

Implementing the Reform Agenda

China has fundamentally transformed from an economy in which key prices were administered and a large share of resources was allocated through bureaucratic planning to one in which almost all prices are determined in competitive markets and private firms, focused on profitability, undertake a large and still growing share of investment. As laid out in a key decision of the Chinese Communist Party at the Third Plenum of the 18th Party Congress in November 2013, China's current reform agenda includes eliminating remaining price controls, which distort resource allocation, and reducing regulatory barriers that impede the entry of private firms into the few domains, mostly in services, where state firms retain near complete control.¹ The key prices that will be decontrolled include those for various forms of energy, foreign exchange, and the cost of capital. Distortions of these prices over the past decade have favored the development of the industrial sector at the expense of services and contributed to an expansion of profits at the expense of wages.

If implemented, these reforms will substantially rebalance China's economic growth. Looked at from the production perspective, they will lead to more moderate growth of industry and a much more robust expansion of the service sector. From the income perspective, reforms will gradually increase the wage share of GDP while reducing the profit share of GDP. From the expenditure perspective, reforms will lead to more moderate growth of investment and more robust growth of private consumption expenditure. From a domestic

1. Chinese Communist Party Central Committee, "Decision on Major Issues Concerning Comprehensively Deepening Reforms," November 15, 2013. Available at www.gov.cn (accessed on December 17, 2013).

saving-investment balance perspective, the promised more-market-determined exchange rate should reduce government intervention in the foreign exchange market and thus promote continued appreciation of the renminbi over the medium term.² That appreciation should largely offset the higher growth of productivity in the production of tradable goods and lead to a continued modest current account surplus as a share of China's GDP.

State Firms Drag Down Growth

The analysis in chapter 3 shows that the footprint of state firms as measured by their share of output, employment, and investment has shrunk dramatically since 1978. Moreover, there is scant evidence that the global economic crisis and its immediate aftermath slowed this shrinkage. The accounting explanation for this long-term trend is very straightforward. First, the productivity of state industrial firms, as measured by return on assets, has consistently lagged that of private industrial firms and has also fallen in absolute terms since roughly the middle of the 2000s. The higher return of private industrial firms translates into a higher level of retained earnings, which in turn finances much of the investment underlying their superior growth performance. A similar pattern occurs in services. As noted in chapter 3, the return on assets of state service firms in 2008 (the only year for which reasonably comprehensive data are currently available) was only 3.4 percent, only half the level of nonstate firms.³ Second, starting at least a decade ago banks began to allocate a larger share of their loans to private firms. On both counts, investment by state firms accounts for a declining share of national investment, the growth of output of state firms is slow relative to that of private firms, and employment in state firms continues to fall, not only as a share of total employment but in absolute numbers as well.

The key theme of this chapter is that state firms are an increasing drag on China's growth, even as they are contributing a declining share of national output because of their relatively low and declining return on assets. Consequently, economic reform should now focus on opening up the portions of the economy that remain off-limits for private firms, including foreign firms. The Third Plenum decision addresses this directly in several ways. First, the decision declares that the market should be the decisive force in the allocation of resources, a substantial elevation of its role compared with previous party documents. Second, it elevates the role of the nonstate sector to

2. The depreciation of the renminbi in the early months of 2014 is most likely an attempt by the authorities to disrupt the carry trade that sought to take advantage of the combination of higher domestic interest rates in China plus a steadily appreciating currency. This carry trade has led to significant inflows on the capital and financial account. However, over the medium term appreciation is likely to resume in order to offset the continued growth in the production of export goods. In the absence of this appreciation, over the medium term China's exports likely would become supercompetitive on global markets, leading to a large and growing trade and current account surplus.

3. See note 53 in chapter 3.

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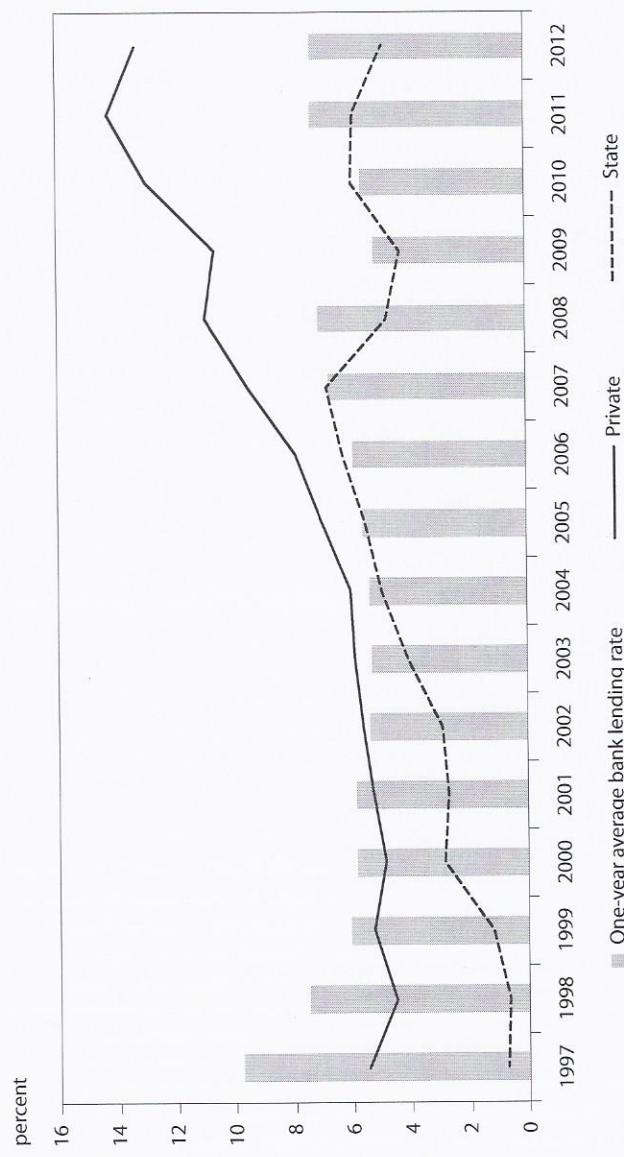
parity with the state sector. This also marks a substantial departure from prior party documents, which acknowledged that the private sector was an important contributor to growth but stopped well short of placing the private sector on a par with the state-owned economy. Third, the decision calls repeatedly for a level playing field, competitive markets, and restriction of state monopoly ownership to natural monopolies.

Figure 4.1 clearly captures why state industrial firms are a drag on China's growth. With the exception of 2010, the return on assets of these firms since 2007 has been less than their cost of capital.⁴ Moreover, because the return on assets of state-owned service firms in 2008 was only half that of nonstate firms and profit margins of state firms in the service sector have since fallen even more than profit margins of state industrial firms (see figure 1.2), it seems very likely that the returns on assets of these firms also remain substantially below the returns of private service sector firms. In short, there is a substantial misallocation of capital, which, if corrected, would allow China to sustain relatively rapid economic growth with a smaller share of resources devoted to investment, one of the key rebalancing objectives of China's political leadership.

Some analysts argue that the widening gap between the return on assets of state and private firms since 2007 is due in large part to cyclical factors. Jon Anderson, for example, points out that state firms are concentrated in mining and heavy manufacturing and that these industries are more cyclical than light manufacturing activities such as textiles, information technology, electronics, and food processing, where private firms dominate. Since China is at the end of a commodity boom and growth is slowing, he argues, it should not be surprising to find that the return on assets of state firms has fallen. Indeed, he argues that "there's nothing in the numbers to suggest that SOEs are (i) significantly worse than the rest of the economy or (ii) in urgent need of aggressive reforms" (Anderson 2013b).

But this sanguine view of state-owned enterprises is not supported by an examination of the relative performance of state and private firms in one of China's most important heavy industries—steel. As shown in figure 4.2, state-owned and state-controlled firms in this industry in the first half of the last decade achieved a return on assets that was roughly the same as the average return of all firms in the steel industry. But in 2006 and 2007, returns of state steel firms fell while returns for the industry as a whole rose; after 2007 returns of state firms fell more rapidly than industry average returns. By 2012, the return on assets of state firms had fallen by 6.5 percentage points compared

4. Typically the cost of capital for firms is calculated as a weighted average of the cost of debt and the cost of equity, the latter measured by the return that an investor would expect from holding a company's shares. But in China few companies are listed on the stock exchanges, and the corporate bond market is extremely small. Thus, other than retained earnings, most capital in the corporate sector comes from bank loans. So the interest rate on a one-year loan is assumed to be a reasonable estimate of the cost of capital. To the extent that state firms rely on funds from nonbank lenders in the shadow banking sector, where interest rates for borrowers are typically higher, the approach adopted here understates the degree to which the return on assets falls below the cost of capital.

Figure 4.1 Return on assets versus cost of capital for industrial firms, 1997–2012

Note: Total profits are earnings before corporate income tax. The annual one-year average lending rate was calculated using the quarterly weighted average lending rate between 2009 and 2012. Prior to 2009, the one-year benchmark lending rate was used.

