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“The Extent of the Government’s Control of China’s Economy, and Implications for the United States”

## **Introduction**

Members of the Commission, thank you for inviting me here today. It is an honor to testify before you about Chinese government involvement in their economy and the implications for American interests. I am a political science professor at Indiana University, and I have conducted research on government-business relations and China’s economic policy process for the past ten years. Although China’s economic policy process has become more transparent, particularly for those with a direct interest in the outcome of policy, understanding the origins and evolution of Chinese policy is still a daunting challenge to outsiders. China’s media devotes enormous attention to publicizing Chinese policies, but provides scant coverage to the debates that produced the policies to begin with. Because of the paucity of information about these topics in the Chinese press or scholarly world, my research is based primarily on interviews with executives from Chinese and multinational companies, business association representatives, Chinese and foreign government officials, the staff of international organizations, lawyers, and industry analysts. Over this period I have conducted almost 500 interviews in China and elsewhere with the aim of better understanding both the process and substance of China’s economic policies, including its foreign trade and investment policies.

I want to make three points in my testimony today. **First**, China’s economic policy process has evolved substantially over the last two decades. The process was originally monopolized by political elites and the bureaucracy, but now non-state actors, particularly from the business world and the scholarly community, are playing a greater role than ever. Hence, although China’s economic policies may appear to reflect a comprehensive and coherent strategy, they are more often the product of contentious debates, during both the drafting and implementation phases. As a result, Chinese policies develop gradually and do not have an internal consistency one would expect of a top-down system. **Second**, although China’s WTO entry presaged a new era of economic openness, certain segments of the Chinese government and industry, both state-owned and private, have over the last decade promoted protectionist industrial and trade policies rooted in exploiting loopholes in the WTO agreements. However, these efforts are regularly thwarted by those who favor continued liberalization, not just foreign businesses and their governments, but among Chinese industry as well. As a result, Chinese protectionist efforts have proven to be quite porous. China’s most successful industrial policies typically are ones that give due recognition to markets and China’s place in the global economy. **And third**, as a consequence, it would be a mistake for the US Congress to pass legislation that would restrict imports from China across the board or would sanction China for areas where greater liberalization is still needed. By and large, existing bilateral and multilateral frameworks are proving sufficient for defending American economic interests. While being vigilant against Chinese transgressions, the best way to meet the Chinese challenge over the long term is for the

US Congress and Executive branch to focus more attention on developing policies that strengthen America's economic fundamentals and improve the country's competitiveness in the global economy.

The rest of my testimony elaborates on these points. I have also provided the committee with several of my publications, which go into these issues in more depth.

### **China's Changing Policy Process**

In the 1970s and 1980s, it was common for Americans to speak of "Japan, Inc." in the belief that the Japanese government and industry cooperated in a unified front to promote the country's economy at the expense of foreign industry. The metaphor has recently begun to be applied to China, another East Asian country with a government deeply involved in the economy and a large trade surplus vis-a-vis the United States. Despite these similarities, terms such as "China, Inc." overstate the Chinese government's control over China's economy or the level of consensus between Chinese authorities and industry about the country's most appropriate industrial policies.

This impression may be the result of at least two factors. The first, as suggested above, is the very limited reporting by Chinese and foreign media on China's economic policy process. Since China's formal political system has not changed, one would not expect the policy process to have changed either. The second may be because the Chinese government and the Chinese Communist Party (CCP) still have important sources of leverage over China's state-owned enterprises (SOE). The management of SOEs are formally approved by the supervisory government agency and the Communist Party Organization Department. SOEs often need government approval for investments over a certain size, and they raise money from Chinese banks and the stock market, both of which are state-controlled. It is also common knowledge that the CCP often has a role in some of the day-to-day management functions of SOEs. Since the early 2000's, much of the direct regulation of SOEs has been shifted to the State-Owned Assets Supervision and Administration Commission (SASAC) at both the national and provincial level. Given such intervention, one would expect SOEs to be docile and obedient and rarely, if ever, challenge government policies.

What is striking is that despite the continuity in the political system and the continued official intervention in SOEs, China's economic policy process has changed considerably during the past two decades. The impetus for this change has been China's move to the market and the associated need to create a regulatory structure to replace the planned economy. The national government has passed thousands of laws and regulations governing every aspect of business behavior, including starting a company, raising capital, engaging in product development, manufacturing, labor, distribution, sales, and taxes. It is this web of regulations that have become increasingly important to the life chances of firms. As a result, firms, Chinese and foreign, have taken a greater interest in shaping policy.

