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Hearing on China's Shifting Economic Realities and Implications for the United States

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Thank you Chairman Shea, members of the Commission, and staff. I appreciate the opportunity to share my views about state-owned enterprises ("SOEs") in China and their implications for the United States. My testimony today addresses four distinctive issues: 1) the role of SOEs in the Chinese economy; 2) the nature of state control of SOEs; 3) China's "Going-Out" policy and SOEs; and 4) U.S. laws and policies on Chinese SOEs.

I. The Role of SOEs in the Chinese Economy

SOEs in China have undergone significant changes since China embarked on economic reforms in the late 1970s. Prior to economic reforms, SOEs were the default arrangement in almost every industry. In the subsequent four decades that followed, China's SOEs were commercialized, corporatized, and in many cases, privatized. Today, China boasts an emerging private sector that has become a major driver of economic growth, employment, and exports.[1]

That said, the state still plays a very important role in China's economy. Official statistics indicates that as of 2011, wholly state-owned enterprises, along with state-holding enterprises in which the state holds the largest percentage of shares among all shareholders, accounted for 26.2% of gross industrial output, 41.7% of total industrial assets, and 19.8% of employment.[2] If the definition of the state sector is broadened to include all enterprises in which the state holds some ownership stakes, then the role of the state in the economy is even greater. By one estimate, these so-called mixed-ownership enterprises alone account for 40% of China's GDP.[3]

While SOEs maintain a strong presence in China's overall economy, they tend to be concentrated among the largest firms in key industries. In 2009, 331 of China's largest 500 firms by revenues were SOEs.[4] Almost all of China's most important industries, including national defense, electricity, petroleum and petrochemicals, telecommunications, coal, civil aviation, waterway transportation, banking, and insurance, are dominated by SOEs. In 2015, of the 98 Chinese

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[1] *See* NICHOLAS LARDY, MARKETS OVER MAO: THE RISE OF PRIVATE BUSINESS IN CHINA 59-122 (2014).
[2] Fan Gang & Nicholas C. Hope, *The Role of State-Owned Enterprises in the Chinese Economy*, at 7, http://www.chinausfocus.com/2022/wp-content/uploads/Part+02-Chapter+16.pdf (citing *China Statistical Yearbook* data).
[3] *See Mixed-Ownership Sector Accounts for 40% of Economy, To Hit 80% in 5-10 Years*, XINHUA, November 25, 2003, http://www.southcn.com/news/china/zgkx/200311250786.htm.
[4] *See* Wentong Zheng, *Transplanting Antitrust in China: Economic Transition, Market Structure, and State Control*, 32 U. PA. J. INT'L L. 643, 665 n.99 (2010).

companies that made their way to the Fortune Global 500 list, the top 12 were all SOEs and only 22 were purely private firms.[5]

The scale and importance of China's SOEs exceed those of the SOEs in other advanced economies. According to a recent OECD study, in 27 of the 34 OECD member countries, employment in SOEs exceeds 6 million people and the value of all SOEs combined is close to US$2 trillion.[6] On average, SOEs in those countries account for 15% of GDP.[7] The composition of SOEs in OECD countries is heavily skewed towards public service sectors like utilities, specialized financing entities, and transportation.[8]

II. State Control of SOEs

Decades of economic reforms have transformed the nature of the Chinese government's control of SOEs. SOEs in China today are no longer the alter ego of the state; instead, they are, like private firms, managed by human agents responding to market incentives and institutional constraints.

One of the hallmarks of China's economic reforms is the delegation of decision-making authority over pricing and other business matters to SOEs. These so-called "commercialization" reforms have largely kept the government out of the day-to-day management of SOEs. As in other former communist countries, such reforms in China have turned SOE managers into de facto controllers of SOEs and resulted in what becomes known in the economic literature as the "insider control" problem.[9]

The Chinese government does retain some important control over SOEs. The State-Owned Assets Supervision and Administration Commission ("SASAC"), a cabinet-level agency established in 2003, supervises 107 or so large SOE groups on behalf of the central government. SASAC exercises the government's rights as a controlling shareholder as well as regulatory power over SOEs. In particular, SASAC has occasionally reshuffled top managers among SOEs. The latest reshuffling took place in August 2015 in the telecommunications industry, where the chairmen of the three largest telecommunications companies in China, all SOEs, swapped positions.[10] Such reshuffling indicates tight state control over high-level personnel appointments at SOEs. Indeed, as scholars have noted, SOEs in China are deeply enmeshed in a larger system of party-state organs, fostered through rotations of managers, personnel exchanges, and the wearing of different hats by managerial elites.[11]

