



Political economy of private firms in China



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ABSTRACT

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The sweeping change in political economy associated with the rapid growth of the private sector in China is rarely studied empirically in the economics literature. Using four cross-sectional surveys of private firms between 1995 and 2010, we examine the dynamics of rent creation from Party membership and other political connections when the regime changed from anti-capitalistic to pro-capitalistic during the period 2002–2004. We find that entrepreneurs with political connection enjoyed significantly more rents only after the constitutional amendments. This finding sheds lights on the nature of the political economy of today's Chinese economy. Endogeneity/causality problems are addressed. *Journal of Comparative Economics* xxx (xx) (2014) xxx–xxx. University of Hong Kong, Hong Kong; Seoul National University, Republic of Korea.

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“We must and we are determined to encourage, support, and guide the development of the nonpublic sectors of the economy...”

[Jiang Zhemin, Speech at the 16th CPC National Congress, 2002]

1. Introduction

The rapid growth of the private sector in China, which started in the 1990s, is well documented. Changes in politics are essential elements of this growth. However, the dynamic aspect of the sweeping change in political economy associated with the growth of the private sector is rarely studied empirically in the economics literature. This paper contributes to the literature in this respect.

Notably, when “the reform” officially started in the late 1970s and early 1980s, the reform agenda did not allow for the establishment of private firms nor for privatization, and the private sector accounted for 0% of Chinese gross domestic product (GDP). Consistently, the Constitution of the Communist Party of China (CPC) [the 1982 version, which codified the reform agenda at that time] is unambiguously anti-capitalist. The document declares, “[t]he proletariat dictatorship will inevitably

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replace the dictatorship of bourgeoisie. . . Basically, the socialist system has incomparable superiority over the capitalist system . . ." (*The CPC Constitution*, 1982). However, the reform agenda was transformed gradually; both the CPC Constitution and the state Constitution were amended in 2002 and 2004, respectively, and the institutions were changed (for the reasons for these changes, see [Xu, 2011](#)). The essence of the constitutional amendments is the "Three Represents" theory, which was invented by Jiang Zemin, the Party General Secretary from 1989 to 2002. According to the "Three Represents" theory, the CPC should always represent the advanced social productive forces, the advanced Chinese culture and the fundamental interests of the majority of the people. Among these three, representing the advanced social productive forces is emphasized as the priority. In particular, owners of non-public sector were recognized as one of the three major advanced social productive forces, with the other two being workers and intellectuals, for the first time by the "Three Represents" theory. A communist party's embrace of entrepreneurs deviates from Marxism, as Mr. Jiang stated, ". . . , private entrepreneurs. . . are all builders of socialism with Chinese characteristics" ([Jiang, 2002a](#)). On policy implementation, Jiang emphasized, "We must and we are determined to encourage, support and guide the development of the nonpublic sectors of the economy. . ." [All emphases in the citations in this section and the next section are added by the authors of this paper]; "nonpublic sectors are important elements of the socialist market economy. . ." ([Jiang, 2002b](#)). The term "non-public" is used to distinguish them from "private" to avoid a direct contradiction of Marxism. Party members have since been "encouraged" and "supported" to become private entrepreneurs, while entrepreneurs are encouraged to join the Party. As a result, a large number of Party members had become extremely wealthy entrepreneurs within a decade.¹

How could a large group of politically connected people become rich within such a short time after the passage of the 2002/2004 constitutional amendments? This is one of the central questions that we address in this paper. Numerous anecdotes of such wealth accumulation by Party members have been reported by the mass media, and many of them imply rent seeking by Party elites when they enter the private sector. Discussions of this phenomenon can also be found in the political science literature (e.g. [Dickson, 2003, 2008](#)). To our knowledge, however, no systematic research has been conducted to address this issue by looking at nationwide data over the entire period. This paper fills the gap by examining the dynamics of rent seeking by Party members when the regime shifted from anti-capitalist to pro-capitalist. Our research is based on nationwide random surveys of private firms, which were designed to represent the population, conducted in the period from 1995 to 2010. Given that the Party is the dominant force both in politics and in the national economy in China, political connections in this paper are captured by CPC membership or a People's Congress (PC) membership.² This paper compares the rent seeking of political elite entrepreneurs in the old regime before 2002/2004 regime change, with that in the new regime that emerged after the 2002/2004 policy changes. We identify the causality of rent seeking and the political connections of private entrepreneurs.

The economics literature on the relationships between political connections and economic variables is extensive as numerous economists have investigated the economic value of political connections. In a seminal paper, [Fisman \(2001\)](#) reports that the Suharto's health-related events caused a significant loss in the return on the price of the securities of politically connected firms. [Faccio \(2006\)](#) extends the scope of the investigation to 47 countries and reveals that the announcement by officers or large shareholders of a company of entering politics is positively associated with cumulative abnormal returns, which vary depending on their political power. This line of research has been applied to various countries, including late Victorian Britain ([Braggion and Moore, 2013](#)), a longitudinal dataset of Italian companies ([Cingano and Pinotti, 2009](#)), Russia's politically connected firms ([Slinko et al., 2005](#)), and US firms connected to Timothy Geithner as a nominee for Treasury Secretary by President Obama ([Acemoglu et al., 2010](#)).

Another group of studies identifies the effect of political connections on access to bank loans and government subsidies. Based on data from Pakistan, [Khwaja and Mian \(2005\)](#) find that politically connected firms can borrow 45% more but are 50% more likely to default compared to firms without political connections. The findings of [Johnson and Mitton \(2003\)](#) and [Faccio et al. \(2006\)](#) support the thesis that political connections affect government or bank decisions. The former paper shows that government subsidies are associated with political connections, whereas the latter paper shows that politically connected firms are more likely to be bailed out.

Some sociological studies document the potential advantages of being a Party member in China. [Walder et al. \(2000\)](#) shows that joining the Party is a necessary condition to become a leader in China. [Li and Walder \(2001\)](#) find that joining the Party in earlier periods of one's careers makes a difference in social advancement. Those who have become Party members at an early time in their careers are reported to have significantly higher chances to become social elites, whereas those who are already successful before joining the Party do not experience a difference in their careers by joining the Party. [Bian et al. \(2001\)](#) suggests that, controlling for talent and education/experience, Party members have higher chances than non-Party members to become top managers in state-owned enterprises (SOEs). In their investigation of the changes after the massive purges of

¹ Most of the richest people in China are Communist Party members, and many are selected, rather than elected, to the People's Congress (PC), the legislature. Nevertheless, the most striking phenomenon is clear evidence that members of the National PC of China have become, by far, the wealthiest legislators in the world, despite the highly incomplete and heavily underestimated data on these elites. The total wealth of the 70 richest members of the PC of China is 90 billion US\$, which is 12 times that of the total wealth of all the members of Congress, Supreme Court, and President of the United States, which is 7.5 billion US\$ (Bloomberg, February 27, 2012).

² A PC member may not be a CPC member, but he/she must be pro-CPC because all the PC members are selected by the CPC. Moreover, in terms of social status and power, average PC members are elites at a higher level than average CPC members. We use the terms "political connection" and "political elites" interchangeably.

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