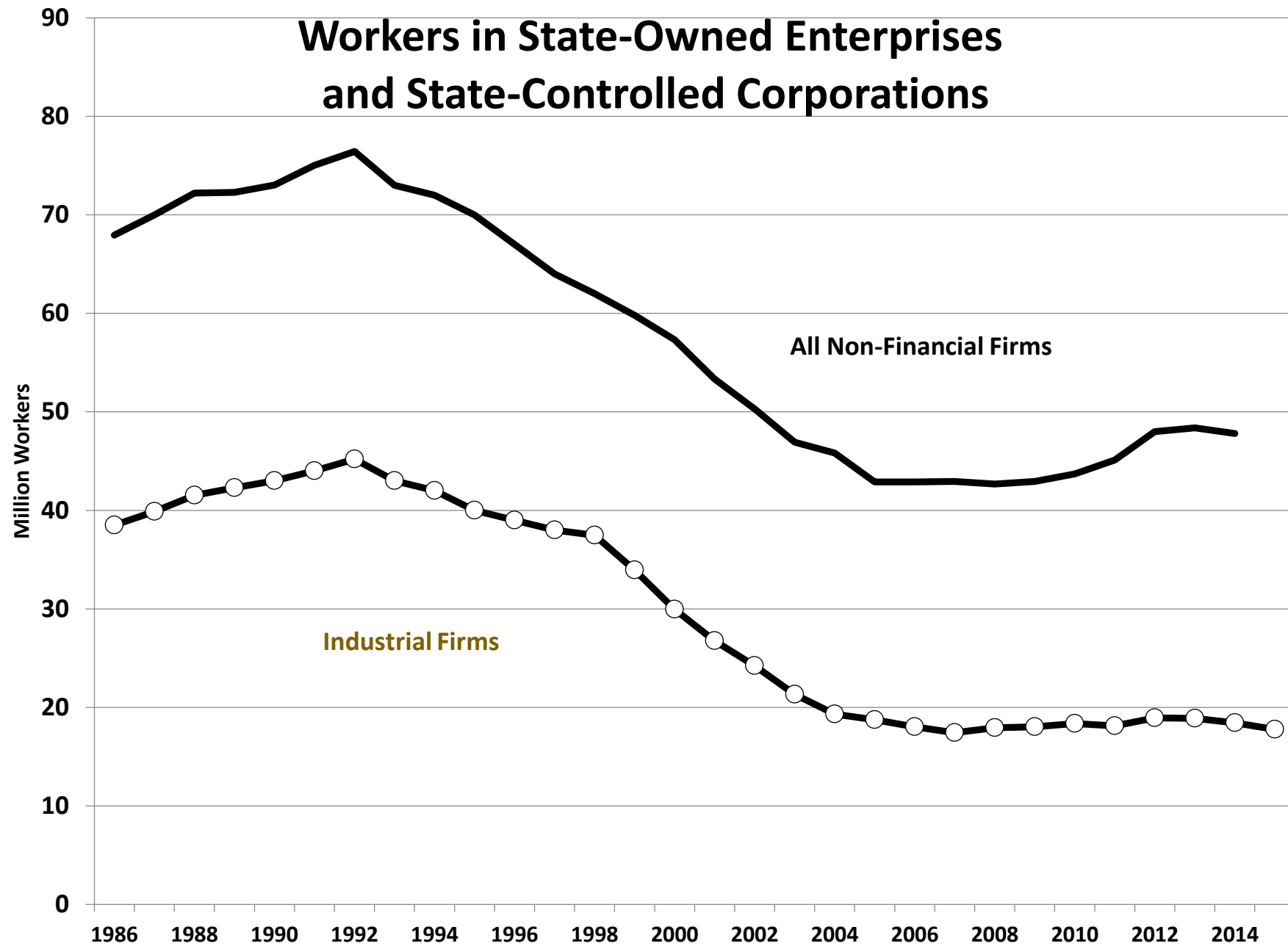


State Capitalism or Socialism: The New Normal in China Today

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UC San Diego
UNAM February 21, 2018

The Happiness Paradox

- Let us start by going back to 2002-2003. As a new Chinese administration (Hu Jintao / Wen Jiabao) took over, something peculiar had happened.
- Economists were happy, because reforms had succeeded.
- Ordinary people were NOT happy, despite the rapid growth in average incomes. WHY?



Happiness Contrast 2003

Economists

- State enterprise downsizing
- New institutions had been successfully created: banks, fiscal, convertible on the current account currency, etc.
- Entered WTO
- Believed growth would accelerate as benefits of reform were realized

Ordinary People

- High unemployment
- New types uncertainty and risk
- Corruption
- Widening inequality
- Profound cultural shifts
- Didn't believe growth would accelerate

Impetus behind Market-oriented Reform Vanished. What is the Objective?

- For most of the period since 1978, it was reasonable to treat China as a country in transition to a mixed market economy, rather similar to Japan, France, or Korea.
- It was always the case that different leadership groups made economic policy in different ways, but at first economic reform was the predominant, acknowledged objective.
- Today, the Xi model is not one of simple economic reform. It is still partial and uncertain. Objectives are more clear, but institutions and instruments are still incomplete and often contradictory.
- I will first look backwards; then look at three dimensions TODAY: the budget and spending priorities; fiscal system; and state ownership.

Common Features: Gradualist Reform vs. “Big Bang”

- Soviet and East European “big bang” reforms were strongly associated with regime change:
 - fear that reforms will be suffocated by bureaucracy/hierarchy
 - unwillingness to use the existing structure to achieve objectives;
- Use liberalization to drive *both* reform and stabilization.
- Willingness to “pause” growth in order to achieve system transformation, esp. in Poland.
- Eastern Europe has the model of EU-style social welfare capitalism: the “end point” was known; China had economically successful neighbors, but the objective of transition was not known.
- Chinese reform was always exploratory and gradual.

