

**Government Commitment and the Outcome of Privatization in China**

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## Government Commitment and the Outcome of Privatization in China

If there has been any significant change happening to the Chinese economic structure in the 1990s, it has to be privatization. But one report, 80% of the firms at or below county level had been privatized by the end of 1998 (Zhao, 1999).<sup>1</sup> Privatization also spread to large SOEs in large cities. However, the performance record of privatization varies from city to city. A question then arises as to why such performance disparity has been resulted. In this paper, we will first use recent survey data to assess the regional performance disparity, and then provide an explanation for it. We ascribe the disparity to the different degrees of local government commitment to privatization.

Privatization transfers the legal ownership of a public firm to a private hand, making the latter the residual claimant. However, privatization by no means binds the government's hand of intervening, nor does it bind bureaucrats' hand of grabbing. One serious problem that private firms encounter in China is the excessive and irregular charges placed by local governments. For example, the survey that this study will draw data from found that the amount of fees is equivalent to the amount of regular taxes among the surveyed firms (Garnaut *et al.*, 2001). Privatization can not exempt a firm of being grabbed by the excessive charges. In other words, privatization does not mean the establishment of the rule of law. The lack of the rule of law has been identified by some authors as the most important factor that leads to Russia's economic failures (e.g., Shleifer, 1997). However, the establishment of the rule of law is not always in the politician's interests, and even it is, it may turn out not to be time-consistent for the politician. On the other hand, having been through frequent government policy changes, the manager of the firm may not trust it even if the establishment of the rule of law is in the politician's interests. Therefore, the politician has to lay a credible commitment currently with privatization to bind his own power of interference and the bureaucrats' hand of grabbing in order to induce good performance records of privatization or even to make privatization happen.

The paper is organized as follows. In Section 1, we will present a brief review of Chinese government's policy toward privatization in the last twenty years. In Section 2, we will construct a theoretical model to explain the relationship between privatization and government reform. The model treats government reform as a commitment device for the politician to commit himself to better state governance. In section 3, we will present the government reform experience in Shunde, Guangdong province to provide an illustration to our theory. In Section 4, we will conclude the paper by a discussion of the implications of the study.

### 1. Government policy toward privatization

Reform of the SOEs has been a major theme of China's reform effort since the urban reform was launched in 1984. Throughout the 1980s, although there were calls for privatization, government emphasis was on how to improve the performance of the SOEs by changing their internal governance. Inspired by the success of the household responsibility system in the countryside, one major effort was to introduce a contracting

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<sup>1</sup> A county level unit does not necessarily mean a rural area. Many counties have turned into urban areas and changed their administrative status to a city although they are still regarded as a county level administrative unit.

system into the SOEs. In such a system, the manager signed a contract with the government on specific terms. The manager promised to maintain a certain record on the firm's financial stance such as sales, profitability, capital accumulation, and so on. In return, the government promised the manager certain returns such as a commission out of the profit. One problem with the contracting system was that the term put on the manager was asymmetric: the manager would be rewarded for his successes, but would not be credibly punished for his failure. As a result, personal collateral put by the manager was introduced into the system.

A further development was to adopt a lease contract by which the manager leased the firm by paying the government a fixed proportion out of the firm's profit. The first significant case of lease contract happened in Wuhan Motor Engine Factory in 1986 when three people put 34,000 yuan as collateral to lease the factory. By the end of 1980s, lease contracts were encouraged by the government as a means to reform small SOEs. A State Council regulation regarding the lease of small SOEs was issued in May 1988.<sup>2</sup> One direct consequence of the adoption of the lease contract was the introduction of private entrepreneurs into the management of SOEs because managers could be recruited outside the enterprise. When it was proliferated in the countryside, leasehold in many cases led to privatization of TVEs. This happened when the manager could retain the ownership of the capital accumulated in the lease period. After the manager leased the firm for several years, his own capital would outweigh the capital owned by the local government, and the firm would be effectively owned by the manager himself.

In addition to contracting and leasing, other reform measures that would potentially lead to privatization were also adopted. Among them, incorporation was the most significant. At the beginning, the government restricted incorporation to be conducted only among SOEs themselves. However, private shares soon appeared. The first case of private shares happened in three Guangzhou SOEs in 1986. In those three firms, employees bought 30% of each's total assets. The first case of incorporation of a large SOE happened in August 1988 when Shengyang Motor Corporation was transformed into Shengyang Jinbei Motors Inc. by issuing shares to the general public.

The opening of the Shenzhen Stock Exchange in 1990 and the Shanghai Stock Exchange in 1991 enabled SOEs to issue shares to the public in a wide range. However, the Chinese government implemented restrictive measures to prevent the state from losing control of the listed SOEs. For example, it requires that a certain proportion of a firm's shares be held as corporate shares that can not be sold.