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[5] Scott Cendrowski, *China's Global 500 Companies Are Bigger Than Ever—And Mostly State-Owned*, FORTUNE (Jul. 22, 2015), http://fortune.com/2015/07/22/china-global-500-government-owned/.
[6] HANS CHRISTIANSEN, THE SIZE AND COMPOSITION OF THE SOE SECTOR IN OECD COUNTRIES 3 (2011).
[7] *Id.* at 17.
[8] *Id.* at 14-15.
[9] *See* Masahiko Aoki, *Controlling Insider Control: Issues of Corporate Governance in Transition Economies*, in CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS 3, 7–12 (Masahiko Aoki & Hyung-Ki Kim eds., 1995).
[10] *See* Charles Clover, *Leadership Reshuffle at China's Three Biggest Telecoms Groups*, FINANCIAL TIMES (Aug. 24, 2015), http://www.ft.com/intl/cms/s/0/09b7296e-4a44-11e5-9b5d-89a026fda5c9.html#axzz40XpuTpnj.
[11] *See* Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 708 (2013).

Besides personnel control over SOEs, the Chinese government still retains price control over certain products or services, such as gasolines, natural gas, and pharmaceuticals, although the number of such products and services has been dramatically reduced. In addition, the Chinese government maintains informal price control over potentially all products and services through exerting pressures on firms, even though such pressures have no apparent legal basis.[12] These formal or informal price controls, however, are not specific to SOEs and apply to firms of all ownership types.

Despite the above-discussed mechanisms of control, state control over SOEs is not perfect. The human agents managing SOEs, like everybody else, attempt to maximize financial or political payoffs for themselves. This means that SOEs have incentives to foster close ties with party-state organs, seek government largesse, and resist government policies that are not in their best interests. The bureaucrats that are supposed to oversee SOEs are agents of the state themselves. Without effective monitoring by the public, there is no guarantee that these bureaucrats will be able to implement policies that are in the best interests of the state.

As a result of this agency problem, the Chinese government controls SOEs to a much lesser degree than its ownership interest in the SOEs suggests. The lack of effective state control is reflected in several patterns observed in the SOE sector. First, the government collects little or no dividends from SOEs. Chinese SOEs pay a dividend rate of only 5 to 15 percent to the state, far below the 50-60 percent dividend rates paid by established industrial firms in the United States.[13] Second, SOE executives enjoy wide discretion in receiving large amounts of compensation in the forms of private benefits and on-duty consumption, despite the government's repeated efforts to reign in SOE executive compensation. Third, the government often fails to implement major policy or operational decisions at SOEs, as seen from the government's failure to have SOEs withdraw from the real-estate sector when housing prices were skyrocketing several years ago. These patterns could be interpreted as government favoritism for SOEs, but they are also consistent with SOEs "capturing" the state and putting state power at their service.

III. China's "Going Out" Policy and SOEs

Since the turn of the century, the Chinese government has promoted a "going out" policy and encouraged Chinese firms to invest in overseas markets. Not coincidentally, foreign direct investment ("FDI") by Chinese firms in the United States and other major markets has experienced exponential growth. According to one estimate, in 2009-2010, China's FDI assets in the United States increased by 130%.[14] The total inflow of Chinese FDI into the United States reached $5.3 billion in 2010, bringing the total amount of Chinese FDI in the United States since 2003 to $11.6 billion.[15]

[12] For detailed discussions of such extra-legal price control, see Curtis J. Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L.J. 665, 687 (2015).
[13] *See* World Bank, *Effective Discipline with Adequate Autonomy: The Direction for Further Reform of China's SOE Dividend Policy* 13, 23-30 (2010), World Bank Policy Note No. 53254.
[14] *See* Charles W. Freeman III and Wen Jin Yuan, *China's Investment in the United States: National Initiatives, Corporate Goals, and Public Opinion*, Center for Strategic & International Studies (Nov. 2011), at 1.
[15] *Id.*

