The Explosive Rise of Subsidies to Chinese Industry

How China's Mercantilism Hurts the Global Economy

In their book Subsidies to Chinese Industry: State Capitalism, Business Strategy, and Trade Policy, authors Usha and George Haley argue that a vast system of subsidies to Chinese industries plays a more important role in their mercantilist policy than currency manipulation. The authors argue that this strategy largely results from a particular view of success: technology acquisition provides a key goal in operations, even at the expense of profits. But another possible explanation i China's "shift strategy," where growth is said to occur by shifting from low-productivity industries to high-productivity ones. Why does it matter? Chinese mercantilism has not only cost the US a significant share of manufacturing job loss, but also has distorted the global location of and nature of production systems. The only real solution to the problem of Chinese mercantilism and massive industrial subsidies in particular, is for the world trading community to say enough is enough.

November 24, 2013 | Robert Atkinson

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The intellectual foundation of free trade, and the North Star guide for US international trade policy, was formulated by David Ricardo, a 19th century classical economist whose theory of comparative advantage holds that the market determines which nations are naturally good at producing and that more trade is always welfare-maximizing. What happens when a nation openly rejects Ricardo, desires absolute, not comparative, advantage, and employs massive state subsidies to attain that end, is the subject of Usha and George Haley's comprehensive and groundbreaking book *Subsidies to Chinese Industry: State Capitalism, Business Strategy, and Trade Policy.*

Neoclassical economy theory would suggest that such a country "will become poorer by not using resources efficiently and through taxing its efficient producers to pay for subsidizing inefficient ones." Moreover, by subsidizing their exports they are providing consumers in other nations discounted goods and services. In other neoclassicalists' counsel, we should pity these poor delusional mercantilists: if they want to screw up their economy and give us cheap imports to boot it's their loss and our gain.

How then do we explain that the nation that has committed the most money in world history to industrial subsidies – China –has had among the highest GDP growth rate over the last decade? How do we explain almost one and a half million US manufacturing workers who lost their jobs due to Chinese competition ove the last decade as the latter racked up over two trillion in cumulative trade surpluses? How has China become the global manufacturing workshop, making everything from consumer electronics to toys?

Most analyses have focused on factors like China's currency manipulation as enabling their export success, but Haley and Haley argue that a vast and often opaque system of subsidies to Chinese industries plays an even more important role in Chinese mercantilist policy than currency manipulation.

The book begins with an analysis of how state subsidies were the driving forces behind the Chinese solar industry, which, over course of less than a decade, became the largest producer of solar photovoltaics in the world. As the authors demonstrate, in 2010, the top five solar companies in China had received the equivalent of over $31.3 billion in low interest loans from the state-owned China Development Bank and other subsidies from national and provincial government agencies. Compare that to the relatively paltry funding of US solar firms by our governments, like Evergreen Solar ($22 million) and Solyndra ($535 million), and you see why the US share of the global solar panel market went from 30 percent in 2000 to 7 percent today, while China's went from 2 percent to 54 percent.[1]

Subsidies extend far beyond the Chinese solar industry. According to Caing statistics, over 90 percent of Chinese companies listed on public markets in 2010 were granted government subsidies.[2] And, as Haley and Haley detail, the subsidies take a variety of forms, including free or low cost loans, subsidized energy, and subsidized raw materials, land, and technology. The Chinese steel industry received $27 billion in energy subsidies alone from 2000 to 2007, while their paper industry received $33 billion in subsidies of all kinds from 2002 to 2009.

Even these figures are likely understated since they don't include all provincial and local government subsidies. These governments routinely give export-oriented Chinese enterprises free land upon which to erect factories or offices, and often the land grants are larger than what's needed to build the facility. Companies then build apartments or commercial buildings on the surplus land, and use the profits to pay for R&D and offset factory losses.[3] One US financial analyst who studies China told me about a Chinese software company whose province gave them valuable land in a downtown location to build their headquarters. On the excess land, they built additional buildings that they rent out to other firms, and the profits from this exceed the profits of the software business itself.

Another form of subsidy is the reduced profit rates state-owned enterprises have to demonstrate. An in-depth 2011 study by the Unirule Institute, an independent Chinese think tank, found in 2009 the return on equity of Chinese state-owned enterprises was about half the rate of non-state owned enterprises, a substantial "subsidy" in and of itself. But without their government-granted advantages, including preferential financing from state banks and free land, Chinese SOEs would have operated at a 6.29 percent loss from the period of 2001 to 2009.

In addition, there are subsidies specifically tied to exports. Even though export subsidies are illegal under the WTO, China uses them extensively. In 2007 China devoted more than $15 billion on export-enhancing subsidies to its steel industry. And while China announced reductions in steel subsidies, the reductions are focused on commodity-grade steels, and it has increased VAT rebates on exports of value-added steels. But the subsidies go far beyond steel. For example, the central government provided subsidy grants of $6.7 million and $22.5 million to Chinese wind turbine manufacturers that agreed not to buy imported components.