There are four aspects of China's national economic policy process that should be highlighted:

First, although China's top central leadership has a veto over major economic policies, it typically does not involve itself in day-to-day economic policy decisions. Most policies are debated among the different parts of the bureaucracy and the National People's Congress. These bodies regularly have conflicting interests, and policies require extensive negotiations between different bureaucratic actors before they are adopted.

Second, companies of all ownership stripes and nationalities regularly lobby the central government bureaucracy and legislature on economic policies that affect their interests. Despite their natural links to the state, SOEs surprisingly do not always agree with policies governing their sectors, and they regularly speak up when their interests are at risk. Large domestic private companies and multinational firms, which obviously also have a stake in China's regulatory regime, have developed their own lobbying capacity as well.

Third, lobbying has emerged despite the government's tight controls on all forms of non-governmental organizations, including industry associations. Industry associations must register with the government and have a supervisory agency, and they are supposed to have monopoly representation of an industry. Although there are some significant exceptions, particularly in sectors and localities dominated by small, private companies, most Chinese companies lobby the government individually or in informal groups. Foreign industry is represented by their national chambers of commerce and public relations firms, but foreign industry associations are officially unable to register. Despite the lack of formal approval, some foreign associations do operate openly with the de facto recognition of Chinese officialdom. Due to these constraints, the largest multinational firms depend primarily on their own in-house government affairs capabilities.

And fourth, the composition of policy coalitions varies by industry and issue area. SOEs are most often in disagreement with private and foreign interests on questions of banking and financial regulation. That makes sense since state banks overwhelmingly lend to SOEs, the stock market is dominated by SOEs, and the vast majority of corporate bonds have been issued by SOEs. It is clear who would and who would not want to break up this cozy relationship. But there are many instances when policy disagreements do not neatly break down by companies' ownership or nationality. One can regularly find companies of different types on competing sides of debates on policies related to intellectual property rights, pricing, standards, taxes, and trade.

The blurring of policy positions based on ownership and nationality is the result of the growing interdependence between Chinese state-owned and private firms as well as between Chinese companies in general and foreign businesses. The latter is the product of Chinese companies in many industries becoming deeply embedded in global production networks. Between 2001 and 2006, China absorbed \$343 billion in foreign direct investment. In 2006 alone, over 41,000 new projects by foreigners were initiated in China with funds of over \$69 billion. At the end of 2006, there were almost 300,000 foreign-invested firms in China employing almost 25 million Chinese. Most investment has originated in Taiwan and Hong Kong, but Japan, the US, South Korea, and the EU are growing sources of capital. This foreign investment is the dominant reason for the rapid expansion of China's exports. Foreign-invested companies account for around 60% of China's overall exports and over 85% of its exports of information technology. Where foreign

firms do not invest directly, they typically contact out production to Chinese suppliers, who in turn, also source a significant proportion of their inputs from global markets. The consequence is that companies' policy preferences have evolved along with their changing business interests. Hence, Chinese and foreign companies some times find themselves in what I call, "transnational political alliances" (TPA), where they either coordinate their policy positions or engage in parallel lobbying activity.

### **China's Porous Protectionism**

The evolution of government-business relations has important implications for China's foreign economic policy. China has instituted a wide range of potentially protectionist policies, but they have run into extensive opposition from both foreign and domestic interests.

In the process of joining the World Trade Organization (WTO), China reduced a wide range of traditional trade barriers, including tariffs, bans or quotas on imported products, explicit subsidies, licensing systems for imports, and limits on product distribution. China today is far more open to international trade and investment than it was 10 years ago or even five years ago, and it is more open than most other countries at a similar level of development, now and in the past. At the same time, China has kept in place some traditional barriers; and more importantly, it has tried to exploit loopholes in the WTO governance regime and adopt more sophisticated forms of protection. Such efforts are meant to help not only state-owned enterprises, but private industry as well. China has created regulatory frameworks for antidumping measures; anti-subsidy (countervailing) measures; safeguard measures; and standards for health, safety, the environment, labor, and product design. In addition, the lax enforcement of intellectual property rights (IPR) serves as a trade barrier to IPR-based foreign industries. Although international rules are less clear, China has created a foreign exchange regime that gives the government significant latitude in controlling movement of the exchange rate; and China is close to adopting an anti-monopoly law which could be used to target foreign companies. Chinese efforts are not unique; in some instances, they are borrowing tactics straight out of the playbook of other WTO members, including the United States, such as in its adoption of antidumping rules as a way to slow imports that supposedly unfairly threaten domestic Chinese industries. But collectively, these tactics cumulatively add up to serious obstacles to American and other foreign companies trying to do business in China.

