The State of China's State Capitalism

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Editors

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Evidence of Its Successes and Pitfalls

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Preface

China's rapid economic growth since the inception of its reform and opening-up policy in late 1978 has been the envy of many developed and developing countries. Its powerful state intervention to keep its economy going after the global financial crisis of 2008 indeed helped the country to serve as a major locomotive of the world economy when most of the advanced economies were stuck in serious and prolonged recession. Ian Bremmer, in an article published in *Foreign Affairs* in 2009 under the title "State Capitalism Comes of Age: The End of the Free Market?", even argued that China's state capitalism was not just an anti-cyclical tool but also a source of its long-run economic boom.

China's success at its experiment with "state capitalism", or "socialism with Chinese characteristics," would seem to suggest that it is an economic model worthy of emulation by other countries. China's state capitalism is a system in which market forces are allowed to operate but subject to powerful and frequent state interventions, and in which the private sector is allowed to expand while state-owned enterprises (SOEs) have remained an important part of the economy to compete with the private sector for resources. To those who are suspicious of a free market system or uncontrolled capitalism such a state capitalism would seem a better model for seeking a good balance of sustained growth and economic stability.

However, after a breath-taking pace of growth over the past three decades, China's growth model is facing increasing challenge on multiple fronts. At home, while its rapid economic growth has lifted the average living standard of its citizens, it is also associated with a substantial increase in income inequality and unaffordable housing prices. Going forward, China's growth prospect is also becoming more constrained by limited resources such as the labour force, land, and energy. The pollution of air, due to the heavy usage of pollution-intensive fossil fuels during China's rapid industrialization and fast urbanization, has increasingly raised the public's concern about environmental sustainability and efficient use of energy. The Chinese government is now under great domestic and international pressures to conduct a series of deeper reforms in industrial upgrading, environmental protection, and social welfare enhancement. Have these issues been particularly acute because of China's state capitalism?

We hope this book, a collection of research papers on some contemporary economic and financial issues in China, based on rigorous research by the collaboration of students and faculties in International Business School Suzhou in Xi'an Jiaotong-Liverpool University, could help readers draw some lessons about China's state-capitalism growth model. We present these papers as chapters in six parts.

Part I (Chaps. 1 and 2) and Part II (Chaps. 3 and 4) present research on issues resulting from the Chinese fiscal system of revenue centralization and spending decentralization. After the 1994 tax-sharing reform, a mismatch between local governments' revenue and spending responsibilities started to emerge. Consequently, local government increasingly resorted to land sale to help finance their expenditures, arguably resulting in a wide range of severe problems. To name just a few. Sales of public land by government officials are a recipe for corruption. The excessive land acquisitions from peasants with inappropriate compensation breed social conflicts. Conversion of agricultural land for non-agricultural purposes undermines food security. Strategies aiming at reaping more land-sale revenues tend to aid and abet property bubbles. Local governments' rising need to rely on issuing bonds to close their budget gaps has been adding to their debt to GDP ratios. Against this backdrop, Chap. 1 examines the effect of China's fiscal system on local governments' land leasing behaviours, controlling for other factors, both theoretically and empirically. Chapter 2 investigates what factors—such as the fiscal gap, governments' investments in housing, other local governments' spending, and financing behaviour—have contributed to the issuance of urban investment bonds (UIB) across 31 provinces in China. Chapter 3 investigates evidence of housing bubbles in different locations of China by examining housing price data at the provincial and city levels from late 1990s to 2016. Chapter 4 investigates whether the entry of a new Wanda Plaza increases the county-level average land prices, aiming at shedding light on the dynamics between local policymakers and real estate developers.