First Two Periods of Reform

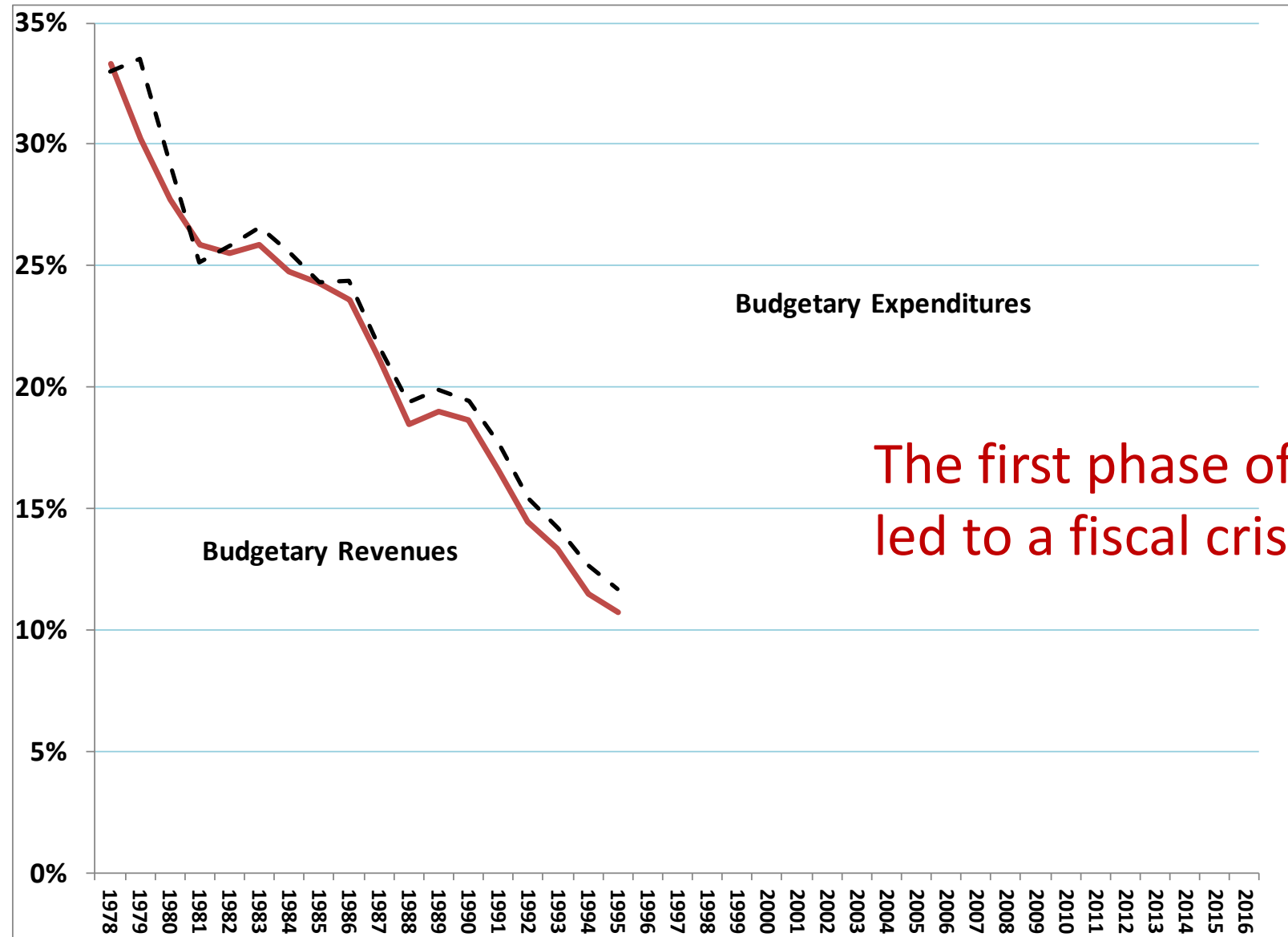
1978-1989

- Zhao Ziyang 趙紫陽
- Introduce Markets, Industry, Agriculture, Foreign Trade
- Decentralization
- Particularistic Contracts, High-Powered Incentives
- Dual-track; Special Zones
- Inflationary “shortage” economy
- Reform “without losers”

1994-2002

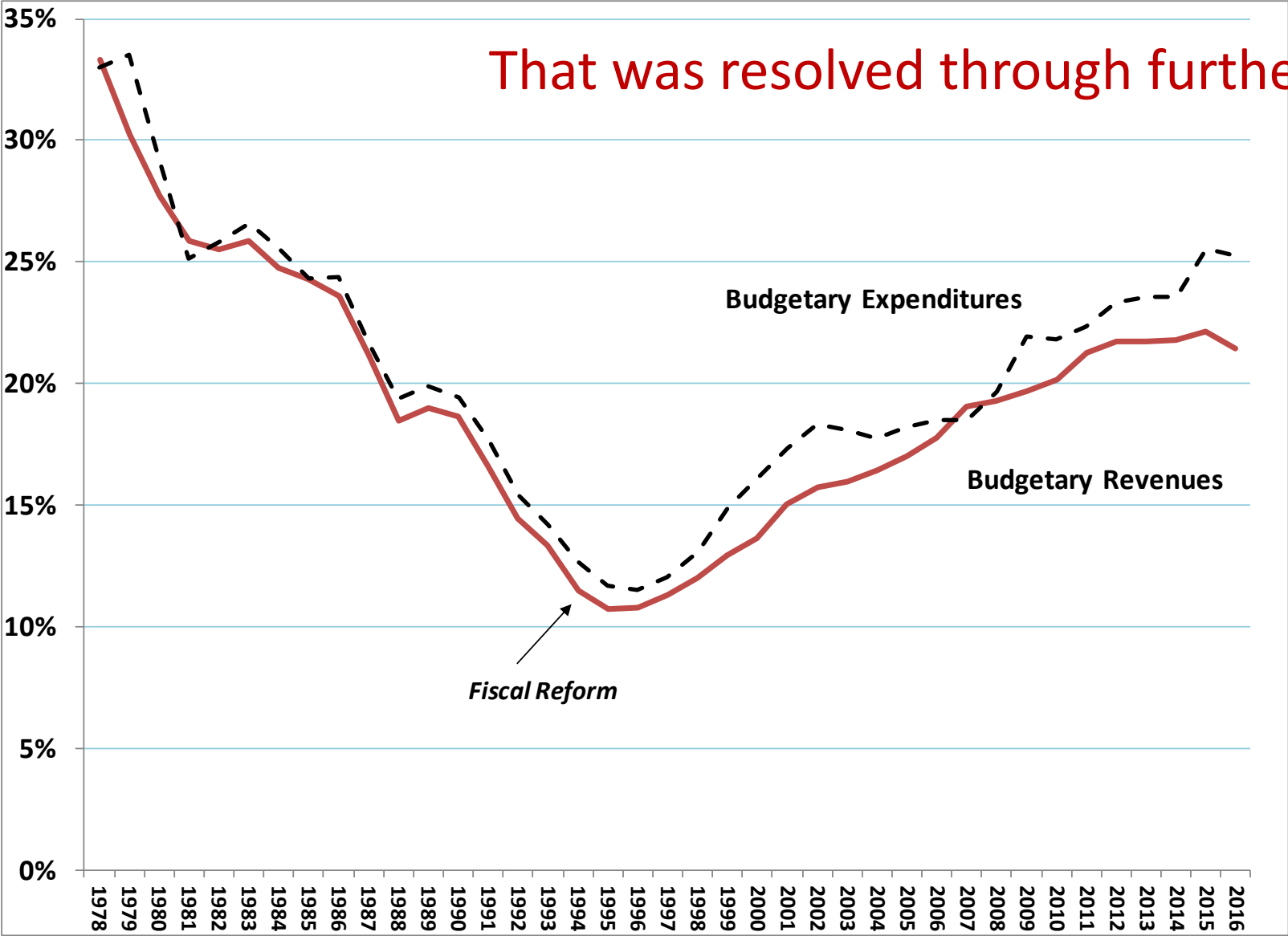
- Zhu Rongji 朱鎔基
- Build Institutions, Finance, Regulatory Regime
- Re-centralization
- Uniform market rules, “level playing field.”
- Unify tracks; special zones become less special.
- Price stability, “surplus economy”
- Reform with losers

