

# The Economics of China

## State Capitalism



Fall 2020

# State Capitalism<sup>1</sup>

- We said that the economic system in China today is not socialist anymore.
- So, is the economic system in China today the same as a typical Western capitalist system?
- The answer is no.
- Are all capitalist systems in the West (Europe and North America) identical?
- The answer is also no.

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<sup>1</sup>These slides are based on: "State Capitalism and the Chinese Economic Miracle", pages 1 to 21 in Naughton, B., & Tsai, K. S. (Eds.). (2015). State capitalism, institutional adaptation, and the Chinese miracle. Cambridge University Press.

- "the "varieties of capitalism" (VOC) approach (Hall and Soskice 2001) distinguished between **two broad types of capitalism**:"
  - liberal market economies (LMEs): examples include the United States and the United Kingdom (Britain).
  - coordinated market economies (CMEs): for example Germany.
- "The VOC approach focused on how larger institutional constraints shape the strategic interaction of firms to resolve coordination problems in five key areas":
  - "industrial relations, education and training, corporate finance, interfirm relations, and corporate governance."
- One of the main differences between LMEs and CMEs is that market arrangements are more prevalent in LMEs while nonmarket contracting relationships are more prevalent in CMEs.

- "the logic of VOC is fundamentally firm-centric."
- "In VOC, decisions about corporate governance, vocational training, finance, and industrial relations are made by individual corporations in strategic interaction with other actors."
- **In China,"so many of the key institutional interactions and complementarities are run through government agencies".**
- This means that "trying to determine whether China is moving toward a well-defined model of LME versus CME obscures the defining role of the state in China's reform process.
- Hence, the authors "conclude that **China's system is neither LME nor CME"**.

# State Capitalism

- China and the "developmental states of East Asia".
- These states include Japan, South Korea, and Taiwan.
- "Chalmers Johnson (1982) observed,
  - A state attempting to match the economic achievements of Japan must adopt the same priorities as Japan. It must first of all be a **developmental state** – and only then a regulatory state, a welfare state, an equality state, or whatever other kind of functional state a society may wish to adopt. (p. 306)"
- Conditions surrounding the rise of the East Asian developmental state model:
  - land reform.
  - state prioritization of industrialization.
  - social stability under authoritarian rule.
  - U.S. security umbrella.

- Characteristics of government policies in the "developmental states of East Asia".
  - market-oriented.
  - bureaucratic discipline.
  - selection of industrial winners.
  - directed credit to the private sector.
  - export-promoting strategies.
  - protection of domestic firms.
  - Low levels of Foreign Direct Investment (FDI).

# State Capitalism

- "we observe clearly that in the cases of Japan, Korea, and Taiwan, their 'developmental state' institutions were fully in place for only the thirty years or so during which their economies were undergoing their growth miracles".
- By the end of the 20th century, "many of the (originally classified) developmental states moved away from various statist instruments, opening their economies and adopting some elements of a liberal market economy."
- "While China's state capitalist system was not in place at the beginning of China's growth miracle, it developed in tandem with the acceleration of growth, and it was shaped by the desire of China's leaders to facilitate rapid growth".
- Therefore, despite having things in common with the East Asian developmental state model, this term does not fully capture the economic system of China today and the government's role in it.

- So, the economic system in China today is not socialist, not entirely a liberal market system, not entirely a coordinated market system, and not entirely an East Asian developmental state system.
- What is it then?
- The authors of this chapter give the following name for China's economic system today: "State Capitalism".
- "It is a twenty-first century version of state capitalism".



# State Capitalism

- What is "State Capitalism"?
  - More than one definition was put forward.
  - The term was (probably) first used by Lenin in a different context.
  - Later, "...state capitalism has been used in a derogatory manner by Marxists as well as neo-liberals".
- A "definition" of State Capitalism as applied to China's economic system today can be inferred from this chapter as follows:
  - **State Capitalism refers to the prominence and maintenance of "a strong and robust" state (business) sector state in a predominantly market economy.**
  - Hence, the term "captures China's combination of a predominantly market economy, emerging capital markets, and large and important government-owned corporations".

- "After 2003, the position and role of state firms stabilized, and, crucially, profitability soared."
- "Today, understanding state firms is important for interpreting virtually every aspect of China's economy and politics."
- "China has developed a distinctive form of state capitalism in which state-owned enterprises remain central to its evolving model of political economy."
- That being said, "SOEs dominate sectors that are either strategic, or not "naturally" competitive – meaning sectors frequently characterized by regulated monopolies or state ownership in many countries in the world."