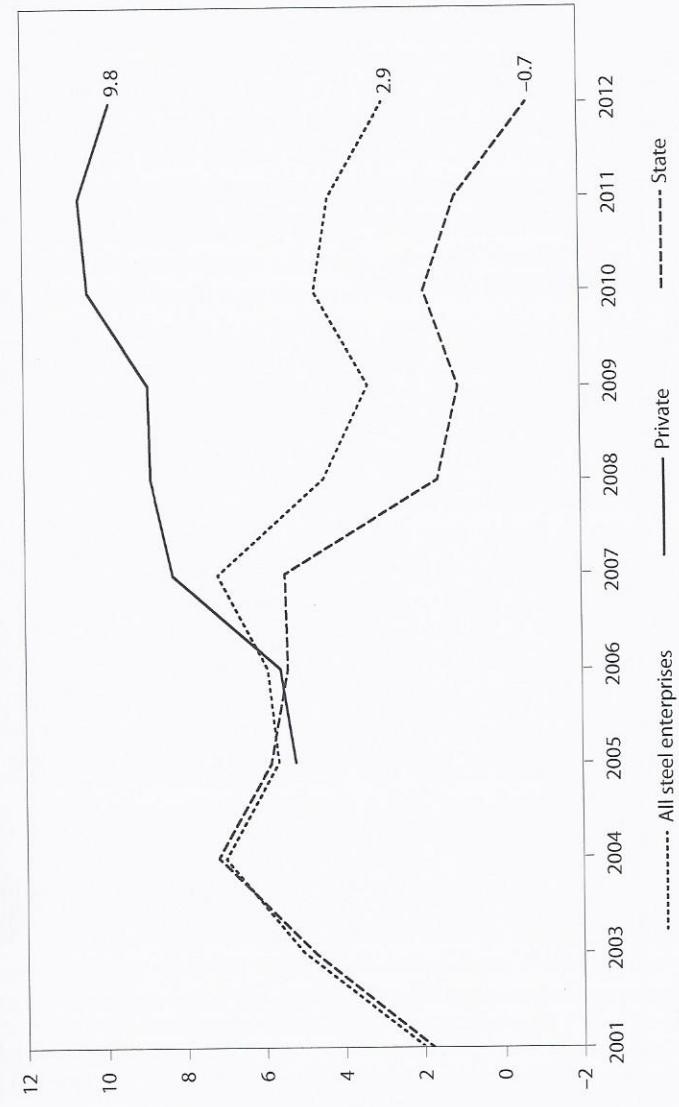
Sources: National Bureau of Statistics of China (2013c, 475–93); SI Emerging Markets, CEIC Database.

Figure 4.2 Return on assets of ferrous metal smelting and pressing by ownership, 2001–12
(percent)

total profits/total assets

Note: Total profits are earnings before corporate income tax. No data were available for 2002.
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Sources: National Bureau of Statistics of China (2013c, 475–93); SI Emerging Markets, CEMI Database.

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Sources: National Bureau of Statistics of China (2013c, 475–93); National Bureau of Statistics of China, www.stats.gov.cn (accessed on February 28, 2014).

with 2005 to a negative 0.7 percent, while average returns in the industry fell by less than 3 percentage points, to 2.9 percent. The mediocre performance of state firms is even more apparent when one compares their returns with those of registered private steel companies. These firms, which produced about a quarter of the output of the ferrous metals sector, earned a return on assets of 10.6 percent in 2011, which was 10 times the return on assets of state firms.⁵ Moreover, private firms managed to double their return on assets between 2005 and 2011. Not until the downturn in the steel industry deepened further in 2012 did the returns of private firms weaken, falling slightly to 9.8 percent. Thus at least through 2012, private steel firms largely escaped the adverse effects of China's economic slowdown while state steel firms were bleeding.

This analysis strongly suggests that cyclical factors are not the major determinant of the declining performance of state firms vis-à-vis their private counterparts in the steel industry. There is a large and still growing productivity differential between state and registered private firms in China's preeminent heavy industry. Private steel firms are more nimble than state firms, adjusting more successfully to changing demand conditions. Whether this same pattern holds in other cyclical industries is an important topic for future research.

The Opportunity in Services

China's service sector offers the greatest opportunities for the next wave of expansion of the private sector for two reasons. First, as demonstrated in chapter 3, the state firms' share of output in industry has already fallen by two-thirds compared with 1978, and in many branches of industry, more efficient private firms have almost entirely displaced state firms. In manufacturing, private firms already account for three-quarters of investment, while the state share has fallen to barely over 10 percent. Thus there are limited efficiency gains from further increasing the private sector's presence in manufacturing (Yao 2013). The state is likely to continue to exercise complete control of electric power distribution, so the opportunity for expansion of private activity in thermal power likely will be limited to power generation. Except in wholesale and retail trade, hotels, and catering, state firms continue to dominate the service sector. The Third Plenum decision signals that the state is prepared to reduce its role in important services that are not a natural monopoly, such as telecommunications.

The second reason China's service sector offers the greatest opportunity for the next wave of expansion is that it is relatively underdeveloped. An Asian Development Bank study shows that the share of GDP originating in services in China throughout the reform era is substantially below the share predicted

5. As noted in chapter 3, state and state-controlled steel firms produced 37 percent of steel output in 2011. Foreign firms produced 13 percent of output and registered private firms produced 26 percent. The residual of 24 percent was produced by limited liability companies in which the majority or dominant owner was private and possibly by collective firms.

based on the relationship between the growth of per capita GDP and the share of the service sector in GDP for 12 Asian economies. Similarly, the share of employment in the service sector in China is also less than the predicted share (Park and Shin 2012, 14–17).

The lagging performance of China's service sector is also apparent in the time path of the growth of service output. At the outset of the reform program, China's service sector was particularly small, reflecting the heavy-industry bias that characterized economic planning and resource allocation before 1978. But as the government began to reduce the scope of economic planning and to increasingly liberalize product prices and factor markets, the pace of expansion of the service sector far outstripped the growth of GDP, pushing up its share of GDP from an average of 22 percent in 1979–81 to 42 percent by 2002 (National Bureau of Statistics of China 2012b, 45). Thus China's growth pattern in the first two decades of the reform era was consistent with the widely observed pattern in which sustained economic growth is accompanied by a rising share of services in GDP.

But in the third decade of reform, three factor price distortions substantially slowed the relative growth of service output. First, starting from as early as 2002, China's currency became increasingly undervalued. This undervaluation of the renminbi was a significant contrast with the first two decades of economic reform, when the renminbi was substantially overvalued, and from the mid-1990s until 2001, when the value of the renminbi was close to an equilibrium level. Renminbi undervaluation raised the profitability of production of tradable goods. Since tradable goods in China are overwhelmingly manufactures, currency undervaluation led to increasing investment in manufacturing at the expense of services and a slowing in the relative pace of growth of service output (Goldstein and Lardy 2009, 10, 59).

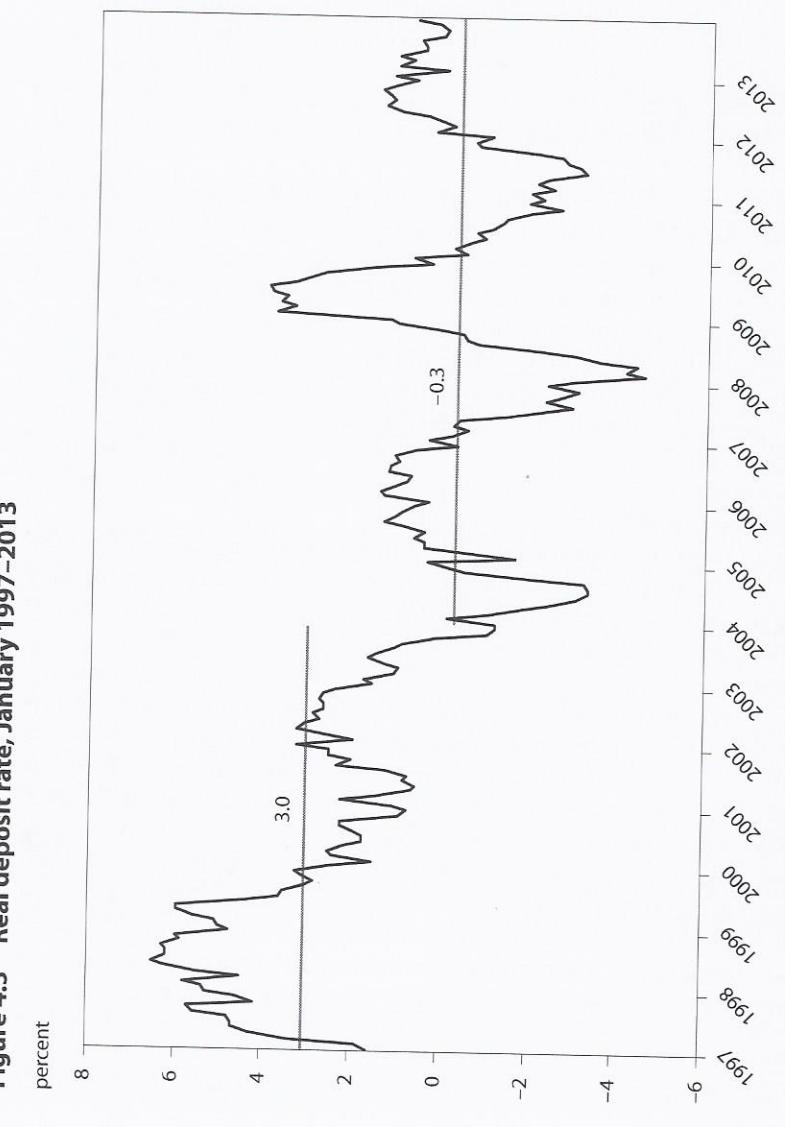
A second factor price distortion contributing to the stagnation of the service share of GDP was the central bank's adoption of a low interest rate policy beginning in 2004. The central bank fixed the ceiling on the nominal interest rate that banks could pay on deposits so low that, taking inflation into account, the real return to savings became negative (figure 4.3). This policy was a distinct change from earlier years, when the bank adjusted the nominal deposit rate ceiling so that the real rate was always in positive territory, regardless of the rate of inflation. As a result, the average real deposit rate starting in 2004 was an average of 330 basis points lower than it had been from 1997 through 2003. Competition among banks meant that the resulting lower cost of bank funding was passed on to bank borrowers. As reflected in figure 4.4, this pushed down the average real cost of borrowing over the next seven years to only 3.2 percent, a decline of 300 basis points compared with the average real cost in 1997–2003.⁶ Since manufacturing is more capital intensive than services, this declining cost of capital also increased the profitability of manufacturing relative to ser-

6. The real cost of borrowing is the nominal interest rate adjusted for inflation as measured by the consumer price index.

