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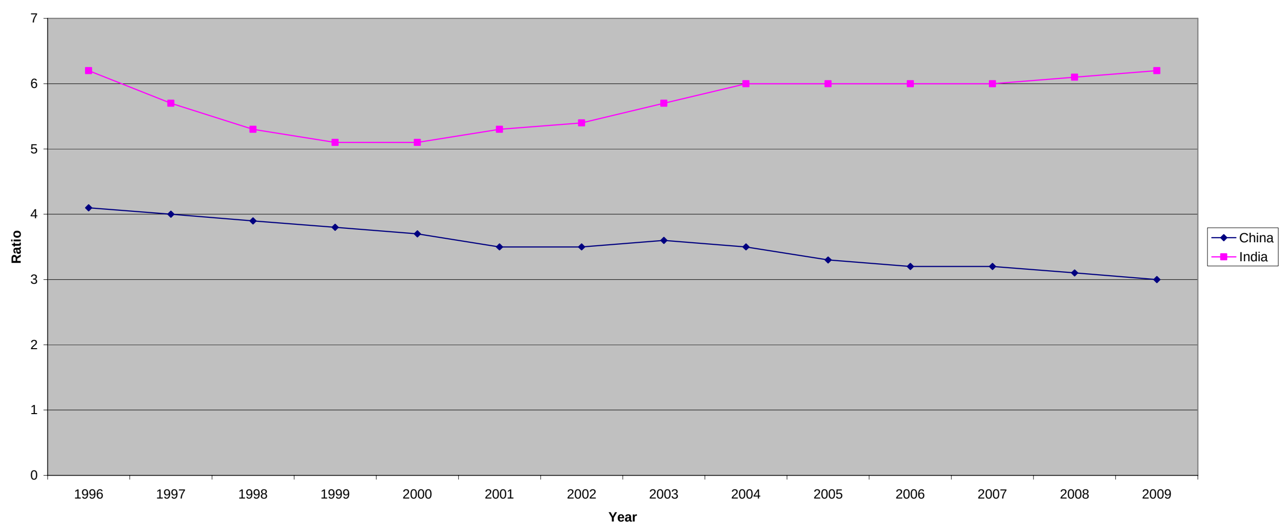
Statement Before the U.S.-China Economic and Security Review Commission
Hearing on the *Extent of the Government's Control of China's Economy, and Implications for the United States*
May 24-25, 2007

I would like to thank the members of the US-China Economic and Security Review Commission, and in particular the Co-Chairs, Mr. Michael R. Wessel, Ms. Kerri Houston and Mr. Jeffrey Feidler, and their staff, for the opportunity to address the USCC today on "The Extent of the Government's Control of China's Economy, and its Impact on the United States".

My testimony derives from over 15 years of research on the business environments in China. In my testimony I will show that the Communist Party of China (CPC), through the Chinese government, thoroughly dominates China's economy, and seeks to continue dominating it through maintaining and enhancing control of its major State-Owned Enterprises (SOEs). The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) exists to manage the CPC's efforts to control more effectively China's SOEs while increasing the SOEs' economic returns, and maintaining the political returns, to the government. Our research has shown that, despite permitting private enterprise, over that last decade, the Chinese government's share of consumption in China has increased substantially[1].

Figure 1
Ratio of Private to Government Consumption



[1] Haley, U. C. V. and Haley, G. T. (2006) "The Elephant and the Tiger: Differing Development Strategies for India and China and Effects on Business Environments", Indian Journal of Economics and Business, India China Special Issue, pp. 131-46.

1. SOEs and China's Developmental and Industrial Policies

Beijing sets non-profit oriented goals for the state-owned enterprises (SOEs) to accomplish, and thereby uses the SOEs to further its industrial policies. These goals may require that SOEs make suboptimal decisions for political rather than economic or developmental purposes. For example, SOEs may be required to establish multiple plants in different geographic locales rather than consolidate production to gain economies of scale or to take advantage of transportation facilities better suited for distributing production, or which are in close proximity to their markets. Alternatively, SOEs may be required to price their products at under market value so as to expand domestic or international market shares more rapidly.

