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Privatisation and Local Governments in Mainland China: A Critical Assessment

Local authorities in China have already privatised most of their small and medium-sized state-owned enterprises (SOEs) following the endorsement of this policy by the 15th Communist Party Congress in September 1997. Their incentives for doing so, however, are often to be found in rent-seeking rather than in the desire to increase competition or attract foreign direct investment. Profound economic and institutional reforms will be required if "market-preserving" incentives are to become the dominant ones in China's transition process.

After a long and tortuous path of reform which had lasted two decades, the Chinese political leadership embarked in September 1997 on a major breakthrough in state enterprise transformation. The 15th Congress of the Chinese Communist Party (CCP) crossed a new threshold into the last stage of the reform of state-owned enterprises (SOEs): the transformation into modern corporations, including their total or partial privatisation. Now, with two years elapsed since this historic decision, the time has come to assess its first results. Scholars in China and abroad have devoted much of their time throughout the past couple of years to exploring the implementation of the programme set out by the 15th CCP Congress and discussing the effects of the measures taken. Some of the most recent literature in the English language, both in books and journals, has been provided by You Ji,[1] Edward S. Steinfeld,[2] Russell Smyth[3] and Yeh Chang-Mei.[4] These early assessments have adopted a critical stance on Chinese privatisation when addressing the two main facets of the CCP programme of "grasping the large and letting go the small" (*zhua da, fang xiao*). On the specific issue of privatisation of small and medium SOEs at the local level, Cao et al.[5] have recently provided a thorough study, which draws controversial conclusions with regard to the behaviour of local governments in the privatisation process.

The present article will attempt to summarise the main conclusions reached by Cao et al. and confront them with evidence provided by previous authors and other information sources from mainland China. Firstly, we will provide a brief examination of the progress of privatisation of small and medium-sized SOEs in China. Secondly, by analysing the incentives of provinces and localities to privatise SOEs, the article will cast doubts on the optimistic view shared by Cao and his co-writers. Thirdly, a new set of incentives will be used to describe the behaviour of local authorities in China, which challenges the arguments given by Cao et al. Finally, a brief critique of the whole privatisation process will be presented. Whereas Western critique is too often restricted to the discussion on corporate governance, we will here emphasise the need for additional reforms, which indirectly affect the course and outcome of state enterprise reform. These profound reforms are critical to the entire transition process in China, as evidence in Eastern Europe has shown.

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Progress of Privatisation at the Local Level

The 15th CCP Congress endorsed the process of enterprise transformation at the local level[6] which had actually been going on in China since the late 1980s. During the implementation of the Contract Responsibility System (CRS), local governments at all levels expanded their control over SOEs by investing in the

[1] You Ji: China's Enterprise Reform: Changing State/Society Relations After Mao, Routledge, London 1998.

[2] Edward S. Steinfeld: Forging Reform in China: The Fate of State-Owned Industry, Cambridge University Press, Cambridge 1998.

[3] Russell Smyth: Toward the Modern Corporation: Recent Developments in the Institutional Reform of State-Owned Enterprises in Mainland China, in: Issues & Studies, Vol. 34, No. 8 (August 1998), pp. 102-131.

[4] Yeh Chang-Mei: Reform of State-Owned Enterprises in Mainland China Since the CCP's Fifteenth Congress, in: Issues & Studies, Vol. 34, No. 5 (May 1998), pp. 52-78.

[5] Yuanzheng Cao, Yingyi Qian and Barry R. Weingast: From Federalism, Chinese Style, to Privatization, Chinese Style, CEPR Working Paper No. 1838 (March 1998). Recently republished in: Economics of Transition, Vol. 7, No. 1 (1999), pp. 103-131.

[6] Unless otherwise indicated, the term "local" refers in the following to all administrative levels below the centre which hold property rights over SOEs, i.e. provinces/regions, cities, counties and townships.

firms and sharing power with managers.[7] Thus, a pattern of de facto property rights emerged, which was officially recognised by the central government in the 15th CCP Congress strategy of "letting go the small" (*fang xiao*). As many as 66,000 industrial SOEs fall under the control of provinces and lower administrative levels,[8] counties and townships being the major "owners" in rural areas, whereas cities play this role in more urbanised regions. Provinces and autonomous regions hold control over a smaller number of enterprises of larger size, frequently of similar dimensions to their national counterparts.