Fiscal Resources explain much of this pattern

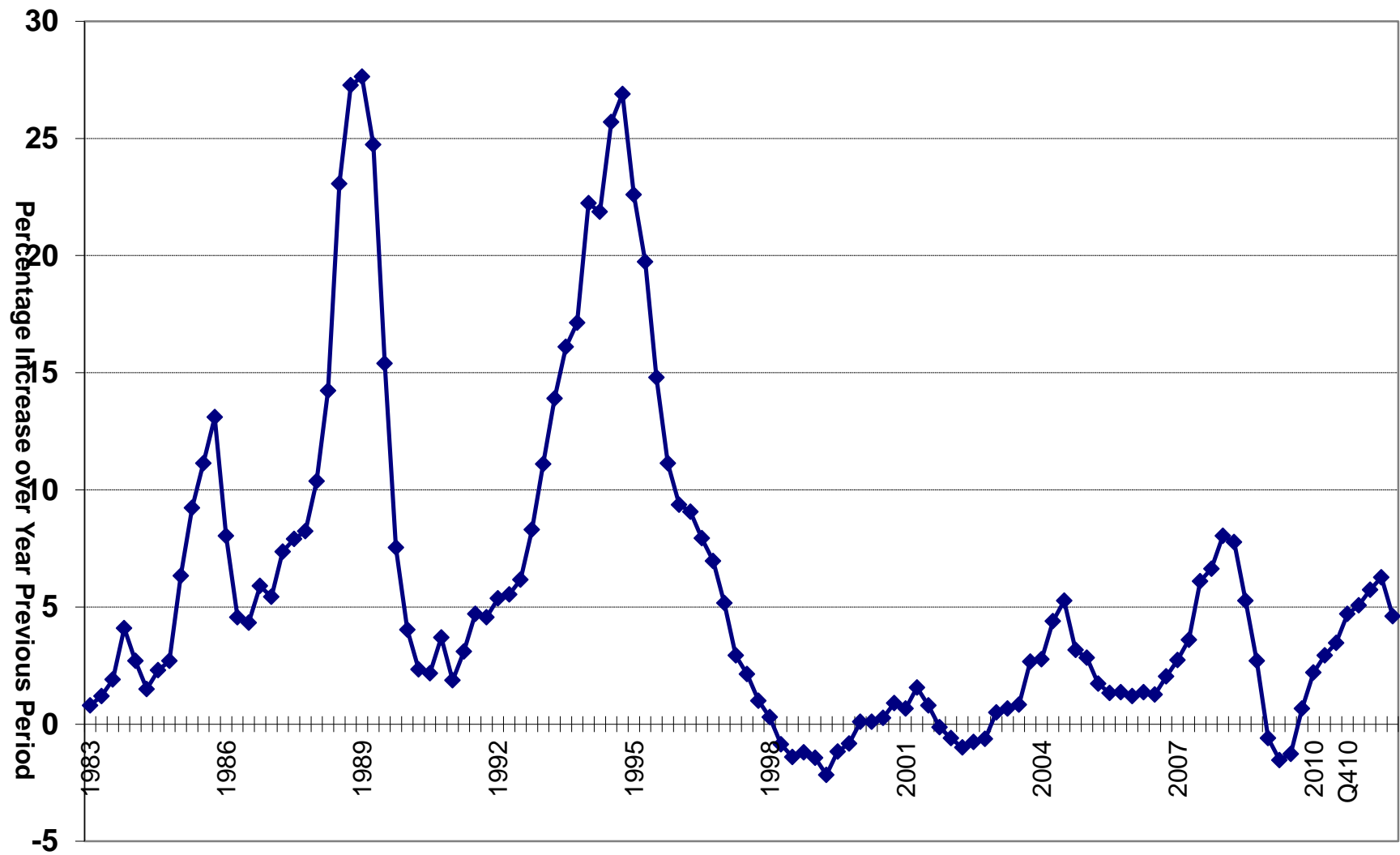


The first phase of reform
led to a fiscal crisis....

That was resolved through further reforms.....



Consumer Inflation (1983Q1-2011Q4)



First Step: Consolidation of Market Economy and Rebuilding of State

2002 16th Party Congress: First Secretary Hu Jintao 胡锦涛; 2003 National People's Congress: Premier Wen Jiabao 温家宝.

Ten-year “Administration” ran from 2003 through 2012.

Significant progress in beginning to address problems of social welfare, social insurance.

Response to Global Financial Crisis in 2009 was decisive and successful.

Reform progress unimpressive to non-existent.

Crisis of effectiveness? Why was there so little progress on economic reform?

By most measures, China is already a predominantly market economy

- In most sectors, private businesses predominate.
- The goods producing sectors in particular are dominated by private businesses; moreover the key info services are dominated by BAT (Baidu, Alibaba and Tencent)
- In many sectors, there is intense competition among different types of firms. For example, between SOEs, foreign firms, domestic private corporations, and domestic small/medium scale firms.
- And yet...

Non-Agricultural Workers

Economic Census, 2013	Number of Workers	Government Own. Share
	(Million)	(Percent)
Mining and Manufacturing	144	9.9%
Labor-Intensive Services	184	8.1%
Capital & Human Capital-Intensive Services	42	34.4%
Human Capital-Intensive Services	69	61.8%
Total	439	18.4%

In China, industry and agriculture are dominated by private businesses and households; but services are often state-controlled.

Share of State Entities in
Investment 2014

TOTAL INVESTMENT 32.2%

Manufacturing	8.4%
Retail and Wholesale Trade	9.1%
Real Estate	22.6%

Share of State Entities in
Investment 2014

Utilities	66.1%
Transportation	75.7%
Water and Urban Infrastructure	75.2%
Technical Services	35.2%
Health	66.3%

Three dimensions:

1. Size of the state: fiscal revenues and expenditures

Chinese state is VERY large.

2. Fiscal system: so far, fiscal reforms have not succeeded in breaking the link between local governments, land, and other types of business.
3. State enterprises: While some market reforms have continued, state firms are bigger, more controlled by the Communist Party, and more mission oriented

This may be a new model of an economic system.