Figure 4.4 Real lending rate, January 1997–2013
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Figure 4.3 Real deposit rate, January 1997–2013
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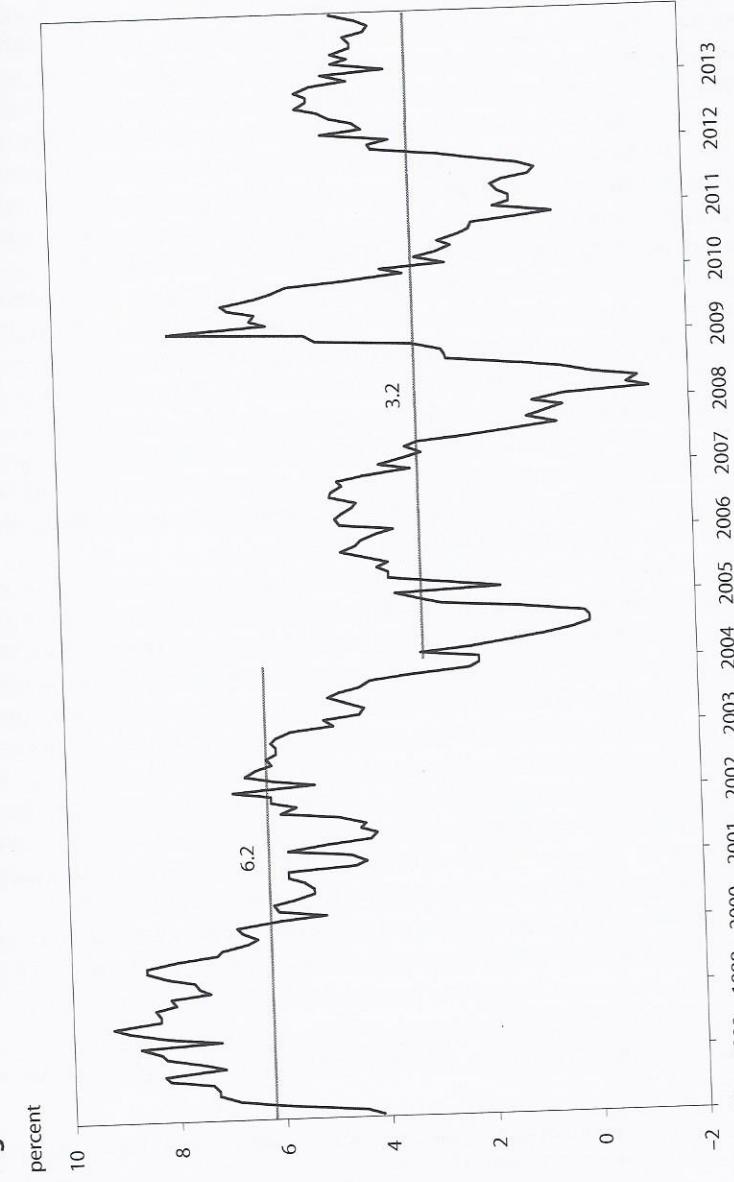
Note: For 1997–2012, the real deposit rate is calculated as the difference between the one-year benchmark savings deposit rate and the consumer price index. After July 2012, it is calculated as the difference between 1.1 times the one-year benchmark deposit savings rate and the consumer price index.

Sources: People's Bank of China, www.pbc.gov.cn; National Bureau of Statistics of China, www.stats.gov.cn (accessed on February 28, 2014); ISIM Emerging Markets, CEMI Database.

Note: For 1997–2012, the real deposit rate is calculated as the difference between the one-year benchmark savings deposit rate and the consumer price index. After July 2012, it is calculated as the difference between 1.1 times the one-year benchmark deposit savings rate and the consumer price index.

Sources: People's Bank of China, www.pbc.gov.cn; National Bureau of Statistics of China, www.stats.gov.cn (accessed on February 28, 2014). [5]

Figure 4.4 Real lending rate, January 1997–2013



Note: For 1997–2008 the real lending rate is calculated as the difference between the one-year benchmark lending rate and the consumer price index. Beginning in December 2008, it is the difference between the weighted average lending rate and the consumer price index.

Sources: People's Bank of China, www.pbc.gov.cn (accessed on February 28, 2014); National Bureau of Statistics of China, www.stats.gov.cn; ISI Emerging Markets, CEIC Database.

vices and tilted investment even more strongly into the manufacturing sector. Because on average service industries are more labor intensive than manufacturing, the bias toward manufacturing as opposed to service investment, in turn, contributed to a reduction in the wage share of GDP and thus a decline in the private consumption share of GDP as well.⁷

A third factor contributing to the relative stagnation of service output after 2002 was a change in government policy on energy pricing. In 2003, in response to a sharp rise in the global price of crude oil and coal, the new Hu Jintao-Wen Jiabao government abandoned the policy of full-cost pricing of electricity and fuels that had been implemented in the late 1990s under the leadership of President Jiang Zemin and Premier Zhu Rongji. Instead, when periodically the international price of crude oil or coal rose sharply, these costs were not fully reflected in the prices either of refined petroleum products or of electricity, leading to large financial losses for refiners and power generators and implicit subsidies for users of energy. Since about three-fourths of all energy in China is consumed in manufacturing, this policy also constituted a subsidy for manufacturing (Lardy 2012, 84–86, 103–104, 106–12).

Largely as a result of these three factor price distortions, the growth of service output slowed dramatically relative to GDP after 2002. Between 2002 and 2007–08, the service share of GDP stagnated at 42 percent. Subsequently, its share rose very gradually, reaching 46 percent of GDP by 2013. So in the first two decades of economic reform, the service share of output rose by an average of 1 percentage point of GDP per year, but in the next 11 years, when distortions in the pricing of foreign exchange, energy, and capital became important, the pace of expansion was only 4 percentage points cumulatively (National Bureau of Statistics of China 2013b, 21).

Another important reason for the slow growth of services since 2002 is the highly restrictive government policy on the entry of private firms into much of the sector. This policy is much more restrictive than it is in manufacturing. An OECD survey of 40 countries ranks China as the most restrictive in terms of barriers to entry in services the OECD identifies as networked sectors (gas, electricity, road freight, postal services, and telecommunications) and second most restrictive in professional services and retail. Where 6 is the most restrictive score possible, China scored 5.4 and 4.5, respectively. India's scores were much lower, at 3.6 and 1.3. Brazil, with scores of 2.4 and 1, has even lower barriers to entry in services.⁸ While this OECD survey is based on data from 2008, barriers to entry in Chinese services likely remain relatively high.

These barriers reduce competition and appear to account for a substantial share of the difference between the growth of total factor productivity (TFP)

7. The wage share of GDP declined from 53.6 percent of GDP in 2002 to 47.0 percent in 2011, according to the most recent flow of funds data (National Bureau of Statistics of China 2012b, 82–83; 2013c, 80–81).

8. Organization for Economic Cooperation and Development, Product Market Regulation Database. Available at www.oecd.org (accessed on November 14, 2013).

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in services and that in manufacturing. Carsten Holz (2006) studied the growth of TFP over the first two decades of economic reform and found that annual TFP growth in nontradable goods, a proxy for services, was 2.6 percent, while annual TFP growth in tradables, a proxy for manufacturing, was 4.1 percent. A more recent study, by several economists at the Hong Kong Institute for Monetary Research focusing on 2001–10, estimated the annual TFP growth for the whole economy, the tradable sector, and the nontradable sector at 3.7 percent, 4.9 percent, and 2.4 percent, respectively. While productivity in services lags that in manufacturing in most economies, He Dong and his colleagues (2012, 9–10, 12) find that the differential in China is substantially greater than in developed market economies and “in line with those of fast-growing emerging economies such as Korea during 1990–97 before it accelerated liberalization of services after the Asian financial crisis.”

A similar result emerges from an analysis from the middle of the last decade, which shows a huge 13-fold gap in aggregate TFP between China and the United States. But in manufacturing, the gap was only 1.3 times, leading to the conclusion that “most of the differences in aggregate productivity, and therefore living standards, between China and the United States have to be rooted in the inefficiency in the nonmanufacturing sectors—mostly domestically oriented services and agriculture” (Ahuja 2013, 202–203). The International Monetary Fund estimates that deregulation of services would have a substantial payoff, increasing TFP growth in the economy by more than 1 percentage point annually (IMF 2013b, 22).