The final stage of enterprise reform at the local level implies the corporatisation of enterprises through the issuance of shares and total or partial privatisation. Enterprises take either one of the corporate forms contained in the new Company Law (limited liability or joint-stock company), or the form of a shareholding cooperative, a hybrid corporate form close to Western cooperatives. In other cases, enterprises are directly sold off to private investors or kept in state hands as wholly state-owned companies. According to Cao et al., corporatisation and direct sales account for more than half of all privatisation cases at county level. In a survey of several provinces, 35% of all small and medium SOEs at the local level (county and city) chose to become shareholding cooperatives through privatisation, with this share reaching 50% in Shandong and 80% in Jiangsu.[9] In a global perspective, privatisation at the county and township levels has progressed rapidly in the past couple of years. By the end of 1996, up to 70% of small SOEs had been privatised in pioneering counties such as Yibin of Sichuan, Shunde of Guangdong and Zhucheng of Shandong. Although Chinese official statistics do not reflect the full extent of the transformation, because privatised firms may still be recorded as SOEs or take different corporate forms, some estimations take the end of 1998 as a turning point when most SOEs at county level should already be regarded as "gone".[10] In the meantime, reform has spread inland from the pioneering southern coastal regions. By 1994, about 24% of all shareholding enterprises (including shareholding cooperatives) were located in the central or western parts of the country,[11] while the northern province of Heilongjiang, home to one of the highest concentrations of SOEs, had privatised 91.4% of all its county-level state firms by mid-1996.[12]

Privatisation at higher administrative levels has progressed at a slower pace. The larger size of the firms and the need for deep restructuring, if existing jobs are to be saved, have called for a more cautious approach in cities and provinces. Large profitable provincial and city-owned enterprises have been partially privatised through stock issuance, both on Chinese domestic markets and abroad. In Hong Kong, for example, among 34 listed companies from the mainland (H-shares), we find the city-controlled Beiren Printing Machinery and the provincial Shandong Xinhua Pharmaceutical.[13] In many other cases, however, city and regional governments have to save ailing firms through the implementation of restructuring plans. Besides the classical Shanghai model of financing enterprise restructuring through the auctioning of land-use rights,[14] Cao et al. briefly describe alternative efforts undertaken by Heilongjiang province in this respect.[15] Across the country, local governments invest fresh capital in former SOEs, partially or totally privatised, in order to improve their financial situation. These funds come in most cases from the issuance and sale of enterprise shares, i.e. from privatisation itself.[16] Cao et al. stress the fact that privatisation in China has not been a widespread free distribution of shares, as occurred in Eastern Europe and Russia, but high private savings have allowed real share prices to be paid.[17] Yet, except for the former case of reinvestment of privatisation proceeds, the authors do not discuss in detail the use of such funds by local authorities.

Incentives of Local Governments

Following previous work on the impact of decentralisation on the budget constraint of local governments,[18] Cao et al. present fiscal federalism as the

[7] See on this issue the classical work by David Granick: Chinese State Enterprises: A Regional Property Rights Analysis, University of Chicago Press, Chicago 1990.

[8] Table 4.1 in Yingyi Qian and Chenggang Xu: Why China's Economic Reforms Differ: The M-Form Hierarchy and Entry/Expansion of the Non-State Sector, in: The Economics of Transition, Vol. 1, No. 2 (1993), pp. 135-170.

[9] Yuanzheng Cao, Yingyi Qian and Barry R. Weingast: op. cit., p. 9.

[10] Ibid., p. 8.

[11] Shu Y. Ma: The Chinese Route to Privatization: The Evolution of the Shareholding System Option, in: Asian Survey, Vol. 38, No. 4 (April 1998), p. 387.

[12] Yuanzheng Cao, Yingyi Qian and Barry R. Weingast: op. cit., p. 8 (footnote no. 8).

[13] "Reform Ripples", in: Far Eastern Economic Review, April 9, 1998, p. 56.

[14] Shanghai pioneered this initiative in 1994 by helping 46 SOEs operating in the red in exchange for their land-use rights.

[15] Yuanzheng Cao, Yingyi Qian and Barry R. Weingast: op. cit., Appendix B. 2 (pp. 34-36).

[16] Ibid., p. 11.

[17] Ibid., pp. 8-9.

main driving force in the Chinese privatisation process at the local level. On the one hand, they emphasise the role of increased product competition from the non-state sector (mainly township and village enterprises – TVEs) in raising the cost of continued subsidisation of SOEs. On the other hand, they show how the budget constraint of local governments has been further hardened by recent developments in the fiscal and financial framework in mainland China.

The major tax reform of 1994 expanded the fiscal extractive power of the central government and reduced the fiscal revenue available to lower administrative levels. Former local product taxes have been merged into the uniform value-added tax, which is to be shared between the national and regional governments at a fixed ratio of 60:40. Moreover, the new Budget Law of 1995 requires local governments to balance their budgets and restricts borrowing in the financial market.[19]

After the latest period of economic overheating, Zhu Rongji led a major monetary and state banking reform in 1993-94. Together with a tight monetary policy, central banking operations were centralised by revoking the authority of local branches of the Central Bank. Also, the four major state specialised banks were commercialised and their management further centralised. All these measures were aimed at disciplining provincial and local governments and preventing them from engaging in destabilising "perverse" behaviour.[20] According to Cao et al.'s arguments, this greater discipline, i.e. the harder budget constraint, has greatly increased the cost of state ownership of unprofitable SOEs, thus encouraging local governments to privatise.

