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EDITORIAL ESSAY

State Management and Malign Growth

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In China targets must be met, by any means necessary.
–Yuen Yuen Ang

This essay is both a reminiscence and a look forward. The reminiscence will be brief though I will return to it at the end. The forward look raises some larger issues related to state ownership and management. These are of possible interest to scholars, especially those contributing to *Management and Organization Review* whose aspiration is 'to develop knowledge that is unique to China as well as universal knowledge that may transcend China' (IACMR, undated).

The reminiscence: Lu Xiaohui and I published 'Managing Indefinite Boundaries: The Strategy and Structure of a Chinese Business Firm' in the inaugural issue of MOR. The core argument is directly from the organizational theory of the 1960s and 1970s:

> Chinese business firms are best understood as simultaneously open and closed, as hierarchically nested systems or systems within systems rather than as discrete units … boundaries between the firm and the state, on the one hand, and the firm and its subsidiaries, on the other, are indefinite, and hence managers must negotiate both kinds of boundaries. Indefinite boundaries complicate managers' tasks enormously but also create opportunities … (2005: 59).

The case in point was China International Marine Container (Group, CIMC) Company, Ltd, in 2005, and today, it is the dominant manufacturer globally of marine shipping containers and related transportation equipment. CIMC's success was due to its bold strategy for consolidating the shipping container industry in defiance of its largest state shareholder, China Ocean Shipping Corporation, which wished to retain CIMC as a captive supplier. Frustrated with CIMC, COSCO ultimately sold its CIMC shares and acquired the China-based assets of Singamas in 2019. CIMC then continued to add capacity until 2021 when the US Justice Department blocked their proposed acquisition of Denmark-based Maersk Container Industry on grounds that it would have 'consolidated control of over 90% of insulated container box and refrigerated shipping container production worldwide in Chinese state-owned or state-controlled entities' (US Department of Justice, 2022).

The larger points concern state management. By state management, I mean the management of firms controlled directly or indirectly by the state as distinct from firms controlled by nonstate shareholders. I'll explore three related topics. The first concerns the scale of state management and how much of the economy is state-managed. The scale of state management is sizable and growing in many developing countries, though exactly how large it is can be hard to determine. The second concerns priorities of the state, in particular economic growth or growth of gross domestic product (GDP). Though I do not quarrel with growth, I'll argue that GDP targets are inherently problematic because conventional measures of GDP, how much you produce, invest, and export, are not the root causes of growth. This mismeasurement yields unsustainable or what I call malign growth. The third topic connecting the first two is the impact of growth-induced overcapacity. I'm concerned that industrial overcapacity, now rife in China, will lead to predatory exporting followed by tariff and technology barriers that will drag down the global economy. The strands of the argument, then, are these: the reach of the state into business is growing; a priority of the state is economic or GDP growth; pursuing inherently flawed GDP targets yields malign rather than sustainable growth; in particular, GDP targets fuel industrial overcapacity and low-cost exporting, weakening both domestic firms and their overseas customers.

The Scale of State Management

The scale of state management is substantial in many developing countries and especially large in China. And it is very hard to measure because state management involves both ownership and control. State-owned enterprises (SOEs) have traditionally been enterprises with 50 percent or more government ownership. It turns out, however, that many enterprises with minority state ownership are also state-controlled. The World Bank's Global Business of the State (2023) database covers 91 developing countries with the notable omission of China. The database covers both traditional SOEs with 50 percent or more direct state ownership as well as 'businesses of the state' where direct or indirect state ownership, the latter via intermediate entities, is from 10 to 49 percent and the state exercises 'effective controlling influence' via corporate or shareholding structures. Only a quarter of the 76,000 firms in the BOS database are majority state-owned, while three-quarters are minority state-owned but still state-controlled. In other words, effective state control is more often than not exercised without majority state ownership. The firms in the BOS database are widely dispersed across industrial sectors including agriculture, mining, quarrying, manufacturing, and wholesale services. The latter includes financial services, operating in far more sectors of the economy, especially services, than traditional SOEs. And BOS firms are large, accounting on average for 17 percent of their countries' GDP, likely an underestimate since some countries do not report enterprise revenues. The BOS population, in other words, shows that state control extends far beyond traditional SOEs with the majority of state ownership and that state-controlled enterprises have become significant players across multiple sectors of developing economies.