Finally, the Chinese government's decision to not let their currency appreciate in any meaningful way against the dollar serves as an across the board export subsidy (and import tariff). While the Obama administration (like the Bush administration before it) refuses to declare China a currency manipulator, the Treasury's semi-annual report to Congress on international economic and exchange rate policies states that China has a "heavily managed exchange rate regime." To paraphrase Bob Dylan, it doesn't take a financial economist to know which way the currency is being manipulated.

So why are the Chinese "shooting themselves in the foot" and giving American consumers a free lunch, as neoclassical economists would have us believe? Is China's drive to gain absolute advantage in all areas, including technology, to ensure it become a dominant military force and then replace the United States as the global hegemon?[4] Certainly this hypothesis should be taken seriously. So should the idea that this system is an emotional reaction to over 100 years of colonial rule when China was dependent on, and exploited by, the West, and in their mind shamed.[5] In other words, are they attempting to demonstrate that China is second to no one such that global players have to come to Beijing, not Washington?

Haley and Haley offer an important insight: Chinese policymakers view firms' bottom lines differently than do Westerners: technology acquisition provides a key goal in Chinese firms operations, even at the expense of profitability. In other words, the Chinese government time horizon is extremely long and they are willing to pay massive costs now (by giving up current consumption) for future gains.

But I believe that an important factor is shaping Chinese strategy is the growth model widely held in China. The Chinese have embraced a particular strategy for development, one also promoted by most global development organizations, including the World Bank, what can be called the "shift strategy." Under the shift strategy, growth is believed to occur by shifting from low-productivity industries (e.g., textiles) to high productivity ones (e.g., semiconductors). So the Chinese lavish massive subsidies on these higher valued added industries. Case in point is China's Strategic and Emerging Industries program, a program targeting seven key industries, including clean energy, biotechnology and advanced manufacturing. To get a sense for the scope of subsidies, for the United States to match China's financial commitment to their SEI on a per-GDP basis, it would have to pass a stimulus package (American Recovery and Reinvestment Act) every year for the next five years and dedicate nearly 100 percent of the funds to seven industries.

The problem, however, the "shift" strategy is actually not the most effective way to grow. As the McKinsey Global Institute 2010 report, *How to Compete and Grow: A Sector Guide to Policy*, finds, countries that outperform their peers do not have a more favorable sector mix, but instead have individual sectors that are more competitive and productive. In other words, the best way to grow is to help all industries get more productive and innovative, not to focus on a few high-tech ones by ramping up exports.

Yet Chinese officials remain deeply committed to the shift strategy. It also doesn't help that most global development organizations encourage this view. For example, in February 2012, the World Bank issued a report called *China 2030*, which aimed at helping China find new growth drivers. It made almost no mention of raising productivity in sectors like retail and wholesale trade, logistics, and financial services. Rather it focused on shifting to new industries, writing for example that "new technological opportunities make green development not just a realistic possibility but a potential driver of economic growth. If successful, green development will create new business opportunities, stimulate innovations in technology, and potentially make China globally competitive in sunrise industries."

Why should we care if China engages in massive subsidies? After all as consumers we get the benefit of those low prices on solar panels steel, toys, DVD players, etc. But the vast majority of consumers are also workers and as such as workers are often hurt by Chinese subsidies. Indeed, as noted above, Chinese mercantilism has cost the U.S. a significant share of manufacturing job loss and this loss ha had ripple effects to other sectors as U.S. manufacturers and their workers cut their spending. These massive subsidies also distort the global location of and nature of production systems, resulting in production that is most efficiently done in another nation to be inefficiently done in China. For example, it may have been more efficient to make solar panels in the United States, but with large Chinese subsidies, the globally inefficient choice was made.

It is important to note that even if China were to embrace the notion of Ricardian competitive advantage and dramatically reduce its mercantilist policies, including subsidies, some US workers would still lose their jobs to China trade. Schumpeterian creative destruction would still exist. But fewer workers would lose their jobs and more importantly many more new jobs would be created in industries exporting to China.[6] Such disruptions are part and parcel of globalization and the price nations pay for the greater benefits o global integration. But defenders of the trade status quo fail to appreciate that there's a fundamental difference between dislocation produced by economic restructuring by nations pursuing comparative/competitive advantage and dislocation produced by absolute los of competitive advantage via foreign mercantilism. The former hurts some workers, companies and communities but generates economic growth. The latter hurts many more individuals, companies and communities and generates economy-wide loss.

So given the pernicious and destructive nature of Chinese mercantilist subsidies why does the world trading community in general and the United States in particular do so little. There are many reasons, including growing Chinese influence at international organizations like the International Monetary Fund, the World Bank and the World Trade Organization, and the remarkable ability of the Chinese government to play a divide and conquer game against Western nations.