In an extension of the argument, Y. Qian and G. Roland[21] stressed the role of fiscal competition among local governments in China for attracting foreign direct investment (FDI). Provinces, cities and even counties face a continuous trade-off between covering the losses of local SOEs and investing in infrastructure as a means of drawing FDI. As fiscal revenue declines as a result of the 1994 tax reform, and the use of financial means becomes more restricted due to Zhu's financial measures, the trade-off of local governments becomes a more acute issue. With rising competition from other regions to attract FDI and increased costs of keeping SOEs afloat due to competition from the non-state sector, local governments may preferably engage in infrastructure investment at the expense of SOE financing. Hence, privatisation again appears as a means of relinquishing control over ailing SOEs resulting from the Chinese federalist structure.

Reassessing the Incentives of Local Governments

The arguments put forward by Cao et al.[22] and Qian and Roland[23] paint a bright picture of Chinese federalism as a device of smooth transition to a market economy ("market-preserving federalism"). However, when faced with reality, some of the lines of thought should be questioned. We will here re-examine the main factors which, according to the authors, have led to a harder budget constraint at the local levels and hence to accelerated privatisation of SOEs. Beginning with fiscal and budgetary constraints, we will later move to a brief analysis of recent financial reforms and end with a view on competition from the non-state sector and the role of FDI.

The 1994 tax reform was inspired by the main objective of raising the fiscal capacity of the central government, as Chinese economists had called for in the early 1990s.[24] However, the first assessments of the reform cannot conclude the attainment of this main purpose, nor the achievement of other secondary objectives such as increasing the capacity for income redistribution from the centre.

In a recent article, Wang Shaoguang showed how the share of central revenue to total fiscal revenue rose in 1994 but soon after declined continuously once again.[25] Although the decline is not steep and it may be too early to reach robust conclusions, Wang questions the future success of the 1994 tax reform in view of the remaining problems, such as tax evasion, tax reductions, tax arrears and the rise of extra-

[18] Yingyi Qian and Gérard Roland: Regional Decentralisation and the Soft Budget Constraint: The Case of China, CEPR Discussion Paper, No. 1013 (September 1994).

[19] Yuanzheng Cao, Yingyi Qian and Barry R. Weingast: op. cit., p. 18.

[20] As first cited in Wang Shaoguang's Proposal of 1993, the concept of "perverse" economic behaviour refers to the direct or indirect promotion of investment and consumption inflation by local governments. See Wang Shaoguang and Hu Angang: The Grave Consequences of the Declines of the State's Fiscal Capacity, in: Chinese Economic Studies, Vol. 28, No. 4 (July/August 1995), pp. 4-6.

[21] Yingyi Qian and Gérard Roland, op. cit.

[22] YYuanzheng Cao, Yingyi Qian and Barry R. Weingast: op. cit.

[23] Yingyi Qian and Gérard Roland, op. cit.

[24] For example, Wang Shaoguang and Hu Angang, op. cit.

[25] Table 2 in Wang Shaoguang: China's 1994 Fiscal Reform, in: Asian Survey, Vol. 37, No. 9 (September 1997), pp. 801-817.

budgetary funds, all of them stemming from undisciplined local governments.[26] The failure of the tax reform to increase the centre's fiscal capacity also raises doubts with respect to its ability to redistribute income through the fiscal system.[27] Income inequality among regions has been on the rise in China since the inception of Deng's economic reform in the late 1970s and the prospects for the next few years do not seem to point at a significant decline.[28] Moreover, another assessment of the 1994 tax reform has shown how income redistribution by the centre is based mainly on political rather than economic criteria. It also shows how a second and more important round of redistribution takes place, which uses pre-reform levels of tax collection by provinces as the reference for large compensations.[29] This practice undoubtedly favours rich provinces, which, in turn, transfer funds to subprovincial administrations.[30]

Already in the late 1980s, fiscal contracts between the provinces and localities led to a steep revenue decline at the county level, a tendency further exacerbated by the taxation reform, as Park et al. showed in 1996 for the Shaanxi province, one of the poorest in China.[31] Besides lacking an effective income-based redistribution from the centre, subprovincial administrative levels have lost the former product/consumption tax, replaced by the value-added tax administered by the centre. With their increasing financial difficulties, local governments have not complied with the Budget Law provisions and have run large budget deficits. By 1995 more than half of the counties in mainland China had fiscal deficits,[32] a fact confirmed by more recent observations,[33] while deficits in provinces and regions have also been on the rise since the late 1980s.[34] As Cao et al. emphasised, it seems clear that the 1994 taxation reform has reduced the availability of fiscal revenues to subprovincial levels through the taxation system. However, whether this has led to a harder budget constraint on local governments is quite a different matter.