Real privatization started after Deng Xiaoping's visit to the south in 1992. As in the case of many other reform initiatives, privatization was first started from localities and then sanctioned by the central government. The most important impetus for local privatization was the large amount of debt accumulated in the state sector. This was a more pressing problem in small cities because of the smaller size of their economy. For example, in Zhucheng city, Shandong province, among the 150 city-owned enterprises, 103 were in red, and the total amount of loss was 147 million yuan, equivalent to the city government's revenue in 1.5 years (Zhao, 1999). Shunde of Guangdong province met the same problem when it first started its privatization program in 1992. The solution reached by the localities was to privatize small firms, but Shunde and Zhucheng were more radical by privatizing almost all its state and collective firms. In 1995, the central

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<sup>2</sup> *Tentative Regulations on the Lease of Small State-owned Industrial Enterprises*, the State Council, May 20, 1988.

government, after several rounds of investigation and discussion, formed a policy called "zhuada fangxiao", or "keep the larger and let the smaller go", that limited the state's emphasis to 500 to 1000 large state firms and allowed smaller firms to be leased or sold out.<sup>3</sup> The government had a good reason to implement this policy. In 1997, the 500 largest state firms had 37% of the assets held by state industrial firms, contributed to 46% of the tax collected on all state firms, and to 63% of the total profit in the state sector. On the other hand, smaller firms owned by local governments had worse performance than those owned by the central government. In 1995, 24.3% of the central firms were in red, but 72.5% of the local firms were in red (Zhao, 1999). Therefore, "Control of the (500) largest firms means we have a control of the largest chunk of the state economy."<sup>4</sup>

From the "let the smaller go" part of the policy came a word "gaizhi", meaning "changing the system". Starting in 1994, *gaizhi* began to spread to the whole country. The content of *gaizhi* included contracting and leasing, the two methods used before, as well as new methods such as selling to private owners, employee-holding, incorporation, listing on the stock market, restructuring of internal and external governance, and bankruptcy. By international standards, *gaizhi* really is privatization.

One content of *gaizhi* was to take off the "red hat" for the red-hat firms, that is, firms with a collective face but actually run privately. In March 1998, the government issued a directive requiring all the red-hat firms to take off the hat by November 1998.

Sichuan provides an example of *gaizhi*. In 1994, the provincial government began to implement *gaizhi*, starting from county-owned enterprises. By the end of 1998, the province finished *gaizhi* for 68.6% of the 42,681 firms that were targeted for *gaizhi*. Among those transformed, 35.1% were transformed into employee-owned companies, 11.0% were transformed into employee-owned cooperatives, 14.3% were sold out, 7.0% were contracted out to individuals, 8.5% were leased out, 7.0% were bankrupt, and 5.0% were taken by other firms.

Countrywide, privatization was more popular in the countryside. From 1993, many localities, including Shunde and southern Jiangsu that had been renowned for their development of the collective economy began to implement massive privatization. Township and village enterprises (TVEs) used to have vaguely defined property rights that did not maintain a clear-cut definition on who, the entrepreneur or the government, or both, owns the enterprise. Because of their marvelous growth records, TVEs have been hailed by some authors as posing a challenge to the neoclassical doctrine of clearly defined ownership (e.g., Weitzman and Xu, 1994). However, as the TVE growth slowed down in the 1990s, the disadvantages of their vaguely defined property rights were acknowledged by academic research. Like their urban counterpart, the SOEs, TVEs also suffered the soft-budget problem (Zhang, 1998). Local governments felt the problem even earlier because they shouldered a considerable amount of debts accumulated by their TVEs' non-performing loans. Financial crisis leads the government to seek institutional change (e.g., North and Weingast, 1989). Li and Zhang (1998) show via a theoretical model that financial competition among local governments is a major cause

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<sup>3</sup> In 1994, as the ministry in charge of the government's economic affairs, the State Economic and Trade Commission sent a report *Suggestions on Revitalizing Small State-owned Enterprises* to vice premier Wu Bangguo who was in charge of enterprise reforms. In September, 1995, the policy was formerly announced by the central committee of the CCP in one of its plenaries and was put into the suggestions to the ninth five-year plan.

<sup>4</sup> Vice premier Wu Bangguo's speech in the national conference on economy, December 20, 1997. Quoted in Zhao (1999).

for China's local privatization initiatives. The evolution of the government policy towards privatization in China, especially in the 1990s, has exemplified the theory.<sup>5</sup>

However, the wave of privatization initiated by *gaizhi* soon met the criticism in 1998 that it led to the loss of state assets. The government also lowered its tone on privatization. Some localities stopped their privatization programs, more of them lowered their profiles to avoid being watched by the criticisms. The new constitutional amendment made in early 1999 has not elicited a new round of privatization. It seems that the government puts more emphasis on developing the private sector itself rather than on using privatization as a means to reform the state sector. However, even amid the criticism, more than 80% of the state and collective firms at or below the county-level have gone through *gaizhi* (Zhao, 1999). This means that the vast majority of the firms in China have left the realm of direct government control. By international standard, *gaizhi* thus qualifies as a property rights revolution although this revolution has been largely silent.

