Testimony before the U.S.-China Economic and Security Review Commission on "China's State-Owned Enterprises and Non-Market Economics"

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Co-chairs, members of the Commission: thank you for inviting me to testify today on China's state-owned enterprises (SOEs) and non-market economics.

My name is Adam Hersh and I am Senior Economist at the Center for American Progress, although the testimony today solely reflects my personal opinions.

In order to fully understand how China's nonmarket economy works, it is important to distinguish between the Communist Party of China and the nation-state of the People's Republic of China. The distinction is this: the Party rules over China's economy and society with an unchecked monopoly on power, while the institutions of state administer this rule. In China, the Party is fundamental while the artifice of state institutions is fungible. One can imagine multiple institutional configurations for governing China's economy consistent with preserving Party rule, of which the reform agenda envisioned in the 18^{th} Party Congress's in the third 3^{rd} Plenum "Decision" is but one.

To be clear, by invoking the Party I am not inciting a "Red Scare." The Party is "communist" in name only and does not espouse an imperial left-wing ideology, but rather a profound nationalism to justify its one-party authoritarian rule whose thread runs throughout the economy and society where members occupy key positions—often simultaneously—in Party, government, and business hierarchies.

What matters—from an economic perspective—is who holds agency over China's economic resources, and what incentives and constraints these people face in making economic decisions? The answer to these questions are—even if the 3^{rd} Plenum reform agenda is fully implemented as envisioned by 2020—the same people, with most of the same policy levers, and facing the same set of incentives will still be occupy positions of controls over China's productive and financial resources and will be linked together through formal and informal networks that allow coordination of activities across discrete institutions.

This should not imply that the Party's foundational role provides a unified, monolithic force capable of issuing directives from the top of the pyramid in Beijing down to the lowest reaches of the governing apparatus. Rather, we should recognize this structure as one of "fragmented authoritarianism," in the words of political scientist Ken Lieberthal,[1] where authority and autonomy is highly decentralized throughout China's political system, particularly with respect to control over economic resources and economic choices: where and when to invest, how to implement strategies for economic growth. This bottom-up structure of state involvement is combined with top-down policies that create a favorable macroeconomic environment for development including through engineering an undervalued exchange rate, setting the price of capital and other inputs for production, coordinating relationships between firms, and restricting access to the domestic market for goods, services, and investments.

Overtures in the 3rd Plenum to a "decisive role of the market" are the just latest step in erecting a façade of a modern market economy. Party influence over the economy runs much deeper than mere state ownership and creates a structural barrier to China moving beyond its nonmarket economy foundations that cannot be separated from specific industries or firms within these industries.

I will make three points to illustrate this assessment.

1. Pervasive Government Influence Within and Across Firms

First, government ownership and Party control run much deeper than the 117 state-owned enterprises, or SOEs, designated by the State-owned Assets Supervision and Administration Commission, or SASAC. As I testified previously before this commission, much of the resources and authority to deliver preferential treatment to businesses reside at the local levels of China's government.[2] Local officials face incentives both for promotion through the Party personnel system—conditioned on maximizing economic output, technological accumulation, and social stability—as well as for personal enrichment. There is a competitive element for powerful local officials embedded in this system, but this competition is based on political advancement rather than market-based competition.

Both the extent of state ownership and the means for delivering preferential treatment to favored businesses are becoming increasingly obscured by policies that have transformed enterprises into corporate structures that assume many of the trappings of a modern global business, including often with publicly traded shares, and boards of directors with ostensibly independent external directors. But function does not necessarily follow form. In practice, these firms operate under quite different decision-making mechanisms than do comparable firms in the United States or other advanced economy countries.

Top managers and members of boards of directors of China's major and minor corporations are not selected by shareholders, but by the Party work groups established within state-owned and many private-owned firms.[3] Senior managers and directors often hold positions of power simultaneously in government institutions, within the Party, and on boards of related enterprises. What's more, scholars identify a system of "institutional bridging" through which the personnel department rotates individuals between industry, government, and Party posts as a mechanism for coordinating activities and strategy across discrete organizations.[4] In one example in 2007, senior executives of China Mobile, China Telecom, China Netcom, and China Unicom all rotated positions between these firms.[5]

Take the case of Changsha Zoomlion Heavy Industries, the world's 6th largest heavy machinery manufacturer. Zoomlion is not registered as a central SOE under SASAC control. The company was founded in 1992 as a spinoff from Hunan province's Ministry of Construction. The company's founder and chairman, Zhan Chunxin had been the Deputy Director of the provincial agency that preceded Zoomlion's reorganization, and has been a longtime representative to the National People's Congress as well as being the deputy chairman of the China Entrepreneurs Association since 2008.