The composition of Chinese FDI in overseas markets has evolved over time. The focus of Chinese FDI was initially on energy and natural resources, then shifted to the service sector, and more recently switched to the acquisition of advanced technologies and customers in developed markets.[16]

SOEs play an important role in China's outward direct investment. According to Chinese government data, SOEs accounted for 70% of China's global FDI stock as of 2009, reflecting the advantages SOEs had in obtaining government approvals for FDI in the early years of the going-out policy.[17] SOEs in the oil and gas sector have been particularly active in outward FDI. In more recent years, however, private firms have begun to play catch-up with SOEs. Between 2003 and 2010, 170 of 230 recorded FDI transactions made by Chinese firms in the United States were made by private firms, defined as having 80% or higher non-governmental ownership.[18]

While SOEs account for a large percentage of China's outward FDI, few of them make FDI decisions based solely on political considerations. Due to the commercial orientation of most of the SOEs, and also due to the lack of effective state control over SOEs, most SOEs invest in overseas markets only if there are sufficient commercial justifications. SOEs may gain from FDI projects either through the projects themselves—if the projects are profitable—or through advantages they may obtain from the Chinese government in the home market for catering to the government's priorities. In short, when it comes to outward FDI, Chinese SOEs should no longer be presumed to be pursuing the political goals of the Chinese government.

IV. U.S. Laws and Policies on Chinese SOEs

Current U.S. laws and policies possess many tools to address the nonmarket behaviors of Chinese SOEs. Upon China's accession to the World Trade Organization in 2001, the United States successfully negotiated special requirements regarding subsidies to Chinese SOEs.[19] U.S. antidumping and countervailing duty laws allow U.S. manufacturers to petition the U.S. government to impose special duties on Chinese imports to address unfair trade practices by Chinese SOEs as well as private firms.[20] The foreign investment approval process in the United States equips the U.S. government with the power to block investment by Chinese SOEs that may pose national securities concerns. Finally, some of the ongoing trade initiatives of the United States, such as the U.S.-China Bilateral Investment Treaty and the Trans-Pacific Partnership ("TPP"), contain special provisions on the nonmarket behaviors of SOEs. In particular, the treaty text of the TPP includes one entire chapter devoted to SOE-related issues.[21]

Current U.S. laws and policies on Chinese SOEs, however, suffer the problem of being both overinclusive and underinclusive. They are overinclusive because they presume *all* Chinese SOEs

[16] *See* Daniel Rosen and Thilo Hanemann, *An American Open Door? -- Maximizing the Benefits of Chinese Foreign Direct Investment*, Asia Society (May 2011), at 20, http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.
[17] *Id.* at 33.
[18] *Id.*
[19] *See* Accession of the People's Republic of China, WT/L432 (Nov. 23, 2001), art. 10.
[20] *See* 19 U.S.C. §§ 1671-1677n (2015).
[21] *See* The Trans-Pacific Partnership Agreement, Chapter 17, https://medium.com/the-trans-pacific-partnership/state-owned-enterprises-and-designated-monopolies-bfddb20cb3b3#.c48idp81n.

to have sufficiently close ties with the Chinese government to warrant special scrutiny. They are underinclusive because they leave out firms that are privately owned but are nonetheless subject to extensive control by the Chinese government. As discussed above, because of agency costs, the Chinese government exercises much less control over SOEs than its ownership interest in the SOEs suggests. But at the same time, the Chinese government exercises much more control over private firms than its ownership interest (or the lack thereof) in the private firms suggests. Because the Chinese government does not scrupulously respect the legal rights that accompany private property, it does not need explicit ownership stakes to exercise control over firms. The government could, and indeed does, exercise extensive control over private firms through informal price control, quasi-governmental organizations such as industrial associations, and extra-legal governmental fiats.[22]

This institutional environment results in blurred boundaries between SOEs and private firms in China. SOEs and large private firms in China share many similarities in areas commonly thought to distinguish state-owned firms from privately owned firms: market access, receipt of state subsidies, proximity to state power, and execution of the government's policy objectives. In light of this institutional environment, U.S. laws and policies that single out Chinese SOEs on the basis of government ownership alone are inherently misleading.

[22] For detailed discussions of state control of private firms in China, see Milhaupt & Zheng, *supra* note 12, at 683-88.