But part of the reason for inaction stems from ideas, not interests. Many U.S. policymaker and neo-classical economists simply cannot conceive that the Chinese have a fundamentally different approach to capitalism than we do. Former Obama Administration economic advisor Larry Summers summed up the view: “The laws of economics are like the laws of engineering. One set of laws works everywhere.” It is this comforting notion that has enabled many U.S. experts to fail to take the threat from Chinese mercantilist policies seriously. For them, the Chinese must be like us and so they will eventually structure their economic policy to focus on consumer welfare generated through free markets. If only we work more energetically to educate the Chinese about “the benefits of free trade and free markets” the thinking goes, they will understand the error of their ways. But it is the American economics and trade community that needs to see the error in failing to acknowledge that not only is the Chinese economic system fundamentally incompatible with the economic systems of the founding General Agreement on Tariffs and Trade (GATT) nations, but that China has little interest in adopting the Washington consensus approach to trade and economic policy. It's not that they don't know the arguments embedded in the Washington consensus. They reject them in favor of the Beijing consensus.

An even more pernicious concept limiting tougher action against Chinese innovation mercantilism is the notion that as long as the United States is not mercantilist it still benefits from its trading relationship with China. William Buiter, Cambridge University economist and former head of the European Bank for Reconstruction and Development, summed up this view when he stated, “Remember: unilateral trade liberalization is not a ‘concession’ or a ‘sacrifice’ that one should be compensated for. It is an act of enlightened self-interest. Reciprocal trade liberalization enhances the gains, but is not necessary for the gains to be present."[7] Some eve go so far as to state that by running a large trade surplus, China helps America by shipping capital back that finances American financia deficits. Neoclassical economists Fehr, Jokisch and Kotlikoff concur, arguing that China, in saving so much (by running large trade surpluses), helps the United States by providing cheap capital.[8]

These views are irrelevant at best and wrong at worst. They are irrelevant in the sense that even the most neoclassical of neoclassical economists should admit that mercantilism harms economic efficiency. After all they are the first to decry such policies whenever they are proposed in the United States trotting out insults like “industrial policy” and protectionism. Do they really think that China helps the global economy by massively subsidizing overproduction industries? By propping up less efficient companies that absent subsidies would have less global market share while more efficient global players reaped more?

They are wrong in the sense that the right question is not whether U.S.–China trade has hurt the U.S. economy—reasonable people can have different views of this issue. Nor is it helpful to ask whether ending Chinese economic mercantilism would fix all or even most of America's economic problems. Of course it wouldn't. But the right question is whether reduced Chinese mercantilism would have non-trivial beneficial impacts on the U.S. economy. And on this question only the most zealous neoclassical ideologues or “Friends of China would assert that it would not. Clearly Chinese mercantilist policies hurt U.S. companies, both here and in China and cost the United States jobs.

Fundamentally the only real solution to the problem of Chinese mercantilism in general, and massive industrial subsidies in particular, is for the world trading community to say enough is enough. If China wants the benefits of being part of this community, they will need to renounce these practices.

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1. Alan Goodrich, Ted James, and Michael Woodhouse, "Solar PV Manufacturing Cost Analysis: U.S. Competitiveness in a Global Industry," *National Renewable Energy Laboratory*, October 10, 2011, http://www.nrel.gov/docs/fy12osti/53938.pdf.

2. "Listed Companies in 2010 that were granted government subsidies," *Caing Statistics*.

3. Hong Sheng, *The Nature, Performance and Reform of State-owned Enterprises* (China: Unirule Institute of Economics, 2012).

4. In the June 13 *American Spectator*, Jed Babbin, former deputy undersecretary of defense under George H.W. Bush, wrote, "China isn't just our lender. It's not a free-market trading partner hoping that a rising economic tide will raise both economies out of the recession. China is an adversary, a 21st century mercantilist nation whose policy is to gain economic strength by manipulating markets. And its role as our reliable lender is aimed at manipulating U.S. economic strength as a means of diminishing our ability to interfere in Beijing's ambitions."

5. As a visitor leaves the local history display state-owned museum in Shenzhen, China the plaque talks about the "shame of China" for being dominated by colonialist and the Japanese.

6. Such dislocation is very costly. See David H. Autor, David Dorn and Gordon H. Hanson, "The China Syndrome: Local Labor Market Effects of Import Competition in the United States" (working paper, National Bureau of Economic Research, June 2011), http://www.nber.org/public_html/confer/2011/CE11/Autor_Dorn_Hanson.pdf.

7. Quoted in Ha-Joon Chang, *Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism* (New York: Bloomsbury Press, 2008), p. 67.

8. Hans Fehr, Sabine Jokisch, and Laurence J. Kotlikoff, "Will China Eat Our Lunch or Take Us Out to Dinner? Simulating the Transition Paths of the U.S., EU, Japan, and China," (working paper 11668, NBER, October 2005), http://www.nber.org/papers/w11668.

Economic Growth