threats of budget cuts.[20]

China has pursued policies similar in principle, though in a more aggressive, coordinated, and direct fashion through local government institutions. In addition to launching new enterprises, local governments used extrabudgetary revenues and other resources to finance investments in technological upgrading of enterprises and the costs of discovering new markets and expanding into new industries. And local government officials have directed this support to both government-owned and private-owned companies with a goal of promoting overall economic and export growth.

As we know, China's economic success since the early 1990s owes to its strong export-led growth strategy. The efficacy of local government-led development policies can be seen by analyzing how export development is statistically associated with the development financing available to local governments as compared to other modes of finance—domestic-bank loans and central-government budgets, foreign-direct investment, and informal private finance—and other standard factors associated with export performance.[21] Econometric analysis shows that extrabudgetary revenues associated with local government industrial policy had a stronger effect on export development than any other mode of finance, including foreign-direct investment. For every 1 percent increase in extrabudgetary revenues in China's provinces, exports from that province increased 0.5 percent to 0.7 percent.

Lessons for the United States

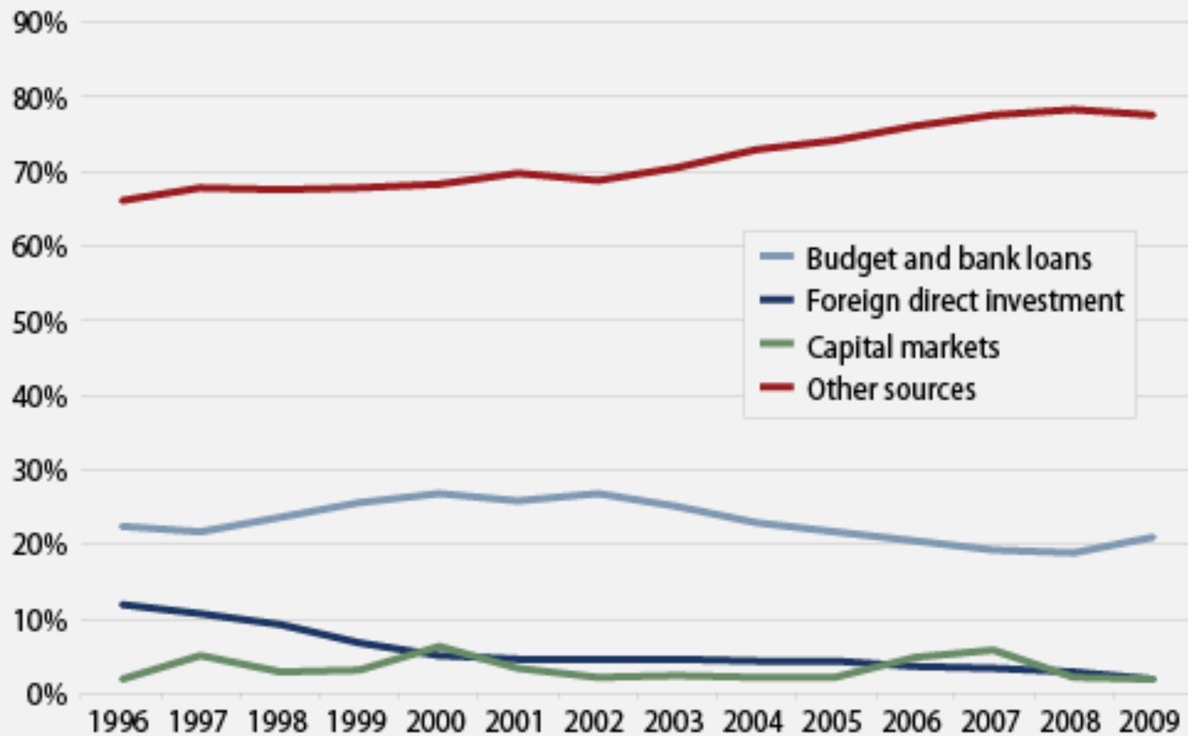
The local government-led industrial strategy system I describe here has been remarkably successful and effective at delivering strong economic growth and steadily rising standards of living for Chinese citizens. While local government officials oversaw much successful microeconomic development, they did not do so on their own—they operated within a

supportive macroeconomic environment that allowed the seeds of local government investment to flourish. In particular, national level policies that reflect:

- Dedication to substantial public investments in 21st century education and infrastructure systems that make for productive workers and businesses
- Commitment to maintaining employment-targeted macroeconomic that have helped develop a middle class in China and provide deepening markets into which Chinese businesses can sell.

U.S. policymakers would not emulate many of the things China's policymakers—at local and national levels of government—do to promote a strong and productive economy. But much of what China does, the United States does or can do through different means: investments in education, scientific research and development, infrastructure, and macroeconomic management for full employment.

Thank you.



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