In view of the widespread fiscal deficits at low administrative levels, we can conclude that the level of spending has not been significantly reduced. On the contrary, the centre has shifted responsibility for the provision of public goods further onto lower administrative levels, which is a classical stabilisation strategy in transition economies.[35] Hence, with higher spending and lower taxation revenue, local governments have resorted to self-raised and extra-budgetary funds to raise new revenue. Ad hoc levies have proliferated in China and have been subject to fierce criticism by scholars for their unclear and regressive nature (rich regions can generate larger off-budget funds).[36] Overall, the picture after reform is one of increased inequality among regions but not of a global reduction of spending. On the one hand, we have poor regions that face continuous difficulty in balancing their budgets. In most cases this has led to an exaggerated focus on revenue creation through off-budgetary means, i.e. through illegal fees and levies on citizens and enterprises, instead of by substantially reducing government size and spending.[37] Privatisation can here be seen as another way of increasing extraordinary revenue. On the other hand, rich regions have not suffered dramatic declines in the availability of funds, as their extra-budgetary funds are large and redistribution policies from the centre perpetuate the favourable pre-reform status quo, altogether compensating for less taxation revenue. Also, as the provisions of the Budget Law on balanced local budgets are not fully implemented, we have to question the disciplinary effect of this new regulation, which Cao et al. stressed as a major device in hardening the budget constraint at the local level. It is therefore questionable to conclude in all

[26] Ibid., pp. 813-815.

[27] Joseph Y. S. Cheng and Zhang Mujin: An Analysis of Regional Differences in China and the Delayed Development of the Central and Western Regions, in: Issues & Studies, Vol. 34, No. 2 (February 1998), p. 66.

[28] Cheng and Zhang expect a deceleration in the growth of regional disparities for the period 1996-2010, but do not believe in a medium-term solution of the problem (ibid., p 65).

[29] Carsten Herrmann-Pillath and Zhu Qiuxia: Stille Föderalisierung oder kalte Desintegration? Zum institutionellen Wandel des chinesischen Steuerstaates, Economics Faculty Working Paper No. 16, University of Witten/Herdecke, Germany, November 1998, pp. 18-25.

[30] Hence, poor provinces such as Anhui or Shaanxi are net contributors to the central budget (ibid., p. 22).

[31] Albert Park, Scott Rozelle, Christine Wong and Changqing Ren: Distributional Consequences of Reforming Local Public Finance in China, in: China Quarterly, No. 147 (September 1996), pp. 751-778.

[32] Wang Zhonghui: Township Public Finance and its Impact on the Financial Burden of Rural Enterprises and Peasants in Mainland China, in: Issues & Studies, Vol. 31, No. 8 (August 1995), p. 113.

[33] Carsten Herrmann-Pillath and Zhu Qiuxia, op.cit., p. 11.

[34] Hu Angang: An Ardous and Difficult Institutional Innovation: A Preliminary Assessment of the Reform in the Tax-Sharing System, in: The Chinese Economy, Vol. 31, No. 4 (July/August 1998), p. 42, Table 3.

[35] World Bank: From Plan to Market: World Development Report 1996, Oxford University Press, Washington D.C. 1996, p. 121.

[36] See Christine Wong (ed.): Financing Local Government in the People's Republic of China, Oxford University Press, Hong Kong 1997.

[37] Some cases of personnel reduction at the county level are reported by Albert Park et al., op. cit., p. 775.

cases, as Cao et al. do, that local governments face harder budget constraints than before. Moreover, privatisation may hardly appear as a means of reducing subsidisation to SOEs, since they increasingly rely on financing through the government-controlled financial system, as described below.

The Financial System

Another major factor in the new framework for local governments is the reform of the Chinese financial system. Here, also, the arguments provided by Cao et al. should be subjected to a closer examination. Zhu Rongji's financial reform of 1994 was mainly focused on the central banking system and did not tackle a major source of funding for enterprises and local governments: non-bank financial institutions (NBFIs). In fact, the most significant reform of NBFIs occurred some years before, in October 1988, when the State Council took action to curtail the booming expansion of trade and investment companies (TICs). Of more than 700 institutions, about 300 TICs remained after the clean-up,[38] although they continued to grow throughout the 1990s. Table 1 presents some relevant data that show the growing importance of NBFIs, especially TICs, in the Chinese financial system. Even in the 1990s, after the great clean-up of 1988, TICs have grown at a faster pace than the whole financial system and faster than NBFIs themselves. By 1994, NBFIs had drawn more than 10% of all financial assets in China.

With the exception of the largest TIC, the nationwide China International Trust and Investment Corporation (CITIC), all TICs are either provincial or municipal, located in large and medium-sized cities in the prosperous coastal regions. Although they are separate legal entities, they are owned and controlled by local governments, which largely use them to provide funding to enterprises and finance development projects. Despite the tight monetary policy imposed by Zhu Rongji in 1994, TICs have been able to attract further private savings by circumventing national provisions on credit quotas and interest rates.

As Jean C. Oi emphasised, control over credit by NBFIs is a fundamental instrument of local governments in shaping local enterprise development.[39] The funds are available through TICs and urban credit cooperatives (UCCs) in cities and provinces and through rural credit co-operatives (RCCs) in townships and counties. A closer look at the asset composition of TICs in Table 2 shows a recent shift towards riskier investments in "other assets", which include leasing operations, investment in long-term construction projects and holding equity in other companies.

