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The Political Economy of Chinese-Style Privatization: Motives and Constraints

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Summary. — The paper examines how the privatization of Chinese state-owned enterprises (SOEs) can be successfully triggered and completed. By identifying the motives of local government leaders and the constraints that face them during transition, we conclude that: first, whether local governments are motivated to privatize their SOEs, depends on if the ownership transfer is expected to stimulate sufficiently high growth of local tax revenues without sacrificing the bureaucrats private control benefits. Second, a specific privatization program can succeed only if it manages to satisfy the managerial cooperation constraint, the workers compensation constraint, and the bank-debt-servicing constraint. The motives-cum-constraints political economy approach offers an important explanation for the pace and scope of the ongoing Chinese-style privatization.

Key words — privatization, enterprise reform, political economy, local government, China

1. INTRODUCTION

Unlike the big-bang mass privatization approach adopted by the Eastern European and Former Soviet Union (EEFSU) countries, the Chinese government until the mid-1990s was still trying to improve the SOE performance by establishing market-oriented incentives [1] while maintaining its ownership and control over a great majority of industrial enterprises. Since then, China has entered a new phase of enterprise reform: the government has explicitly pursued a "2-R" strategy—*retain* government control of large enterprises that operate in the strategic sectors and *retreat* from small and medium-sized enterprises that operate in highly competitive markets (e.g., Green & Liu, 2005).

With regard to the restructuring of large SOEs, corporatization and stock flotation are the key measures used to privatize a fraction of government cash flow rights, in return for funds to the extent that the government is still able to maintain ultimate corporate control

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(Liu & Sun, 2005a, 2005b). Meanwhile, hundreds of thousands of small and medium SOEs at local level have been granted privatization permission during the last decade. Moreover, a large amount of evidence shows that the major players behind the rise of privatization are local governments, especially those at municipal and county levels (Garnaut, Song, Tenev, & Yao, 2005; OECD, 2005; Tenev & Zhang, 2002). [2]

Then natural questions arise as to what motivates the government to relinquish its control of industrial firms, what constrains the smooth progress of privatizations, and what economic and socio-political factors affect the dynamics of government-initiated privatization programs. Unfortunately, in comparison with a vast amount of literature devoted to assessing the extent of success of privatization by examining the profitability and operational efficiency of privatized enterprises, in-depth analyses of the factors that initially trigger privatization and further constrain its progress are relatively inadequate both in general theoretical formulations and in empirical studies.

Amongst a limited number of existing works relevant to the research questions just posed, Yarrow (1999) makes a general conjecture that the worldwide spread of privatization during the 1980s and 1990s can largely be attributed to the escalating government expenditure relative to GDP growth, together with the increasing cost of government finance. So governments privatize SOEs in order to ease their fiscal pressures. This "fiscal pressure" view seems to be a parsimonious answer, but it fails to capture the deep political economic nature of the privatization decision-making process. For instance, Biais and Perotti (2002) provide a model showing how privatization can be employed as a strategic policy by incumbent politicians to maximize their probability of winning the re-election. [3] Although not directly applicable to the Chinese context, the "political-benefit" view is illuminating in reminding us that political and institutional factors do have a direct bearing on government officials' privatization decision.

Moving to the developing country context, Bienen and Waterbury (1989) not only mention the significance of fiscal austerity and international donor duress in triggering privatization, but argue that "to assess the constraints on and possibilities for privatization, one must have a clear picture of … the gains and losses that will be sustained by the constituent elements of dominant political coalitions" (p. 618). "… even in nonelectoral systems, leaders must find enough support or create new bases of support to sustain privatization policies" (p. 629). Such insights are echoed and further elaborated by the World Bank (1995) in a chapter entitled "The Politics of SOE Reform." On the basis of a comprehensive study of the reform experience in the developing world up to the early 1990s, the policy research report generalizes some essential conditions of a successful privatization program, notably the political desirability from the leaders' viewpoint and the political feasibility ensured by government leaders in withstanding opposition from potential losers.

This paper closely follows the "political-benefit" view suggested by the aforementioned literature in general; and the discussion of motives and constraints involved in China's privatization in the last decade serves to update and enrich our understanding of the critical issues concerning political desirability and feasibility in particular. In fact, the World Bank (1995) did touch upon the case of transition China when discussing the two conditions. But obviously its assessment was grounded on the extremely limited, if any, formal private ownership presence in the Chinese industrial sector in the late 1980s and early 1990s. The transformation of the industrial landscape since the mid-1990s, however, prompts us to rethink how the incentive structure within the authoritarian regime and the change of wider institutional environments can interact to significantly alter the desirability and feasibility of privatization in transition China. [4]

In this paper, we aim to answer the "why-privatize" question by identifying the unique institutional settings that have shaped the incentive structure of the privatization-friendly Chinese local government leaders. Based on an analytical framework that integrates the extant China-based studies, we maintain that local government leaders will be keen to privatize their SOEs only if they can assure themselves of both higher growth of fiscal revenues and the retention of their private benefits from the privatized firms.

Moreover, the willingness of government officials to privatize SOEs alone does not necessarily translate into the success of privatization programs in practice. Rather, they are subject to a series of entangled economic and socio-political constraints that are always of country-specific nature, since privatization itself means a complete reshuffling of the extant interest structure concerning not only governments, but also managers, workers, and