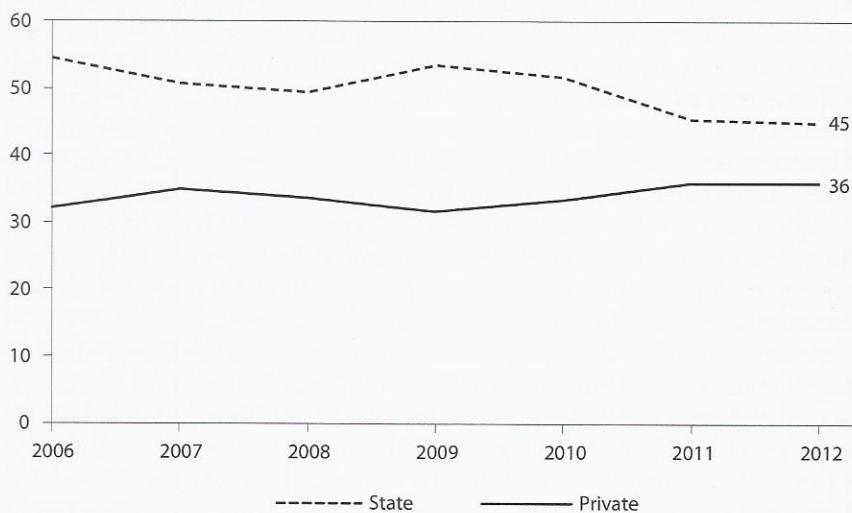
The difference in the restrictions on private activity in services versus industry is clearly reflected in differing trends in the sectors’ sources of investment. As shown in chapter 3 (see figure 3.10), the share of investment in industry by state and private firms was roughly equal, at about 40 percent in 2006.⁹ But by 2012, private firms accounted for 65 percent of all industrial investment, while the share of investment by state firms had fallen to only 20 percent. By contrast, as reflected in figure 4.5, the state share of investment in services was much more elevated in the middle of the last decade and has declined much more slowly. By 2012, state firms were still responsible for 45 percent of service investment, twice their share of investment in industry and four times their share of investment in manufacturing. Private firms’ share of investment in services has increased quite slowly since 2006 and by 2011 stood at only 36 percent.

The private share of investment in services could increase quite substantially even if the state remains the dominant investor in components that governments dominate in most market economies: education, health, science, water conservancy and public facilities, and public management. In 2011 state investment in these public services accounted for 40 percent of state investment in services. If private investment by private enterprises had completely

9. 2006 is the first year for which industrial investment data based on the nature of the majority or dominant owner are available.

Figure 4.5 Investment in services by firm ownership, 2006–12

percent of fixed asset investment



Sources: National Bureau of Statistics of China (2013c, 170–73); National Bureau of Statistics of China, www.stats.gov.cn (accessed on February 28, 2014).

displaced state investment from the remaining components of services in 2011, the private share of investment in all services would have been 63 percent rather than 36 percent, an increase of three-quarters.¹⁰

The potential for an expanded role for private firms is especially large in modern services, where state firms have an elevated role. Modern services include information technology, financial services, leasing and business services, and technical services, while traditional services include wholesale and retail, hotels and catering, transportation and storage, personal services, and public services such as education and health.¹¹ A number of studies have shown that modern services have strong positive spillover effects to the rest of the economy. Moreover, modern services are not the natural monopolies or social services that governments commonly choose to closely regulate or provide directly. The share of investment in modern services undertaken by China's state and private companies is 46 percent and 34 percent, respectively.

Information on investment by ownership in the four components of modern services is presented in table 4.1. The state share of investment both in information transmission, software, and information technology (IT) and

10. The private share of services would have been 27 percentage points (= 60 percent of 45 percent) higher than the observed 36 percent.

11. "Technical services" is my label for the component of the service sector identified as "scientific research, technical services, and geological prospecting."

Table 4.1

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Technical service...

Source: National Bu...

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Table 4.1 Investment in modern services by firm ownership, 2012
(percent)

	State	Private
Total	46	34
Information transmission, software, and information technology	60	19
Financial intermediation	60	22
Leasing and business services	35	43
Technical services	49	35

Source: National Bureau of Statistics of China (2013c, 170–73).

in financial intermediation is a relatively high 60 percent. Within the IT, software, and IT services category, the state accounts for fully three-quarters of all investment in telecommunications and transmission services, half of all investment in internet and related services, and just under a third in software and IT. Private and foreign firms account for the balance of investment, with the private share of investment reaching almost a third in internet and related services and almost half in software and IT. In contrast, the state dominates investment in all the subcomponents of financial intermediation (banking, capital markets, and insurance) except for a small residual category of other financial services where the private share approaches one-half (National Bureau of Statistics of China 2013c, 172). The only modern service where private investment exceeds state investment is leasing and business services. Where data are available, the return on assets of state firms in modern services is far below that of nonstate firms, suggesting that further liberalizing the barriers to their entry would enhance China's economic growth.¹²

Financial Sector Reform

Given private firms' substantially higher returns on assets, reforms of the financial sector that improve the flow of funds to them should be growth enhancing. The most important reforms are the gradual liberalization of deposit rates and the formation of more private banks. China's central bank has long set benchmark rates for both deposits and loans. While banks have been free to price loans upward from these rates since November 2004 and downward since July 2013, deposit rates are much more tightly controlled. Until June 2012 the central bank allowed banks no upward flexibility on deposit rates. Since then it has allowed banks to pay as much as 10 percent over the benchmark rates on deposits of various maturities. When this change was made, the benchmark rate on a one-year deposit, for example, was 3 percent; thus the maximum banks could offer was 3.3 percent.

12. The 2008 economic census shows that in the software industry the return on assets of state and state-controlled firms was 6 percent, while in nonstate firms it was 9.1 percent. In computer services, returns were 6.1 percent and 11.0 percent, respectively, for the two ownership categories.

There seems little doubt that liberalization would lead to higher deposit rates. First, when the central bank first allowed 10 percent upward flexibility in June 2012, almost all banks immediately floated their one-year deposit rates up to the maximum. Second, beginning in 2012, banks increasingly competed to retain customer funds by offering unregulated wealth management products that typically paid 100 to 150 basis points more than bank deposits of the same duration. Third, China's largest internet firms, notably Alibaba Holdings Ltd. and Tencent Holdings Ltd., are beginning to offer financial services that compete with state banks. Alibaba, in cooperation with Tianhong Asset Management Co. Ltd., created Yu'e Bao, a wealth management service.¹³ By November 2013 it had attracted deposits of more than RMB100 billion, and deposits jumped to RMB500 billion by mid-February 2014.¹⁴ Yu'e Bao is essentially a money market account. Funds in these accounts can be transferred back to Alipay at any time to pay for online purchases, so they are similar to bank demand deposits or checkable money market accounts. But the interest rates the internet firms pay on these accounts are up to ten times those that Chinese banks pay on demand deposits, where the central bank ceiling on interest rates still applies (Cui 2013). In early 2014 competitive pressures from these internet companies led banks to also float their interest rates on longer-term deposits to 1.1 times the benchmark rates for those maturities.¹⁵

Since Chinese banks are funded overwhelmingly by deposits, implementing the Third Plenum decision to liberalize deposit rates will further raise their cost of funds. The banks, in turn, will pass along a portion of this increase to their customers. In short, if banks have to pay higher rates on their liabilities, they will seek to earn higher rates on their assets. Given that, on average, state firms' return on assets is already less than the average loan rate, higher rates would presumably lead more state firms to reduce their demand for loans. Even if their demand for loans did not decline, banks likely would curtail lending to them. Conversely, the many private firms that have had no or limited access to bank loans and rely to some degree on informal credit markets, where interest rates are typically several times those charged by banks, would be an obvious new market for bank lending. Thus it seems likely that deposit rate liberalization would increase the share of bank lending to private firms, which tend to make much better use of the funds than state firms do. This conjecture is fully consistent with the experience of deposit rate liberalization in other economies, which has generally led to increased lending to firms

13. In October 2013 Alibaba invested RMB1.18 billion to become the controlling shareholder in Tianhong Asset Management Co. Ltd., with a 51 percent equity stake. Chen Jia, "Now securities and Internet firms look to linkups," *China Daily*, February 12, 2014, pp. 13–14.

14. "Yu'ebao boosts capital supply for economy," *China Daily*, March 10, 2014, available at www.chinadaily.com.cn (accessed on July 2, 2014).

15. Jiang Xueqing, "Banks strike back at online financial startups," *China Daily*, February 12, 2014, p. 13.

that previously were underserved by the banking system (Feyzioğlu, Porter, and Takáts 2009, 16).

A second reform that would improve the flow of funds to private firms would be to allow the creation of truly private banks that would likely lend an even larger share of their funds to private companies than do China's existing banks and provide additional competition with China's predominantly state-owned banks. China has long had a few banks that arguably are private. And the extent of private ownership in shareholding banks, city commercial banks, and rural banks is higher than many recognize. Private and collective capital accounted for 41 percent of the total equity of shareholding banks, 54 percent of city commercial banks, and 73 percent of rural banks at the end of 2012 (China Banking Regulatory Commission 2013, 38).¹⁶ Thus while most rural banks and many city commercial banks may be privately controlled, the state remains the majority or dominant owner of shareholding banks, which account for a much larger share of total bank assets than do either rural banks or city commercial banks.

In 2013, momentum grew to green-light the establishment of more private banks. In its July financial sector guiding opinion, the State Council called for experimentation with private banks.¹⁷ The China Banking Regulatory Commission (CBRC) almost immediately followed up, posting for comment a draft regulation on establishing banks, which included a provision for private banks.¹⁸ Two months later, central bank governor Zhou Xiaochuan, in an important article in the party's *Qiushi* magazine, called for the promotion of private banks and other reforms to increase the financial support for small and microenterprises.¹⁹ He reiterated these themes in the party's newspaper, *People's Daily*, in November.²⁰ In March 2014 CBRC announced that the State Council had accepted applications for the establishment of five private

16. The report gives these percentages for minjian (民间) ownership, a category that includes both private and collective ownership. Collectively owned units (including units that are pure collectives and units in which a collective is the majority or dominant owner of a corporation in another registration category) were less than 4 percent of the total number of corporate units in China at the end of 2011 (National Bureau of Statistics of China 2012b, 27). In banking, collective capital is significant only in rural banks and rural credit cooperatives.

17. State Council Management Office, "Guiding opinion concerning finance supporting economic structural adjustment and upward transformation," July 5, 2013. Available at www.gov.cn (accessed on March 12, 2014).

