

## State Intervention and Private Enterprise: Japan, the U.S., and China

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*This conference addressed the topic of state intervention in private enterprise, comparing recent and historical trends in the United States, China, and Japan. Speakers and discussants addressed a broad range of topics relevant to the subject of intervention, from state-owned enterprises, to government buyouts of distressed firms, to regulation surrounding foreign direct investment. This event was co-hosted by the Center for Japanese Legal Studies (CJLS) at Columbia Law School, the Center on Japanese Economy and Business (CJEB) at Columbia Business School, and the Japan Economic Foundation (JEF).*

### Panel I: United States

In the first panel, Gary Clyde Hufbauer, Reginald Jones Senior Fellow at the Peterson Institute for International Economics, gave a presentation on state intervention in the U.S., followed by responses and further discussion with Christopher J. Mayer, Paul Milstein Professor of Real Estate at Columbia Business School, and Roger Kubarych, vice chairman of Craig Drill Capital and former national intelligence manager at the National Intelligence Council. Merit E. Janow, dean and professor of professional practice in international economic law & international affairs at the School of International and Public Affairs (SIPA), Columbia University, moderated the panel.

Dean Janow opened the panel discussion by sharing a memory from the 1980s, when many in the United States were debating Japanese interventionist policies in the industrial sector, including direct subsidies, bailouts, and



(Left to right) Roger Kubarych, Christopher J. Mayer,  
Gary Clyde Hufbauer, Merit E. Janow

heavy import tariffs. Then the U.S. government made several large-scale interventions, albeit generally followed by a rapid government exit, in the wake of the 2008 financial crisis. With this in mind, she asked the panelists what they believe to be the nature and effectiveness of U.S. intervention in private enterprise.





Hugh Patrick, Robert D. Calkins Professor of International Business Emeritus and director of the Center on Japanese Economy and Business

Dr. Hufbauer responded by stating that every country has its national myths. In the case of the United States, the myth is that the government does not intervene in private enterprise. He asserted that, on the contrary, the United States has at least three distinct, regular forms of industrial intervention policy. The first is the tax code, which he contended is an illustration of interventionism favoring small enterprises. He asserted that this type of intervention strongly disfavors large firms, who pay the highest statutory tax rates. The second example of U.S. intervention is the provision of explicit and implicit loan guarantees; while Fannie Mae and Freddie Mac were not explicitly guaranteed before the Great Recession (c. 2008), they were implicitly supported, and since the Great Recession have been explicitly guaranteed. In addition, since the Great Depression (c. 1930), U.S. farmers have benefitted from favorable-rate and easy-term agricultural loans. In general, the U.S. Congress favors loan guarantees for select frontier industries, and for the last decade, has strongly favored renewable energy. The third example Dr. Hufbauer cited was price and volume support for favored industries. While agricultural commodities are perhaps the most obvious example, he also addressed renewable energy and health policy. For example, the U.S. government guarantees prices for green energy, and Obamacare requires the compulsory purchase of insurance by individuals.

Dr. Hufbauer concluded by outlining three phases of robust U.S. interventionism: agricultural subsidies beginning in the Great Depression; support for the housing industry after the Great Depression; and the recent bailouts of large failing firms. The continuation of these policies is evidence that the United States is an interventionist state, despite myths to the contrary.

Professor Mayer, an expert on the housing and financial service credit markets, agreed with Dr. Hufbauer's remarks that the housing industry is a favored industry. The fact that implicit rent is non-taxable is one clear piece of evidence for this assertion. Professor Mayer added to this idea, explaining that housing is the most significantly subsidized sector worldwide because the largest financial return to owner-occupied housing is that "you get to live in the home." He stated that, as far as he knows, virtually no country has a wealth tax specific to housing.

With regard to the 2008 economic crisis, Professor Mayer differentiated Freddie Mac and Fannie Mae from other "bailed out" companies, such as American International Group (AIG) and General Motors (GM). Freddie Mac and Fannie Mae, he explained, were purchased by the U.S. government without an exit plan. However, the government did not purchase every share of the two entities and left many private stakes outstanding, which have since been acquired by private equity investors. Professor Mayer contended that this lack of exit planning confuses investors and taxpayers alike. Investors need more information to make good decisions, and taxpayers need to maintain realistic expectations of their government.