From the recent development of NBFIs, and in particular of TICs, it seems clear that any increased discipline exerted by the fiscal system on spending by local governments may be offset by their constant resort to the local financial system. Through government influence on emerging NBFIs, funds can be assigned to projects and enterprises, even if taxation revenues are scarce. Instead of relying on these declining fiscal resources, local authorities may draw through NBFIs on the large Chinese private savings, which amount to nearly 40% of GDP. As long as local authorities count on such financial channels, it may be premature to assert that they face harder budget constraints than before. At present, the *soft* budget constraint of both local governments and enterprises

Table 1
Growth of NBFIs and TICs in Comparison
(per cent)

Share of total assets in the financial system:	1986	1991	1993	1994
Banking system	71.32	71.52	69.49	73.64
NBFIs	9.34	11.13	14.03	10.74
TICs	1.69	3.22	3.16	3.47
Total growth of assets:	1986-91		1991-94	
Financial system	200.2		116.8	
Banking system	203.5		132.2	
NBFIs	257.7		109.0	
TICs	471.7		133.3	

Sources: World Bank: China's Non-Bank Financial Institutions: Trust and Investment Companies, World Bank Discussion Paper No. 358 (1997), Table A1.1 and own calculations.

Table 2
Asset Composition of TICs
(per cent)

	1986	1988	1990	1992	1994
Loans	74.5	79.2	75.4	73.5	52.0
Required reserves	0.5	2.8	1.9	1.5	1.6
Deposits at Central Bank	6.6	3.2	4.5	3.4	2.5
Interbank loans	18.5	13.7	16.9	18.1	10.1
Other assets	0.0	1.1	1.3	3.4	33.7

Source: World Bank: China's Non-Bank Financial Institutions: Trust and Investment Companies, Table A2.1b.

[38] Cecil R. Dipchand, Zhang Yichan and Ma Mingjia: The Chinese Financial System, Greenwood Press, Westport 1994, p. 104.

[39] Jean C. Oi: The Role of the Local State in China's Transitional Economy, in: China Quarterly, No. 144 (December 1995), p. 1143.

is no longer to be found in direct fiscal subsidies to cover the operational losses of SOEs, but in soft bank loans and sophisticated government-backed support from NBFIs to specific projects and risky investments by private agents (e.g. through leasing operations and equity investment). Recent empirical studies have confirmed the persistence of the *soft* budget constraint problem in the Chinese economy, pointing to political influence, the inefficient financial system and insider control of firms as its main causes.[40]

Competition from the Non-state Sector

The relationship between competition and privatisation has been a major issue of discussion in modern economic literature.[41] Recent studies on transition economies have stressed the role of introducing competition into state-dominated sectors as a first and fundamental step in enterprise transformation.[42] Competition magnifies the losses of SOEs, thus increasing the cost of keeping state ownership, and fostering privatisation. This is also the main line of argument of Cao et al. when accounting for the rapid pace of privatisation at the local level in China. However, two counter-arguments may be raised in this respect.

Firstly, the present degree of domestic competition within mainland China is significantly low, as economists both in the country and abroad have pointed out.[43] Interregional barriers to the mobility of goods remain in place in many provinces, where local state enterprises are required to buy from other local enterprises.[44] Distribution is also severely restricted throughout many regions, especially in sectors with a heavy presence of SOEs. It is therefore difficult to conclude that fierce competition has become a hallmark of the Chinese economy as a whole. Yet, within regions and localities, TVEs successfully challenge the market share of SOEs.

Secondly, as competition from the non-state sector is mainly restricted to the local level, one should expect to observe a certain correlation between the level of development of the non-state sector and the degree of privatisation of small SOEs in a certain province. However, Cao et al. provide contradictory evidence when they assert that Heilongjiang province is a top privatiser with more than 90% of small SOEs in private hands by mid-1996.[45] This northern region has never excelled in the development of the non-state sector and has, in fact, one of the highest concentration ratios of state ownership. In contrast, another case cited by the same authors, the Jiangsu province, is one of the cradles of TVEs and indeed shows a high degree of privatisation. Hence, competition from the non-state sector as a main driving force of privatisation shows mixed results when applied to these two regions at very different stages of rural industrial development.[46] While waiting for a more accurate empirical work on the causality between TVE development and privatisation, we should remain cautious about drawing premature conclusions.

Fiscal Competition and FDI

Fiscal competition among regions is also a basic assumption in the model underlying Cao et al.'s conclusions, which arises from previous work by Qian and Roland.[47] For several years, local governments in China have engaged in infrastructure investment to attract foreign investors. Also, some regions have granted preferential treatment of all kinds to these investors, involving tax rebates, exemptions, subsidies and other fiscal or financial incentives. Now, with declining fiscal revenues and restrictions on the use of financial means, this fiscal competition for FDI becomes fiercer. Local authorities prefer to invest their scarce resources in infrastructure to attract FDI and engage in the privatisation of SOEs to ease the burden on their budgets.