18. Wang Xiaotian, "Boost for private capital in banking industry," *China Daily*, August 13, 2013, p. 14.

19. Zhou Xiaochuan, "Practice the Party's Mass Line; Promote Inclusive Financial Development," *Qiushi*, September 16, 2013. Available at www.pbc.gov.cn (accessed on May 28, 2014).

20. Zhou Xiaochuan, "Thoroughly Deepen Financial Reform and Opening; Quickly Perfect the Financial Market System," *People's Daily*, November 28, 2013. Available at <http://theory.people.com.cn> (accessed on May 28, 2014). Large portions of this article were subsequently translated in *China Daily* under the title "Road map for financial reform," December 11 and 18, 2013, p. 11.

Table 4.2

Year
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011

a. Includes employment in state-owned enterprises.
b. Includes employment in party organizations.

Note: A programmatic change in 2011 led to double counting of government workers in 2011.

Sources: National Bureau of Statistics of China and Ministry of Human Resources and Social Security 2011, table 4-1.

banks in four jurisdictions: Zhejiang and Guangdong Provinces, Tianjin, and Shanghai.²¹ Interestingly, applicants for the first five private banking licenses include Tencent and Alibaba.

Power of the Chinese State in Perspective

How powerful is the Chinese state? Stephen Green, a well-regarded analyst at Standard Chartered Bank, believes that “China has a large and powerful government sector. It is one of the world’s most powerful bureaucracies in terms of employment, income, ownership of the means of production, and regulatory powers.”²² Yet on some criteria this assessment exaggerates the power of the Chinese state.

First, the size of the Chinese government and party bureaucracy is surprisingly modest (table 4.2). In this respect, the Chinese Communist Party is similar to previous Chinese dynasties as far back as the Han, which ruled the vast Chinese empire with a modestly sized civil service (Maddison 1998, 21). Total government employment in 2011 was 42.3 million.²³ This number includes employment in all government offices at central, provincial, and local levels that are mainly controlled by and financed by the government. It is inclusive of not only those working directly in government agencies and organizations but also those employed in institutions (事业单位), a category that includes educational institutions, hospitals and clinics, research organizations, and so forth, almost all of which in China come under the purview of and are financed by the government. It also includes those employed in Chinese Communist Party organizations (中国共产党机关).²⁴ Government employment excludes workers producing goods and services in enterprises (企业) that are mainly owned or controlled by the government.

Forty-two million is a large number; indeed, it exceeds the population of many sovereign states. But government workers in all states are primarily involved in the provision of services ranging from public safety to health and education. Since the delivery of most of these services is very labor intensive, more populous countries inevitably have larger bureaucracies. Thus the standard practice of the International Labor Organization and other agencies analyzing the size of government bureaucracies is to express the number of

21. “CBRC Vice-Chairman Ju Qingmin discusses trial work on private banks,” March 11, 2014. Available at www.cbrc.gov.cn (accessed on February 11, 2014).

22. Stephen Green, “China—Dreaming of Economic Reform in 2013.” January 7, 2013. Standard Chartered Global Research.

23. This is the sum of reported employment in state agencies and organizations, state institutions, state nonprofit organizations, and a tiny residual “other” category. An identical number can be derived by subtracting state enterprise employment from total state employment (National Bureau of Statistics of China and Ministry of Human Resources and Social Security 2011, table 4-1).

24. Employment in party positions is relatively small, 561,000 in 2011 or 1.3 percent of the total.

Table 4.2 Public sector employment, 1999–2011 (millions of workers)

Year	Public sector employment	Public enterprise employment ^a	Government and party bureaucracy employment ^b
1999	96.5	59.8	36.8
2000	94.3	57.3	37.0
2001	90.2	53.3	36.9
2002	86.9	50.3	36.6
2003	83.4	46.9	36.5
2004	83.0	45.8	37.2
2005	80.5	42.9	37.6
2006	81.0	42.9	38.1
2007	81.6	42.9	38.7
2008	82.1	42.7	39.5
2009	77.6	37.6	40.0
2010	79.0	37.8	41.2
2011	87.4	45.1	42.3

a. Includes employment in state-controlled shareholding companies (国有控股企业) and traditional state-owned enterprises (国有企业).

b. Includes employment in public institutions (事业单位) and agencies (机关).

Note: A program to corporatize certain public institutions accelerated in 2011. There appears to be some double counting in the original sources for the 2011 data. Thus public sector and public enterprise employment in 2011 is probably overstated.

Sources: National Bureau of Statistics of China and Ministry of Human Resources and Social Security (2006–13); National Bureau of Statistics of China Population and Employment Statistics Office (2012; 2013, 262).

government employees relative to the population of the country in question. When scaled this way, China has only 31 government and party employees per thousand residents. The number of civil servants per thousand residents in France is 95, in the United States, 75, and in Germany, 53.²⁵

Of course, a bureaucracy's size is also a function of a country's per capita income. High-income countries typically provide more services to their populations, and this almost always involves a larger civil service. So comparisons with countries closer to China's level of economic development are more appropriate. Government employment per thousand residents is 38 in both Mexico and Turkey and 32 in South Africa. In short, in government employment relative to population, China does not rank particularly high, even when those employed by the party are included.

Including employment in state-owned enterprises, China's total public sector employment in 2011 was a much higher 87.4 million, accounting for 11

25. International Labor Office (ILO), ILO LABORSTA Database, 2010. Available at <http://laborsta.ilo.org> (accessed on November 1, 2013). The US number would be even higher if it included workers in the post office, which is considered a quasi-government agency, employees of government-sponsored enterprises such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and government contract workers.

percent of China's economically active population.²⁶ This is significantly less than the 15 percent and 14 percent figures for the United States and Germany, respectively, and far below France's 24 percent. Compared with countries closer in per capita income, China's 11 percent figure is higher than the 9 percent level in both Thailand and South Africa but slightly below Malaysia's 13 percent and Turkey's 12 percent.²⁷ Yet no one is charging that the government bureaucracies in Malaysia and Turkey are among the world's most powerful.

Moreover, employment in state-owned enterprises has been falling, and by 2011 was 25 percent less than in 1999 and accounted for only 13 percent of urban employment.

Neither does the Chinese state look so powerful on the second metric, income—that is, fiscal revenues relative to GDP. At the outset of reform, consolidated central and local government revenue accounted for 31 percent of GDP, a relatively high share for China's level of economic development at the time. But as firms were able to retain an increasing share of their profits rather than remitting them to the Ministry of Finance, government revenues relative to GDP shrank. By 1995, fiscal revenues were the equivalent of only 10 percent of GDP, one of the lowest ratios in the world. Various tax reforms, notably the expansion of the scope of the value-added tax starting in 1994, have boosted the ratio of government revenues to GDP. But in 2011 the ratio was only 22 percent (National Bureau of Statistics of China 2013b, 72), compared against the 28 percent average for emerging markets and developing economies. China's government revenue relative to GDP is identical to that of Mexico, 2 percentage points below that of Malaysia, and 5 percentage points below that of South Africa.²⁸ Thus, there is little evidence in the fiscal data of the overwhelming power of China's bureaucracy.

The case that the Chinese state is one of the world's most powerful in terms of the ownership of the means of production is closer to the mark than the claims with respect to employment and income. But this study has already presented evidence that the state's power in this domain is shrinking. This is reflected in the declining share of industrial output produced by state and collective firms, from 100 percent of output in 1978 to about one-quarter in 2012. State and collective firms controlled all of the country's productive capital in the industrial sector as reform was getting under way, and one can infer from the production data that its share of productive assets has dropped precipitously since. Second, the investment data examined in chapter 3 show that state firms' share of investment in industry has been declining since 1980,

26. The economically active population is the sum of employed workers and unemployed workers.

27. International Labor Office (ILO), ILO LABORSTA Database, 2010. Available at <http://laborsta.ilo.org> (accessed on November 1, 2013).

28. Data for government revenue as a share of GDP for countries other than China and for the average of emerging market and developing economies is from the IMF, World Economic Outlook database, April 2013. Available at www.imf.org (accessed on November 1, 2013).

gnificantly less and Germany, countries closer the 9 percent Malaysia's 13 ne government most powerful. en falling, and 13 percent of second metric, set of reform, for 31 percent evelopment at of their profits ment revenues valent of only us tax reforms, rting in 1994, t in 2011 the na 2013b, 72), and developing tical to that of entage points e fiscal data of st powerful in r to the mark this study has n is shrinking. duced by state ut one-quarter y's productive , and one can s has dropped chapter 3 show ng since 1980,

while that of private firms has been rising. By 2011, private firms' investment was almost three times that of state firms in absolute terms, and the ratio is higher when private foreign firms' share of investment is taken into account. Given this large and increasing disparity, the state's share of total productive assets must be falling as the private sector's share is rising.

Figure 4.6 provides a more precise measure of the share of productive assets owned by state firms in industry, with a further disaggregation into its three components: manufacturing, mining, and utilities. Not surprisingly given trends in the state share of output of manufactured goods, state ownership of assets in manufacturing has declined by more than half, from 60 percent in 1999 (the first year for which these data are available) to only 25 percent by 2012. In mining the decline is much less, only a quarter, and the decline in the state share in utilities, from 91 percent to 88 percent, is negligible. The share of industrial assets the state controls is simply the weighted average of its three components; the decline from 69 percent in 1999 to only 38 percent in 2012 was a little more than two-fifths. All of these data exclude the assets of below-scale firms, which are disproportionately private and so somewhat overstate state companies' share of assets. While the state share of manufacturing assets is declining, the one-quarter remaining in state hands undoubtedly puts China at the top of any global ranking of state ownership of manufacturing assets.²⁹

Assessing the regulatory powers of states is more difficult since there is no commonly accepted, widely available metric. The OECD's Product Market Regulation Survey includes a component called "use of command and control regulation," which provides a starting point. China is rated a 3 on a scale of 0 to 5, a rating it shares with South Africa and Chile. Among those countries with greater use of command and control are India and Greece, both with a score of 5, and Brazil, Russia, Belgium, Israel, Turkey, and Indonesia, all with a score of 4. The remaining 29 countries are all judged to have less pervasive government command and control regulation. The limits of the OECD survey are that it was last completed in 2008, the vast majority of countries included in the survey are high-income developed economies, and the questionnaire on which the scores are based is quite limited.³⁰ But one clear finding is that China exercises less government command and control than the other BRIC group members (Brazil, Russia, and India). Thus the OECD study also fails to support claims of the power supremacy of Chinese bureaucracy.