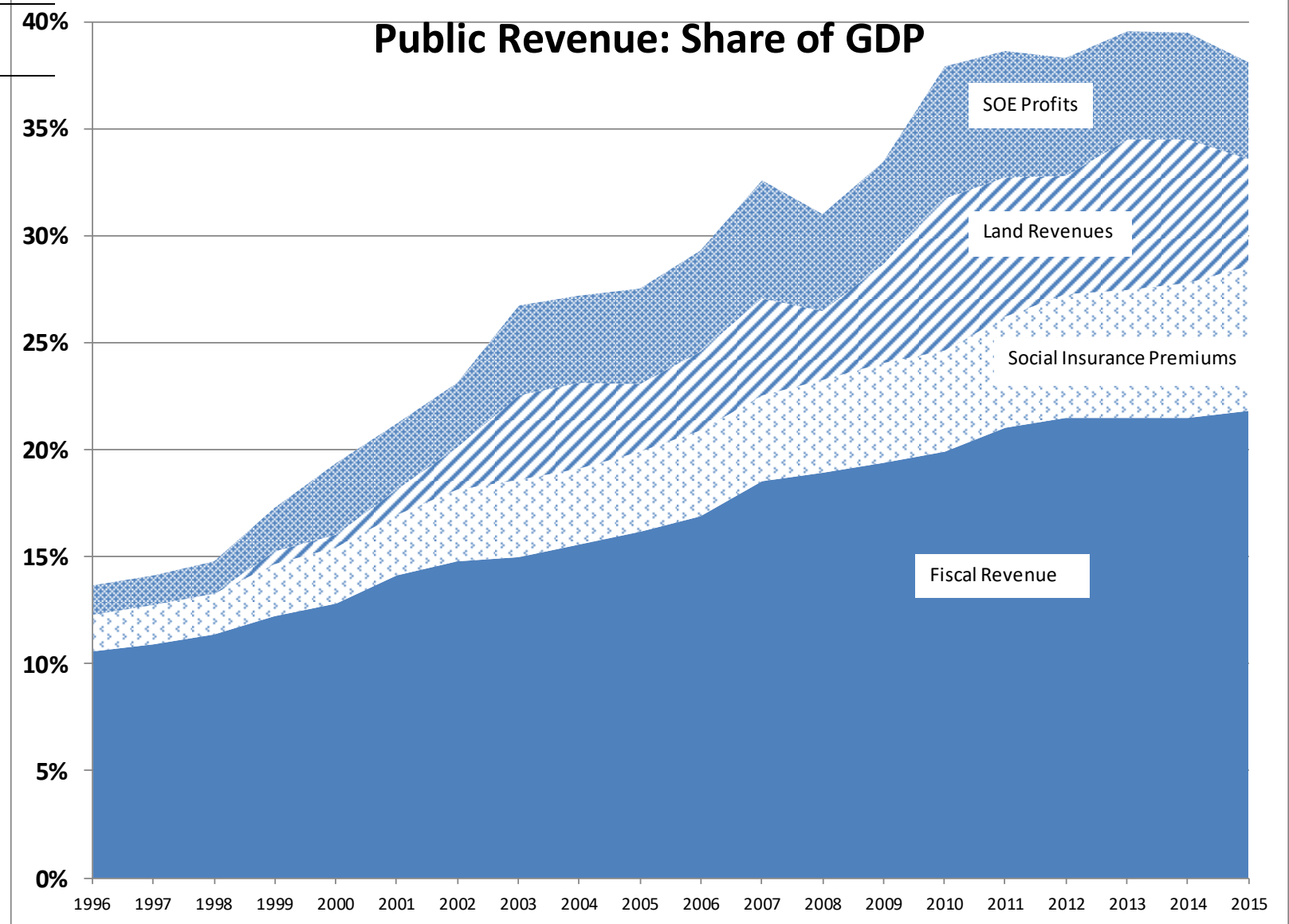
1. Chinese state is large, and increasingly tackles social problems

- China today is very different from China in the 1990s (which seemed like Wild West capitalism).
- Basic health insurance systems have been rebuilt, and nearly universal coverage achieved. Coverage is limited in amount, but still makes a big difference.
- The principle of universal pensions has been articulated, but actual coverage in rural areas is very weak.
- The government is inching into public housing provision.
- So the composition of spending is changing, but shifts in composition are dwarfed by changes in scale.

China has a big government:

OECD Fiscal Revenue Share of GDP

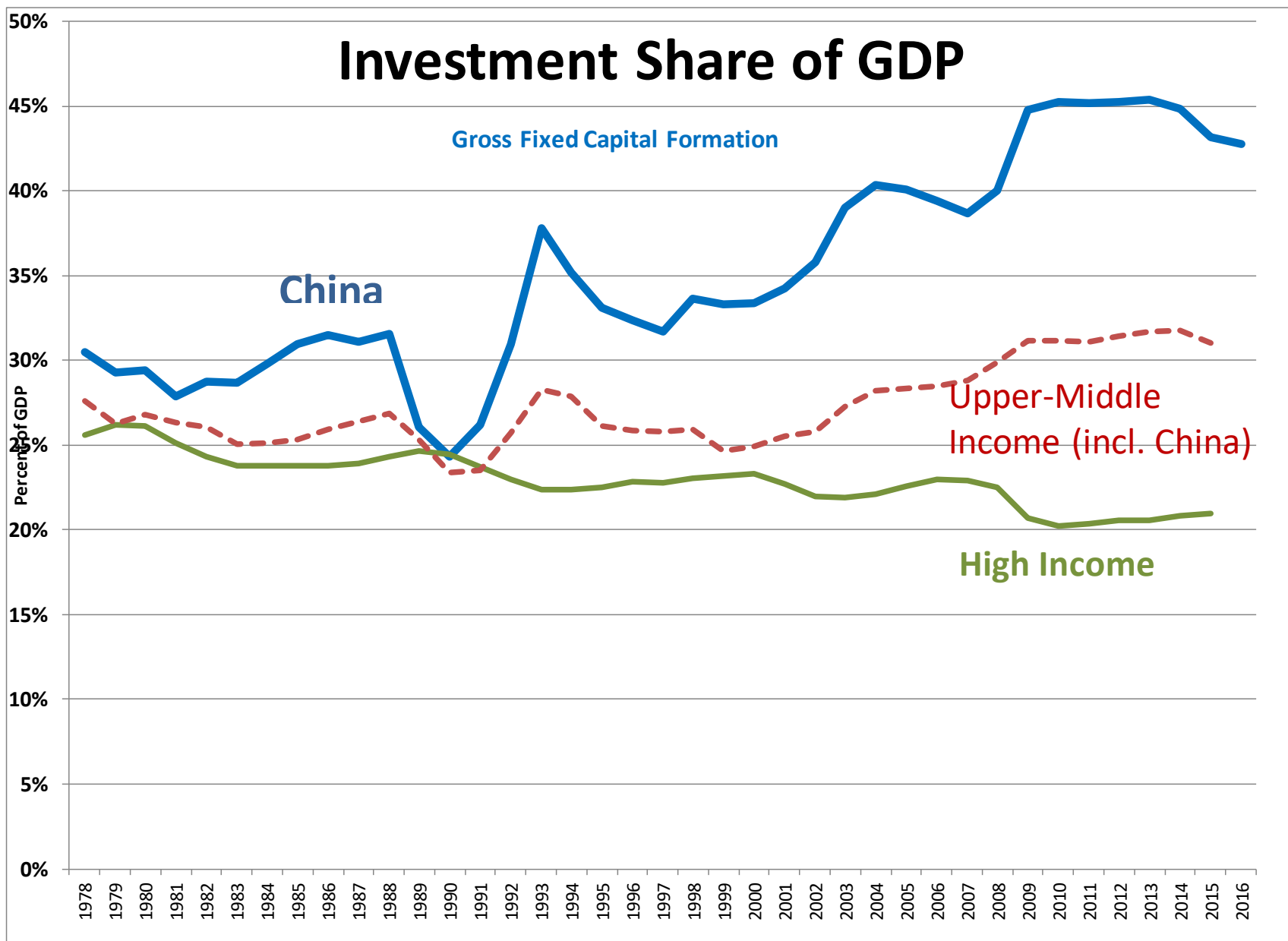
TOTAL		Without Social Security
Mexico	19.6	Slovak 15.7
Chile	21.4	Mexico 16.7
US	24.4	Japan 17.2
Korea	24.8	Korea 18.7
Switzerland	26.9	US 18.9
Ireland	27.3	Czech 19.0
Australia	27.3	Poland 20.0
Turkey	27.6	Chile 20.0
Slovak	28.1	Turkey 20.1
Japan	29.5	Switzerland 20.2
Israel	29.6	Spain 20.6
Canada	30.7	Estonia 20.8
Porugal	31.2	Netherlands 21.4
Spain	32.1	Slovenia 21.6
Poland	32.1	Porugal 22.4
Estonia	32.1	Germany 22.5
NZ	33.0	Greece 22.9
UK	33.0	Ireland 23.1
Greece	33.7	Israel 24.6
Czech	33.8	Hungary 25.8
Iceland	35.3	Canada 25.9
Netherlands	36.3	UK 26.7
Germany	36.5	Luxembourg 27.2
Slovenia	36.5	Australia 27.3
Hungary	38.5	Austria 27.4
Luxembourg	38.5	France 27.5
Austria	41.7	Italy 29.8
Norway	42.3	Belgium 29.8
Sweden	42.3	Finland 30.1
Italy	42.7	Iceland 31.7
Finland	42.8	Sweden 32.4
Belgium	44.0	Norway 32.7
France	44.0	NZ 33.0
Denmark	47.2	Denmark 46.3