That said, the success rate of these efforts has been far less than what one would expect, particularly if one looks at China through a "China, Inc."-type lens. Chinese seeking protection have been stymied in part by other governments who, at the behest of their companies faced with protection, lodge complaints through diplomatic channels. Also, as noted above, foreign companies have developed their own lobbying capacity. Besides maintaining good relations with different parts of the bureaucracy, foreign firms have become adept at meeting with officials from the Ministry of Commerce and other agencies when disputes arise. But in addition, Chinese protectionist efforts have run into opposition by liberal-oriented parts of the bureaucracy and domestic industry (state-owned and private), whose interests lie in expanding, and not hindering, international trade and investment links. Hence, China's post-WTO protectionism has been

decidedly “porous,” thwarted by a combination of pressures.

One area where this is true is China’s antidumping regime. First adopted in 1997 and then revised in 2004, China has come from nowhere to become one of the most active initiators of antidumping cases against foreign exporters. Between 1997 and 2005, China launched investigations into 42 products involving 136 countries, including 22 cases against American companies. These cases have been pushed by several Chinese law firms, who are the international trade equivalent of “ambulance chasers.” However, the foreign respondents have won a partial or complete victory in over 48% of all concluded antidumping cases. American firms have been successful in avoiding significant penalties in at least 7 of the 19 cases completed as of the end of 2005. In addition, the average antidumping tariffs instituted by China is relatively low compared to those adopted by other regular antidumping users, such as the United States and European Union. Although foreign respondents do not win a majority of cases, their victories are important and surprising. Why does foreign industry regularly escape punishment despite the fact that these cases are adjudicated by the Chinese government, an obviously biased referee? To some extent, it may be that the charges are frivolous, but antidumping cases typically do not turn on an unbiased reading of the facts anywhere. They are highly political actions. More likely, foreign firms have done relatively well because of lobbying by themselves and their Chinese downstream customers. When those customers need the imported product because of high quality requirements and the importer is economically and politically powerfully, they usually are effective in helping the foreigners avoid sanction.

A good example is a 1999 case brought against Japanese and South Korean stainless steel producers. They seemed unlikely to win at the outset because the Chinese applicants were three important steel producers (Taiyuan Steel, Shaanxi Precision Steel, and Pudong Specialty Steel), and Pudong had just been merged into Baoshan Iron & Steel, China’s most advanced and politically influential steel manufacturer. Despite being the world’s largest producer of steel, in the 1990’s China became a large importer of high-quality stainless steel that its firms could not produce themselves. It was, therefore, in the domestic applicants’ interest to lock foreign firms out of the market while they developed a greater independent capability in this area. Behind the scenes the applicants and Baoshan lobbied hard for an affirmative ruling, which they at first obtained. Several Japanese respondents paid antidumping duties, while one Japanese and six South Korean firms agreed to a price undertaking in which they raised the prices of their goods an amount equal to the dumping margin.

Despite the apparent ruling in favor of the applicants, the respondents won a partial victory. Many of their goods were granted exemptions from the penalties, and any of the goods they sold to duty-free zones in China were exempted from having to pay any tariff whatsoever. The compromise was reached because the respondents persuaded their Chinese customers to submit briefs to the Chinese authorities in their defense. They argued that the domestic stainless steel producers did not produce precisely the same goods as the foreigners and that the imported goods were critical to their final products, which were to be exported. In addition to the vital role of these products to their businesses, the end-users that complained were famous large home appliance and auto manufacturers that could gain the ear of senior trade officials and could also

mobilize local and national officials to carry their banner. Feeling pressure from both sides, the government decided on a compromise that largely left the imports uninterrupted.

Another good example is China's safeguards regime. In March 2002, the Bush administration adopted safeguard duties against a supposed glut of foreign steel it claimed injured American producers. At the behest of domestic manufacturers, China joined other steel exporters in challenging the US action before the WTO, and it invoked its own safeguard measures (quotas and duties) against foreign steel, claiming that the US tariffs had led others to suddenly redirect their steel to China. Before long, though, Chinese steel importers and large downstream users in the automobile, oil, and consumer appliance sectors complained loudly about shortages in critical types of steel and rising costs. In a September 2002 public hearing, lawyers for the Chinese oil drilling industry claimed that their clients had to buy imported equipment because the domestic machinery they had previously used led to the deaths of several workers. As a result of public and private complaints, the Chinese government drastically reduced the number of products against which the measures applied and then suspended the safeguards altogether.

A final example comes from the area of technical standards. Over the past decade Chinese industry has tried to develop unique product standards in information technology. Historically, Chinese firms have assembled products developed elsewhere; being at the bottom rung of the value-added chain, they have been required to pay royalties by foreign patent holders (though they have not always done so). The effort to develop their own standards, which is part of a strategy to promote "indigenous innovation" and move up the value-added chain, has presented a genuine challenge to firms from the United States and Europe in areas where they are supposed to be world leaders. The Chinese have developed standards on dozens of technologies, including for video players, broadband wireless networks, photography, computer operating systems, third-generation mobile telephony, radio frequency identification (RFID), home networking, and digital television.