29. Net assets of state-controlled manufacturing firms in China at year-end 2011 were RMB7.3 trillion, or \$1.1 trillion. An OECD study reports that the total value of state-owned enterprises in 27 OECD countries that responded to a survey was \$1.4 trillion. Of this amount, only 7 percent, or \$100 billion, was accounted for by manufacturing firms (Christiansen 2011, 7–8, 15).

30. The survey has only about a dozen very limited questions covering five specific sectors. For example, in the retail sector one question is whether shop opening hours are regulated. For professional services, one question is whether the government regulates the profession's advertising and marketing. Available at www.oecd.org/economy/pmr (accessed on July 17, 2014).

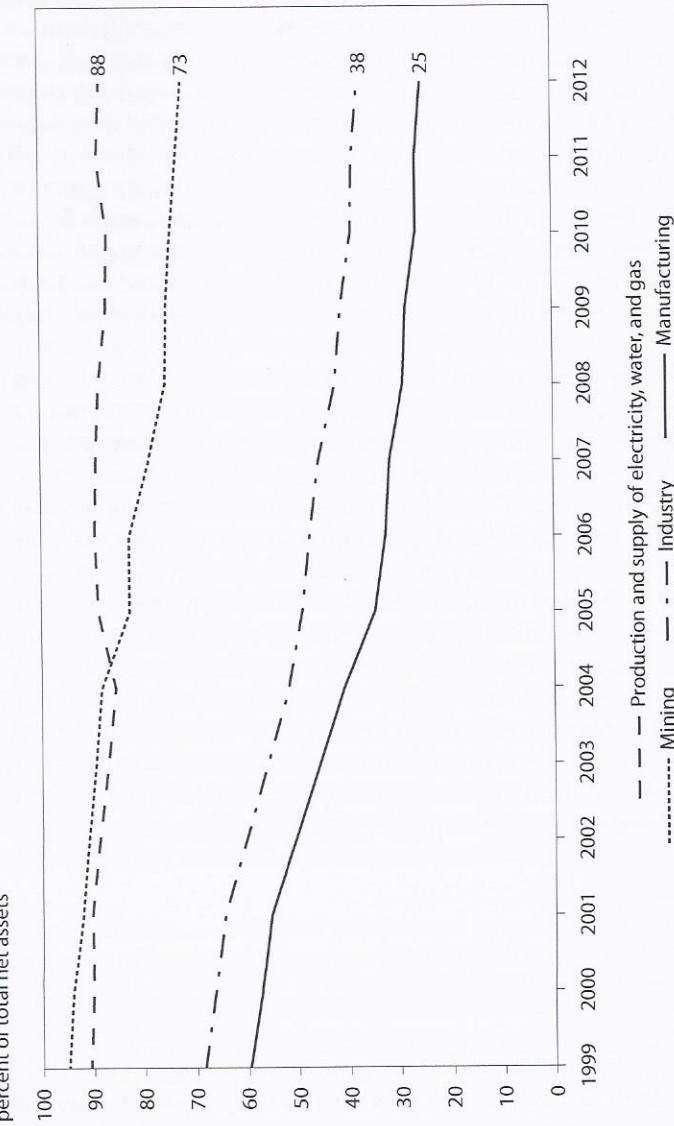
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Figure 4.6 State control of net assets by sector, 1999–2012



Sources: National Bureau of Statistics of China (2013c, 475–85); National Bureau of Statistics of China, www.stats.gov.cn (accessed on February 28, 2014).

It might be useful to examine not just the pervasiveness but also the effectiveness of regulations, which the OECD survey does not. As a first approximation, it appears that the regulatory power of China's central government in the economic domain is strong primarily when its objectives align well with the interests of provincial and local governments. When this alignment is lacking, Beijing struggles to achieve its regulatory objectives. The difficulties the central government has had in engineering consolidations in the steel and automobile industries and in enforcement of environmental regulations illustrate this point.

The government since 2003 has sought to consolidate steel production in a smaller number of technologically efficient and profitable large enterprises (Naughton 2009). They provided explicit support to three large steel mills—Baogang, Angang, and Wugang—in an attempt to create what some call national champions. Simultaneously, the central government sought to shut down low-tech and small-scale steel mills. The initial government efforts produced little result, so in April 2007 the National Development and Reform Commission negotiated and signed specific compliance contracts with provincial government leaders in the 10 biggest steel-producing provinces calling for the closure of steel mills with 78 million metric tons of steel capacity. This plan, too, failed; local governments actually increased their investment in steel production (Naughton 2009). In 2009 the State Council launched another steel consolidation campaign that sought to increase the share of national steel production of the top five steel producers to 45 percent by 2011.³¹

None of these campaigns achieved its objective. When the first campaign was launched in 2003, China had 4,100 steel companies; 485 of these companies were state owned (National Bureau of Statistics of China 2004, 518, 528). By 2011 the number of steel firms had expanded to 6,742; 312 of these companies were state owned (National Bureau of Statistics of China 2012b, 502, 512). Thus the government had achieved a one-third reduction in the number of state owned firms. But it had no ability to control private firms, the numbers of which expanded from 3,600 in 2003 to more than 6,200 in 2011.³² Local governments had no interest in blocking the entry of these profitable private firms into the industry since they hired local workers and paid tax revenues, a share of which accrued to the local government. The result, already noted in chapter 1, was that the share of production of the top handful of steel firms actually shrank rather than expanded.³³

31. State Council, "Steel Sector Adjustment and Revitalization Plan," March 20, 2009. Available at www.gov.cn (accessed on November 12, 2013).

32. About two-thirds of these are registered private firms; the balance are limited liability companies or shareholding limited companies in which the majority or dominant owner is private.

33. By 2011 the share of the top five steel producers was only 30 percent, far short of the goal of 45 percent.

The central government's efforts to consolidate the vehicle industry likewise illustrate the weakness of Beijing's regulatory powers. China has long had an exceptionally large number of assembly plants, in part because almost every province has sought to develop its own production capacity. In 1995, for example, China had 122 assembly plants producing only 1.45 million units, meaning the average annual volume per firm was only 12,000 vehicles. Only 15 of these plants produced cars, but given national output of 326,000 cars, output per plant was far below the level that would capture economies of scale. "As a result China had the most fragmented motor vehicle industry in the world."³⁴ The central government since 1994 has repeatedly sought to consolidate the industry. The goal was to create three or four globally competitive auto producers by 2010.³⁵ This effort was not entirely successful. While a few assembly plants now do account for a much larger share of auto production than was the case 20 years ago, the majority of these plants are joint ventures between state and foreign firms. There are still many domestic automakers producing relatively high-cost, low-quality vehicles. As a result, the market share of domestic passenger cars peaked at 31 percent in 2010, fell to 27 percent in 2013, and then to less than 23 percent in the first two months of 2014. Moreover, exports of these brands are tiny. "The country that boasts the world's biggest car market, unlike Japan and Korea before it, thus far has failed to produce a national champion of its own that can compete globally."³⁶ While some argue that China has sought to promote economic growth through industrial policies that are more far reaching than those in post-World War II Japan and Korea, so far these policies have achieved limited success in China's auto industry.

The long-term deterioration of China's environment is also due in part to the weakness of the Chinese state. With a population about five times that of the United States, China's central environmental protection bureaucracy employs only one-sixth of the workers the United States does; spending on environmental protection is woefully inadequate; and there is no central environmental agency or commission that is even "capable of convening the full range of ministries necessary to resolve many complex environmental challenges that cross bureaucratic boundaries" (Economy 2010, 277). The increasing importance the central government attaches to addressing environmental issues was reflected in the upgrading to cabinet level of the previous National Environmental Protection Administration and its renaming as the Ministry of Environmental Protection in 2008. But despite this enhanced status, the ministry lacks jurisdiction over local environmental protection bureaus, which

34. Eric Thun, "Going Local: Foreign Investment, Local Development, and the Chinese Auto Sector," unpublished manuscript, May 2001.

35. State Council, "Notice concerning the promulgation of the 'auto industry policy,'" March 12, 1994. Available at <http://chinafindlaw.cn> (accessed on February 5, 2014).

36. Tom Mitchell, "Chinese carmakers yet to make their marque," *Financial Times*, February 14, 2014, p. 13; Tom Mitchell, "Chinese branded cars suffer sales fall," *Financial Times*, March 11, 2014, p. 11.

local governments control. These local governments typically prioritize economic growth over environmental protection. As a consequence, levels of funding are frequently so modest that one local bureau official responsible for enforcement of environmental regulations reported that he was unable to carry out required quarterly inspections of every factory in his district since "he lacked regular access to a car and thus could not get himself to the factories to perform the inspections" (Economy 2010, 115).