In 1999, during the central government's SOE reform campaign to "grasp the large and let go the small," Zoomlion absorbed a number of other smaller heavy equipment manufacturers from around the country,[6] which allowed SASAC to take a minority holding in the company of nearly 17 percent, while the Hunan provincial government retained 75 percent ownership and with the remaining 9 percent equity was distributed to investment holding companies in which Mr. Zhan and other senior managers in Zoomlion and the absorbed enterprises held ownership.[7] In other words, part of the public's assets was transferred directly to the private wealth of Party officials controlling the enterprise.

Then in 2006, Zoomlion created an offshore financial holding company and re-registered itself onshore as a foreign-invested joint stock limited company in preparation for an IPO on the Hong Kong stock exchange in December 2010. This share offering floated a minority stake of 18.5 percent of the companies equity—1.5 percent of which were deposited to China's National Council for Social Security Fund.[8]

Through holding companies, the Hunan provincial government still controls 60 percent of Zoomlion, and its board of directors is comprised of individuals with linkages to enterprises in protected strategic industries both upstream and downstream from Zoomlion's core businesses, according to company reports. These relationships allow coordination between firms to procure key inputs for production—namely steel—and to secure steady demand for Zoomlion's outputs in the infrastructure construction and mineral extraction industries.[9]

In 2012, the company report notes, Zoomlion received 212 million yuan in direct government grants and have used access to favorable credit from state-owned financial institutions to provide consumer credit in order to expand its market share.[10] Zoomlion has also used its state financial backing to "go out" into foreign markets through direct investment in global competitors, in 2008 purchasing a controlling 60 percent stake in the Italian company Compagnia Italiana Forme Acciaio, known as CIFA.[11]

The case of Zoomlion is one example of the pervasive pattern of state ownership and privileged treatment masquerading as a private corporation. But state involvement to support business operations also extends to ostensibly private companies, such as automaker Geely of Zhejiang province, where support is consistent with local officials' incentives to maximize output, employment and other benchmarks for political promotion. Thus, though privately owned, Geely routinely received a range of tax breaks, land grants, subsidized utilities, and preferential loans from local government-controlled banks.[12] When private Geely sought to "go out" into the foreign marketplace by purchasing foreign automaker Volvo in 2010, it found a number of readily willing financial backers including financial holding companies controlled by the Shanghai city government, the Daqing city government (Heilongjiang province), and state-controlled banks.[13]

2. Structural Barriers to a Marketized Financial System

Second, China's status as a nonmarket economy is underscored by the structural barriers to marketization of its financial system posed by ongoing pervasive state-ownership of both financial institutions and nonfinancial corporations. Despite boasting many of the world's largest banks and world record-breaking IPOs, China's financial system is not poised to operate on market principles anytime soon, even with the marginal opening proposed for the Shanghai Pilot Free Trade Zone, or SFTZ. Relaxing controls on interest rates, international capital flows, trading of derivatives products, and the provision of financial services are insufficient conditions to overcome these barriers to market-based pricing and allocation of capital, and market-based control and governance of China's corporate sector. Banks do not operate on market principles in their lending decisions and other asset positions. Firms also do not operate on market principles in their borrowing and investment decisions as they are neither accountable to lenders for repaying the loans (soft budget constraints), nor are they accountable to shareholders.

Consider first China's financial institutions. China boasts a number of the world's largest banks, measured by market capitalization, yet these banks are conspicuously absent from most of the world's markets for financial services. This seeming anomaly is symptomatic of the non-market foundation for China's financial system and hints at the real objective function of China's mammoth financial institutions: serving the needs of national economic development. Unlike market-oriented U.S. banks, China's banks appear to have little interest in expanding into new, foreign markets for financial services—except, perhaps, to provide financial services in support of SOEs that are "going out" with direct investment in overseas markets.

