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Economic and institutional reform packages and their impact on productivity: A case study of Chinese township and village enterprises

Junichi Ito *

Policy Research Institute, Ministry of Agriculture, Forestry and Fisheries, 2-2-1 Nishigahara, Kita-ku, Tokyo 114-0024, Japan

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In this paper, we investigate the privatization of township and village enterprises (TVEs) in rural China by considering the economic and institutional reform packages and examining their effects on enterprise performance. Using production function analysis, we conclude that the impact of privatization per se is not determined unambiguously because it is indistinguishable from the contribution of technological progress. In addition, we find that market competition is a significant factor in promoting efficiency gains in TVEs. Moreover, the modernization of fiscal and financial institutions in the mid-1990s is shown to be a major proximate cause of privatization and to play an important role in improving enterprise performance through the elimination of the soft-budget regime. We conclude that these reform packages interacted together to generate the economic benefits observed from the privatization of TVEs. *Journal of Comparative Economics* **34** (1) (2006) 167–190. Policy Research Institute, Ministry of Agriculture, Forestry and Fisheries, 2-2-1 Nishigahara, Kita-ku, Tokyo 114-0024, Japan.

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* Fax: +81 03 3940 0232.
E-mail address: jito@affrc.go.jp.

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1. Introduction

Non-agricultural sectors located in rural China and referred to as township and village enterprises (TVEs) can be categorized into two broad types. These are collectively owned enterprises (COEs) run by township and village governments[1] and non-public enterprises established by farmers solely or jointly after the Open Door Policy initiated at the end of the 1970s. De jure owners of the former are residents in rural areas, while de facto owners of the latter are private individuals. This interpretation requires some explanation. Historically, under the socialist regime, public sectors were able to claim ownership of enterprises and company organizations officially. Thus, owners of private enterprises (PEs) tried to circumvent political intervention from the central government by placing them under the protection of red umbrellas to shield the essentially private nature of their activities by designating the enterprises to be collectively or publicly owned, as Walder and Oi (1999) discuss. Moreover, the law stipulates that residents who are registered as farmers in rural communities are supposed to own COEs; but in fact, they are not permitted to claim the residual income or to transfer the assets because branch Party secretaries or local cadres exert the exclusive rights over COE properties. Accordingly, what local residents are able to assert is only nominal ownership.[2]

Often, COEs are cast as the Southern Jiangsu Model to contrast them with PEs represented by the Wenzhou Model in Zhejiang Province or the Pearl River Delta Model in Guangdong Province. COEs, some of which originated in commune and brigade enterprises in the era of the People's Commune System, were founded by the local cadres' initiative with economic surpluses and human capital accumulated by collective activities, as Jin and Qian (1998) discuss. Hence, such enterprises have ownership structures similar to those of state owned enterprises (SOEs); they are owned collectively and constitute an integral part of the local bureaucracy. By contrast, collective activities were rarely conducive to the foundation of PEs for which merchant or overseas Chinese capital was utilized. However, this dichotomy of rural industries was invalid for much of the 1990s because a growing number of COEs was privatized under economic circumstances in which market liberalization was accelerated with Deng Xiaoping's southern tour in 1992 providing the turning point. Furthermore, the emergence of a variety of ownership types ranging from government-management partnerships and leased contracts to complete privatization changed China's industrial landscape, as Walder and Oi (1999) describe.

According to established theory, privatization is a natural consequence of the competitive advantage of PEs over public enterprises regarding productivity. Ehrlich et al. (1994) provide the theoretical rationale of this superiority, especially in the long run. In effect, public enterprises are liable to employ more workers than is necessary and suffer from inefficiencies associated with a series of agency costs. Therefore, most economists believe that privatization alters the incen-

[1] Joint stock and limited liability companies are classified as COEs in China if individuals hold less than 50 percent of company shares. In this way, the Chinese government tries to maintain the socialist nature of economy to some extent, which results in an overestimation of the number of COEs. In this paper, all enterprises that operated under the control of township or village governments are designated as COEs, while those that were established by private individuals are designated as PEs.

[2] According to Chang and Wang (1994), residents and local governments shared the rights; however, Weitzman and Xu (1994) assert that a claimant could not be identified definitively. Li (1996) argues that defining property rights in an ambiguous manner was not only necessary but that it was also an appropriate response of COEs to the environment of market imperfection and political hostility toward PEs. Although opinions vary somewhat regarding who was the final proprietor of COE assets in the era of collective economy, certainly local cadres not local people or factory directors exerted the property rights.