Professor Mayer concluded by referencing Dr. Hufbauer's comments on the corporate tax code, arguing that the discussion is about "tradeable" versus "non-tradeable" goods. He explained that tradeable goods include those provided by large, economy-dependent firms, and non-tradeable goods include real estate. When tradeable goods are taxed, they move to other markets. When non-tradeable goods are taxed, they stay in their current markets. Thus, he argued that tradeable goods should have a lower tax rate.

Mr. Kubarych focused his comments on the restrictions that the U.S. government has placed on the ability of foreign companies to invest in the U.S. market. The United States is not unique in that every country has foreign direct investment (FDI) restrictions; many of these regulations are defense-related, but they also apply to aircraft and airlines, infrastructure, and broadcasting.

Mr. Kubarych explained that state intervention in this realm is coordinated by the Committee on Foreign Investment in the United States (CFIUS). This inter-agency committee assesses the national security risk of FDI transactions. About 100 foreign acquisitions of U.S. firms are brought to CFIUS yearly. CFIUS operates on tight deadlines so as to not hold up transactions. For the transactions that raise national security issues, the Committee can ask for modifications or discourage the transaction in its entirety. Mr. Kubarych asserted that the vast majority of the cases are amicable and CFIUS does not represent a significant barrier to FDI.

Dean Janow then opened up the discussion by asking the group if they believe that cases of recent U.S. intervention have been successful, and if so, why. The first response came from Dr. Hufbauer, who asserted that the success of government intervention in Freddie Mac and Fannie Mae is yet to be seen. Professor Mayer agreed with Dr. Hufbauer, but went further to say that government intervention in this case should be a model of “what not to do.” Professor Mayer asserted that part of the reason the housing market has not fully recovered is that Freddie Mac and Fannie Mae have acted neither in the market’s interest nor in their own financial interest. Mr. Kubarych expressed a slightly different view, recalling the history of Freddie Mac and Fannie Mae. He contended that they did indeed misbehave, but not in the way economists thought they would. He also argued that it was the private sector that truly got the housing market into trouble by creating collateralized mortgage obligations based on subprime mortgages.

Dr. Hufbauer pointed out that the case of General Motors was a successful example of U.S. government intervention. The government effectively prioritized stakeholders’ interests while maintaining investor confidence.

Dean Janow posed additional questions: how should the rest of the world react to U.S. intervention? Is it a violation of the subsidies code or was government intervention absolutely necessary during such a crisis? Should states be allowed to intervene during crises?

In response, Dr. Hufbauer stated that, should other countries wish to continue as democratic, middle-class countries, they should follow the example of the United States and prevent the financial sector collapsing during a crisis. Complete collapse ensures fire sale conditions, which are terrible for middle class families. He cited Greece as an example.

Mr. Kubarych asserted that high-level policy forums such as the G-20 should facilitate extended dialogues on excesses, and countries should be prepared to compensate for their own misdeeds in intervention when their actions create negative externalities for the global economy. Mr. Kubarych maintained that this is the reason he is supportive of multilateral trade pacts such as the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP); these are venues in which countries can achieve mutually beneficial results.



Kazuhiko Toyama

## Panel II: China

Yasheng Huang, international program professor in Chinese economy and business and professor of global economics and management at MIT Sloan School of Management, gave a presentation on state intervention in China, and Long Ke, senior fellow at the Economic Research Center of Fujitsu Research Institute served as discussant. Professor Curtis J. Milhaupt, Fuyo Professor of Japanese Law and director of the Center for Japanese Legal Studies, moderated the panel.

Professor Huang refuted any argument claiming equivalence between the United States bank bailout and the type of intervention the Chinese have long been engaged in. He pointed out three critical dimensions against which to assess the way each country has handled state intervention. First is the rationale for state intervention, which has two parts: 1) response to a market failure; and 2) acting as substitute for the private sector. In the case of China, the state intervenes as a private sector substitute. The second dimension is whether or not the state intervenes with a social or an economic purpose. For example, he explained that Obamacare is designed to deal both with a market failure and to promote a social objective. The third dimension is the institutional setting in which the interventions are undertaken—in short, whether or not the intervention is deliberated in a democratic setting will determine the level of transparency.