China's efforts at financial liberalization are doing little more than erecting a façade of modern financial markets that supplants direct bank lending to favored companies with indirect lending through bond markets. But it is clear that corporate bond markets are serving the same borrowers that directed lending served, though without the problem of accumulating non-performing loans. As China's corporate bond markets developed after 2005, the share of capital raised by local government-connected enterprises rose from a marginal share in January 2005 to more than 93 percent of the market by January 2014.[14]

Most of the corporate bond debt raised by local government entities flowed to areas typically thought to be China's most commercially-advanced areas: Shanghai, Jiangsu, and Zhejiang accounted for 45 percent of all corporate bond borrowing by local governments in 2009; Beijing, Tianjin, and Guangdong accounted for another 21 percent.[15] The shift from bank lending to debt issued in China's capital market helped banks avoid the embarrassing predicament of accumulating more non-performing loans from subsidized credit directed at favored firms and convey the impression of market-based mechanisms for assessing risk and pricing credit. However, while there new issues of bond debt have grown, trading volumes remain low and China's state-owned banks hold more than 70 percent of all bond issues.[16] Thus, China's bond markets are not working to price risk and interest rates. Only one percent of China's domestic debt obligations is held by non-state controlled entities.[17] This means that the Chinese state enjoys a monopoly in setting the domestic price of capital.

China's equity markets are also unable to operate on market principles due to widespread state ownership and control of nonfinancial corporations. To understand why, consider the role played by capital markets in shaping corporate business decisions and performance. In a market-based financial system, equity markets:

- price and allocate capital based on economic risk assessments,
- provide a price signal to guide firm managers,
- provide an opportunity to participate in control over the firm, including governance and ownership decisions, and
- provide a claim on the income (dividends) generated by the firm.

None of these conditions can be said to pertain to China's equity markets. Chinese laws and regulation constrain the control that shareholders can exercise over management, but because only non-controlling minorities of shares are ever in play in the market firm managers and boards of directors—appointed by Party systems—are insulated from the possibility that market investors could threaten state control of the firm, which remains squarely in the hands of those inside the system. What equity listings do achieve, however, is alleviating state budgets and state banks from the burden of financing SOEs without fundamentally changing the system of control over productive assets. In essence, the strategy of corporatization has infused Chinese firms with a new source of capital that comes with no strings attached.

For private investors, public offering of shares does provide a way for investors to claim a speculative slice of the pie of China's state capitalism. But these investors are merely along for the ride, with no prospect for management control or for exercising control through market mechanisms. Floating thin blocs of shares, rather than liberalizing control and governance of SOEs, strengthens the position of these entities inside the system of China's state capitalism.

It is also worth noting the role that major international investment banks, consultancies, and accounting law firms have played in assisting this strategy of corporatizing China's SOEs by providing the professional services to restructure the legal ownership forms, underwrite IPOs, and—perhaps most importantly—cloaked the restructured Chinese companies with credibility by championing the trading of their equities.

3. The 3rd Plenum's Non-reform Agenda

Third, business as usual in China's nonmarket economy is confirmed by the lack of foreign business enthusiasm for the most-heralded aspect of China's 3rd Plenum agenda: reforming the regime governing foreign investment. The 3rd Plenum calls for moving from a "positive" list defining permissible investment activities and a system of broad administrative discretion over investment approval to a "negative list" that specifies prohibited activities and promises to streamline investment approval.

This changes has long been a priority for U.S. officials and businesses investing in China that complain of discriminatory practices and that the investment approval regime facilitates technology transfer.[18] But it is also worth noting that one key impetus for inbound foreign direct investment in China is the restrictions on market access and discriminatory practices in business and government sourcing decisions that put foreign producers at competitive disadvantage. In order to access China's commercial market where businesses desire a share of the growth, foreign businesses are subject to accede to conditions for entry.

The negative list and national treatment approach called for in the 3rd Plenum is now being pioneered in the Shanghai Pilot Free Trade Zone, or SFTZ. But this change thus far appears merely symbolic. The negative list promulgated in September 2013, covering nearly 200 activities, in essence replicates the restrictions of the positive list foreign investment catalogue. In other words, the negative list expresses the same restriction on foreign investment activities as the existing foreign investment catalogue, only in different terms. Investment in industries or activities on the negative list within the SFTZ will still need to apply for investment approval—just like before and just like outside the zone where the positive foreign investment list still governs.

While China's leaders have pledged annual review of the SFTZ's negative list, those closest to the issue, such as John Frisbie of the U.S.-China Business Council report suspect intentions that the economic reform agenda and its test implementation in the SFTZ make a break with past practice.[19] But the most telling indication of China's departure from existing policies is that little foreign investment has yet to flow into the zone, although Shanghai still remains an attractive destination for foreign direct investment.[20]

[1] Kenneth Lieberthal and Michael Oksenberg. *Policy Making in China: Leaders, Structures, and Processes*. Princeton University Press: 1990. http://books.google.com/books/about/Policy_Making_in_China.html?id=7kgIN9KJwSwC.