Indirect state ownership appears to be extensive and growing in China. Equity networks constructed from the State Administration of Industry and Commerce enterprise registration data (Allen, Cai, Gu, Qian, Zhao, & Zhu, 2023) show that, as of 2017, about 968,000 or slightly over 1 percent of China's nearly 90 million enterprises had direct or indirect government ownership of 10 percent or more. Of these nearly 1 million firms, 601,000 had local government shareholders, 167,000 provincial government shareholders, and 200,000 had shares held by the Chinese central government. Like BOS firms, many are sizeable. Their registered capital comprises nearly half – 48 percent – of the registered capital of all SAIC-registered Chinese firms. Paradoxically, then, state ownership in China is concentrated mainly in larger firms and is growing yet increasingly fractional and indirect. Whether effective state control follows from indirect and widely dispersed state ownership cannot be determined from the SAIC data. However, the World Bank's BOS dataset may be informative on this point: of the 87,000 firms with 10 percent or more state ownership that were candidates for the BOS dataset, 76,000 were judged to be effectively state-controlled and retained in the dataset.

What the State Wants

By conventional accounting measures, state-controlled firms underperform private firms and the performance gap widens when private and state firms are matched on basic attributes (Phi, Taghizadeh-Hesary, Tu, Yoshino, & Kim, 2020). State-controlled firms are also heavily subsidized (OECD, 2024). Underperformance in combination with subsidization suggests that performance may not be the main priority of the state or of state managers. Here I'll focus on the state's interest in, if not obsession with, economic growth – I'll deliberately overlook noneconomic objectives, whether managers' pursuit of private gain or the state's pursuit of broad social objectives. Economic growth, as gauged by GDP, normally does not enter management research, but I hope to persuade you that the consequences of GDP targets are far-reaching and reach into firms. I won't gainsay that a growing economy is good for firms as in 'a rising tide lifts all boats'. However, GDP targets, as distinct from growth, may not be good due to the distortions they induce. Bear with me.

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To start, an excursus on GDP and GDP targets. GDP is the size of an economy, the sum of goods and services produced within a country's borders. Per-capita GDP is sometimes a surrogate for the well-being of its citizens. Developing countries especially pay attention to GDP growth as a simple indicator of economic progress and, not incidentally, government effectiveness. Many developing countries that historically had command economies continue to set and incentivize GDP targets as a means of spurring growth. China is the most conspicuous among them, as it is the largest and sets GDP targets at the national, provincial, and local levels, regularly reporting its performance against these targets. China, further, aims for the size of its economy to overtake the US soon. China's current GDP growth target is around 5 percent. Vietnam, also a former command economy, like China, tracks GDP growth and posted disappointing results when the economy grew 5.66 percent against a 6.5 percent target in the first quarter of 2024. This led Prime Minister Pham Minh Chinh to call for 'drastic actions' to accelerate growth (Bloomberg, 2024a). Few were surprised when Vietnamese growth leapt 6.93 percent growth in the second quarter.

