Does China Cheat? A Careful Analysis

By Matthew Person

China cheats by subsidizing the exports of government-owned “national champions” to crush its free market competitors and dominate global markets.

China cheats by subsidizing manufacturing with cheap loans and cheap energy, and also by turning a blind eye to environment, health and safety standards.

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- Steven Mosher, Fox News, “How Does China Cheat on Trade?”

In today’s polarized political climate between the U.S. and China, oftentimes rhetorically-charged, sweeping claims are published in news outlets to spark outrage. When egregious charges are made, it is important the reader does his own research to determine the claims’ validity.

One such claim often levelled by Western sources towards China is that the eastern nation “cheats” on trade. In his article, “How does China Cheat on Trade?” Steven Mosher, amongst other claims, accuses China of “cheating” by “subsidizing the exports of government-owned ‘national champions’” and “by subsidizing manufacturing with cheap loans and cheap energy” to the effect of crushing its free market competitors (Mosher). He asserts that, because of its cheating, [China] already dominates industries ranging from ship production and refrigerators, to color TV sets, air conditioners, and computers.

A more thorough analysis of the situation surrounding this simplified statement reveals that, while Chinese companies do offer illegal subsidies, they only do so to certain companies in certain industries. Other Chinese companies succeed due to free market ingenuity.

“Cheating” is a loaded word, and, in order to determine whether China “cheats”, a consistent definition of “cheating” must be established. Cheaters are those who get ahead by breaking rules. In the economic realm, many countries, China included, have agreed to a common set of rules established by the World Trade Organization. Rather than explicit tariffs, Mosher argues China cheats through subsidizing Chinese companies.
To determine whether China “cheats,” we must first establish that China actively subsidizes, then investigate whether these subsidies violate rules of the WTO. Through analysis of an in-depth quantitative report submitted to the government in 2008 by Capital Trade Incorporated (CTI), a US-based international pricing consulting firm, (Delgado) one can analyze the nature and extent of subsidies provided to many Chinese companies.

The CTI report analyzes two main classes of industries in China: Those over which the government asserts “absolute control” and others the government deems “heavyweight,” or still very important to the economy, albeit not “state-controlled”. (Capital Trade Incorporated v.) To determine whether China’s subsidies “cheat”, we should focus on the “heavyweight” industries as these tend to be ones in which China competes internationally. It encompasses fields like autos, information technology, and textiles. By analyzing financial statements from Chinese companies that are, in-part, publicly listed in Hong Kong, the report determines the size and category of subsidies received (vi).

Mosher’s claim rests on his assertion that China subsidizes “government-owned” national champions. Obviously, the government owns and controls its domestic “State Owned Enterprises”, for which a comprehensive list is published (“State-Owned Assets...”). However, further research reveals China’s government can own significant stakes of privately listed companies which tend to compete in international markets.

Just because a Chinese-based company is privately listed does not mean it is not controlled by the Chinese government. Take the Jingwei Textile Machinery Company, for example, which received total subsidies equating to 2.3% of its revenue (Capital Trade Incorporated 66). In 2008, only 66% of the company was listed on the HKEX. 33% of the company was owned by the China Textile Machinery Group (“CTMC”) (66). 87.5% of the CTMC is owned by the China Hengtian Group Company, which is wholly-owned by the Chinese government (66). Therefore, the Chinese government really owns roughly 29% of a supposedly “privately-held” company.

While some may argue that a less than 30% share is not a majority, and thus not a significant stake, market players commonly exert influence over their “champions” with far less ownership. U.S. activist investing hedge fund Elliot Management’s $3.2 billion stake in AT&T, for example, represented less than 2% of AT&T’s overall market cap but still effectively pushed for “cost cutting and management changes” (“AT&T, Elliot…”).

Thus, the JTMC example reveals that China owns many more companies than its official “SOEs” in industries that compete with American firms, and owns enough to wield influence over their operations. Then, to claim that many “state-owned” enterprises receive subsidies proves valid, as many companies are significantly owned by the government and receive beneficial subsidies.

Next, we must determine whether the subsidies received constitute “cheating” by comparing subsidies in heavyweight industries to WTO guidelines. According to the WTO, subsidies are prohibited if they are “contingent, in law or in fact, on…export performance, or on the use of domestic over imported goods” (“WTO Subsidies…”). According to the CTI report, many subsidies are delivered to Chinese companies are delivered in the form of “Tax subsidies,
preferential loans, and grants” as well as providing “favorable input prices and asset transfers” below market prices” (Capital Trade Incorporated v.).

Some subsidies, such as preferential loans and below-market prices, would indeed go against WTO guidelines as they disproportionately reduce Chinese input costs compared to U.S. firms, letting Chinese firms lower end prices to consumers and increase relative net exports. And, these types of subsidies do occur. For example, when IRICO Group Electronics Company Limited bought a production facility for 280 million RMB that cost its government-owned parent 800 million RMB to build, it effectively received a fixed-cost-reducing subsidy which allows it to price its goods lower than American firms (Capital Trade Incorporated 75). Given this, it is fair to assert that some Chinese players have “cheated” by receiving subsidies in violation of WTO code which, even if it occurred in 2008, means they received unfair advantages which are still reaped today.