[2] Adam Hersh, "Chinese State-Owned and State-Controlled Enterprises," Testimony before the U.S.-China Economic and Security Review Commission. February 15, 2011. http://www.americanprogressaction.org/issues/economy/report/2012/02/15/11069/chinese-state-owned-and-state-controlled-enterprises/.

[3] Richard McGregor. *The Party: The Secret World of China's Communist Rulers*. Harper: 2012.

[4] Li-Web Lin and Curtis J. Milhaupt, "We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Stanford Law Review*, Vol. 65, no. 697, pp. 697-760.

[5] Nicholas Howson. "China's Restructured Commercial Banks: *Nomenklatura* Accountability Serving Corporate Governance Reform?" In Zhu Min, et al. (eds.) *China's Emerging Financial Markets: Challenges and Global Impact*. Wiley and Sons: 2009.

[6] Unlike in a market system, inefficient capital assets in China are not recycled back into the market through bankruptcy for alternative, more productive uses. Rather, smaller and lower-performing state enterprises will be resorbed into their larger, more profitable big brothers.

[7] Zhang Boling and Yu Ning. "Dirty Clash of China's Heavy Equipment Heavies." *Caixin (English).* November 6, 2013. http://english.caixin.com/2013-11-06/100600019_1.html; http://www.easecurities.com.hk/tc/Research/ipo/ipo01157.pdf.

[8] BEA Securities. "Main Board H-share Listing Research: Changsha Zoomlion Heavy Industry Science & Technology Development Co., Ltd." December 13, 2010. http://www.easecurities.com.hk/tc/Research/ipo/ipo01157.pdf.

[9] Zoomlion Heavy Industry Science and Technology Co., Ltd., "2012 Annual Report," available at http://zoomlionresource.icm.cn/attach/h000/h00/attach201304250855360.pdf (accessed February 2014).

[10] Dinny McMahon, "China Machinery Makers' Gamble," *The Wall Street Journal,* September 17, 2012, available at http://online.wsj.com/news/articles/SB1000087239639044357190457763098161626 2896.

[11] "PE Firm Hony Finds a Way to 'Go Global,'" *Caijing Magazine*, October 28, 2008. http://english.caijing.com.cn/2008-10-21/110029936.html.

[12] Greg Anderson, *Designated Drivers: How China Plans to Dominate the Global Auto Industry*. Wiley and Sons: 2012.

[13] Liu Peng. "Where is Geely Getting the Money to Buy Volvo?" *The Economic Observer (English)*. April 20, 2010. http://www.eeo.com.cn/ens/2010/0429/168910.shtml; "Status Symbol," *The Economist*. March 31, 2010. http://www.economist.com/node/15825810.

[14] On an annualized basis. Author's analysis of CEIC China database.
[15] Carl Walter and Fraser Howie. *Red Capitalism: The fragile financial foundation of China's extraordinary rise.* Singapore: Wiley and Sons. 2011. Table 5.1.
[16] Carl Walter and Fraser Howie. *Red Capitalism: The fragile financial foundation of China's extraordinary rise.* Singapore: Wiley and Sons. 2011. P. 85.
[17] Carl Walter and Fraser Howie. *Red Capitalism: The fragile financial foundation of China's extraordinary rise.* Singapore: Wiley and Sons. 2011. P. 206.
[18] U.S. Chamber of Commerce. 2012. *China's Approval Process for Inbound Foreign Direct Investment*. https://www.uschamber.com/sites/default/files/legacy/reports/020021_China_InboundInvestment_Cvr.pdf; James McGregor. *China's Drive for Indigenous Innovation : A web of industrial policies*. https://www.uschamber.com/sites/default/files/legacy/reports/100728chinareport_0.pdf.
[19] "USCBC Head Sees ITA Collapse As Casting Doubt on Chinese Reforms." *Inside U.S. Trade*. February 14, 2014.
[20] Daniel Ren. "Foreign investors sideline Shanghai's free-trade zone in favour of manufacturing." *South China Morning Post*. January 27, 2014. http://www.scmp.com/business/economy/article/1414449/foreign-investors-sideline-shanghais-free-trade-zone-favour.