Though the focus of this hearing is on SOEs, I would like to add that China's private companies are also often used to further its goals. Examples surface of using both SOEs and private companies to further Beijing's ambitions in the area of natural resources. China will soon be faced with importing 50% of its oil and natural gas (in the form of liquefied natural gas) and it is determined not to be at the mercy of supplier nations/companies. Hence, China National Offshore Oil Company (CNOOC) engaged in an abortive attempt to purchase the US's UNOCAL. This effort was unsuccessful, but others have not been. For example:

A.) West African oil has proved successful for Beijing. In recent years, Western oil companies have been withdrawing from mainland facilities in West Africa due to violence on the part of bandits, revolutionaries and local terrorists. The oil companies now maintain a presence only on deep-sea drilling rigs. West Africa only possesses about 4% of proven oil reserves, and its deep-sea fields, West Africa's largest, remain under control of Western firms. Yet, the oil flowing through West Africa's Chinese controlled refineries, regardless of whether it comes from Chinese land-based oil fields or the Western companies' deep-sea fields, now is mostly committed to China.

B.) Husky Oil's oil-sand project proved successful for Beijing. Canada's Husky Oil is privately owned with the controlling interest held by Mr. Li Ka-shing of Hong Kong. Husky Oil has very large oil-sand deposits and is, presently, the company furthest along in developing economically viable extraction processes. The most economically desirable method of transporting this product to world markets was to build a pipeline from the project to the Northern tier of the US pipeline network. At the time the decision on how to transport the project's oil to market was being made, there appeared several substantial rumors that Chinese government interests wanted to buy Mr. Li's controlling share of Husky Oil. The Canadian press and some Canadian legislators began to question the wisdom of permitting a foreign government to take over Canada's fifth-largest company. When Husky Oil made the decision to build a pipeline to the Canadian port of Edmonton, with participation by the Chinese government, the rumors of a Chinese government purchase of Husky Oil ended.

SOEs lie at the core of the government's industrial policy: the Chinese government plans to control the economy by owning the three largest firms in each of six heavyweight and seven strategic industries, and to develop 150 SOE global champions. Many Western policy analysts do not believe that efficient, profitable SOEs can emerge. Yet:

1.) Chinese policy makers do not accept Western economic thought as the only road to economic success;
2.) Chinese expectations of acceptable profitability do not necessarily correspond to Western expectations;
3.) Chinese policy makers view the bottom line differently than do Westerners – technology acquisition is a key goal in the operation of any Chinese company, even if it means surrendering profitability;
4.) Chinese policy makers also view successful use of SOEs as instruments to obtain foreign policy goals as part of the SOEs' profits;
5.) Historically, any Chinese SOE, especially a major one, has been able to rely on government bailouts whenever it got into trouble – just as BOE Technology group, China's largest flat-panel display maker, is lobbying for at this time.

As mentioned above, two goals of the Chinese government are to minimize China's energy dependence on non-Chinese assets and to acquire technology. In demonstration of Chinese SOEs serving as extensions their government, since 2001, about 80% of major overseas acquisitions have been in two sectors – technology and communications, and natural resources.

2. "Grasping the Large, and Letting the Small Go"

The 15th Communist Party Congress formed a policy known as "grasping the large, and letting the small go" to guide the management of SOEs. To quote Ecclesiastes, the slogan says that, in China, "That which has been is what will be, that which is done is what will be done, and there is nothing new under the sun." China's government is determined to maintain control over its economy and society. The slogan, developed by Zhu Rongji, then China's Premier, showed the government's pragmatic recognition that in the more complex economic world that China was moving towards, China's bureaucrats could not control every detail, so they should focus on controlling the most important details, i.e., 'the large'. China's ambitions, both industrial and political, remain the same. The Chinese government intends to carve out a lion's share of the world's economy and political power/prestige while maintaining the Communist Party of China's (CPC's) absolute control of China. The large comprises the seven industries the government considers strategic and the six industries the government feels are heavyweight industries that most heavily influence economic performance and growth.