Growth targets have perverse effects that are understood in theory but often ignored in application. GDP is conventionally measured as the sum of consumption (both household and government), investment, and net exports (exports minus imports). You can always look back to learn what GDP was. But here is the paradox: if you try to increase GDP by spending or investing a lot of money, you'll walk into the Malthusian trap of decreasing returns to scale – you get less and less for each dollar spent or invested and, ultimately, decelerating growth. For economists, the escape from the trap is a residual called total factor productivity or TFP. TFP is the growth *not* accounted for by capital and labor inputs into an economy. It creates space for growth despite decreasing returns to scale. Note, however, that TFP is a derived quantity rather than observed directly. Hence, as a practical matter, it is much harder to command TFP growth than growth of production, investment, or exports (more on exports shortly) as much as governments would like to. TFP growth has been a very good predictor of GDP growth. This is good news for most countries. But it is very bad news for China since their TFP growth has declined steadily since the 2008–2009 Global Financial Crisis (Brandt, Litwack, Mileva, Wang, Zhang, & Zhao, 2020; Zhu, 2024). As TFP growth or efficiency gains in the Chinese economy have spiralled downward, so has Chinese GDP growth.

The main culprit has been excessive investment in real estate and infrastructure. Real estate currently accounts for about 30 percent of the Chinese GDP, a 'stunning' percentage attributable to the government's reliance on real estate for GDP growth according to Rogoff and Yang (2024). Memories are short. Few recall that at the height of the Global Financial Crisis, the Chinese central government mandated massive local government investment in real estate and, for the first time, authorized local governments to borrow in support of stimulus-mandated real estate projects. The borrowing was done via newly created local government financing vehicles or LGFVs. At the time, it was assumed that the appreciation of land, all owned by the government, would cover LGFV indebtedness. But appreciation did not materialize. Today, LGFV debt is far beyond the capacity of local governments to service, as much as RMB 90 trillion or 88 percent of Chinese GDP (Jia & Yang, 2023). Two of China's largest developers, Country Garden and Evergrande, face liquidation and the Chinese central government, via SOEs, may have to step in as the buyer of last resort of distressed real estate. China's high-speed rail network is similarly distressed as zombie rail lines and stations abound and railway debt approaches RMB 6 trillion. Fares on high-speed trains have increased sharply (Nikkei Asia, 2024). High-speed passenger service has all but crowded out rail freight service, leaving most goods on trucks and overall Chinese logistics costs stubbornly high, at about 14 percent of GDP (State Council of PRC, 2024).

The underlying problem of GDP growth targets is that they are too easy to achieve the wrong way, e.g., by borrowing rather than enhancing efficiency, and too susceptible to the law of diminishing returns – the more you consume, invest or export, the less their contribution to economic growth. Indeed, the ultimate drivers of economic growth remain hotly debated among economists, among these drivers are entrepreneurship, transparent markets, and high-quality management (Susskind, 2024). Entrepreneurship has withered in China since the takedown of Jack Ma in October 2020.

VC-backed startups have all but vanished from a peak of 51,000 in 2018 to 1,200 in 2023 (Financial Times, 2024).

Wither Global Commerce?

I'll now turn to the prospects for firms. They are fraught. What has happened in real estate and railways is now occurring in manufacturing: overcapacity. Unlike real estate and railways, however, manufactured products are readily exported, and China has pivoted from an investment to an export binge consistent with the policy of preserving basic industries enunciated in the 14th Five-Year Plan. Growing household consumption, which remains stuck below 40 percent of GDP, seems not to be an option as consumers have lost their appetite for spending due to the collapse of real estate and the sharp decline of the Chinese stock market (Bloomberg, 2024c) that have triggered a sharp decline in consumer confidence. The key data are these: since COVID, capacity utilization in the Chinese industry has fallen steadily, though with a slight uptick in the second quarter of 2024. Inventories – unsold goods – have crept upward despite declining capacity utilization (Rhodium Group, 2024). And August 2024 Chinese exports increased 8.7 percent year-on-year compared to a 0.5 percent increase in imports (Reuters, 2024).

Overcapacity and excess inventories notwithstanding, China exports from a position of strength. The problem for smaller countries is not only their trade imbalance with China. It is also their disadvantage in the face of coordination of Chinese manufacturers.

> … the Chinese government can encourage companies to partner together, merge and consolidate, coordinate to gain market shares, raise prices, restrict access to products where they already have substantial market power, or favor domestic firms in their suppliers and client networks. As a result, China's dominant position across so many product categories considerably limits the space for new entrants to emerge as new manufacturing powers (Rhodium Group, 2024: 5).