The examples of the steel and auto industries and environmental protection all suggest that the regulatory power of the state is weak when the objective is to accomplish something positive, like reshaping the ownership structure of an industry or enforcing environmental regulations. But state regulatory power can also be exercised in a negative direction, for example by imposing difficult licensing and other requirements to prevent the formation of new businesses. The Third Plenum document released in November 2013 calls specifically for the deepening of the reform of the "administrative examination and approval system" (行政审批制度), going so far as to call for the elimination of examination and approval in areas where the market can effectively regulate itself.

Premier Li Keqiang launched this policy in May 2013, shortly after taking office. He announced the goal of reducing government interference in the market and called specifically for a one-third reduction within one year in the number of items that required examination and approval by the State Council.³⁷ By the end of the year the State Council had either eliminated or transferred to lower administrative levels its examination and approval authority over about 300 items. Among those eliminated are the minimum capital requirements of RMB30,000, RMB100,000, and RMB5,000,000 to register a limited liability company, an individual limited liability company, and a shareholding limited corporation, respectively.³⁸ The latter reform has stimulated a surge of 43 percent in new company registrations in the first quarter of 2014 compared to the first quarter of 2013, when the capital requirements were in effect. Most of the new companies are small and thus presumably private.³⁹

These administrative reforms are likely to improve China's rankings in the World Bank's survey of the ease of doing business. In 2013, China ranked 96th out of 189 countries, essentially unchanged from its ranking of 93rd in 2007. In two components of the index, starting a business and ease of getting

37. Li Keqiang, "Speech at a videoconference meeting of the State Council on transforming and mobilizing the functions and powers of the bureaucracy," May 14, 2013. Available at www.gov.cn (accessed on January 23, 2014).

38. "Li Keqiang convenes a State Council Standing Committee meeting to dispose and carry out a reform of the company registered capital registration system to lower the cost of starting a business and stimulate social investment activity," October 27, 2013. Available at www.gov.cn (accessed on January 24, 2014).

39. Chen Dun, "Starting out with nothing, reaping rich rewards in the market," *China Daily*, May 20, 2014, p. 17.

construction permits, China ranked near the bottom, at 158th and 185th, respectively.⁴⁰ These rankings suggest that new business formation in China is weak.

However, these World Bank rankings seem detached from reality. In 2002 China had 2.6 million registered private businesses with registered capital of RMB2.48 trillion, employing 32.5 million workers. By 2012 these numbers had shot up to 10.9 million, RMB31.1 trillion, and 113 million, respectively.⁴¹ Over the same period the number of household businesses rose from 23.8 million, employing 47.4 million workers, with capital of RMB378 billion, to 40.6 million businesses, employing 86.3 million workers, with capital of RMB1.98 trillion (All-China Federation of Industry and Commerce 2013, 26, 30). In short, Chinese entrepreneurs created 25 million businesses in 10 years, discrediting the World Bank's contention that China is among the most difficult countries in the world to start a new business. Similarly, it is hard to credit the World Bank's assertion that it is very difficult to get a construction permit in a country where new starts (including homes, offices, and commercial buildings) rose from 428 million square meters in 2002 to over 2 billion square meters in 2013 (National Bureau of Statistics of China 2011a, 196; 2014a).

In sum, the evidence does not seem to support the view that the Chinese state exercises extraordinary regulatory power. The OECD survey of product market regulation shows that China makes less use of command and control than Brazil, India, and Russia, which with China make up the BRIC group. The central government is frequently unable to effectively use its regulatory power to reshape industries or enforce environmental regulations when its objectives are not aligned with those of local governments. And while the state has substantial power to regulate a broad range of activities through the formal administrative examination and approval system, this power has not impeded the extraordinarily rapid registration of new private businesses that now produce about two-thirds of China's GDP, up from nothing when reform began.

Debating the Role of the Market

Even as the rise of competitive markets since 1978 has increasingly allowed private firms to displace state firms over broad swaths of manufacturing and

40. International Finance Corporation and World Bank, *Doing Business*, available at www.doing-business.org (accessed on January 23, 2014). "Starting a business" measures the number of procedures, time, and cost for a small and medium-size limited liability company to start up and formally operate.

41. The data on the number of private businesses include branches. But based on a count excluding branches—that is, based on the concept of enterprise legal person—the growth of registered private businesses follows a similarly robust trajectory, from 1.3 million in 2001 to 5.9 million in 2012. The numbers in the text for 2002 and 2012 are for registered private businesses. In addition, in 2012 there were about 635,000 limited liability companies and shareholding limited companies where the majority or dominant owner was private (National Bureau of Statistics of China 2013c, 27–29).

to some extent in services, there has been a continuing, active debate in China concerning the degree to which the market should guide China's economic development. In the early years of reform, Chen Yun, who by the mid-1950s was the fifth ranked leader of the Chinese Communist Party and had served as minister of commerce and a member of the State Planning Commission, was a proponent of contracting down to the household and expanding the role of rural markets, price incentives, and private plots to stimulate agricultural production. These policies were similar to those he had advocated in the early 1960s to encourage rural recovery from the agricultural disaster induced by Mao's Great Leap Forward (Lardy and Lieberthal 1983). While he supported the role of the market and liberalized prices in agriculture and light industry, Chen had severe reservations about enhancing the role of market forces in other parts of the economy, particularly the heavy industrial sector. By the early 1980s Chen articulated the view that the market was like a bird that needed to be constrained by a cage, that is, the plan. If the plan was all encompassing, the cage would be too small and the bird would suffocate, an outcome Chen opposed. But if there was no plan, the bird would fly away—in other words, the market would be all powerful, leading potentially to economic imbalances such as excess investment and inflation, which could be avoided if the plan was given primacy over the market. Thus Chen was an advocate for market liberalization, but within a carefully and narrowly defined sphere (Bachman 1985, Vogel 2011).

By the mid-1980s Chen had clearly lost this debate, as the party approved an expansion of the role of the market far beyond the limits he favored and the role of the plan was substantially reduced, as analyzed in chapter 1. But the debate on the role of the market resurfaced in the mid-2000s, when some Chinese economists criticized what they regarded as China's excessively market-oriented economic reforms. The most prominent of these critics was Liu Guoguang, director of the Institute of Economics in the Chinese Academy of Social Sciences in the early 1980s, who wrote extensively on the relationship between plan and market and later served as president of the Academy. In 2006, long after he had retired, he wrote that the excessive reliance on the market was contributing to rapidly increasing income inequality and that the Chinese Communist Party would lose power if it did not rein in market reforms.⁴²

In the wake of the global financial crisis, internal critics of the market-centric model gained new strength (Freeman and Yuan 2011). Previously, it had been difficult for these critics, sometimes identified as the new leftists, to gain much traction against the widespread view that China should emulate the American market-oriented economic model, particularly its increasingly deregulated financial system. But the clear US origins of the global crisis provided new ammunition for Chinese critics to challenge the presumed superiority of the US market-based, deregulated financial system. Many of them argued that

42. Richard McGregor, "Challenging change: why an ever fiercer battle hinders China's march to the market," *Financial Times*, February 28, 2006, p. 11.

China should preserve a large role for state-owned enterprises, in part because their profits could be redistributed to alleviate growing income inequality (Kelly, Rasmussen, and Ek 2012, 24). Even some mainstream Chinese economists argue publicly that large state-owned enterprises should continue to play a leading role in China's future economic growth (Hu Angang 2012).

At the other end of the economic spectrum, more reform-oriented economists in China have used the phrase "the state advances while the private (sector) retreats" (国进民退) to criticize what they see as the resurgence of the state in response to the global financial crisis and the waning of the market-oriented reform impetus of earlier years. This group believes China's continued growth is threatened by the large claim that inefficient state enterprises have on resources (Kroeber 2012, 17). These economists championed the market-oriented economic reform agenda that was adopted by the party in November 2013.

While the debate in China over the appropriate role of the market is likely to continue, I anticipate that it will influence only the pace of reform, not its direction. In the coming decade, the role of the market is likely to further expand, in line with the vision laid out in the Third Plenum decision, for several reasons.

First, the rationales that were once and sometimes are still advanced in China to support a large and continuing role for state-owned enterprises are substantially less compelling than they were a decade or two ago. At one time it was argued that state-owned enterprises were essential to absorbing new entrants into the labor force, providing housing and a broad range of social services to their employees, and thus maintaining social stability. Similarly, it was argued that state-owned firms made disproportionate contributions to government fiscal revenue and that any reform that led to a smaller role for state-owned firms could significantly erode the government's fiscal position. Finally, some have argued that state-owned firms are an important source of innovation that will drive China up the technology ladder to higher and higher levels of per capita income. None of these arguments is very compelling.

As pointed out in chapter 3, employment in state and collective firms, which in 1978 accounted for all urban employment, today accounts for less than a fifth.⁴³ The absolute number of workers in state firms has been falling for years and by 2011 was not much more than estimates of the number of workers who lost their jobs in the downsizing of the state sector in the second half of the 1990s. In addition, the growth of China's labor force has slowed dramatically. In 1995–2010 the labor force grew at almost 1 percent per year. This pace is slowing to 0.3 percent in 2011–15, and over the next five years the labor force will actually shrink by 0.2 percent per year (World Bank 2012,

43. This figure includes firms in services and industry and incorporates both traditional state-owned firms and corporatized firms in which the state is the sole, majority, or dominant shareholder, plus employment in collective firms, which may be partially controlled or owned by local governments.

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in traditional state- or dominant share- or owned by local

9). So the challenge of labor force absorption is commensurately less. Taking both these factors into account, the case for retaining a large role for state firms to provide employment and thus contribute to the maintenance of social stability is extremely weak.

