The ultimate challenge is to have vitality in the economy. Vitality in practice takes the form of measured competition. That sounds like an empty phrase, but I would suggest that there are two key aspects to making this relevant. First is that you need to have incumbents sufficiently under pressure that they actually have to adapt, innovate, compete. Second, you need to have enough new entrants having a chance to make it, not just at a small level, but to become potentially the next generation’s incumbents. The importance of this framework is illustrated by the productivity problems in Europe and the ability of the United States to overcome its many growth problems. In short, much of northern Europe saves more and educates better than the United States, but the United States still comes out ahead on productivity growth because of private-sector competition. This framework is quite consistent with the enterprise and investment reform agenda, as I understand it, laid out by the Third Plenum last fall.

First, a definitional point. You will notice that I mentioned that the incumbents have to be sufficiently afraid that they compete. That intentionally does not specify whether the incumbents are state-owned enterprises or not. For many reasons that people at this forum are well aware of, having too heavy a hand of the state is harmful to both economic growth and for political stability. But it is equally important that we recognize that supposedly private entities can be just as protected from competition and just as self-satisfied and deterring of new entrants as public sector entities. Though it is rarer, there are instances around the world, including in the United States, France, and Germany, where public sector entities have been sufficiently under competition that they can be a useful part of the economy. (There is, of course, a separate class of industries and sectors where you see a natural monopoly or at least need a utility model but let’s leave that aside. That is the easy part.)

By almost any metric, China’s state firms are already growing less important: Investment by state firms accounts for a declining share of national investment; the growth of output of state firms is slow relative to that of private firms; and employment in state firms continues to fall, not only as a share of total employment but in absolute numbers as well. The productivity of state industrial firms, as measured by return on assets, has consistently lagged that of private industrial

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1 President, Peterson Institute for International Economics (PIIE). I am grateful to many colleagues for their helpful suggestions for this essay. I am particularly indebted to Nicholas Borst, Gary Hufbauer, Nicholas Lardy, and Ryan Rutkowski for their guidance and inputs. The views expressed here however are solely my own, and do not represent the views of the Peterson Institute for International Economics, its Board, or its staff. Contact: posena@piie.com
firms and, since roughly the middle of the last decade, has also fallen in absolute terms. A similar pattern is evident in China’s services sector. The return on assets of state-owned service firms in 2008 (the only year for which reasonably comprehensive data is currently available) was only 3.4 percent, only half the level of nonstate firms. Tellingly, with the exception of 2010, since 2007 the return on assets of state firms has been less than their cost of capital.\(^2\) Moving on constructively from here, however, has to be more thoughtful than either a crusade against state-owned enterprises (SOEs) or just letting them hang on where politically convenient.

So turning to the first point, how does one determine whether incumbents rest easy in their beds, and what should one do to make sure that does not happen? This starts with the kind of antimonopoly laws that were so important to the United States at the start of the 20th century, which have been adapted in numerous countries, and which are explicitly part of the current reform agenda here in China. But that is, while necessary, insufficient. I think there is clear evidence that one needs to look beyond the consumer price criterion, which is too narrow, and often allows too much political combination, to instead a broader sense of what constitutes a monopoly or oligopoly.

But I think a more fundamental point arises from corporate governance. That is a term that gets bandied about a great deal, but unlike monopoly power, to my mind, it can be assessed in a very simple manner: Are corporate entities, whether public or private, allowed to hoard large amounts of cash? Are they allowed to invest them in risky manners inconsistent with their core business? Are they essentially allowing the managers to loot the company in the extreme case (but unfortunately not too uncommon an extreme)? This is a key insight. From 40 years ago, the work of Jensen and Meckling (building on the earlier work of Bearle and Means) posits a very strong negative relationship between the discretionary power of managers as insiders and the value that the firm creates for shareholders and thus, frankly, for society. We should view the mergers and acquisition wave in the United States in the 1980s and the subsequent taking on of debt in many corporates as a means of disciplining managers. There is some legitimate concern that this leveraging up was taken to an extreme in certain cases (which is a different form of looting). Still, the fundamental idea that unemployed cash on the balance sheet left to managerial discretion is the best indicator of dysfunctional corporate governance is, to my mind, right.

Some in this audience may now raise their eyebrows and note that there is a large amount of cash sitting on corporate balance sheets in the United States and Western Europe, which arose in the last few years, and that there has been a persistent condition of very large cash balance on balance sheets in Japan since their problems of the mid-1990s. A little bit of this can be attributed to precautionary measures by management against financial disruption and are reasonable. Most of this accumulation, however, is indeed an indicator of lack of competition and corporate governance problems. In Japan and increasingly in parts of Italy, France, and Southern Europe, this has been followed by a visible lack of economic vitality. This is indeed now also becoming a real problem in the United States where we have seen far less innovation.

and far less competitive threat to entrenched incumbents (even though one can always point to the odd Silicon Valley company that blows its lead).³

Another aspect of focusing on corporate stocks of free cash, whether in the state-owned or private sector, is that it is something that central government can go after directly. Proper accounting and auditing lets both the public and the markets know where this is going on. Proper outside directors let people know where and when managers are behaving in untoward ways. Proper taxation and shareholder rights can reduce the incentives to hold on to cash. Again, none of this is perfect. Auditors can be subverted and outsider directors can be co-opted as we have seen in the United States and throughout the world. But, broadly speaking, there is consistent evidence that external directors, good auditing, and shareholders’ rights combined reduce the extent to which you build up these large cash balances and— to the degree that they exist— the abuses they are put to.