## 2. A model of government commitment and privatization

Although privatization has spread across the country, its performance is not uniform. Liu, Wang and Yao (2001) show that many privatized firms in southern Jiangsu, a region once famous for its collective firms, have got into problems. The owners of many privatized firms moved the assets from the old firms into new firms, and the local economy has regressed to one based on small family workshops. Qin (1998) finds similar phenomenon. In addition, in a study by Zhi (2001), it is found that among six cities with heavy privatization, Shunde performs better than other five cities in terms of firm profit and value-added. It is no coincidence that Shunde is the only city that has been engaged in a continuous government reform since 1993. In this section, we will present a formal model explaining the relationship between government reform and firm performance. Before we present the formal model, we first provide a verbal description of the ideas behind the model.

Consider an economy comprised of a firm, a politician and a firm manager. The firm is initially owned publicly. The manager is delegated to manage the firm with a fixed wage so he also provides a fixed amount of effort. The politician leads a bureaucracy of many bureaucrats and delegates to them the regulations of the firm. In the Chinese context, regulations include project approval and direct interventions into the firm's management affairs (such as employment target, wage determination, investment decisions, etc.) as well as other regular regulatory activities such as taxation, standard enforcement, etc.. However, if they are unregulated, these bureaucrats tend to be corrupted and grab from the firm and these regulatory functions provide a vehicle for the grab. The politician needs these functions to achieve particular goals that are valuable to himself. One example is that maintaining full employment increases his popularity among certain portion of the population. Another example is that implementing a specific industrial policy drives out some industries (like those creating heavy pollution) that he thinks are bad for the local economy. In addition, the politician cares about the opinion of the general public and the support of his subordinates. The general public cares about the revenue of the firm, and the bureaucrats care about their grabbing capacities. Therefore, the profit of the firm, government intervention and the bureaucrats' grabbing capacities

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<sup>5</sup> In this respect, Zhao (1999) is a nice reference.

all enter his utility.

A governance reform is defined as the establishment of the rule of law that eliminates the bureaucrats' grabbing from the firm. The reform is different than eliminating government intervention into the firm. Under certain circumstances (such as the Mao Zedong era in China), government intervention does not necessarily lead to corruption. However, it facilitates, if it is not a direct cause for, corruption in most cases. We assume that it is at the politician's discretion whether to take the reform and eliminate his subordinates' grabbing power. Under public ownership of the firm, the manager's supply of effort does not respond to the grab, so corruption is not harmful to the politician and he will not take the reform.

Privatization is a shift of ownership that makes the manager the residual claimant. It does not guarantee that government intervention disappear together with the ownership shift, though. However, because the manager begins to respond to the severity of the grabbing hand, corruption becomes costly to the politician and it may be an *ex ante* efficient decision for him to conduct the governance reform together with privatization. More importantly, the manager will not take the firm at the first place and privatization fails if the governance reform is not taken. Therefore, the two reforms are pre-condition for each other. Nevertheless, there is a critical difference between them: While the ownership reform is an irreversible reform, the governance reform has a time-consistency problem. This is because if the manager believed him and provided effort, it would be in the politician's interest to renege, i.e., to let loose the corruption. But the manager can perfectly envision this renege behavior and will take precautions in advance, probably providing the effort that he provided under public ownership. As a result, privatization will not be an attractive choice for both the politician and the manager. This is a typical time-inconsistency and subsequent inefficiency problem when a player can not make a binding commitment.

However, this problem may merely arise as a result of the limited number of choices that are available to the players. In the real world, the number of choices that a player can choose from is large and once they have been made, some of them become binding constraints on the player (he may be held legally responsible to keep the choices). Even a government in a totalitarian state can not be totally free of observing their choices. In our case, removing government intervention can be made a binding constraint (probably through the privatization contract) on the politician, and if this is done, it can serve a credible commitment for the politician to stick to the governance reform because by removing the intervention, corruption becomes more visible and its cost to the politician becomes higher.

The commitment mechanism discussed here is different from those frequently appearing in recent literature that concentrates on decentralization of decision-making (e.g., North and Weingast, 1989; Qian and Weingast, 1996, 1997; and Bai and Li, xxxx). Here the commitment can be termed "burn the bridge", a military tactic that can be traced back to Chinese Han dynasty two thousand years ago. In one battle, General Han Xin put his army against a big river without a bridge on it so no retreating route was left for his men and the only hope for them to survive was to defeat the enemy. They did that. In this story, Han Xin had another choice, putting the army against a river (and burning down the bridges over it), in addition to killing retreating soldiers by himself. The former was an automatic binding constraint on his men and himself because retreating into the river

would mean immediate death, but the latter was not because even he wanted to kill all the cowards, many of them would succeeded in escaping from the messy battle field.