State companies once did provide both highly subsidized housing to more than 90 percent of their employees (including retirees), comprising half of all urban residents, and an array of free social services. For example, in the mid-1990s state-owned enterprises operated more than 18,000 schools with an enrollment of 6.1 million students, requiring 600,000 teachers and staff. Hospitals built, run, and paid for by state firms accounted for one-third of all hospital beds in China (Lardy 1998, 51). The cost of providing these services amounted to about 40 percent of the wage bill of a typical state firm (Broadman 1995, 9). The traditional dual role of state-owned firms as production units and providers of housing and social services was once an argument for maintaining a large role for state-owned firms.

But when the government began its campaign to downsize state-owned companies in the second half of the 1990s, it also launched programs that accelerated the sale of enterprise housing units to their employees and curtailed firm-provided social services. The sale of public housing on an experimental basis began as early as 1982 and picked up speed in 1988, when the National Housing Reform Plan was adopted. The principal goal was to encourage private ownership of housing (Zhang 2001, 69–70). Privatization accelerated significantly after mid-1998, when the state announced “the termination of the administratively planned housing distribution system,” which led state enterprises to sell off virtually all of their housing units to their employees, typically at relatively low prices (Ye, Song, and Tian 2010, 274). Through these reforms, housing has largely become a commodity allocated through the market.

The contribution of state firms to state fiscal resources has also eroded substantially. As already noted, state firms’ remission of profits to the Ministry of Finance was a key source of fiscal revenue at the outset of and in the early years of reform but diminished rapidly in the 1980s and was completely eliminated after 1993. Since then, the growth of fiscal revenue relative to GDP, as private businesses became increasingly important, shows that the Chinese government is perfectly capable of taxing private firms. It does so largely through the value-added tax and the corporate income tax, which are paid by all enterprises, regardless of ownership.

Finally, there is scant evidence that state firms are an important source of innovation in China. Indeed, the opposite may be the case. An analysis of listed Chinese state-owned companies shows that average research and development expenditures relative to sales revenue was well under 2 percent and falling in 2009–12, while 10 leading private companies had much higher and rising research and development expenditures, reaching 4.5 percent of sales revenue by 2012 (Ma, Shi, and Lan 2013, 30). The best macro evidence on the relative innovation performance of state firms was reviewed in chapter 3. A number of studies summarized there showed that state firms have lagged in the growth

of total factor productivity throughout the reform era. If state firms have an advantage in innovation, it should be reflected in higher growth of productivity than firms with other forms of ownership. It is not.

State firms are almost entirely absent from some of the most dynamic segments of the Chinese economy. Internet businesses, such as ecommerce, are perhaps the best example. China's e-tail revolution is being driven entirely by private firms, notably Taobao (Alibaba's online auction house), Tmall (Alibaba's online mall), and Tencent's Paipai. These three firms account for an enormous share of China's e-tailing market, which has been growing by more than 100 percent annually since 2003 and now accounts for a larger share of retail market transactions than e-tailing does in the United States (Dobbs et al. 2013, 1, 3).

These private internet firms also are exploiting the internet to make inroads into businesses traditionally dominated by state-owned companies. The increasing range of financial services offered by leading internet companies such as Alibaba poses an increasing competitive challenge to China's state-owned banks. Another example is Weixin (WeChat in English), an online chat platform introduced by Tencent at the beginning of 2011. It attracted more than 300 million users within two years of its introduction, crowding out a considerable portion of the traditional mobile phone text-message business offered by China's three state-owned telecom companies (Ma, Shi, and Lan 2013, 25).

A second reason to anticipate that the role of the market will continue to expand is the growing recognition by the party that the role of state must evolve in order to respond to increasingly urgent popular demands for cleaner air and water, safer food supplies, a stronger social safety net, and more inclusive economic growth. To meet these rising demands and new objectives, the state will need to cede a greater role for the market in resource allocation and to concentrate its own limited resources on providing the public goods and services that the market cannot supply.

Premier Li has expressed the critical need for this evolution in State Council documents, and it is one of the most important points endorsed by the Central Committee at its Third Plenum in the fall of 2013.⁴⁴ The plenum decision called for a "reduction of the direct role of the government in the allocation of resources" and the promotion of resource allocation "based on market principles, market prices, and market competition. The duties and functions of the government are mainly to maintain macroeconomic stability, strengthen and improve the provision of public services, guarantee fair competition, strengthen market supervision and management, safeguard market order, and

44. "Premier Li Keqiang convenes a State Council Standing Committee meeting on research to promote strengthening government provision of public goods and on plans to strengthen urban infrastructure construction," July 31, 2013. Available at www.gov.cn (accessed on February 14, 2014). State Council, "Guiding opinion concerning strengthening the government's provision of services to society," September 30, 2013. Available at www.gov.cn (accessed on February 14, 2014).

promote sustainable development.⁴⁵ So the state will continue to play a major role in the development of China's infrastructure and "will maintain control and operation of natural monopolies," presumably meaning public utilities such as supply of water and electricity and certain forms of transportation such as rail.⁴⁶ But it will eliminate its monopoly of other sectors and shift its attention increasingly to improving the environment, providing stronger and better-enforced regulations to improve food safety, and providing more subsidized housing and higher-quality health care and education, especially to underserved rural residents and migrants in urban areas. This shift can help to ensure more inclusive economic growth, another major party objective.

A third reason to anticipate that the role of the market will continue to expand is an increasingly broad consensus in China that the growth model of the past decade is dysfunctional and that continuing on the path of investment-driven growth entails unacceptably high risks for the Chinese Communist Party. China's bank-financed stimulus program, which started in the fourth quarter of 2008, has resulted in a large increase in the ratio of private credit to GDP. Including off-balance sheet credit and credit extended by nonbanks, this ratio has jumped by over 60 percentage points, from a little over 120 percent in 2008 to almost 200 percent by the end of 2013. Jon Anderson (2013a, 15) notes this increase is "one that is not only huge by Chinese historical standards but also places China near the top of the emerging market league tables in terms of the five-year increase in credit penetration." A number of analysts have pointed out that this increase is of a magnitude that has been observed in other countries before they have encountered financial crises, typically triggered by a sudden stop in credit growth or the collapse of an asset bubble.

There are several reasons to believe that the probability of such a crisis in China is low. First, all of the credit is domestic in origin, meaning China is not vulnerable to a sudden stop in foreign funding, as occurred in several countries at the time of the 1997 Asian financial crisis. Second, China's bank credit boom is largely financed by deposits rather than through the wholesale interbank market, which is more vulnerable to sudden stops. Most notably, China's systemically important financial institutions finance their loans entirely from deposits. These deposits are very "sticky" in all financial systems, but especially so in China, where the range of alternative financial assets available to households is quite limited. Third, there is almost no securitization of bank assets, a practice that contributed significantly to the financial crisis in the United States. Fourth, China has a national saving rate of around 50 percent, far and away the highest in the world, which makes financing a large credit buildup more feasible. Finally, it should be noted that, due to its very strong external position, China is not vulnerable to the capital outflows that have in a number

45. Chinese Communist Party Central Committee, "Decision on Major Issues Concerning Comprehensively Deepening Reforms," November 15, 2013. Available at www.gov.cn (accessed on December 17, 2013).

46. *Ibid.*, section 2.

of emerging market economies accompanied the so-called tapering in the pace of asset purchases by the US Federal Reserve. Several of these economies have been forced to raise interest rates in an attempt to reduce these outflows but are likely to suffer slower growth as a result.

While China's current high ratio of credit to GDP may not lead to a financial crisis, there is little doubt that the pace of credit expansion must soon begin to moderate to one that is less than the growth of nominal GDP so that the ratio of credit to GDP first plateaus and then falls. This deleveraging process will be painful for firms that have become more highly leveraged in recent years, particularly for those that are generating a return on assets that is less than their cost of capital. As noted in chapter 3, this is particularly a problem for state firms. Moreover, it is likely to be a more severe problem than might be anticipated simply by comparing the average return on assets of these firms with the cost of capital. The average returns of state firms as a group are pulled up by the outsized profits of a few state-owned companies such as China Mobile, CNOOC, and the China National Tobacco Corporation, so the median return of state firms is likely lower than the average. Consequently, many state firms will find deleveraging a painful process.

Moderation in credit growth, other things being equal, is likely to lead to slower growth. But if the party is successful in changing China's growth model, other things will not remain the same, and the impacts of a slowdown in growth can be at least partially ameliorated. As the reforms endorsed by the party at the Third Plenum are implemented, two results can be expected. First, more credit should flow to the private sector, where returns are much higher than for state firms. There is room for some expansion of the private sector even in manufacturing, where the most progress has been made. There are still tens of thousands of state manufacturing firms at the provincial and local levels that have returns less than the cost of capital. Unless increased competitive pressure leads to increased productivity, these firms should shrink or exit as the cost of capital rises. But, as noted above, the more substantial opportunities for the expansion of the private sector are in large swaths of the service sector, where competition has been much more limited and productivity of state firms particularly low. As reforms lead to a larger share of investment flowing to more productive private enterprises, particularly in services, the slowdown in growth will be proportionately less than the reduction in the share of investment in GDP.

Second, the reforms are likely to increase the pace of growth of private consumption relative to GDP growth. More rapid growth of the service sector, which is more labor intensive, will lead to more rapid growth of employment and wages, thus increasing the wage share of GDP. And higher real interest rates on household deposits will lead to an increase in household disposable income. These trends should be positive for consumption growth, thus partially offsetting the slowdown associated with a lower share of resources flowing to investment.

This process will take the better part of a decade, will involve significant transition costs, and will be opposed by the interest groups that have benefited disproportionately from the imbalanced growth of the past. But a party that has staked its legitimacy on delivering sustained growth of incomes and rising living standards for China's population is likely to act on the reform blueprint it adopted in the fall of 2013.