- Three "tiers" in the current Chinese economy.
- Another author in the book<sup>2</sup>, Pearson, divides the economic sectors in China into three tiers, "each characterized by a distinctive pattern of regulatory institutions".
  - Top tier: dominated by state.
  - Middle tier: mixed.
  - Bottom tier: dominated by private firms.

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<sup>2</sup>Naughton, B., & Tsai, K. S. (Eds.). (2015). State capitalism, institutional adaptation, and the Chinese miracle. Cambridge University Press.

- The top tier:
  - **strategic industries.**
  - pervasive state ownership.
  - typically managed directly by the central government.
- "the establishment of the State Asset Supervision and Administrative Commission (SASAC) in 2003 represented an important movement toward an 'ownership agency'" under which state owned enterprises (SOEs) fall.
- "On establishment, more than **two-thirds of SASAC's assets** were in four sectors: **oil and petrochemicals; electricity; telecommunications; and military industry.**"

- The middle tier:
  - production is efficient at a less than gigantic scale
  - no immediate national strategic interest is at stake.
  - entry barriers are modest
  - State ownership has become much less prominent
- "Middle-tier firms operate in important sectors, such as machinery and autos, chemicals, and pharmaceuticals, which are **less immediately strategic**".
- "Middle-tier firms are exposed to global competition".
- "these are sectors in which technological dynamism and relations with foreign firms are critical to China's future".

# State Capitalism

- "As a result, the government tends to treat them with a light touch".
- "Despite the state's relatively light touch, state ownership is by no means absent in these dynamic middle-tier sectors".
- "The **state firms in the middle tier** are much more likely to be owned by **subnational levels of government**, such as provinces and municipalities".
- Individual state firms that have shown themselves able to survive competitive pressures, and which are viewed as having accumulated significant specialized expertise, are preferentially supported as potential national champions.
- "For now, the middle tier is strongly characterized by light regulation, competitive markets with an important role for state firms, and a nascent effort at governmental steerage through industrial policy".
- Therefore in this tier, "local state firms mix and compete with private firms".

- The bottom tier:
  - consumer-oriented, light manufacturing, and export-oriented sectors.
  - Many (private) small and medium enterprises operate in these sectors.
  - In contrast, SOEs "have largely retreated" from the bottom tier

# State Capitalism

- SOEs and corporate governance.
- "The position of state enterprises in China's economy today reflects substantial improvements in their corporate governance".
- "Ownership rights are more clearly specified than before, and incentive systems have been clarified and rationalized".
- Therefore, recently:
  - In principle, the government's role in SOEs is an "asset holder for the public".
  - "The Chinese government seeks to maintain and increase the value of a range of public assets".
  - "corporate managers have been given more freedom and also clearer direction about how to maximize value".
- "The improvement in Chinese corporate governance coincided with a wave of disillusionment with the U.S. model of corporate governance following the global financial crisis of 2008–9".



- The Purposes of Public Ownership:
  - **Security:** "traditional national defense" and "economic security" like energy and resource security for example in the case of oil SOEs.
  - Meeting some **policy goals and contributing to future growth.**
  - For example, "China's state-owned firms are being ordered to become technologically dynamic, foster the adoption of "indigenous innovation," and lead China on its way to becoming an innovative society".

- " **Seven** defining characteristics of Chinese state capitalism as it has emerged in the early twenty-first-century includes the following:"
  - 1. Direct central state control of strategic sectors: telecommunications, electricity, petroleum and defense industries, as well as finance.
  - 2. Party control: "state" control is in fact exercised by the dual intertwined hierarchies of state and party.
  - 3. Market foundation: Large swaths of the economy operate on a predominantly market basis, and foreign-invested corporations have a large and prominent role in many sectors of the economy.

- "Seven defining characteristics of Chinese state capitalism as it has emerged in the early twenty-first-century includes the following:"
  - 4. Industrial policy: In China, industrial policy represents a kind of interactive developmentalism, communicating to decentralized decision makers some of their options and constraints.
  - 5. State control over finance: state-owned banks remain dominant, and state firms have significant presence in stock markets.
  - 6. Regulatory fragmentation and layering.
  - 7. Dualistic welfare regime.

- "Ultimately, China's form of state capitalism rests on a dual structure."
- " In this structure, top-down state-guided initiatives and governance are tempered and balanced by bottom-up (often private) entrepreneurial forces."