### Settings

Consider an economy comprised of a firm, a politician and a firm manager. The firm is initially owned publicly. The manager is delegated to manage the firm. We assume that public ownership makes an incentive contract infeasible for the manager. This assumption can be justified on the ground of the soft budget constraint first proposed by Kornai (1979) and later refined by Qian (1994) and Dewatripont and Maskin (1996). It is also consistent with the wide observed failure of the former command economies whose salient feature is public ownership. Therefore, we assume that the manager provides a fixed amount of effort  $e_0$  into firm management. At this level of effort, the disutility to the manager is zero. Consistently, the wage that the manager gets is normalized to zero.

In the meantime, the politician maintains a certain level of intervention  $s \in [0, 1]$ , say, that is delegated to the bureaucrats to implement on the firm. Although the management may help the firm's production because the government has accesses to resources that the manager does not have (such as bank credits),<sup>6</sup> it is still an inefficient device and brings a net deadweight loss to the firm. In addition, the bureaucrats tend to grab from the firm if they are not properly checked. We assume that their total grab is proportional to the firm's revenue, with the proportion being  $t \in [0, 1]$ . Same as the intervention, the grab also brings a deadweight loss to the firm. In summary, we can specify the firm's net revenue as

$$(1) \quad R = \varrho e_0 - t - s,$$

where  $\varrho$  is a parameter representing the firm's technology and market. A larger  $\varrho$  thus implies a stronger local economy. To structure the discussion, we set a boundary condition that  $R$  is non-negative for any  $t$  and  $s$ .<sup>7</sup>

The politician cares about the general public's interest, the support of the bureaucrats as well as the result of the intervention. The public's interest can be represented by the size of  $R$ , the support of the bureaucrats by  $t$ , and the result of the invention by  $s$ . However, corruption also brings a cost on the politician, and the cost is likely to increase as  $t$  becomes larger. Nevertheless, government intervention can serve as a damage control device and mitigates the cost. These concerns are best represented in the politician's utility function

$$(2) \quad U = R + \alpha t + \beta s + \gamma s,$$

where  $\alpha$ ,  $\beta$  and  $\gamma$  are all positive numbers. The sum  $\alpha t + \gamma s$  represents the net gain from granting the bureaucrats the corruption power, and  $\beta$  represents the weight that the politician puts on the result of the intervention. We assume that this weight is larger than one, that is, the politician values more of the special interests achieved by intervention than the general public's interest.

Governance reform is defined as the politician's elimination of the corruption and setting  $t$  to zero. As the setup shows, the interests involved may prevent it from happening.

<sup>6</sup> This is typically assumed in the literature on Chinese rural public firms, see for example, Li xxxx.

<sup>7</sup> This assumption is inessential to our results. But since the revenue function and the politician's utility to be introduced later are both linear, we need this assumption as a boundary condition. With this boundary condition, our analysis will be simplified technically.

### *Public ownership*

Governance reform may not be desirable for the politician under public ownership of the firm. Because his utility increases monotonically with  $s$ , the politician will set  $s$  to one. He will also set  $t = 1$  under corruption because his utility is linear in  $t$ . If that is the case, his utility is

$$(3) U_0^c = \hat{e}e_0 - 2 + \mathbf{a} + \mathbf{b} + \tilde{a}.$$

With governance reform,  $t$  is set to zero, his utility is

$$(4) U_0^* = \hat{e}e_0 - 1 + \hat{a}.$$

However, setting  $t = 0$  may not be compatible with the politician's incentive if the following condition holds

$$(5) \hat{a} + \tilde{a} > 1.$$

It is noteworthy this condition has nothing to do with  $\hat{e}$ , so the government of a city with a stronger economy does not have a stronger incentive to engage in governance reform than the government of a city with a weaker economy. We will show that with privatization, governance reform could occur even when condition (5) holds, that is, privatization would give the politician an extra incentive to engage in the reform. On the other hand, only when the reform is carried out and committed to by the politician will privatization be a Pareto improvement to both the politician and the manager.

### *Governance reform and privatization*

Privatization shifts the ownership of firm from the government to the firm manager and makes the latter the residue claimant.<sup>8</sup> We let the politician and the manager play the following game:

On day 1, the politician announces whether to privatize the firm and determines the level of intervention in the firm. On day 2, the manager decides whether to accept the offer of privatization and if he does, how much effort to put into the firm. On day 3, the politician decides whether to engage in governance reform and the production is carried out.