Ironically, the Chinese business community also looks to the central government to temper excess production. China's solar panel industry, which today commands an 80 percent global share, has pleaded for relief:

> Leaders from some of China's top solar manufacturers called for increased government action to guide the industry as excess production capacity slashed prices and profits … China's central government should help coordinate the solar industry's development to help companies avoid over-competition, Trina Solar Co. Chairman Gao Jifan said at a conference in Shanghai … Gao said. 'Local governments are trying to attract business, and banks want to lend too much' (Bloomberg, 2024b).

Excess capacity has upended the position of global automakers in China. General Motors CEO Mary Barra has called the situation in China unsustainable. 'Very few people are making money, and a lot of OEMs are prioritizing production over profitability', Barra said, adding 'the amount of companies losing money there cannot continue indefinitely' (Bomey, 2024).

It is hard to predict what will happen. Will export of excess manufacturing capacity spread – will other countries become predatory under the guise of industrial policy to maintain growth at home? Will tariff and technology barriers curb predation and at what cost? (Should we remind MOR readers of the pernicious effects of the 1931 Smoot-Hawley tariff?) What we do know is the arithmetic of GDP: my net exports are your net imports and as my GDP grows through net exports yours suffers from net imports. Hence, as I export to increase my GDP, the GDP of my overseas customers shrinks and their capacity to import ultimately declines. Again, diminishing returns to scale.

Wrapping Up

In this short essay, I'm seeking a corrective to standard thinking about state management. Conventionally, state management is viewed as archaic, a holdover from planned economies impairing

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firms' profitability, productivity, and in most instances innovativeness. Further, due to its inferior performance, state management is receding and of limited interest to management scholars. Here, I take issue with convention. I've shown that state control, if not outright state ownership of enterprises, remains substantial and may be growing (as it almost certainly is in China). I've suggested that while short-term GDP targets of the state rather than the value delivered to nonstate shareholders may justify state management and motivate state managers, GDP targets contribute to excess investment and industrial capacity and, consequently, declining productivity and predatory export strategies, all elements of malign growth.

The immediate challenge is reducing the allure of GDP growth targets. Targets would be less attractive, I believe if global institutions like the World Bank and the IMF explained that growth forecasts aren't very accurate. From 2010 to 2020, same-year World Bank country GDP forecasts were off by 1.3 percentage points, and IMF forecasts were off by 1.5 percentage points, with the IMF consistently more optimistic than the Bank (Gatti, Lederman, Asif, Nguyen, Lotfi, & Mennatallah, 2024). Growth targets would also be less attractive if evidence from smaller firms confirmed that higher targets are detrimental to innovation as among Shanghai- and Shenzhen-listed firms (Sun, Chen & Wu, 2024). And part of the burden falls on economists and behavioral scientists to explain that targets are always two-edged swords, and that what you measure rather than what you want is most often what you get. The measure – not the cause – of GDP is output. Short-term GDP targets get you greater output, not the creativity and innovation that are the ultimate sources of efficiency and hence economic growth and improvement in peoples' well-being.

To return to the reminiscence: the tenor of this essay differs from 'Managing Indefinite Boundaries'. 'Indefinite Boundaries' was, on balance, optimistic about the prospects for state management given that CIMC succeeded by keeping its principal state owners at bay and sometimes fighting them. Twenty years later, I find less cause for optimism. The reach of state management has extended and its grip has tightened, certainly in China and possibly elsewhere. The concern here is the fondness of officials and state managers for growth targets ultimately getting in the way of the economic growth that is sought. A further concern is cultural: how to reverse reflexive reliance on the state to maintain economic growth even as growth targets prove counterproductive. Let's hope that the right questions are asked and lessons learned from the experience of China and elsewhere and shared via journals like *Management and Organization Review*.

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