Social Welfare Expenditures Increased Under Hu/Wen, but have Plateaued under Xi

(Percent of GDP)

	2006	2010	2016
Education	2.5%	3.9%	3.8%
Health	0.6%	1.3%	1.8%
Public Housing	N.A.	0.8%	0.9%



2. Fiscal System Remains Highly Inadequate

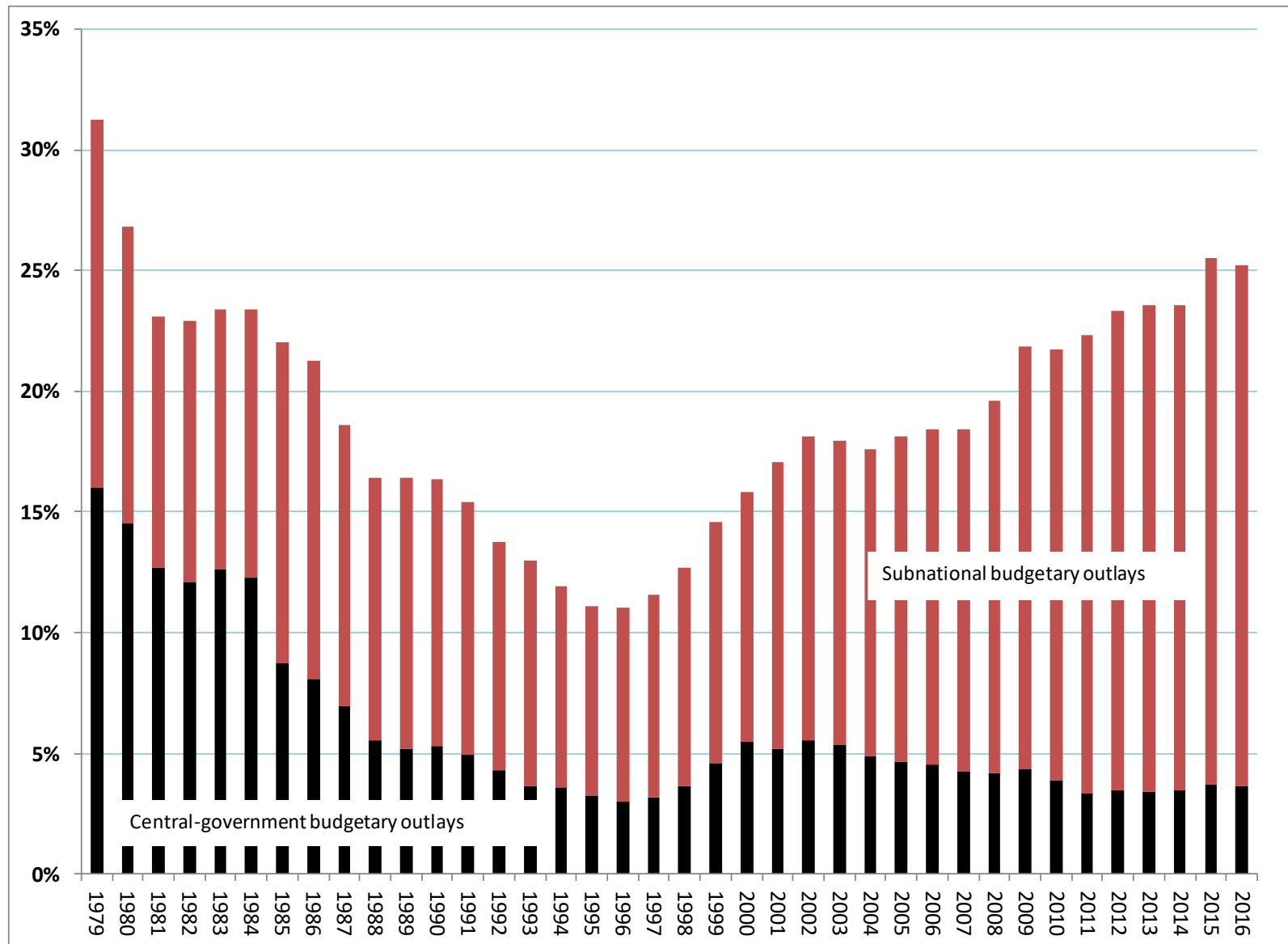
- China has a paradoxical fiscal system: formally very centralized, but in practice extremely decentralized.
- The result is an extreme dependence on local government officials. These officials:
 - Can be effectively motivated to develop their own local economies. Monetary rewards and promotions reward them for doing so.
 - They do so most effectively by engaging in land development, which leads to serious distortions of the economy and corruption.
 - They are accountable ABOVE but not to the people in their local jurisdictions.
- It is very hard to improve this system. Taxes are already high. New taxes are needed, but that means other taxes must be abolished.