We assume that privatization and the politician's decision on intervention in the firm are irreversible and observable by the manager. We put the politician's decision on governance reform after the manager's effort to capture the non-enforceability of the reform. To wit, it may be an *ex ante* optimal decision for the politician to engage in the reform, i.e., to set  $t$  be zero, but if the manager believed him and acted accordingly, it would be in his interests to renege and give up the reform afterwards, i.e., to revert to corruption. However, the manager can well envision the politician's time inconsistency problem and act accordingly. Like the feature shared by the time consistency literature, this will result in inefficient outcome on the part of the politician. In what follows, we will first replicate this standard result and then propose two commitment mechanisms that the politician can use to commit himself to his *ex ante* efficient decisions.

We start with the politician's *ex ante* efficient decisions on day 1. In making these decisions, he takes into account the manager's response to the grabbing hand because the latter now becomes the residual claimant of the firm. For any level of effort  $e$ , the

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<sup>8</sup> Implicitly, we assume that the firm is given to the manager for free. While it could be justified by empirical findings on Russia and to some extent, on China (Yao, forthcoming), this assumption is made to simplify our analysis and allows us to concentrate on the incentive effect of privatization.



disutility (in monetary term) to the manager is  $\frac{1}{2}(e - e_0)^2$ . He maximizes his net profit  $\mathbf{p}$

$= (1 - t)(\dot{e}e - t - s) - \frac{1}{2}(e - e_0)^2$  by choosing his effort  $e$ . This immediately gives us a

solution to  $e$ ,  $e(t) = \dot{e}(1 - t) + e_0$ . Taking this for granted, the politician maximizes his utility by choosing  $t$  and  $s$ , that is, he solves the following problem

$$(6) \quad \underset{s,t}{\text{Max}} U = [\mathbf{q}e(t) - t - s] + \mathbf{a} + \mathbf{b}s + \mathbf{g}s.$$

The optimal solution to  $s$  is still 1. To making governance reform (i.e.,  $t = 0$ ) attractive to the politician, we need that the marginal utility of  $t$  be negative, that is,

$$(7) \quad \dot{a} + \bar{a} < \dot{e}^2 + 1.$$

The left-hand side of this condition is the marginal benefit of corruption, and the right-hand side is the marginal cost of corruption that includes the deadweight loss and an extra cost due to the manager's lost incentive. This condition can be satisfied easily. In particular, if  $\dot{a}$  and  $\bar{a}$  are both less than 1, it is satisfied for sure. It may hold even if (5) holds. Therefore, governance reform is easier with privatization than under the public ownership. This is because now the manager's effort responds to the grabbing hand and an increase in  $t$  causes an extra cost of a factor  $\dot{e}^2$  due to the manager's lost incentive. It is noteworthy that government reform is easier under a larger  $\dot{e}$ , in other words, a city with a more prosperous local economy will be more likely to take the reform.

If condition (7) holds,  $t$  is set to 0 at which the manager's supply of effort is  $e^* = \dot{e} + e_0$ , and the politician's utility is

$$(8) \quad U^* = \dot{e}^2 + \dot{e}e_0 - 1 + \hat{a}.$$

Obviously,  $U^*$  is greater than  $U_0^*$ . Under (7),  $U^*$  is also greater than  $U_0^c$ . Therefore, privatization makes the politician better off if he can commit himself to the governance reform. On the other hand, the surplus left to the manager is all the firm's revenue  $\dot{e}^2 + \dot{e}e_0 - 1$  so his net utility is  $\dot{e}e_0 + 0.5\dot{e}^2 - 1$ , which is positive by our boundary condition (this condition guarantees that  $\dot{e}e_0 - 1$  is positive. Lastly, the general public is also pleased as the firm's revenue is increased from  $\dot{e}e_0 - 2$  to  $\dot{e}^2 + \dot{e}e_0 - 1$ . Therefore, we have the following proposition

**Proposition 1.** If the politician can commit to governance reform, privatization will be a Pareto improvement to the politician, the manager and the general public.

However, governance reform may not be time consistent for the politician because if the manager spent  $e^*$  on day 2, he might gain by letting loose his control on his subordinates on day 3. To examine this possibility, we notice that the marginal utility of  $t$  on day 3 is the same as in the case before privatization, which is positive by condition (5). Therefore, sticking to governance reform is not an ex post optimal choice for the politician. Of course, the manager can readily envision the politician's opportunist behavior and would have not provided  $e^*$  on day 2. Since the tax rate under corruption is 1 when the number of bureaucrats is large, the manager will provide  $e_0$ , exactly what he did under public ownership. As such, both the manager and the politician are made indifferent between public ownership and privatization. Therefore, we have the following proposition

**Proposition 2.** Without commitment to governance reform, privatization will not be a better choice for both the politician and the manager.