China certainly may “cheat” in some instances, but in order to establish it as a serious “cheater” they must do so on a large scale and offer subsidies significant enough in size to negatively impact American companies. The CTI report calculated that, in 2008, the range of subsidies that could be reasonably calculated across all industries ranged from 0.57 percent to 44.93 percent of revenues, with the average rate being 18.6%. (14). Certainly, an 18% subsidy can make a large difference between a firm posting a profit or a loss. However, it is important to recognize not all of these subsidies make significant impacts on each company, as evidenced by combing through financial statements of two previously-mentioned firms. Some firms, like JTMC, have high profit margins already and receive low subsidies. In 2007, JTMC received a 2.3% subsidy (68), while having a total profit margin of 21.5% (“JMTC Annual” 4). Other firms, like IRICO Group Electronics, have low profit margins that are boosted by subsidies. Without its 10.5% subsidy rate (76), the firm would have posted a -8.5% loss on revenue instead of a 2.0% profit margin (“IRICO Annual” 4). Though these are just two examples, the intuition behind it makes sense. Firms that already have high margins do not need subsidies as much as those struggling to turn a profit. Based on this, it is fair to claim that illegal subsidies do have a significant impact on some companies in some industries, but one cannot assert that China “cheats” across the board.

It is reasonable and true to claim that China unfairly supports some businesses in its heavyweight industries to the detriment of those in the US. If one considers heavyweight industries “national champions,” then Mosher’s statement that China cheats by subsidizing “national champions” has some validity, as they do illegally heavily subsidize some companies. However, many companies in heavyweight industries are also barely subsidized at all and compete on free market principles. Additionally, if one considers truly privately-owned, high-profile Chinese companies such as Alibaba “national champions,” then Mosher’s claim is weakened. Plenty of Chinese businesses seem to have become powerhouses without state ownership and “cheating”. Alibaba was able to grow and grab market share organically without ownership by the government. Unlike “heavyweight” industry companies, Alibaba is completely privately held, majorly owned by Masayoshi Son’s Softbank (Zucchi).

Furthermore, many argue it was able to become successful without government help, rather through smart business decisions made by Jack Ma. When launching Taobao, he chose to
advertise on TV, not charge listing fees, and develop a more consumer-focused platform, all which helped fend off E-bay (Wang). While this does not prove China’s government did not unfairly help Alibaba, it suggests that not all Chinese companies require subsidies in order to beat out western competition. Sometimes, they just have better business models, or are more in tune with the consumer, resulting in market forces carrying Chinese companies to victory.

Finally, given that some companies receive illegal subsidies and others do not, is it fair to claim that China’s cheating allows its firms to “crush” their free market competitors? Data does show that US firms would be better off if China did not issue subsidies, though it is difficult to conclude to what extent “cheating” subsidies shift the tides of industry, and the extent to which each industry is affected.

Many people believe that Chinese subsidies harm US firms by allowing them to sell at lower prices, or “dumping”. When foreign firms “dump” products at prices below the established domestic market price, sometimes even below the per-unit cost, they do so to obliterate market share in the short term (“International Trade”). Indeed, a recent case decided by the International Trade Commission found at least 20 Chinese companies “dumped” steel nails in the US from 2017-2018 at below market prices (“Steel Nails”…). While dumping does occur, it is possible for a firm to lower product prices without subsidies if they possess privately-raised liquidity on their balance sheets to cover input costs and weather the short-term storm. Thus, not all “dumping” can be attributed to cheating government subsidies.

Overall, it is clear that China does have ownerships stakes in some of the domestic companies which it helps through subsidies. It is also true that China “cheats” economically sometimes by providing favorable loans, favorable input prices, and assets below market price in violation of WTO principles. Sometimes Chinese firms even sell their goods below market price with the intent of gaining new customers. And, when this happens, American firms, who cannot fairly compete with deflated prices, are worse off because of it while Chinese firms – sometimes sizably owned by the government, benefit.

However, it is also apparent that the extent and nature of subsidy-related help offered by the Chinese government varies across industries and, furthermore, companies. Plenty of Chinese business successes can be attributed to the ingenuity of its businesspeople like Jack Ma.

Thus, Mosher’s broad-based claim that “China cheats” through subsidies and destroys American industries oversimplifies the issue. In highly-tense times, this rhetoric pins China as a scapegoat, when, realistically, evidence does not reveal an overarching Chinese effort to consistently “cheat” American firms across the entire economy. Instead of painting the issue in broad terms, Americans should be analyzing instances of cheating through subsidies on a case-by-case basis. In doing so, hopefully tensions can be reduced, and the Chinese companies that do violate international trade law can be addressed in a civilized way that also fairly and properly punishes violators.
Works Cited