China's current fiscal system was created as the response to the crisis of the 1990s...

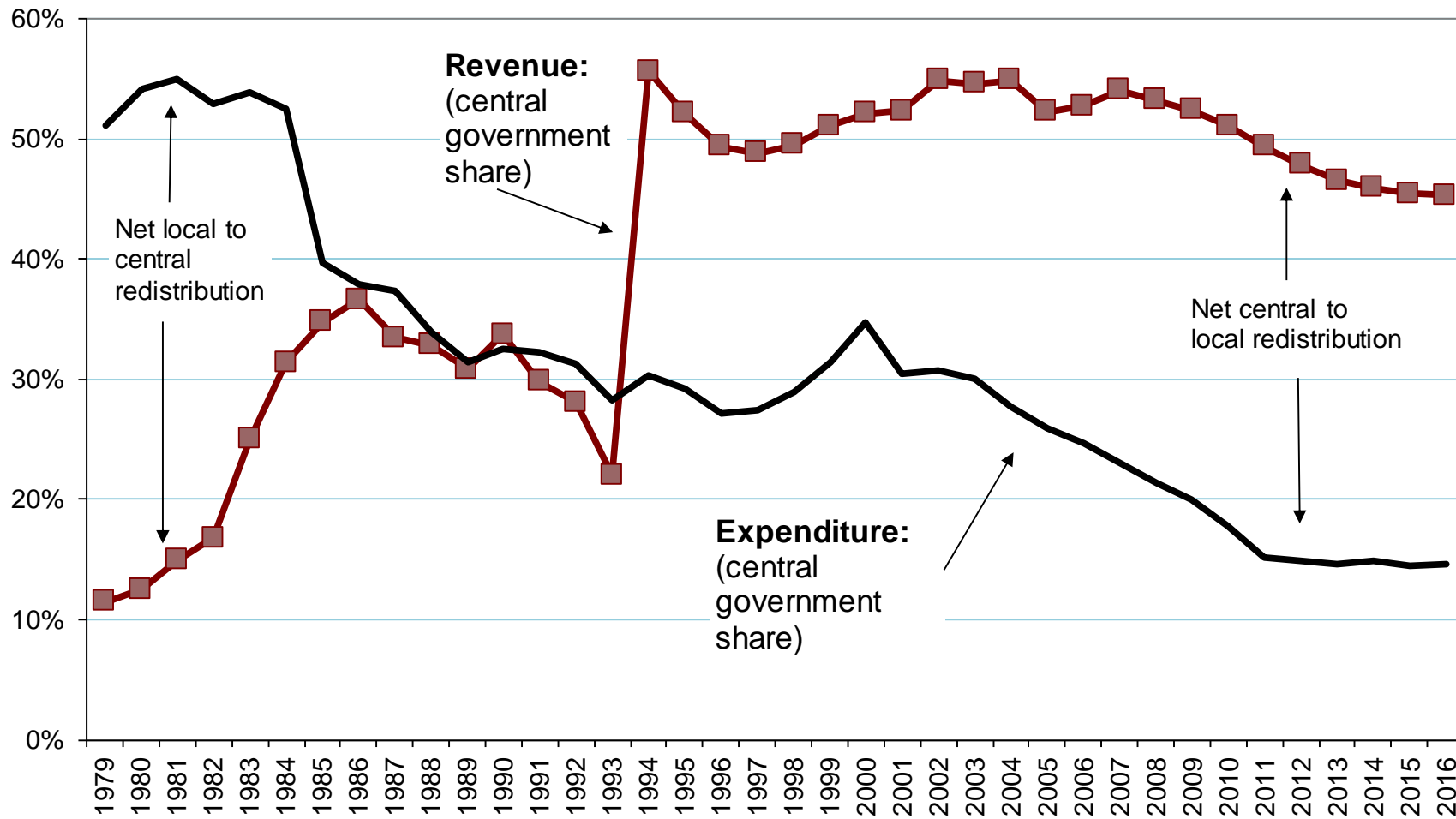
1. Overall budget revenues were falling (as a share of GDP), and central government revenues in particular were inadequate.
2. The objective of reform was thus to have a more efficient fiscal system, that raised funds more equitably; but also one that strengthened the central government.
3. New taxes: VAT especially.
4. New institutions: Central Taxation Authority
5. New revenue-sharing rules

Today, almost 25 years later, this system is still in place.