Proposition 1 and 2 bring a dilemma to the politician. To break up the dilemma, the politician has to make a credible commitment on day 1 in order to assure the manager that he will stick to governance reform. This can be done by setting  $s$  zero. When  $s$  is zero, the marginal utility of  $t$  on day 3 becomes  $-1 + \hat{a}$ , which is negative if

$$(9) \hat{a} < 1.$$

This condition implies that the weight of the bureaucrats' support is less than the weight of the general public if corruption is exposed due to the lack of disguise of government intervention. While whether this is true depends on the politician's preference and the society's tolerance on corruption, it is clear that it can happen even when condition (5) holds. The politician's utility under commitment is

$$(10) U^* = \hat{e}^2 + \hat{e}e_0,$$

which is smaller than  $U^*$ . That is, commitment is costly to the politician. However, his utility can still be greater than the highest he can get under public ownership,  $U_0^c$ , if the following condition holds

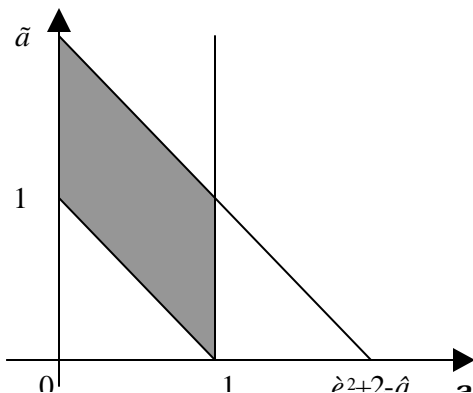
$$(11) \mathbf{a} + \mathbf{b} + \tilde{\mathbf{a}} < \hat{e}^2 + 2.$$

The left-hand side is the cost of privatization and commitment, and the right-hand side is the gain of it. So the condition requires that the gain be larger than the cost. If it holds, the manager gets  $\hat{e}e_0 + 0.5\hat{e}^2$ , more than what he gets when there is no commitment problem. It is noteworthy that with the commitment, the revenue of the firm also increases from  $\hat{e}e_0 + \hat{e}^2e_0 - 1$  to  $\hat{e}e_0 + \hat{e}^2$ , the highest possible. Commitment demands the politician to sacrifice his own gain, but a side effect of it is to increase social output. Indeed, by making the commitment, the politician's own utility comes solely from social output, making it as if he only cared about the general public's interest although in reality he is forced to do so.

At this point, it is a good time to reiterate the conditions under which the commitment problem arises and can be overcome. They are conditions (5), (9) and (11). The permissible parameter region defined by these three conditions is shown in Figure 1. Notice that the size of the region depends on condition (11). In particular, a more robust local economy (that is, a high  $\hat{e}$ ) and a smaller weight that the politician puts on special interest groups (i.e.,  $\hat{a}$  is not significantly larger than 1) enlarge the region. Generally, we have the following proposition:

**Proposition 3.** There exists a feasible commitment mechanism for the politician to commit to governance reform.

Figure 1. Permissible parameter region for Proposition 3



### 3. Government Reform in Shunde

The government reform in Shunde was started in 1993 and finished in 1999. It was a radical reform by any measurement. It was a top-down reform starting with the municipal government itself. It downsized the government by nearly half in terms of the number of government agencies and by a quarter by the number of employees, transformed the functions of the government, increased the transparency of government administration and enhanced the rule of law. In this section, we will first provide a description of the reform, and then analyze the factors leading to its success, putting the emphasis on its linkage with privatization. At the end of the section, we will conclude with a discussion of the future problems.

#### *Accomplishments of the reform*

The major contents of the Shunde government reform are consolidation of government agencies and downsizing, transformation of government functions, the establishment of administrative transparency, and enhanced efficiency and rule of law.

Before the reform, there were 62 regular government agencies and more than 100 temporary agencies in the municipal government. The reform trimmed the number of regular agencies to only 36 and eliminated 80 temporary agencies (Jiang, 1999). All the intermediary committees between bureaus and the mayor were eliminated, many bureaus with similar functions were combined. The most radical was to combine the parallel departments in the government and the party organ. For example, the government secretary office was combined with the party secretary office, the department of organization and the department of veteran leaders in the party organ were combined with the department of personnel in the government, and the party discipline committee was combined with the bureau of inspection in the government. The party organ is an indispensable entity in Chinese politics and government administration. Important government policies and directives are determined by the standing committee of the Communist Party, and the government's responsibility is only implementation. The consolidation of government and party departments enhances the characteristics of a party-state and its long-term merits can be much disputed, but it is a practical choice to downsize the government precisely because the Shunde reform was confined by China's party-state establishment.

In addition to cutting the number of government agencies, Shunde's government reform also took a tough position on government employees. Before the reform, there were 1235 employees in the municipal government, the reform took a 25.8% cut and downsized the government with only 916 employees. This is really a small government in terms of the city's own population of 1.2 million and a similar size of migrants. However, the 319 employees who left the government were not simply laid off, 284 of them were transferred into newly founded businesses that were transformed from government agencies, 15 people got early retirement, 8 people were transferred to townships, and only 12 people found their own employment. As a result, the resistance to the reform was lessened considerably. The real test, however, were the 123 officials whose ranks were lowered or even stripped off (Jiang, 1999).