Professor Huang presented his summary of the three key characteristics of state capitalism: 1) intervention in the economy is performed in a one-party system; 2) the government acts as a substitute for the private sector; and 3) government intervention into private enterprise is not done for social purposes, but instead performed for economic, even political-economic, purposes. Professor Huang criticized this model, arguing that economic performance is sacrificed in state capitalism.

By dissecting China's model and current status, Professor Huang challenged the assertion that China is the “new magic for economic development.” He recalled the importance of maintaining a historical perspective: state capitalism may spur the economy to grow quickly, but it compresses and causes a long lag in growth. Professor Huang drew on examples of Brazil in the 1960s and the Soviet Union to support his analysis.

Professor Huang addressed the argument that became popular after the 2008 global recession that democracy is “bad” for economic growth. He stressed the importance of using relevant benchmarks when comparing economic growth. If one compares India and China, for example, then India's growth looks quite small. However, if one then compares India and Pakistan, one could conclude that GDP grows faster within a democracy than under an authoritarian regime.



(Left to right) Long Ke, Yasheng Huang, Curtis J. Milhaupt

Comparing democracies to one-party systems, Professor Huang stated that one-party systems either do extremely well or extremely poorly. He argued that a country's political system is a reflection of how risk tolerant it is; one-party systems have higher economic growth potential but are much more volatile.

Professor Huang asserted that there are many challenges facing the Chinese economy today, chiefly the unbalanced nature of the country's economic growth. While state capitalism is good at producing GDP growth, it is not good at increasing personal income. He explained that personal income as a share of GDP started out in the early 1990s in China at about 45–47%, which was already low among countries in its income range. Currently, personal income to GDP is around 35–37%, by far the lowest among any major economy for which data are available. In addition, labor's share of GDP has come down significantly; consumption share of GDP is destined to decline further as a result.

Professor Huang concluded by noting that very few countries have been able to graduate from the middle income trap after World War II. The countries that were able to graduate in the 1970s and 1980s had low income inequality. Therefore, China's high level of inequality will most likely prevent it from graduating. However, he noted that the current administration of Xi Jinping is more interested than previous administrations in correcting income inequality.

Mr. Ke expressed agreement with Professor Huang's analysis, asserting that due to the policies of the Hu Jintao administration, the current Xi Jinping administration faces many difficulties, such as how to approach government reform, sustain economic development, and stabilize growth. Mr. Ke agreed with Professor Huang, particularly regarding the serious problem of income inequality, with 3% of the population owning 75% of the country's assets.

Mr. Ke concluded by stating that China's challenge is to maintain its progress in economic development. In order to succeed, the Xi Jinping administration must reform the economic system and strengthen the rule of law to realize that goal in the long term.



*(Left to right) Long Ke, Yasheng Huang*

Professor Milhaupt stated that while both Professor Huang and Mr. Ke alluded to the propensity of the Xi Jinping administration toward reform, he finds it unlikely that the political system will be fundamentally overhauled any time soon. He asked Professor Huang and Mr. Ke what kinds of reform they believe are feasible, which specific reforms are most important in the next few years, and whether it is possible to gauge the seriousness of the government in generating real reform.

Mr. Ke responded by contending that the current Chinese administration is concerned about social stability, but also about slowing economic growth, and as such, is finding it hard politically to advocate for reform. Professor Huang responded by explaining that, before 2008, Chinese private entrepreneurs were largely supportive of the government. Since then, there has been a shift in opinion, which has only been exacerbated by arrests of those who speak up against the government. By and large, members of the private sector are disappointed with Xi Jinping's leadership, Professor Huang claimed. He concluded by stating that, while capitalism may be associated with income inequality, it is not the reason for Chinese inequality; state control is the ultimate cause.



### Panel III: Japan

Kazuhiko Toyama, representative director and CEO of Industrial Growth Platform, Inc., gave a presentation on state intervention in Japan, followed by responses and further discussion with Sota Kato, professor at the International University of Japan and senior fellow at the Tokyo Foundation, and Edward Lincoln, professorial lecturer at George Washington University and adjunct professor of economics at Columbia's Department of Economics. The panel was moderated by Alicia Ogawa, senior advisor at CJEB and adjunct associate professor at SIPA.