Most Outlays are Sub-National



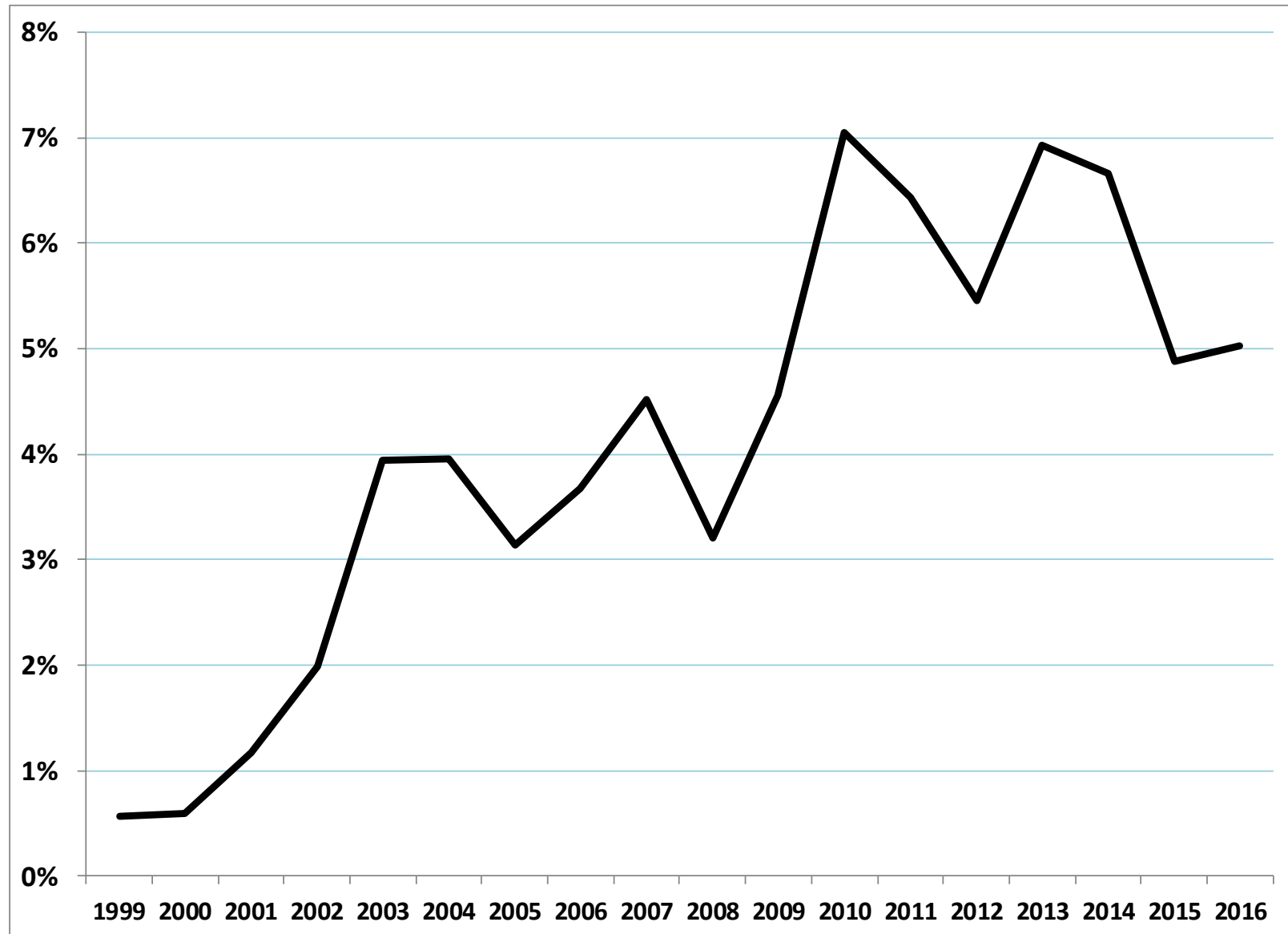
Inter-governmental Transfers



This system raises a host of difficult issues:

- What expenditures should the central government be responsible for? What expenditures should local government be responsible for?
 - ☐ Do localities differ in the public goods preferences?
 - ☐ How effective is local oversight?
 - ☐ What are the most important national public goods?
- What taxes should government use?
- Which level of government should collect the taxes?
- How should revenues be distributed among different levels of government?

Local Government Land Revenues as a Share of GDP



Fiscal Reforms Were Supposed to Lead the Way after the 2013 “Third Plenum”

- Summer of 2014, ambitious fiscal reforms launched.
- Finance Minister Lou Jiwei lays out ambitious three-stage program in interview.
 1. Reform budgetary procedures; improve transparency, etc. Cap and restructure local government debt. Year One.
 2. Introduce new direct taxes (income tax and property tax). Year Two.
 3. Restructure Central-Local Relations. Complete by end of Year Three (2016).
- State Council #43 (October 2, 2014). “Managing Local Gov’t Debt”
Debt: Inventory; Cap; Sell new bonds into the market; No bail-outs.
- Multiple objectives: reduce risk of flimsy structures; reduce debt burden on local govts.; jump start capital markets; foundation for new fiscal system.

Almost four years later, to make a long story short....

1. First step (more transparency) achieved; local debt restructuring began.
2. Ambitious marketization of local debt failed, and it became a bail-out. Over three years, 15 trillion RMB in existing local debt has been converted into bonds and placed on the balance sheets of state-owned banks. Interest rates were reduced by administrative fiat and the interest payment burden stabilized.
3. Local governments are now allowed to borrow directly within a strict central government-set cap; and not allowed to borrow from LGFVs.
4. New taxes: complete failure.
5. New inter-governmental transfer system: no basis to proceed.

Today: Some Progress in Local Government Debt Markets

- The new “municipal debt” market is showing signs of life. Interest rates on some of these bonds are rising, as the market recognizes that the center’s guarantee is not absolute. This is healthy (although mainly confined to inter-bank market for bonds). The idea is to have a few “orderly defaults” in this institutional market.
- After the restructuring and debt conversion, officially recognized local government debt was 16 trillion RMB end-2015, and declined to 15.32 trillion at the end of 2016. This is well within the cap of 17.19 trillion set by the central government. But...

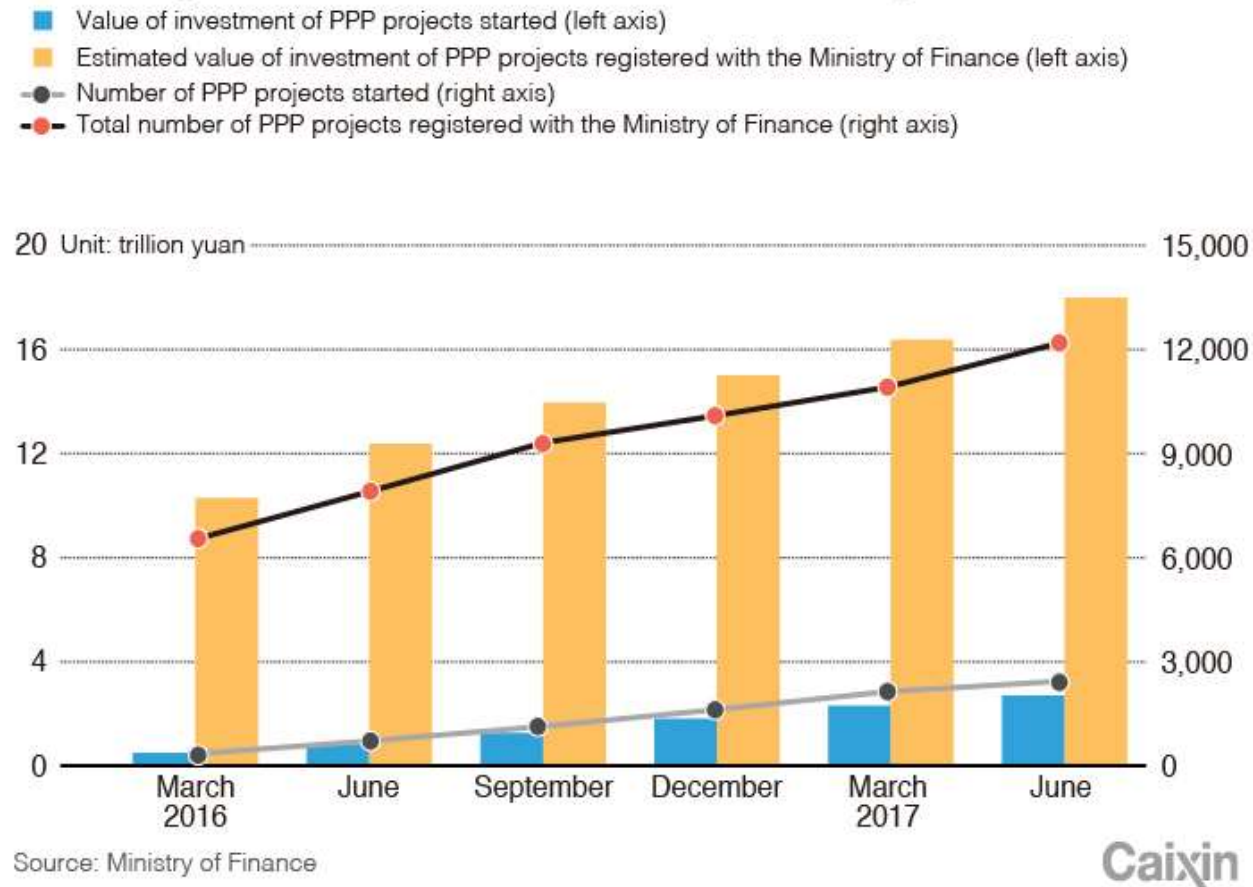
Local Government Work-arounds: Alternative ways to Borrow

- Public Private Partnerships (PPP). Total of 16.3 trillion RMB intended projects registered with MoF as of June 30, 2017. Of this, 3.3 trillion RMB actually underway.
- Contractual Service Procurement. Perhaps 1.1 trillion RMB?
- Investment Funds. End of 2016, 1,013 local government investment funds had been set up, with plans to invest 5.3 trillion RMB in various industries. 1.9 trillion RMB has already been injected into the funds.

