



Too many mothers-in-law?

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ABSTRACT

Developing countries with low tax capacity may rely on predation to finance government functions. Government predation, in turn, is often accused of imposing a choking effect on state-owned enterprises (SOEs), contributing to the latter's poor performance. We formalize this choking effect as a problem of inefficient predation that arises from time inconsistency, and show that having multiple government bodies supervising the same SOE may mitigate this problem. Our theory provides an efficiency rationale for the Chinese style of decentralization before 1978, and challenges the wisdom of China's recent enterprise reform that attempted to consolidate supervisory power.

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1. Introduction

One of the most important reform measures implemented in China in the last decade concerned the country's state-owned enterprises (SOEs). The reform measure established a central government agency called SASAC (State Assets Supervision and Administration Commission) to consolidate the supervisory powers over all major SOEs in 2003. There are two contrasting views regarding whether this measure would bring real improvement to corporate governance of SOEs.

The first view argues that the establishment of SASAC would resolve once and for all the multiple-supervisory-bodies problem that had plagued China's SOEs for decades. Advocates of this view include Naughton (2003), Shi and Zhao (2003), and Wu (2010). The multiple-supervisory-bodies problem is also known as the *popoduo* ("too many mothers-in-law", or TMM) problem in China, and refers to the miscoordination and free-rider problems that often characterized the multiple supervisory bodies of a single SOE. *The Economist* once articulated the problem as follows:¹

The worst problems, however, lie in corporate governance. It is by no means the case that all SOE managers are incompetent—although some are. [...] Even when managers know what needs to be done,

they often cannot do it. The Chinese call this the dilemma of too many [...] mothers-in-law. The [mothers-in-law] include droves of bureaucrats at all levels of government—from grass-roots party cadres to prefectural, provincial and central-government officials. All have the power to siphon resources from SOEs. Quite often, they compete for the biggest share—a situation exacerbated by the regime's decentralization of power. The most obvious way to exploit SOEs is through a plethora of arbitrary taxes. More subtle ways include leaning on them to build, say, a local library or swimming pool for which local officials then take the credit. (*The Economist*, "China's State-Owned Enterprises," September 30, 2000, pp.71–73.)

The second view argues that the reform measure would at best be irrelevant, because consolidation of *de jure* supervisory power cannot achieve consolidation of *de facto* power. According to their arguments, many original supervisory bodies of an SOE would continue to wield *de facto* power over the SOE after the reform, making the reform irrelevant. Advocates of this view include Sun (2007), Yeo and Pearson (2008), Siqueira et al (2009), and Yeo (2009). They argue that, notwithstanding the establishment of SASAC, authorities such as the National Development and Reform Commission, the Chinese Communist Party, and various regulatory bodies and local governments, continued to have power over many SOEs.

It is not the goal of this paper to take side in this debate. Our goal is to address a common premise accepted by both camps. Regardless of their positions on the effectiveness of this reform, both sides agree on one point: that having multiple supervisory bodies is bad for the corporate governance of SOEs, and consolidation of supervisory power, if

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¹ For more scholarly accounts of this problem, see, for example, Granick (1990) and Tenev and Zhang (2002).

successful, will improve economic efficiency. The goal of this paper is to explain why this is not necessarily the case.

Although this paper is motivated by China's recent reform, the TMM problem is a general problem shared by other transitional economies. Some authors, such as Berkowitz and Li (2000), argue that the problem is even more severe in Russia than in China, and that partly explains why Russia's reform performance has been worse than that in China.

The standard view that consolidation of supervisory power, if successful, can mitigate the TMM problem implicitly assumes the models of Shleifer and Vishny (1993) and Berkowitz and Li (2000), who show that having multiple government bodies predating a single firm in an uncoordinated manner is worse than having a single government body predating that same firm. Their argument is similar to that of double marginalization, where each predatory government body can be viewed as equivalent to a monopolist selling some essential input. Their models, however, are static. In a dynamic setting, where government bodies have to make non-trivial decisions regarding when to predate, having multiple predators can be better than having only one, because the former can result in a more efficient timing of predation.

In this paper, we present a simple dynamic model to illustrate this logic. We assume, as is often the case in reality, that firms make investments that take time to build, and the predatory government learns the prospects of these investment projects only gradually. The TMM problem corresponds to early predation, where every project is choked off at an early stage before its quality is revealed. It is a "problem" because a better scenario is possible, where the government postpones its predation until more information arrives, chokes off the project only if it turns out to be a bad one, and postpones even further if it is good. This better scenario may not arise in equilibrium because of time-inconsistency problem: by the time when more information arrives, part of the investment costs are sunk, and the government would like to postpone predation again regardless of the new information. Anticipating that new information will be ignored anyway, the government predates without waiting for its arrival. Having multiple government bodies results in more aggressive predation after information arrives, which "corrects" the time-inconsistency problem, and helps sustain the better scenario as an equilibrium outcome.