Professor Ogawa commenced the session by framing industrial policy as either reactive or proactive. Proactive economic policy is what Japan is famous for—from managing the decline of industries that are overly mature to supporting new industries that the government foresees to be winners, both domestically and in export markets. However, this policy has resulted in the government intervening to fill voids the private sector is reluctant to fill. The private sector is thus disinclined to take any risks, illustrated by its hesitancy to supply risk capital, manage its own consolidation of excess capacity, and pay wage increases.

Mr. Toyama began by explaining that the majority of his remarks were based on his experience as chief operating officer of the Industrial Revitalization Corporation of Japan (IRCJ) from 2003 until 2007. The IRCJ was a government-owned fund that bought failing companies' debt and equities, restructured the firms, and then sold the companies back to the market through a control-share auction. The IRCJ assessed more than 200 companies and intervened in 41 during its time of operation (April 2003 – March 2007).

Mr. Toyama classified two main challenges with his work at the IRCJ: 1) determining the criteria for intervention; and 2) being conscious of the public interest. Both challenges were complicated by political and media pressures, leading to market distortion. Mr. Toyama used the bankruptcy of Japan Air Lines (JAL) as an example to explain these



(Left to right) Edward Lincoln, Sota Kato, Kazuhiko Toyama, Alicia Ogawa

challenges. Specifically, when JAL ran into trouble, the government provided so much assistance that it was unfair to JAL's competitors. Mr. Toyama argued that it was necessary for the government to step in to protect the domestic economy—allowing JAL to fail would have created a domestic shock. However, since JAL did not go through the typical control auction and the government allowed JAL to re-list its shares, this hampered the market power of All Nippon Airlines (ANA), JAL's main competitor; if JAL had been brought to auction, ANA would have had the chance to buy in.

Mr. Toyama concluded by saying that once a government chooses to intervene in private enterprise, the government itself becomes a market player and runs the risk of distorting the market through government influence. Intervention can be justified, but the government should not manipulate the competition and should be careful in implementation. In this sense, the IRCJ is viewed as a successful venture in Japan. However, Mr. Toyama argued, “the reality of intervention is that human beings don't have invisible hands.”

Professor Kato generally agreed with Mr. Toyama's comments, but said they brought up a key question: can the guidelines on these public-private funds be implemented? More specifically, can market incentives prevail despite heavy Japanese government intervention? He also pointed out that there is a high level of political involvement in these funds, further restricting market forces.

Professor Kato illustrated this dynamic with an example regarding these public-private funds and their administrator, the Ministry of Economy and Industry (METI), an agency which also creates and implements industrial policy. Historically, METI was insulated from politics, even during Japan's high-growth era. It lacked the authority of the Ministry of Finance and had little influence on the banking sector. Without having financial tools, METI was only able to act as a weak coordinator of the private sector during the high-growth era. Because of this weakness, METI often had to succumb to the market incentives of the private sector. However, METI's portfolio now includes public-private funds that provide long-awaited financial tools for METI bureaucrats. METI is also more susceptible to political influence; recently, PM Shinzo Abe convened a Cabinet meeting regarding these funds, exemplifying the politicization of industrial policy. In turn, METI's influence on the private sector is also enhanced.

Given the politicization of METI and these funds, Professor Kato said he finds the political, bureaucratic, and economic motivations of all different parties involved hard to reconcile. He concluded that one of the key success factors for public-private funds is to allow market incentives to prevail. Therefore, it would be necessary to develop a long-term strategy for governing these funds, with careful design of incentive mechanisms.



Sota Kato

Professor Lincoln initiated his comments with a broad observation: Japan resembles neither the United States nor China with regard to state intervention in the private market. Looking back to the 1970s and 1980s in Japan, there was a deep mistrust of markets on the part of government officials, academics, and the private sector. They did not trust the market to allocate resources in the correct direction to enable the economy to grow faster. Therefore, Japan initiated an active industrial policy including state financing through the Japan Development Bank, some state ownership (but not to the extent of China-style SOEs), very specific tax breaks, and subsidies to the agricultural sector.