Cat and Mouse Game: Each of these is potentially legitimate, and also being misused. PPP new regs (May 3, 2017 NDRC, MOF, PBC, CSRC, CBRC); Service procurement regs (June 2, 2017 MOF regulation);

Public-Private Partnerships (PPP)

Projects Started Are Fraction of All Registered PPP



Conclusion: Fiscal Reforms

- Short-term local government debt problem has been stabilized, problems are containable for the next couple of years.
- NONE of the fundamental, systemic problems were ultimately tackled.
- Whether the situation has improved or not depends on whether the center can subject new local government borrowing mechanisms to regulatory oversight: PPP, government service contracts, and industrial investment funds.
- So far they have not, but the issues are on the agenda and will be taken up after the 19th Party Congress.

3. Strengthened State Enterprises as Instruments of Ambitious National Goals

- Aggregate importance of SOEs has declined, but the largest SOEs are being groomed and strengthened to be strong international actors.
- China Development Bank has been recapitalized by \$48 billion in funds In July 2015, “repurposed” as a government-directed development bank.
- Inclusion of Communist Party in strategic decision-making of SOEs is in part designed insure alignment between national goals and enterprise decisions.
- Establishment of “state capital investment and operation funds” designed to provide strategic goals to SOEs and include them in their reward functions.

Financialization and “Reform” of State Enterprise System

- A new corporate governance system and rapid “financialization” are now transforming the Chinese state-owned enterprise (SOE) sector.
 - Events in 2017-2018 have accelerated substantially, following years of vacillation.
 - The 2013 Third Plenum made a few cryptic comments about managing “capital” rather than “assets,” but the best ideas were rejected.
- Objective: less intrusive management and more arms-length, finance-based control but also more effective Communist Party control.
- Changes are significant, but its too early to determine whether those reforms are “market-oriented,” much less “successful.”
- The “market-oriented” elements have the potential to make Chinese outward investment more easily acceptable; the “non-market-oriented” elements make Party/State-Guided investments *less* compatible and acceptable in our systems.
- I will use the market/non-market dichotomy, then discuss the “government guidance funds” that have significant implications for China and for countries that host Chinese outward investment.

Are these “market-oriented reforms”? YES and NO

YES

- “Corporatization,” begun in 1995, is finally being completed (23 years later).
- Most State-owned enterprise (SOEs) now have clarified and legally explicit corporate governance, including Boards of Directors.
- Many more SOEs now have diverse ownership (which tends to support profit orientation).
- Social Security Fund is receiving 10% of equity in virtually all SOEs.

With more political CONTROL

- Chinese Communist Party Committee is formally embedded in this corporate governance system. Enterprise charters say the firm pays Party expenses.
- Party Secretary is chair of Board of Directors.
- Major firm decisions must be discussed *first* by the Party Committee; the Board of Directors and Managers must consult with the Party Committee *first* before making big decisions.
- State ownership or CCP ownership of firms?

Xi Jinping (2016): “SOEs should also become important forces to implement decisions of the CCP Central Committee, the new development concept, deepened reform, major strategies such as the ‘going out’ strategies and the Belt and Road Initiative, as well as to enhance overall national power.”

Are these “market-oriented reforms”? YES and No

YES

- All SOEs have much greater freedom to set up financial subsidiaries and operate arms-length ownership structures.
- “Guidance funds” at the local level are an improvement over “Local Government Funding Vehicles”
- The pace of stock market listing is accelerating.
- SOEs are being classified into “public service,” “ordinary commercial” and “special commercial.” Indications are that a large majority will be classified “ordinary commercial.”
- “Ordinary commercial” firms escape salary caps.
- “Ordinary commercial” can take in private shareholders and reduce state holding share below 50%, after which more autonomy kicks in. (They cannot get below 50% by selling shares, though; “privatization” is not permitted.)

Are these “market-oriented reforms”? YES and No

NO

- Multiple objectives are assigned to SOEs, including high technology; supply-side “reform;” even anti-poverty
- Mergers may reduce competition.
- New ownership agencies (State Capital Investment Companies and State Capital Operation Companies) are all mission-oriented owners, not pure return maximizers.
- SCI companies seek to grow new sectors, including through investment in private firms; SCO companies primarily restructure existing sectors; but lines blur in practice.
- Intended to be more effective instruments to “plan,” i.e., to shape industrial development.

Motivations

1. These policies are designed to make the state sector more efficient by incorporating more market-oriented elements. The corporate structure of both the top-level holding companies and the funds themselves are substantially improved. The traditional supervisory organs (such as SASAC) pull back from direct interference in management. With less effort to manage current operations, more time and resources can be spent shaping the future direction of the economy.
2. SOEs and their managers and Party Secretaries benefit significantly. SOEs get more resources *and* more freedom to do things with those resources. SOEs have long pushed to have financial subsidiaries, and now they have them. They can more of their pre-tax profits before turning over to the Ministry of Finance. Commercial SOEs with mixed ownership will escape from salary caps. In some respects, it is an obvious power play.
3. Planners expect more effective steerage, by concentrating resources and attention on the *new* areas of industrial restructuring and innovation-led development. Stronger Communist Party power is seen as being compatible with more effective steerage.

Four Key Take-aways

1. The Chinese economy is still market based. The Chinese state-owned system is changing in important ways that make it more flexible and more financialized.
2. The system is becoming more topdown, more Party-directed and more mission-oriented. High technology is the most important part of this mission.
3. The difference between state and private companies is becoming less important. “National champions” are being supported, and these can be either private or state-owned.
4. These changes dwarf the movement towards a better social safety net and improved welfare. Eliminating poverty by 2020 is an important goal, and financialized mechanisms are being adopted to help with this goal. Overall the system is become more nationalistic faster than it becomes more socialistic.

Postscript

Chinese people report they are significantly happier than in 2003.

Happiness reached a trough in 2005/6, and since then has climbed moderately rapidly.

Although there are contradictions in the current Chinese system, they are no greater than those in countries like the United States and