Part III presents research related to energy and environmental issues in China. China's rapid economic development has resulted in a rapid rise of its excess demand for energy, and of a serious pollution of its environment. Its energy shortage still imposes considerable obstacles on urban development even though substantial government budgets have been devoted to energy-infrastructure constructions such as Three Gorges Project and West-East Electricity Transmission Project. Its severely polluted environment has meant the majority of Chinese people are exposed to unhealthy air, water, and soil. To curb carbon emission, the Chinese government tested a pilot carbon emission trading markets in 2013 to pave way for the official establishment of national carbon market in 2017. As it is potentially the largest carbon trading market in the world, finding the key factors that drive the carbon permit price to help forecast its future price is important for both investors and government. Chapter 5 thus explores the prospect of forecasting the carbon permit price in three pilot markets (Beijing, Shanghai, and Shenzhen) using the structural time-series modelling approach. To shed light on appropriate policies for inducing energy-saving consumption behaviour, Chap. 6 investigates whether consumers undervalue future expected electricity costs relative to purchase prices when they choose among different types of refrigerators. The authors found that there is considerable energy efficiency gap in China's refrigerator market, suggesting the need of using government subsidy to encourage consumption of energy-saving electronic appliances.

Part IV presents research related to income inequality. Along with China's remarkable economic growth, income inequality in China has also become more serious. Its Gini coefficient reached 0.491 in 2008, from 0.343 in 1990. Since 2008, China's Gini coefficient has been edging down somewhat, but it was still higher than the worrisome level of 0.4 as of 2015 (at 0.462). Chapter 7 investigates whether China's fiscal system of revenue centralization and spending decentralization has been effective in mitigating the problem of rising inequality. Chapter 8 ascertains whether the rising income inequality has resulted in effective state intervention intended to boost Chinese people's nationalism. Chapter 9 aims to solve the puzzle of the rising gender income inequality in China. The gender income gap started to emerge soon after China's economic reform began in late 1978. After early 1990s, the rise in that gap quickened pace despite the narrowing gap between male and female educational attainment. What happened? Does it reflect a rise in gender discrimination or the change of economic structure?

Part V contains two chapters related to issues in foreign direct investment (FDI). Inward FDI has been instrumental to China's rapid economic growth after the early 1990s. Even though empirical studies of FDI's impact on host countries' economic growth are quite diverse in general, almost all studies focusing on China have found unambiguous evidence that inward FDI made a significant and positive impact on China's economic growth. Clearly, the Chinese government's growth strategy of attracting FDI and their technology transfer by offering various incentives has worked. However, China's outward FDI has been rising faster than its inward FDI in the past decade. Is it partially due to a policy shift in response to the rapid accumulation of China's foreign exchange reserves? Or is it driven by changes in fundamental determinants of FDI flows? Chap. 10 inquires what made FDI inflows more beneficial to China's growth than in most other developing countries. It does so by investigating why in the literature the estimated effect of inward FDI on economic growth is significantly higher in China than in India. Chapter 11 investigates what are the major determinants driving the movement in China's outward FDI.

Part VI presents research intended to shed light on China's corporate tax and the optimal model for forecasting cash flow in various industries in China. Starting from 2000, China's authority has published a series of tax regulations to improve the sophistication of China's tax regime. In 2002, the State Council stopped unauthorized corporate tax rebate from the local government. In 2007, State Council states that the top statutory corporate tax rate becomes 25%, which is lower than the previous tax rate (33%) by 8%. In addition, foreign-invested enterprises (FIEs) and China's domestic enterprises (DEs) share the same corporate tax rate (25%) thereafter (prior to that change, FIEs enjoyed a preferential tax rate of 30%, whereas DEs paid a higher tax rate at 33%). Within the context of 2007 tax reform, Chap. 12 investigates two questions. First, has the 2007 tax reform increased or decreased corporate marginal tax rates of China's listed companies? Second, in what ways are the changes in the marginal tax rate different with respect to companies' characteristics (such as ownership and industry)? Chap. 13 aims to offer an optimal model suitable for forecasting cash flow—the lifeblood of a firm—in various Chinese industries. It does so by investigating the relationship between accruals and cash flow prediction in China's industries, drawing upon existing models explored in studies of US and UK industries.

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Contents

List of Figures

List of Tables