Another, more widely-studied, problem that plagues SOEs in transitional economies is the soft budget constraint (SBC) problem.² The SBC problem is the polar opposite of the TMM problem, where an SOE has too much, instead of too little, easy funding, so much so that it spends it on too many unprofitable projects, lowering its overall performance. In the SBC literature, "principals" of a firm are not modeled as predatory supervisory bodies, but instead as financiers or banks that interact with the firm through incentive contracts. Previous studies have shown that reducing the number of these "principals" can worsen the SBC problem.³ Our work complements this result by showing that the same is true for the TMM problem as well, although the two problems are polar opposites of each other in nature.

This is not a coincidence, and there is a common economic force at work behind both results. For any project that takes multiple stages to construct, and where information of the project's quality is revealed to the "principals" only gradually, there is always a commitment problem: once part of the investments are sunk, terminating bad projects becomes non-credible. Having multiple "principals" mis-coordinating with and free-riding each other serves as a mechanism to overcome this commitment problem, which in turn improves the discipline of the SOE manager. This benefit exists regardless of whether the "principals" are predatory or not. The pitfall of the conventional wisdom that "consolidation of supervisory power, if successful, necessarily cures the TMM problem" is its implicit presumption that what works for the SBC problem does not work for the TMM problem.

Naturally, this paper is also related to the literature on state predation. This literature studies how the concerns of state predation motivate various institutions such as collective ownership (Che and Qian, 1998) and anonymous banking (Bai et al., 1999). Our focus is similar: we study whether consolidation of supervisory power necessarily helps in harnessing state predation.

The rest of this paper is organized as follows. In Section 2, we outline the history of China's SOE reform, with special attention to the TMM problem. Two particular lessons we shall learn from that section are: (1) the multiheaded nature of Chinese SOEs is a legacy of several waves of decentralization before 1978, and (2) successive decentralization and recentralization reforms can be viewed as the Chinese government's attempt to search for the optimal number of supervisory bodies.

Section 3 then outlines our model, and Section 4 provides analysis. Our model is stylized, where different supervisory bodies are symmetric, which allows us to treat the number of supervisory bodies as a design variable. We show how consolidating the supervisory power over an SOE may inadvertently worsen the TMM problem.

In Section 5, we modify our model to include a kind of asymmetry between the supervisory bodies, with a local government having better information than the central government. We hope to provide an alternative explanation of why China's style of decentralization was often accompanied by retention of some supervisory powers in the central government. In a sense, we do not fully embrace the conventional wisdom that the multiheaded nature of Chinese SOEs is solely due to misguided policies in the past. Instead, we think it might have certain efficiency justification at certain point in history, and the search for the optimal number of supervisory bodies is never-ending only because the environment is ever-changing.^{4,5}

Section 6 concludes with some discussions on our modeling choices.

2. History and institution

Before economic reforms started in the late 1970s, China's SOEs were merely administrative departments of the government. What made them peculiar was their multiheaded nature; i.e., they had to follow instructions from many different supervisory bodies, sometimes from different levels of government. For instance, a local SOE might have to fulfill the planned output targets mandated by the corresponding industrial ministry, while at the same time its utilization of land and other key inputs might need the approval of the local government. These supervisory bodies can hence siphon resources from an SOE in many ways. Three most important ways emphasized by Granick (1990) are: (i) grabbing the output, (ii) grabbing the cash, and (iii) utilizing the labor force without payment. Other authors have added the following to this list as well: (iv) making an SOE hire redundant workers, and (v)

⁴ Our analysis of decentralization, Chinese style, complements previous studies that explain why China's decentralization reforms have improved efficiency. For instance, Qian and Xu (1993) and Qian et al. (2006) suggest that China's decentralization reforms before 1978 resulted in a system that resembles the M-form (multi-divisional form) organization, in contrast to the U-form (unitary form) organization typically found in other centrally-planned countries. This has allowed China to do better reform experiments than other transitional economies. Furthermore, Xu (2011) suggests that China can be characterized as a "regionally decentralized authoritarian" regime, under which the central government controls the power of appointing key personnel of local governments while the latter are given relative autonomy in economic management.

⁵ Our analysis of decentralization, Chinese style, also complements the literature of partial decentralization. See, for example, Ahmad et al. (2006), Brueckner (2009), Devarajan et al. (2009), and Joanis (2009). This literature suggests that decentralization in developing countries is often at best partial, because local governments often have low tax capacity and hence lack fundings to perform duties that are decentralized to them. Partial decentralization, in turn, often results in institutional arrangements where different levels of government overlap in their duties. Partial decentralization hence resembles decentralization, Chinese style, in this paper; while complete decentralization resembles decentralization, extreme style. We, however, differ from this literature in that we do not view decentralization, Chinese style, as a compromised version of decentralization, extreme style. Instead, we view the former as having its own merits, and hence may even outperform the latter.

² See, for example, Qian (1994), Dewatripont and Maskin (1995), Brandt and Zhu (1998), Qian and Roland (1998), and Kornai et al. (2003).

³ See, for example, Huang and Xu (1998) and Povel (2004).

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