However, these arguments may be questioned in the light of the regional disparities in China. Economic geography has shown how proximity to factor and final demand markets is a key criterion in choosing a production location, which has to be balanced against the fixed costs of production and transportation costs.[48] In the presence of restrictions to the mobility

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[40] Chong-en Bai and Yijiang Wang: Bureaucratic Control and the Soft Budget Constraint, in: Journal of Comparative Economics, Vol. 26 (1998), pp.41-61; David L. Li and Minsong Liang: Causes of the Soft Budget Constraint: Evidence on Three Explanations, in: Journal of Comparative Economics, Vol. 26 (1998), pp. 104-116.

[41] See, for example, Aidar R. Vining and Anthony E. Boardman: Ownership versus Competition: Efficiency in Public Enterprise, in: Public Choice, Vol. 73 (1992), pp. 205-239.

[42] World Bank, op. cit., p. 45.

[43] See the scholar discussion of the early 1990s on regional protectionism in: Chinese Economic Studies, Vol. 26, No. 5 (Fall 1993).

[44] World Bank: China 2020: Development Challenges in the New Century, Oxford University Press, Washington D.C. 1997, p. 38.

[45] Yuanzheng Cao, Yingyi Qian and Barry R. Weingast, op. cit., p. 8.

[46] For a closer look at the pattern of TVE development in China, see Wang Tuoyu: Regional Imbalances, Chapter 12, in: William A. Byrd and Lin Qingsong (eds.): China's Rural Industry: Structure, Development and Reform, Oxford University Press, Oxford 1990, pp. 255-273.

[47] Yingyi Qian and Gérard Roland, op. cit.

[48] See, for example, the classical work by Paul Krugman: Increasing Returns and Economic Geography, in: Journal of Political Economy, Vol. 99 (1991), pp. 183-199.

of both factors and goods, as in China at the present time, fiscal incentives or investment in infrastructure by local governments cannot compensate for distant locations. This can explain the concentration of investment in the coastal regions and the backwardness of the central and western parts of China. At the same time, it raises doubts with regard to fiscal competition theory's applicability to all Chinese regions. The contrast between Jiangsu and Heilongjiang as two fast privatising regions again provides a useful illustration. The benefits of fiscal incentives and infrastructure investment may hold for coastal regions like Jiangsu, where any location in this large dynamic area may be close enough to both factor (mainly labour) and final demand markets. However, Heilongjiang authorities may not engage in such competition as their chances of attracting FDI are very slim, given their location. As we argued above, it is not obvious that fiscal competition can be a major factor behind privatisation, since not all regions in China face the same chances of success in FDI-oriented policies. Neither are all regions actually allowed to use the same incentives for investors; special economic zones and open cities enjoy a privileged position. In fact, recent literature on the origins of increasing income inequality in China point to this discriminatory treatment by the centre as a basic policy which must be corrected in the future.[49]

Alternative Incentives for Privatisation

The arguments provided by Cao et al. on the privatisation process at the local level have been re-examined above and found to be inconsistent with the evidence provided by other authors and unable to explain the degree of privatisation in different Chinese regions. In sum, the last two arguments (fiscal competition and development of the non-state sector) may apply to southern coastal regions like Jiangsu, but they cannot account for the progress of privatisation in central and western provinces such as Heilongjiang. In contrast, the first two arguments (harder budget constraints due to fiscal and to financial reforms) do not hold for the rich coastal regions, but they pose a real constraint on poor ones, especially at subprovincial levels. Hence, it is not clear that Chinese local authorities privatise as a result of harder budget constraints in order to use their scarce fiscal resources to invest in infrastructure. We may instead find an alternative set of incentives which do not stem from a "market-friendly" orientation of local bureaucracies, but from their predatory behaviour.

Poor localities and regions in a difficult financial situation resort to extra-budgetary and self-raised funds, given their scarce taxation resources and insufficient transfers from higher administrative levels. Therefore, townships raise illegal levies on peasants and enterprises,[50] while counties use numerous ad hoc non-budgetary fees and levies.[51] The privatisation of public property and even of public activity[52] appears as another source of extraordinary revenue. As Chinese privatisation is not based on the free distribution of shares but on sales at real prices, according to Cao et al., privatisation proceeds may be significantly large. In their search for revenue, predatory local governments have even forced workers to acquire shares in newly privatised SOEs. Soon after the closing of the 15th CCP Congress, in October 1997, the central government issued a critical notice reprimanding local governments which used administrative means to force staff and workers to subscribe to shares. The document mentioned not only poor western and central provinces such as Sichuan, Shanxi and Jilin, but also the prosperous coastal Shandong.[53] More recently, on July 10, 1998, the central government again criticised the *blind* privatisation of small and medium-sized SOEs at the local level, expressing deep concern for the fact that the sale of such enterprises is often accompanied by cronyism and corruption.[54]

Even in prosperous cities like Shanghai, recent studies have unveiled predatory actions by the local bureaucracy.[55] This contrasts with the traditional picture of local governments in coastal areas as market-friendly and fostering private entrepreneurs. In this respect, Jean C. Oi uses the concept of the "developmental state",[56] akin to the one applied in the East Asian context by other authors.[57] As in the East Asian case, local governments in China may have promoted key enterprises, in particular through preferential financing.[58] Yet, it is doubtful whether such investments are directed to optimal projects, yielding

[49] Joseph Y. S. Cheng and Zhang Mujin, op. cit., p. 51.