The seven strategic industries are:

1.) **armaments,**
2.) **power generation and distribution,**
3.) **oil and petrochemicals,**
4.) **telecommunications,**
5.) **coal,**
6.) **aviation, and**
7.) **shipping**.

The six heavyweight industries are:

1.) **machinery,**
2.) **automobiles,**
3.) **information technology,**
4.) **construction,**
5.) **iron and steel and**
6.) **non-ferrous metals.**

China, or more correctly the CPC, through SASAC, seeks to maintain absolute control of the seven strategic industries, and to maintain a dominant presence in the six heavyweight industries. In both instances the CPC seeks control through SASAC's control of government SOEs (China's big 4 Banks are not under SASAC's authority, but under the authority of the "Huijin Corporation'). Control occurs, just as in ancient imperial times, at both the central government level and the provincial levels. Provincial SASACs will receive guidance from the central government's SASAC, but will operate largely independently of the Center under the control of the provincial CPC Cadres. This is, again, consistent with historic tendencies in both China's modern-day Communist era and in China's Imperial era.

3. SASAC's Formal and Informal Structures

SASAC's Structure
SASAC's original purpose was to introduce and to promulgate capital-budgeting procedures in China's governing bodies and SOEs. SASAC follows a typical structure for a Chinese bureaucracy. A national agency governs the largest Chinese SOEs, and similar provincial agencies govern the larger provincial, municipal and township SOEs. Some of the wealthier provinces' SASACs, such as Guangdong's and Zhejiang's, are ahead of the Center in reforming their various governing units' SOEs and budgetary practices; most lag far behind. Since being named the founding Chairman, Mr. Li Rongrong has successfully increased the scope of SASAC's duties and powers to make it more akin to a highly powerful, intrusive and activist holding company's board.

SASAC's Membership
To a great extent, SASAC's governing board evaluates and supervises clones of itself. The short bios of SASAC's Chairman, Vice-Chairmen and Vice Chairwoman presented in Exhibit 1 of the attached documents demonstrate what I mean. Three of these administrators, including the Chairman, Li Rongrong, started their careers working in China's SOEs; four of them have experience in several of the CPC's Discipline Committees, the primary tool the CPC uses to root out corruption and ensure good governance. Given their similar experiences and backgrounds, today's administrators will probably not develop a ruse or trick SASAC's board members have not already conceived or tried in the past.

The Ties of SASAC's Board Members
SASAC's Board is well connected politically and some of these connections go back for a long time.

Along with the other Politburo members, Li Rongrong is a member of the CPC's Central Committee, and along with Mr. Huang Ju, he is a member of the Standing Committee. He also has strong ties to Premier Wen and former Premier Jhu Rongji's economic reform wing of the CPC.

Two of SASAC's board members, Mr. Wang Ruixiang and Ms. Huang Danhua, have spent time in the higher echelons of the Communist Youth League (CYL), one of President Hu's primary bases of power. Ms. Huang, though serving at a different time, served in the Secretariat of the Central Committee of the CYL, and is likely to have ties to President Hu. Though Mr. Wang never reached as high a position as Ms. Huang, he served as a student representative of the CYL when Hu was its President and is likely to have ties to President Hu as well.

Li Wei's term as Secretary of the CPC in Shanghai overlapped with Huang Ju's term there in the same office.

Huang Shuhe and Huang Danhua, serve on the CPC's Central Commission for Discipline Inspection along with the Politburo Standing Committee's Wu Guanzheng.

So far, Li Rongrong, Director of the Center's SASAC seems to have at least minimized the appointment of incompetent political appointees to the Center's SASAC and the SOEs under its direction. However, the CPC's local provincial cadres control appointments at the provincial level. Consequently, some of the provincial SASACs and their SOEs seem rife with incompetent, political appointees, especially in the poorer provinces that can least afford them.

The biggest threat to 'SASAC Rising,' is not the disloyalty of its appointees, but their level of competence. Li and SASAC have had increasing difficulty hiring the technically competent people they need from local sources. SASAC has begun two programs to address this problem.

