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Determinants of privatization in China: The role of the presence of foreign firms ☆

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ABSTRACT

This study investigates how the presence of foreign firms in a sector influences the privatization policy of domestic firms in that sector in China. We consider several variables to proxy for such a presence, from the perspective of the relative production scale, R&D and marketing, and labor productivity. By using the enterprise surveys carried out by the World Bank in 2005 of nearly 12,400 Chinese firms located in over 100 cities, we find that a rise in the presence of foreign firms increases the extent of the private ownership of domestic firms in a non-linear fashion. Additionally, we apply IV-Tobit estimation with valid instruments and Tobit estimation with lagged key variables to deal with the possible endogeneity in the relationship between the presence of foreign firms and the privatization decision. Empirical evidence supports the main findings.

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1. Introduction

Since the early 1990s, the Chinese government has reformed its economy in two directions: encouraging foreign direct investment (FDI) and (partially) privatizing government-owned firms. In this study, we examine how these two policy initiatives interact with each other in China. Specifically, we investigate whether the presence of foreign firms (termed foreign presence hereafter) in an industry affects the level of public ownership of domestic firms in that industry. Moreover, we examine the extent to which the competition provided by foreign firms in an industry is a significant determinant of privatization.

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While numerous studies investigate the *consequences* of privatization,[3] the literature on the *determinants* of privatization is relatively small. Clarke and Cull (2002) investigated the political determinants of privatization among Argentine public banks and found, *inter alia*, that political incentives such as provincial deficits, federal transfers to provinces, and the political affiliation of the provincial policymaker significantly affect the probability of privatization. Mizutani and Uranishi (2010) examined the determinants of privatization by using a cross-sectional dataset of 74 Japanese public corporations in 2001 and showed that market conditions and the extent of regulations are important. Roberts and Saeed (2012) focused on the economic, political, and institutional determinants of privatization, using an unbalanced panel macro dataset with 50 countries over 1988–2006. Sprenger (2011) examined the effect of firm quality on the privatization decision, using data for 530 Russian manufacturing firms, and found that the privatization decision is positively associated with firm size, labor productivity, and average wages. Zohlnhofer, Obinger, and Wolf (2008) analyzed the effect of political control in the privatization process in EU and OECD countries between 1990 and 2000 and found significant partisan influences on privatization decisions in the OECD sample but not in the EU sample.

Since China began its privatization policy in the early 1990s, several studies have shown that government-owned firms (including nationally, provincially, and locally owned) were suffering from low productivity, wasted resource, and over-staffing. From 1995 to 2001, the then prime minister Rongji Zhu implemented a policy to reduce the number of state-owned enterprises (SOEs) from 1.2 million to 0.47 million. However, as opposed to the privatization experiences of other countries, the Chinese government still controls a large share of those partially privatized firms. In other words, the country's privatizations have tended to be partial. Indeed, the ratio of the general assets of those state-controlled firms to the total general assets of all industrial firms in China is still more than 50%, according to Garnaut, Song, and Tenev (2005).

The process of privatization has also been selective in China. Among studies of the determinants of privatization in China, Ng, Yuce, and Chen (2009) examined the relationship between state ownership and the performance of privatized firms, using data for 1996–2003, and found a convex relationship between the two variables. Further, Li (2003) showed that a firm is more likely to be privatized in the presence of fiercer product market competition and more binding governmental budget constraints.

In this study, we examine the degree to which foreign presence in an industry determines the extent of the public ownership of firms in that industry. In particular, we hypothesize that local firm-level competition, as measured by foreign presence, influences the privatization decision in China. Since it is expected that foreign presence fosters local privatization efforts as new capital inflows, the technology and managerial skills that accompany the setup of foreign plants in the local market make the environment more prone to competition, providing the government with an incentive to privatize inefficient SOEs. The increase in foreign presence in the local market thus benefits inefficient SOEs in need of restructuring by raising funds, providing new technologies, improving human capital, offering new managerial skills, and enhancing corporate governance. Thus, foreign presence is assumed to raise domestic privatization since economies that are more open to foreign plants usually have better institutional frameworks and the higher protection of private property rights, which facilitate foreign firms' participation in the local market (Boubakri et al., 2013).

We measure foreign presence from various dimensions such as relative production scale, expenditure on R&D and marketing, and labor productivity. Including different measures of foreign presence as an explanatory variable allows us to account for the different ways in which domestic firms in an industry face competition from foreign firms in the same industry in China. We first represent foreign presence from the perspective of production scale by using the average net fixed assets of all foreign firms in a sector relative to that of domestic plants in the same industry, plus the average net fixed assets of all other domestic firms in the same sector relative to that of the same domestic plants (termed FP *via* NFA). The idea here is that a large foreign cohort indicates a tremendous production scale and enormous foreign competition for local firms. Additionally, the large production scale provided by the domestic cohort would promote foreign presence.[4] We also follow Fagerberg (1988) and consider a composite measure including relative average foreign R&D expenditure and advertising expenditure in the sector relative to that of the local firm in the same sector (FP *via* RDA). Larger foreign presence is expected to have a competitive edge because of foreign firms' ability to provide internal financing for a number of activities including R&D and advertising. Following studies that consider the efficiency levels of firms as a determinant (see, for example, Li, 2003; Liu & Woo, 2001; Yang, 1998), we consider the average unit labor cost of all foreign firms in a sector relative to that of domestic firms in the same industry as a measure foreign presence (FP *via* ULC). As stated, these three variables, FP *via* NFA, FP *via* RDA, and FP *via* ULC, represent foreign presence relative to the domestic plant in the same industry.

In addition, we examine the nonlinearity of FP *via* NFA and FP *via* RDA on the extent of the public ownership of firms in that industry, while controlling for lagged FP *via* ULC and assuming firm-level foreign presence measured by the productive efficiency constant. Since the prevailing hypothesis asserts that partial privatization is the optimal solution under foreign competition, if foreign presence indeed represents competition, increasing state ownership would cause productive inefficiency while

[3] The consequences of privatization can be categorized into the effects on firm productivity (Bai, Lu, & Tao, 2009; Bridgman, Gomes, & Teixeira, 2011), the effects on employment (Bhaskar & Khan, 1995; Chang & Brada, 2011; Naito, 2013), and the effects on macro-level FDI flows (Boubakri, Cosset, Debab, & Valery, 2013; Reece & Abdoul, 2012). A large volume of the literature on the consequences of privatization has been based on demand.

[4] The average production scale of the local cohort affects foreign entry in two contrasting ways. First, a large average scale of the local cohort indicates the prosperous development of the industry, which may ensure the profitability of foreign entry and thus spur foreign presence. Second, the large average scale of the local cohort may also indicate the presence of monopolists or oligopolists in the industrial local cohort, preventing foreign entry and reducing foreign presence. To verify the effect that dominates in our case, we examine the correlation between the average NFA of the foreign cohort and that of the local cohort. We find that these are positively correlated, indicating that the spurring effect dominates.

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