[50] Wang Zhonghui, op. cit., pp. 117-118.

[51] Albert Park et al., op. cit., p. 777.

[52] Ibid., p. 775.

[53] Yeh Chang-Mei, op. cit., p. 64.

[54] "Reforms on Ice", in: The Economist, July 18, 1998, p. 60.

[55] See the thorough study of SOEs in Shanghai by Christian Henriot and Shi Lu: La Réforme des Entreprises en Chine: Les Entreprises Shanghaïennes entre État et Marché, L'Harmattan, Paris 1996.

[56] Jean C. Oi, op. cit., p. 1139.

[57] For example, Gordon White: Developmental States in East Asia, McMillan, London 1988.

[58] Jean C. Oi, op. cit., pp. 1143-1144.

sufficient profits and social benefits. In contrast, financing is mainly directed to "well-connected" firms, where bureaucrats can obtain personal benefits. The fall of the Guangdong International Trust and Investment Corporation (GITIC) in October 1998, preceded by the bankruptcy of two other TICs and various UCCs, has shown the costs of "developmental" strategies linked to corruption. One-third of China's 243 TICs have trouble repaying their debts and another third are losing money.[59] Although they still hold a modest share of all financial assets in China, the figures should be added to about 1.6 trillion yuan of non-performing loans by state-run banks, thus posing a constant threat to macroeconomic stability in China.[60]

The "developmental" and the predatory views of the Chinese state show two different faces of the same phenomenon. A rent-seeking local bureaucracy has emerged in China with the expansion of market mechanisms and the relaxation of control from the central administration. With exclusive control over the privatisation of small and medium-sized SOEs, as endorsed by the 15th CCP Congress, local governments have taken the chance to create new rents through corporatisation of SOEs into shareholding cooperatives (with workers as forced shareholders), enterprise sells-off, asset-stripping and excessive dividend earnings. The drain of public assets through these means has been estimated at 30 to 100 billion yuan every year.[61] In exchange for such personal benefits, enterprise managers in rich areas have obtained additional public funds, frequently disguised in the form of project financing. Over-investment in fixed assets and infrastructure projects by NBFIs is often the result of such clientele-building actions. Since local administrations have not undertaken significant downsizing in the course of economic reform and lack sufficient taxation funds, in particular at subprovincial levels after the 1994 tax reform, they are further forced into rent-seeking actions.

Making Market-friendly Incentives Really Work

Western criticism of Chinese privatisation has frequently been based on the issue of corporate governance. Inadequate corporate forms (such as the ambiguous "shareholding cooperatives") and the lack of effective state asset management mechanisms have been held responsible for the drain of state assets, corruption and rent-seeking by bureaucrats.[62] However, the experience in Eastern Europe has shown that the success of ownership transformation is not solely dependent on corporate governance issues. Allocation of property rights to "insiders" (managers and workers) and local governments is too often an unavoidable policy to make privatisation politically feasible, once de facto ownership patterns have been consolidated after years of socialist experiments (such as the CRS in China).[63] Thus, the main purpose of the central government should be to achieve an effective "depoliticisation" of the privatisation process and of economic activity as a whole.[64] Instead of restricting effective privatisation to the building of effective corporate governance mechanisms, it should be linked to the global transition process, in which complementary reforms play a more fundamental role. Deep financial, fiscal and institutional reforms have shown their positive effect on hardening budget constraints and depoliticising economic activity, even in transition countries with widespread "insider" privatisation, such as Hungary and Poland.[65] Although many SOEs at the local level are already "gone" in China, especially at subprovincial levels, such reforms are still needed to discipline all firms and introduce new mechanisms for the smooth functioning of the entire economy.

First of all, China should make the incentives described by Cao et al. really work, i.e. it should impose effective fiscal and financial constraints on all local governments, promote interregional competition and foster more equal regional development. This calls for another fiscal reform reaching subprovincial levels and not only province-centre relations. Starving poor localities of taxation revenues only promotes predatory actions, as long as they keep widespread control over economic activity, while rich regions mismanage public funds without proper supervision. A profound fiscal reform may draw on recent recommendations, such as providing lower administrative levels with at least one tax to finance their own

[59] Todd Crowell: Big, bad and busted, in: Asiaweek, October 23, 1998.

[60] "Breaking the Bank", in: Far Eastern Economic Review, July 16, 1998, p. 68.