1.) In 2006, through the PRC Embassy in Canada, SASAC hired 81 Overseas Chinese from Canada. Though technically skilled, these recent hires may not have the political skills or connections to prosper in China's bureaucracy. By Chinese standards, these people are being paid princely sums, and jealous colleagues may be waiting for the slightest chance to trip them up and exploit a political failing.
2.) SASAC has contracted with one of Europe's best business schools, HEC, to provide an Executive MBA degree program for SASAC's personnel and Chinese SOEs' executives (the promotional materials are included in the attached documents).

As Chairman of SASAC, Li has performed remarkably well, but without Premier Wen's strong support, which he currently has, and President Hu's support, he could not have garnered his victories. The Ministry of Finance, from who's hide many of SASAC's powers and prerogatives have been carved, has been fighting a rearguard action in defense of its turf. The Ministry would have won a substantial number of past battles with SASAC had Premier Wen supported Li less strongly. Another threat to 'SASAC Rising' is a new political faction, The New Left. It is rising in power on the platform that SASAC and China's other agencies of economic reform are creating a draconian, harsh form of capitalism that does not sufficiently care for workers, peasants and the other poor.

SASAC's Power to Control SOE's Executives
All senior bureaucrats in SASAC, either in the central unit or the provincial units, and all senior executives in SOEs, whatever their qualifications or capabilities, have some things in common:

1.) They have been screened and found to be loyal members of the CPC.
2.) Company directors appointed by SASAC remain loyal to SASAC, and through SASAC, if they do not have higher connections in the CPC, to the CPC.
3.) They are basically supervising clones of themselves.

They are not likely to have much trouble enforcing loyalty to the CPC among the managers of China's SOEs. Chapter 3 of the **Interim Regulations on Supervision and Management of State-owned Assets of Enterprises** states the following:

> "**Article 16** The State-owned assets supervision and administration authority shall establish and improve the mechanism for selecting and appointing the responsible persons of enterprises and the mechanism of incentives and restraints that meet the requirements of modern enterprise system.
> **Article 17** The State-owned assets supervision and administration authority appoints or removes, or makes a proposal to appoint or remove, the responsible persons of its invested enterprises in accordance with the relevant provisions:
> (1) appoint or remove the general manager, deputy general manager, chief accountant or other responsible persons of a wholly State-owned enterprise;
> (2) appoint or remove the chairman, vice chairman, or director of the board of a wholly State-owned company, and make a proposal to the company for the appointment or removal of the general manager, deputy general manager, or chief accountant, etc.;
> (3) nominate the candidate for the director of the board or supervisor to be dispatched to a State-owned holding company according to the company's articles of association, recommend the candidate for the chairman or vice-chairman of the board, or the chairman of the supervisory panel of a State-owned holding company, and make a proposal to the company on the candidate for the general manager, deputy general manager, or chief accountant;
> (4) nominate the candidate for the director of the board or supervisor to be dispatched to a company with State-owned equity according to the company's articles of association"

Thus, SASAC has full authority over the appointment and replacement of SOE officers. Other articles within the authorizing promulgation (No. 378) issued on May 27, 2003, also give SASAC control over evaluating and compensating SOE executives, and over the policies that SOEs should follow.

Final Observation
President Hu is not President Gorbachev; he will tolerate neither his fall from power nor the CPC's fall from power. Indeed, if past behaviors offer ability to predict, Hu will do whatever is necessary to maintain his and the CPC's power. His willingness to employ ruthless brute power if necessary was demonstrated when he was Party Secretary of the Tibet Autonomous Region.

4. Provincial and State Governments' Support for SOEs

Provincial/state and municipal governments offer many kinds of support and advantages to SOEs. As shown in earlier testimony to the USCC,[2] support includes subsidies like:

- **A.) Low Cost Loans:** Provincial governments use their influence over the state banks to ensure that SOEs receive low-cost and even free loans that amount to an outright transfer of capital.
- **B.) Asset Injections:** Provincial and municipal governments transfer assets, such as toll roads and toll bridges to their SOEs at prices far below market value or replacement costs.
- **C.) Subsidized Purchasing:** Provincial and municipal governments subsidize purchases of equipment, component parts, raw materials and supplies at below-market prices or below costs through sales from one SOE to another or through pressuring their suppliers to do so.
- **D.) Tax Breaks:** Provincial and municipal governments provide tax breaks of various types to their own SOEs. Tax breaks include reduced utility tax breaks, reduced income based taxes and reduced general taxes.
- **E.) Energy Subsidies:** Provincial and municipal governments sell their SOEs energy and other utilities at below market prices.
- **F.) Land Subsidies:** Provincial and municipal governments consolidate land parcels and sell them to their SOEs at below-market prices.
- **G.) Purchasing:** Provincial and municipal governments purchase goods and services from their SOEs at above-market prices, higher than less well-connected companies' lower bids.

A host of government and networks provide other advantages. The following are among the most common advantages that Chinese SOEs receive:

- **A.) Special Market Information:** Provincial and municipal governments provide their SOEs with what, in the US, would be considered insider information. They are provided with future government plans that will affect the SOEs or their markets, expected price levels to obtain a contract, and a host of other desirable kinds of information.
- **B.) Control over Distribution Channels:** Through their control over local distribution channels, provincial and/or municipal governments and the People's Liberation Army will sometimes block a competitor's products from getting to its markets.
- **C.) Labor Controls:** Chinese workers are controlled through the Dang'an (a worker's employment dossier; many people claim they are no longer used). Without a favorable record and recommendation a worker cannot get a job. In addition, the provinces and municipal governments also control people though the use of the prison labor or admitting more legal immigrants from rural areas into their labor markets.

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[2] Haley, Usha C. V. (2006), USCC Hearing on *China's World Trade Compliance: Industrial Subsidies and the Impact on U.S. and World Markets*

- **D.) Stock Listings:** Provincial and municipal governments' assistance in getting their SOEs listed on one of the Chinese stock exchanges is one of the most devastating advantages that they can render to their SOEs. By arranging for SOEs to have preference over competing private companies, the governments can arrange to provide SOEs with low cost capital formation through the provision of equity financing. Even worse, they deny their private companies the financing they need to grow and compete more effectively.
- **E.) Preferential Supply Contracts:** SOEs are given preference in contracts to supply government agencies thereby helping to ensure economies of scale.

5. Chinese SOEs, Outward FDI and Global Competitiveness

SOEs are extremely active abroad. Lenovo, the purchaser of IBM's PC division, and China's leading appliance company, Haier, are just the two best known examples of SOEs active outside China's domestic market. TCL is another SOE. TCL gained control of the RCA brand name when it formed a joint venture with French consumer electronics firm, Thompson Electronics, in their television operations. After running significant losses and failing to turn the joint venture's European operations around, TCL recently closed down its European operations. Other Chinese SOEs active outside the PRC's borders are generally less well known, however they are probably more detrimental to US and international competition. For example, Chinese steel companies, when local demand dries up, enter the international markets, dumping steel and creating a glut. Besides its abortive attempt to buy control of UNOCAL, CNOOC has also been very active and successful.

CNOOC, along with two other Chinese petroleum SOEs, China National Petrochemical (Sinopec) and Petro China, has aggressively pushed into Africa to acquire oil rights and supplies: 30% plus of China's oil imports now come from Africa. Using a combination of aid, debt forgiveness, technology transfer and a willingness to operate in high risk areas, China has developed oil supply agreements with 20 African nations, including Sudan, and now imports more oil from Angola than from Saudi Arabia. One reason for today's high price of oil is the growing demand for oil from China and its success at acquiring its supplies. China's success at acquiring oil resources is why the shipment of Husky's oil sands production through the Northern tier of the US pipeline system was a goal of the present Bush Administration. The oil's shipment through a new, as yet to be constructed all-Canadian pipeline was considered a defeat for the administration.

In 2001, the Chinese government initiated the 'Go Outside' policy for Chinese companies. Since then Chinese companies have actively pursued overseas investments. In general, they have been good investors, but poor owners. The breakdown of the number and amount of Chinese Outward Direct Investment (ODI) is presented in Table 1. When taking a minority interest in a foreign company the Chinese have generally had good returns. When taking an ownership interest their results have not been so good. Lenovo has been overtaken by Taiwan's Acer Computers in worldwide market share. Lenovo is also having significant profitability problems due to a hypercompetitive domestic environment and an inability to ship sufficient computers to its fastest growing market, Europe. TCL has been forced to close it European operations.