The downsizing could not only meet the resistance from those who lost their privileges,

but also constitute a potential conflict with higher government establishments. A standard practice in China is that lower-level governments have to have the same, if not more, departments that a higher government has. The elimination and consolidation of departments in Shunde thus raised potential conflicts with Guangdong provincial government. The way that this problem was solved was that each remaining department assumed more responsibilities and the work intensity of the remaining employees increased dramatically.

Downsizing of the government can not sustain if its functions are not transformed. Shunde had a lesson on that. In 1984, it had a government reform that cut 9 government agencies and 171 people. However, as the government was still deeply involved in the management of the economy, the government size increased quickly again. By 1987, the number of agencies increased by 10 to reach 66, and the number employees increased by 378 to reach 1299 (Jiang, 1999). The 1993 reform not only consolidated government agencies, but also stripped off many functions assumed by the old agencies. This was made possible by the ownership reform. Before the reform, the government needed a bureau to manage the municipal-level firms and another bureau to provide administrative guidance to firms at the township and village levels. It also had separate bureaus in charge of domestic trade, international trade and cooperation, custom, rural trade, and tourism. After the reform, the two bureaus in charge of industry were combined into the bureau of industrial development and the other bureaus in charge of trade issues were combined into the bureau of trade development. Together with the consolidation, the functions of these bureaus were reduced considerably. For example, the new industrial bureau no longer has the power to interfere the internal management affairs of the old municipal firms most of which have been privatized. Since their functions have been reduced, the industrial and trade bureaus are under the way to merge into one bureau.

The reform has reduced the government's role in economic management to the minimum, yet the government has not become a figurehead. The Shunde government still maintains an active role in attracting investments, creating jobs, enforcing government regulations, providing local public goods, and managing an active industrial policy. This last function is mainly directed to environmental protection. Shunde has large textile, dyeing and tile industries that pollute heavily. As income increases, the public demand for clean water and air has increased considerably. The Shunde government consciously rejects projects in these industries and uses taxation to force small labor-intensive and polluting firms out of business. This definitely affects employment, but it is still unknown as to how serious the adverse effect is.

One striking change after the reform is the increase of transparency and efficiency in Shunde government's administration. This is exemplified by its reform on its project approval process. The rule in China is that the government has the power to determine whether a project is worthwhile for the economy. The provincial level government and cities designated to have separate fiscal plans can approve a domestic project with an investment less than 30 million yuan RMB or an FDI project with an investment less than 30 million US dollars, beyond that, the project has to be approved by the central government. To get a project approved and the firm established, the owner has to have the patience to go through the maze-like government bureaucracy, spending considerable amounts of time and financial resources. The Shunde government can not break the rule of approval, but has substantially increased the transparency and effectiveness of the

approval process. Their innovation was to establish one approval office that provides “one-stop” approval to a project: it has the power to hand over the approval and is also responsible to prepare all the necessary documents for the project. This saves tremendously the owner’s efforts and increases the transparency of the approval process.

Another sign of transparency is the monthly administrative bulletin *Shunde Administrative Affairs* published by the government. The bulletin publishes the newest laws and regulations issued by various levels of government and is sent to larger firms as well as public venues like hotels. This bulletin is unique among Chinese cities and serves as a bridge between the government and the private sector.

In relation to economic performance, the most important change brought about by Shunde’s government reform is the increased regularity of government administration and enhanced rule of law. This is shown in the IFC survey. To a question of how many major changes to laws, regulations, or policies happened in the last three years that affected a firm’s business, the average answer in Shunde was 0.36 times while the average for all the six surveyed cities was 2.54 times. In particular, Beijing had 6.19 times. Although Shunde’s government levies were not the lowest among the six cities, they were certainly the most stable. For example, for rate of fees, the most variable part of government levies, its coefficient of variation was 0.84 for Shunde, but in the range of 1.30 to 1.77 for the other five cities (Zhi, 2001). Therefore, the policy environment is much more predictable in Shunde than in other cities. In addition, more people in Shunde than in other cities trusted the court when they had a dispute. There were 40.6% of the firms in Shunde checked going to the court as a solution to a dispute while the average for all the cities was 30.7%.

Best predictability leads to better firm performance. Zhi (2001) shows that other things equal, a firm makes 10 million yuan more of value-added and 34 million yuan more of profit if it is in Shunde. In addition, he shows that the variation of taxes significantly reduces a firm’s value-added and profit although the tax burden itself does not cause significant harm. Since firms in Shunde are subjected to less tax variation, this result eventually shows that firms in Shunde have better performance.