Professor Lincoln stated that, since these industrial policies of the 1980s were implemented, there has been a reversal trend: some tax breaks have been removed, Japan National Railways and NTT have been privatized, and even agricultural subsidies have been somewhat relaxed. Additionally, the Japanese market is more open to imports, which in turn creates more domestic competition, and makes it difficult to run an industrial policy “behind the closed door of protectionism.”

Professor Lincoln addressed Mr. Toyama's argument that, while there is a case to be made in favor of government intervention and bailouts, the government must be very careful about choosing when to act. Building upon this, Professor Lincoln argued that perhaps the IRCJ was not being careful enough when deciding which companies to bail out; referring back to a list Mr. Toyama provided detailing the 41 companies that the IRCJ rescued, he said some of those businesses deserved to fail.

Professor Lincoln said he was disturbed by the addition of many more Japanese public-private funds similar to the IRCJ, calling them reminiscent of an old-fashioned industrial policy rather than crisis-response mechanisms. He was concerned that PM Shinzo Abe was trending toward renewed government involvement in the economy, and questioned if this move was political in nature. Professor Lincoln expressed concern about Japanese government intervention moving forward, saying that the ultimate

justification for intervention is market failure, which occurs much less in modern times than it did in previous decades such as the 1950s and 1960s. He contended that today, Japan has a harder case to make for intervention.

Professor Ogawa asked the panelists if they believed that the absence of risk and venture capital is a market failure, and why the IRCJ and the similar private-public funds have not jump-started the venture capital industry in Japan. Professor Kato explained that he considered the funds to be the transition step in the creation of a new, alternative private-led financial system that will someday include risk capital. Professor Lincoln claimed that these funds will not fix the problem of lack of risk capital, but this issue can instead be resolved by providing incentives for Japanese companies to be more accepting of foreign firms and capital, which, in turn, would change the risk environment.

The three panel sessions were followed by a roundtable discussion and audience Q&A. Two of the more interesting questions came from Professor Takeo Hoshi of Stanford University, one China-related and one Japan-related. His China question addressed Mr. Ke's remark that reform in China has been talked about both during the Hu Jintao administration and now in the Xi Jinping administration. He asked the panelists whether, based on the lack of progress with reform, they believe the government is actually serious about reform.

His Japan-related question referred to Professor Ogawa's point regarding the lack of private risk capital. He wondered whether a reason why the private sector is reluctant to provide risk capital is due to the potential for government intervention. In other words, does the government willingness to supply risk capital draw down the demand for the private sector to supply it.

Regarding the China-related question, Mr. Ke asserted that Japan acts in a more socialist way than China. The difference between Japan and China is transparency; in China, there is an enormous lack of transparency while Japan is very transparent. With regard to reform, strengthening transparency is politically very difficult for the Xi Jinping administration.



(Left to right) Alicia Ogawa, Kazumasa Kusako, Hugh Patrick, Curtis Milhaupt, Merit Janow

Mr. Ke said he did not know of an adequate solution to address the issue of transparency within a one-party system.

Regarding the Japan-related question, Mr. Toyama said that when the IRCJ came into being, some in the private sector were against it, while others were supportive. He contended that public-private funds can encourage private sector venture capitalists to get more involved, as these public-private funds have been very successful. However, when there is no economic crisis, the public-private funds do less work, and therefore don't provide examples of success to private sector venture capitalists. As such, he encouraged the government to come up with an adequate policy to encourage venture capitalists in times of economic stability.

Professor Milhaupt gave closing remarks for the conference, stating that the panels and roundtable had covered a huge range of topics. He said he was struck by the different mechanisms, motivations, and constraints at work in government intervention, and how this mixture has changed over time in the three countries discussed. The United States used to be more interventionist and now is more crisis-driven in its approach to government involvement in the economy. Japan shifted from old-fashioned industrial policy to a more market-conforming model, though perhaps it continues to vacillate between those two poles. Over the last thirty years, China has changed its mode of intervention from central planning to engagement in the economy through state-owned enterprises and investment vehicles; hopefully, it will continue to withdraw from direct market interventions.