In China and the United States both, we should think about getting at this problem of unemployed cash pots with the tax code. Actually, this case is in some ways easier to make for state-owned enterprises than for private sector firms, although it is valid for both. There is a need to mobilize the cash in China’s SOEs to public ends. It is a legitimate concern of the people’s representatives to make sure there is some satisfactory stream of dividends being turned over to the ultimate owners of state-owned enterprise and to the People's Liberation Army (PLA) or to would-be oligarchs. Furthermore, these revenues should not be captured by local politicians who then protect their local favorites from new competitors, and this becomes a self-reinforcing cycle: The politician protects the local monopoly, local state-owned enterprise, or even the dominant local private firm. That firm provides money to the incumbent politician. They do nice little things for the localities, but they become deeply entrenched and distort capital allocation.

We have seen this repeatedly, for example, in Germany where the power of the incumbent is dressed up as a public deal that involves a wide range of stakeholders. In reality, it means that people who happen to be living in towns where they had the good fortune to be located in western not eastern Germany, and to have had a 19th century concern that was going well, are still doing well. In effect, they are taking away money from the rest of Germany and are favoring the old firms of the incumbents. That is why Germany is still specialized in the same four sectors— bulk chemicals, autos, machine tools, and large engineering— that it was in the early 1950s. And broader productivity growth has been poor as a result of this incumbent sclerosis especially in the service sector.

Another means to establish a vital corporate sector is to open up the service sector to investment, including foreign investment. Work by the Asian Development Bank shows that the share of GDP originating in the services sector in China has consistently been below the levels seen in other Asian economies during similar periods of development. Based on international comparisons, China’s service sector share of GDP should be about 10 percentage points higher than it currently stands. A key reason behind this divergence is the relative closure of the service sector to private and foreign enterprises. In contrast to industry, where the share of output by state firms has already fallen by two-thirds compared to 1978, much of the service sector remains

dominated by state firms. Some of this is natural, and we can see that state-run utility companies are common throughout the world. In many other sectors, however, including finance, media, information technology (IT), and transportation, the state retains an unnecessary barrier to investment and competition. In education and health care, the state may desire to maintain its dominant role, but there are still large opportunities for more private investment and thus competition. Going forward, these barriers to investment will become increasingly damaging, because the service sector offers the greatest opportunity for the next wave of economic expansion.4

The flip side of this cash flow idea as I mentioned, and the other key component to productive vitality, is the environment for small business. I do not mean the old trite statements that several hundred percent of all good jobs are created by small businesses or other such risible claims often made. And as my colleague Nicholas Lardy cautions people, it is unrealistic to claim that China has been unsuccessful in breeding small businesses. Even nonspecialists like me know that the transformation, which began with Deng Xiaoping’s reforms in 1978, started at the level of individual farmers bringing crops to market, the individual retail seller, the individual entrepreneur, and we now have millions of businesses on net arising in China every year.

That said, a place China has to concentrate its efforts in the spirit of maintaining vitality and competition is enabling small businesses to grow, become medium-sized, and create new industries and competitors. In some important work done by Stefano Scarpetta and coauthors at the Organization for Economic Cooperation and Development (OECD), we have learned about cross-national differences in the so-called “demographics of corporations” growing or dying, by age and by size. What they find is that the critical difference between the United States and some of the most liberalized economies, on one hand, and some of the other economies that have done quite poorly on the productivity front, like Germany and France, is the frequency with which small businesses become large businesses. In economies where small businesses are discouraged from evading into real competitors, long-term productivity growth is worse. Encouraging these transformations is necessary for either an advanced economy or an advancing economy like China.

The barriers to this kind of growth are many. It oftentimes involves political gestures and specific regulations like the regulations of Germany that insist on certain kinds of union representation once you get above 25 or 200 employees. We are seeing a few of those kind of issues being addressed here in China to some degree, at least on the proposed reforms, with respect to minimum establishment size and capital. But the attack on these growth stifling regulations is so far insufficient. Usually the major factor in these problems is that you have entrenchment of sectoral regulations and barriers to entry that are direct political reflections of the power of the incumbents. These are abetted by a bias from the political class toward low risk opportunities and incumbent protection, because then they get their cash flow without having to meet new people or to annoy the businesses who give them the cash flow. This clearly is the problem with SOEs dominating China’s service sectors. There is no one simple measure that can

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4 See Bridging the Pacific: Toward Free Trade and Investment Between China and the United States by C. Fred Bergsten, Gary Clyde Hufbauer, and Sean Miner, PIIE forthcoming, autumn 2014; and Lardy, op cit.
get you around this. So following where the free cash piles are continues to be important for encouraging small business growth as well.

What is needed I would argue are three practical steps which again I believe are consistent with the thrust of reforms the Plenum and now this Forum are discussing for China. First, one needs to have a financial sector that is willing to fund new businesses and a structure to provide credit and investment for new businesses. There is a lot of literature on this. It may essentially come down to, however, not allowing there to be an oligopoly in the banking system of large banks, because they do not tend to be very good at this kind of effort. You need multiple banks competing, and you need the availability of alternative financing institutions to banking.

The second principle for getting productive vitality and growth of small businesses is to break down unnecessary regulations that cloak themselves as safety or professional standards. No one would claim you do not need greater safety regulations in China right now. But it should not be done on an industry-by-industry basis, and it should not be done at a highly micro level, or else political capture by incumbent workers and businesses take over. As I noted, this is particularly problematic for the service sector in China right now where productivity has lagged behind and where there needs to be change. And third, one needs to improve the corporate governance of the SOEs, and of large Chinese corporations more broadly—combining tax law, shareholder rights, auditing, outside directors, and foreign direct investment—so that neither the government nor markets let incumbent businesses sleep soundly on piles of cash.

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\(^5\) I have spoken about this at great length with regard to the United Kingdom when I served on the Monetary Policy Committee at the Bank of England 2009–12.  