Table 1[3]
Chinese Outward Foreign Direct Investment: 1986 – 2005

Type of Investment	No. of Deals	Avg. Deal Size in billions (US$)	Total Invested in billions (US$)
Minority Investment in Foreign Company-Overseas	186	0.052	9.6
Control Obtained of Foreign Company-Overseas	223	0.081	18.0
Minority Investment in Foreign Company/JV-Domestic	30	0.02	0.6
Control Obtained of Foreign Company/JV-Domestic	76	0.021	1.6

Chinese companies that invest overseas or enter foreign markets are supported by a host of government services, including:

- Low interest loans,
- Traditional commercial advocacy operations by diplomatic personnel,
- Databases on foreign business conditions,
- Databases on foreign regulatory conditions,
- Public relations and lobbyist firms to counter political backlash in controversial acquisitions
- Training and educational programs for the SOEs' executives (as Exhibit 2 showed).

Four basic reasons exist for Chinese ODI:

- Resource acquisition –such as the Chinese oil industry's push into Africa,
- Market entry and distribution channel acquisition – such as Lenovo's purchase of IBM's PC operations,
- Brand name acquisition – such as TCL's acquisition of, and TV joint venture with, Thompson Electronics,
- Technology/Brand acquisition – such as Shanghai Automotive's acquisition of MG Rover.

[3] Derived from Boston Consulting Group data

One consistent weakness of China's ODI and business environment arises from the domestic market's hyper-competitiveness, the lack of effective intellectual property rights protection in China, and the traditional Chinese emphasis on dominating distribution channels. Consequently, most Chinese companies have been unwilling to make the investments to develop their own brand names and corporate brand equity. Chinese SOEs have therefore had brand-name acquisition as one of the primary reasons guiding their ODI. In this respect Haier, the Chinese SOE appliance maker, and Li Ning, the private Chinese athletic wear company with distributions and operations in Europe, the Middle East, Asia, Africa and Latin America, have been groundbreaking exceptions. However, both companies have seen their domestic market margins shrivel as domestic competitors have poached on their reputations, logos and brand names.

In May 2007, the Chinese government created a new agency to invest a portion of its foreign reserves. The agency's first purchase of US$3 billion is for a 9.9% of Blackstone, the US buy-out fund, which is issuing a US$40 billion IPO.

US Misconceptions

No true market socialism exists in China. Market socialism presumes guarantees of minimum subsistence level benefits to the citizenry: yet, no such guarantees exist in China. However, contrary to US policy makers' beliefs, China is not moving toward a true market-based economy. Today's economic situation in China, and the economy towards which China is moving, bears a greater resemblance to the Confucian economy of the Imperial era than to any Western capitalist or socialist system. Confucian economies had a great deal in common with communist economies. First, like communist economic systems, Confucian Economies were subsistence economies. The masses were entitled to sufficient income to provide themselves and their families with housing and food, and additionally, a sufficient excess to honor their ancestors. All national income above this became the rulers' rightful properties. While Confucian economies did possess capitalist elements, the rulers retained control of all strategic technology and production. The rulers' mandarin bureaucrats viewed the merchant class with suspicion and actively persecuted merchants. Most Chinese merchants, regardless of how wealthy they became, died as paupers due to persecution by the mandarins. Everything China has sought to do with SASAC confirms that, whether it is doing so purposefully or not, it is seeking to return to China's Confucian roots. Given the CCP's intention to retain control of China's society and economy, a Confucian economic and political system would appear extremely appealing. Not only did the Confucian system seek to maintain the rulers' control of the economy, but Confucius believed no possible justification existed for rebelling against the rulers or limiting the rulers; freedom to act independently of any restrictions, such as laws and constitutions. Hence the rulers enjoyed absolute political power. Today's CCP desires nothing less than maintaining its own approximation of absolute political and economic power in China.