Despite the efforts of numerous agencies and thousands of people, China has yet to achieve any substantial successes. So far, American and other global leaders have not lost market share in any of these product categories. Whenever the Chinese government has endorsed a unique Chinese standard, foreign companies and their Chinese partners have successfully lobbied against such moves. The only Chinese standards that have had any chance of success have been those that include significant foreign involvement and cooperation. When the Chinese government in 2004 anointed WAPI as their their own wireless local area network standard, the foreign developers of the globally used standard, Wi-Fi, rose up in vocal opposition. But major Chinese hi-tech firms who have Wi-Fi as part of their own business plans also quietly signaled that they were unenthusiastic about WAPI. When Vice Minister Wu Yi announced in April 2004 that China would suspend mandatory implementation of WAPI, she was doing so in the face of widespread industry opposition, foreign and Chinese. Wi-Fi is the only wireless local area network standard used in China today. Recently, some Chinese firms announced they would develop their own metro-area wireless standard, McWill, to compete against the more widely used WiMax. But most of China's major telecom producers already are deeply invested in WiMax and are unlikely to switch to McWill even if pressed by the Chinese government.

The same story line is playing out in numerous other standards cases, from third-generation telephony to home networking. Whereas the Chinese originally hoped to blocked foreign participation in these markets, they have increasingly accepted international standards or invited foreign producers to join Chinese standards consortia, allowing foreign parties more institutionalized access to shape these technologies in ways that benefit themselves and their Chinese partners.

There is no doubt that the Chinese government will continue to attempt to promote domestic Chinese industry, both fairly and unfairly. However, foreign industry has been far from powerless and has been able to thwart many of these efforts. Case-specific intervention by foreign governments and lobbying by the multinationals have both been important. Yet involvement by the Chinese partners of foreign businesses has been just as critical on occasion. Americans and others have the best chances to fight protectionism in the People's Republic of China when there is a substantial domestic Chinese interest in maintaining openness. As my colleague Andrew Mertha of Washington University in St. Louis has shown, the primary reason China has reformed its intellectual property rights (IPR) laws has been due to foreign pressure. Consistent with the position put forward here, there has been less success on the implementation front because only a small proportion of Chinese industry depends on protecting IPR for the business success. Only as their importance to the economy increases will IPR-based industries make substantial headway. (There are some small tentative signs of improvement. The Business Software Alliance reports that software piracy in China has dropped from 92% to 82% in the last three years. This may in part stem from the emergence of China's own software sector as well as computer producers who have bundled legal software with their machines. Chinese trademark and patent holders are also increasingly going to court or seeking administrative relief for IPR violations.)

### **Implications for American Policy**

The United States government needs to be concerned about Chinese industrial policies. But the record to date suggests that case-by-case vigilance of foreign governments along with lobbying by multinational producers and their Chinese partners are in general successful at hindering many Chinese protectionist efforts. In addition, bilateral and multilateral efforts to cooperate with the Chinese government, industry associations, and producers to develop more even-handed and sophisticated governance regimes is also paying off. For example, the American National Standards Institute, the National Institute of Standards and Technology and their European counterparts have engaged in extensive cooperation with the Standardization Administration of China and other parts of the bureaucracy to improve China's standards-setting system and make it less vulnerable to protectionist manipulation.

Yes, China will continue to try to employ protectionist policies; yet the mechanisms currently in place have been remarkably successful at defending American interests. Consequently, I think it would be a mistake to adopt pending legislation which would raise tariffs on Chinese products across the board or institute other comprehensive sanctions against the PRC. Instead, I would

encourage continued case-by-case vigilance by the Administration and Congress and the use of existing bilateral and multilateral mechanisms, such as the WTO dispute resolution process. Over long term, the greatest way to meet the challenges (and opportunities) from China and other countries does not center on bilateral trade strategies but rather involves strengthening America's economic fundamentals and improve the country's competitiveness in the global economy. This includes: 1) Investing more in education in the sciences, math, and foreign language and area studies; 2) Providing industry with more incentives to engage in research and development to encourage continued innovation; 3) Improving the various components of America's physical infrastructure; and 4) Reducing our country's dependence on inefficient and polluting fossil fuels.

The economic relationship between the United States and China has been highly beneficial to both of our countries and to the world economy, and that understanding needs to be kept forefront in our minds as we consider policies today and in the future.

Thank you for the opportunity to testify. I look forward to answering your questions.

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