[61] Yingyi Qian: Enterprise Reform in China: Agency Problems and Political Control, in: The Economics of Transition, Vol. 4, No. 2 (1996), p. 434.

[62] See, for example, the discussion on the "corporate governance vacuum" by the World Bank: China's Management of Enterprise Assets: The State as Shareholder, World Bank Country Study, Washington D.C. 1997.

[63] Maxim Boycko, Andrei Shleifer and Robert Vishny: Privatizing Russia, MIT Press, London and Cambridge Mass. 1995, p. 63.

[64] This need was also recognised by Yingyi Qian, op. cit.

[65] See the recent assessment by the European Bank for Reconstruction and Development (EBRD): Transition Report 1997, London 1997.

needs,[66] transferring basic public services back to higher administrative levels (e.g. education),[67] strengthening budget control and establishing an effective income-based redistribution system from the centre.[68] Even Wang Shaoguang's Proposal of 1993 should still be fully implemented, in particular with regard to removing intermediary administrative levels and reforming the Chinese Constitution to delineate the powers of central and local governments.[69] In sum, these measures should bring the Chinese fiscal system closer into line with other federal countries, which still appears to be a distant target according to the figures in Table 3.

Secondly, other measures should open up the Chinese distribution system, break regional monopolies and thoroughly reform the financial system. After the recent collapse of some NBFIs, the time has come for an effective restructuring of the financial system, as announced by Zhu Rongji at the 9th National People's Congress (NPC) in March 1998. However, it is not clear whether "depoliticisation" of financial institutions, both locally and centrally controlled, will be the main focus of the announced reform. This would require shutting down many institutions, privatising some of them, enhancing the regulatory framework and opening the market to new entrants.[70]

Besides imposing a real hard budget constraint on all local administrations and SOEs, the end of the rent-seeking state in China may require other far-reaching reforms in the administrative and political spheres. Downsizing central and local administrations is a fundamental step in transition. With declining control over economic activity, line ministries and government agencies should be phased out, thus cutting operational expenses and reducing the scope for rent-seeking actions. Administrative reform, which Zhu Rongji accentuated at the 9th NPC as a major goal in the following years, is already in progress in China. Three specialised ministries and several industrial bureaus at the central level as well as 170 provincial bureaus had already been removed by 1997.[71] However, most of them have simply been transformed into sectoral associations or private corporations, keeping their control over SOEs, even after their partial or total privatisation. This "phantom" administrative downsizing simply perpetuates rent-seeking activities by officials, now turned into company or association directors.[72]

Finally, one last and controversial question remains open: political reform. The CCP monolithic rule leads to a lack of accountability of both local and central governments. The absence of independent supervision over bureaucrats is the key to understanding corruption and rent-seeking in China. Without proper parliamentary and judiciary supervision, only the press can challenge the power of bureaucrats. Although deep financial and administrative reforms are on the agenda of the Chinese leaders, political opening still remains an insurmountable taboo. The recent crack-down on political dissidents is combined with experimental elections for township people's congresses, thus bringing additional ambiguities to the discussion on political openness. Yet, at the same time, any positive conclusion from Eastern Europe may be challenged by the bleak picture of the Russian experience with political reform. Hence, China may choose once again to grope its own way to economic reform. Only time will show whether rent-seeking or real market preservation will become the driving force of the Chinese state at all administrative levels.

Table 3
Fiscal Expenditure in China and Other Federal Countries
(per cent)

	Fiscal expenditure as a share of GDP	Share of overall fiscal expenditure Centre	State	Local
Industrial countries				
Canada (1993)	60.1	41.7	41.2	17.1
Germany (1995)	57.2	59.2	24.1	16.7
USA (1994)	41.3	53.4	25.6	21.0
Developing countries				
India (1993)	30.8	54.7	45.3	n.a.
Brazil (1993)	56.6	65.7	24.8	9.5
China (1995)	10.7	29.9	70.1	

Sources: Angang Hu: An Ardous and Difficult Institutional Innovation, Tables 1 and 13; Teresa Ter-Minassian: Decentralizing Government, in: Finance & Development, September 1997, Table 1.

[66] Christine Wong (ed.), op. cit.

[67] Albert Park et al., op. cit., p. 776.

[68] Wang Zhonghui, op. cit.

[69] Wang Shaoguang and Hu Angang: The Role of the Central Government in the Transformation to a Market Economy, in: Chinese Economic Studies, Vol. 28, No. 4 (July/August 1995), pp. 50-60.

[70] See the recent analysis of the Chinese financial system by Nicholas R. Lardy: China's Unfinished Economic Revolution, Brookings Institution, Washington D.C. 1998.

[71] You Ji: China's Administrative Reform: Constructing a New Model for a Market Economy, in: Issues & Studies, Vol. 34, No. 2 (February 1998), pp. 69-103.

[72] See the example of the Beijing Liulihe Cement Factory described by You Ji, ibid., pp. 97-99.