



China's State-Owned Enterprises and Nonmarket Economics

Testimony before the U.S.-China Economic and Security Review Commission

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Co-chairs, members of the commission: Thank you for inviting me to testify on China's state-owned enterprises, or SOEs, and nonmarket economics.

My name is Adam Hersh, and I am a Senior Economist at the Center for American Progress.

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 party rules with an unchecked monopoly on power, while the institutions of state administer this rule and provide a veil for party control. Even if governance institutions change, the thread of party influence will still run throughout China's economy as members continue to occupy key positions in the party, the government, and business hierarchies—often at the same time.

What matters—from an economic perspective—is not the name we give this system but who holds control over China's economic resources and what incentives and constraints they face in making economic decisions. The answer to these questions—even if the Third Plenum agenda is fully implemented—is that the same people with the same policy levers, facing the same set of incentives, will continue to be in charge of China's productive and financial resources. This fact defines the fundamentally nonmarket nature on which China's economy operates.

To be certain, there are some significant changes proposed in the Third Plenum, and China has a growing number of private companies.¹ But overtures in the Third Plenum to a “decisive role of the market” are the just latest effort to create an illusion of marketization. Private companies are still playing the party's game.

Today, I want to focus on three aspects of China's nonmarket economy.

First, state ownership and party control run much deeper than the 117 SOEs administered by the State-owned Assets Supervision and Administration Commission, or SASAC.² The majority of state ownership and the ability to deliver preferential treatment reside at the local government level, where officials operate with broad independence from Beijing. Both the extent of state ownership and the means to privilege favored businesses are becoming increasingly obscured as more enterprises are corporatized and registered in offshore tax havens. These assume the form of modern global businesses; however, they continue to operate on a nonmarket basis.

Top managers and board members are selected not by shareholders but through party mechanisms—even in joint ventures with foreign companies. Individuals in these positions typically also hold roles in government, the party, and on boards of related enterprises. The interpersonal linkages help coordinate noncommercial dealings between legally unrelated firms and are reinforced by party personnel systems that rotate people between such posts.

Changsha Zoomlion Heavy Industries, the world's sixth-largest heavy machinery manufacturer, is a representative case.³ Zoomlion is not a SASAC SOE. It was founded in 1992 as a spin-off from Hunan's provincial government.⁴ In 2006, Zoomlion created an offshore financial holding company and reorganized itself as a foreign-invested joint-stock company.⁵ Despite listing shares on the Shenzhen and Hong Kong stock markets, Zoomlion is still 60 percent owned by the Hunan government, 17 percent owned by SASAC, and 9 percent owned by a state-backed private equity fund.⁶ Its board is comprised of people connected to businesses upstream and downstream from Zoomlion. Board members connected to upstream state-owned steel producers can influence Zoomlion's sourcing decisions, and board members connected to downstream construction and mining businesses help secure Zoomlion's market share.

Chinese officials have also proven themselves willing to deliver preferential treatment to favored private businesses when it serves their interests of maximizing gross domestic product, or GDP; technological accumulation; social stability; and their personal wealth. For example, private automaker Geely routinely received a range of tax breaks, land grants, subsidized utilities, and preferential loans from state-owned banks throughout its growth.⁷ And Geely received eager financial backing from local governments in Shanghai and Heilongjiang to acquire Volvo in 2010.⁸

Second, extensive government ownership of financial and nonfinancial corporations creates structural barriers to the true marketization of China's financial system. These barriers are foundational and will not be overcome by relaxing controls on interest rates and international capital flows. Capital raised in China's corporate bond markets flows almost exclusively to local government enterprises and is supplied almost exclusively by state banks. This is supplanting bond debt for policy lending, not allowing markets to price capital.

China's stock market also does not operate on market principles, which would provide a market for corporate control and allocate capital resources. Because only noncontrolling minorities of shares are ever offered in China, it is not possible for the market to govern corporate control or price capital assets. Firm managers and boards of directors are appointed by party systems and thus are insulated from the possibility that investors could threaten management positions or state control of the firm.

Stock market listings do achieve two things:

- They inject substantial capital into SOEs without burdening state banks and budgets and without losing state control over productive assets.
- They legitimize China's SOEs in the global economy by vesting them with the credibility of international investment banks, consultancies, and accounting and law firms that help take them public.

Third, one of the most-heralded aspects of the Third Plenum agenda really only gives the appearance of change from current policy: the pledge to shift from a positive-list regime for restricting foreign investment to a negative list with national treatment. This pledge is being tested today in the Shanghai Pilot Free-Trade Zone, or FTZ.⁹ So far, it appears to be merely symbolic. The negative list for the zone in essence just replicates the positive list of the current foreign investment catalogue in a different form. Investment in industries or activities on the negative list within the zone will still need to apply for investment approval—just like before and just like outside the zone. This equivalence is not lost on foreign businesses, which have continued to invest strongly in Shanghai but still mainly outside the FTZ.

It is worth noting that the reason discriminatory treatment of foreign investment has been such a big issue is because discriminatory treatment of foreign goods and services is so prevalent. This discrimination against imports creates pressures on foreign businesses to invest in China and transfer key technologies in order to gain access to the world's fastest-growing and soon-to-be-largest market.

These are just three of the many aspects that define China's nonmarket economy. Thank you for the opportunity. I look forward to our further discussion.

Endnotes

- 1 *China Daily*, "The Decision on Major Issues Concerning Comprehensively Deepening Reforms in brief," November 16, 2013, available at http://www.china.org.cn/china/third_plenary_session/2013-11/16/content_30620736.htm.
- 2 Adam Hersh, "Chinese State-Owned and State-Controlled Enterprises: Testimony before the U.S.-China Economic and Security Review Commission" (Washington: Center for American Progress, 2011), available at <http://www.americanprogressaction.org/issues/economy/report/2012/02/15/11069/chinese-state-owned-and-state-controlled-enterprises/>.
- 3 Zoomlion Heavy Industry Science and Technology Co., "2012 Annual Report" (2013), available at <http://zoomlion-resource.icm.cn/attach/h000/h00/attach201304250855360.pdf>.
- 4 Ibid.
- 5 BEA Securities, "Main Board H-share Listing Research: Changsha Zoomlion Heavy Industry Science & Technology Development Co., Ltd." (2010), available at <http://www.easecurities.com.hk/tc/Research/ipo/ipo01157.pdf>.
- 6 Ibid.
- 7 G. E. Anderson, *Designated Drivers: How China Plans to Dominate the Global Auto Industry* (New York: Wiley, 2012).
- 8 *Economic Observer*, "Where is Geely Getting the Money to Buy Volvo?", April 20, 2010, available at <http://www.eeo.com.cn/ens/2010/0429/168910.shtml>.
- 9 Deloitte, "Circular of the State Council on the Framework Plan for the China (Shanghai) Pilot Free Trade Zone" (2013), available at [http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Tax/ftpa/cn_tax_China\(Shanghai\)PFTZFrameworkPlan_Bilingual_290913.pdf](http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Tax/ftpa/cn_tax_China(Shanghai)PFTZFrameworkPlan_Bilingual_290913.pdf).