#### *Factors leading to the success of the reform*

The success of the Shunde government reform is closely tied to its ownership reform, a visionary and strong leadership, a prosperous local economy and meticulous design of the reform.

As the review in the last section showed, the ownership reform was brought out by the financial problems faced by the public firms. Our theoretical model in Section 3 then showed that ownership reform creates conditions for government reform. This is because on the one hand, ownership reform makes firm managers the residual claimant so they become sensitive to irregularities in government administration and law enforcement; and on the other hand, ownership reform dispenses many government functions. Both increase the politician’s costs to maintain a large and loosely controlled government so his incentive to launch the government reform is enhanced. In return, government reform lays a credible commitment to better state governance and reduced corruption, so privatization turns out good firm performance. As a result, government reform and privatization create a synergy for a better economy.

In addition to the conditions created by privatization, the role played by Shunde’s

leadership was also indispensable in bring about the government reform. Our theoretical model predicts that the preference of the politician is an important factor determining the possibility of the reform. In Shunde, the reform-oriented leadership played a pivotal role in its ownership and government reforms. The party secretary is young, open-minded and determined to engage in reform. Under his influence, the whole leadership has adopted a new philosophy toward government administration, that is, the government should draw away from direct engagement in the economic affairs and should instead concentrate on public good provision (including the provision of a fair, just, and open competitive environment) and law implementation. After several years of reform efforts, this new philosophy has gained popularity in the government and provided an important informal constraint to the behavior of government officials. No matter how thorough the reform is, the formal rules thus established would still be incomplete and government officials would still be empowered with a considerable degree of discretion in their decision making. Under this situation, informal constraints such as the new philosophy established in Shunde become important. One example of the effect of this informal constraint is the failure of the Bureau of Industrial Development to establish a SME service center that was to provide charged services to SMEs. The bureau sent the proposal to the government office for screening before it was sent to the mayor for approval. The government office, staffed with junior officials, rejected the proposal and did not send it to the mayor. The message was simple: Charged services could become a jump-board for corruption and should not be encouraged. The decision of the government office was not consistent with the rule of hierarchy commonly found in the Chinese bureaucracy, but consistent with the new philosophy in Shunde.

The third factor contributing to Shunde's success is that it has a viable local economy. Although many firms were in red when Shunde's privatization program began in the early 1990s, their losses were not created by their non-viability in the market, but rather by their mismanagement. Shunde is a production base for China's home electronics, an industry with continuously expanding domestic and international demand. Governance reform involves a tradeoff between a decreasing bureaucratic support and an increasing social output, but a better local economy makes it easier for social output to increase, so as our theoretical model predicts, the politician's willingness to engage in the reform is enhanced. In addition, a better local economy also makes layoff easier as the private sector is more capable to absorb the laid-off workers.

The last factor contributing the Shunde's success is its well-designed reform plan. This plan was not formed from the very beginning, but had been revised and enhanced in the course of the reform. Laid-off workers were not simply thrown out of the government, instead, they were first put into government supported companies in the transition period. After that, these companies were privatized and the workers were gradually absorbed by the private sector. For workers remaining in the government, a major measure to boost their morale is to increase their wages. The income of a government employee is now above the average in the private sector. However, even this wage is not enough to balance off a person's desire for corruptive income. As a complement, the Shunde government maintains an active promotion system that puts able officials in important positions. In addition, the new administrative philosophy gives government officials a sense of honor as well as responsibility, which plays an important role in guarding the integrity of the administration.

#### 4. Conclusions

The transition from a planned economy to a market economy is not merely a transformation of the ownership, but also the transformation of the state governance. In Eastern Europe and the Former Soviet Union, the transformation of ownership was accomplished almost overnight, but their initial performance records were uniformly bad. After almost a decade, some of them (such as Poland and the Czech Republic) have improved their performance records, but many of them (especially those in the Former Soviet Union) are still in deep trouble. As Shleifer (1997) points out, the diverse performance records in Poland and Russia were a result of their different ways of state governance, especially in the area of rule of the law. The Shunde experience provides yet another example.

The problem with Russia is not so much with its economy, but rather with its state governance. In particular, the dissolution of the Soviet Union and the fall the communist regime created a power vacuum, and in the process to fill this vacuum, special interest groups and monopolists have captured the state. China is luckier than Russia for having not gone through the destruction of the state apparatus. The danger, of course, is that without the destruction China may be stuck with the old system and never be able to build a sound state governance structure. In this regard, privatization as forced by financial problems may well provide an opportunity for China to take a serious governance reform, starting with the government itself. Right now, government reform at the central level has been finished, the central government has reduced its size by 15% and 20 ministries have been eliminated. Reform at the local level is under way and radical downsizing is expected. With China's economy being continuously privatized, the government reform may well be likely to sustain, so the synergy of a private ownership based economy and a sound state governance structure can be formed.

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