

Enterprise Privatization and Public Goods Provision in Rural China

Denise Hare
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My research will examine the effect of rural industrial enterprise privatization on the provision of public goods in rural China. China's rural industrial boom has received considerable attention as one of China's earliest reform successes. Changes in the fiscal system early in the reform era are credited as one of the main stimulants of the rural economic expansion (Whiting, 2001; Oi 1999; Wong, 1992). Ironically, the very incentives that facilitated economic growth also contributed towards increased inequality. The situation is particularly acute in rural inland China, which suffers from both low private incomes and a severe shortage of public resources (West and Wong, 1997; Park, *et al.*, 1996). Fiscal decentralization—which gives local governments greater autonomy over their expenditures, but also more responsibility for funding them—is one factor contributing towards concerns about public service provision in rural China. However, the problem is further accentuated by recent policy efforts directed towards privatization—the transfer of production assets into private hands.

To be specific, privatization is a relatively recent phenomenon. China's economic reforms began with early efforts to *decentralize* production decisions, but *privatization* of production assets came later, starting only in the 1990s, that is, the second decade of government reform. The process of privatizing assets was slower in some places and faster in others, but by 2003, collectively owned rural enterprises contributed only a 10 percent share to the sector's gross output value, nationwide, relative to a 65 percent share in 1990 (*China Township and Village Enterprise Yearbook*, 1991 and 2004).

State-owned enterprises have long been the largest revenue source for China's central government (Saich, 2002; Lin, 2000), and locally, many township governments have relied almost exclusively on support from rural enterprises to finance their spending (Ong, 2006; Whiting, 2001). Changes in enterprise ownership have implications for the ways in which governments can draw their revenues. The objective of my research is to understand how the privatization of production assets bears on local government capacity to provide public goods and services.

Advocates of privatization often call attention to the surpluses it generates through more efficient allocation of resources, and there is much to be said for this advantage. Certainly some inefficient outcomes stemming from the collective nature of rural enterprise ownership have been noted (Hare and West, 1999). However, China presents an unusual situation in which, until recently, the government has laid claim to potentially the whole of enterprise profits. When production is privatized, the claim to such profits shifts to the private owner(s) of enterprise assets, with unforeseeable impacts on tax remittances. The tax collector and enterprise owner will negotiate over tax liability, and the bargaining scope may be rather wide. The problem is exacerbated, in China, by accounting practices that do not correspond to international standards nor are optimally transparent (Lardy, 1998) and by application of taxes and fees that is highly arbitrary (Bernstein and Lü, 2003; Wong, 2002). It is no surprise, therefore, that tax evasion is common (Lin, 2000).

We know surprisingly little about how privatization influences government revenues and its capacity to provide services. The impacts of fiscal decentralization get far greater attention, in China (Wong and Bird, 2005 or Yu and Tsui, 2005 are two very recent examples) and elsewhere (Ahmad and Tanzi, 2002). Similarly, the effects of privatization on enterprise performance have been investigated (Dong, *et al.*, 2006; Li and Rozelle, 2003). However, privatization's influence on a broader array of social indicators remains unknown and such knowledge is essential to improve policy response and management. My analysis of China's rural enterprise privatization will help to inform and clarify debates about the role of government in the economy and how it can best serve the needs of its citizens.

From an economics perspective, one of the most important functions of government is to provide public goods. A public good might be described as one for which there is a positive spillover that accrues to a wider community beyond the individual consumer. Taking education as an example, the social benefits of achieving universal literacy and numeracy are strong arguments in favor of publicly funded primary schools. Of course the expenditures required in order to provide public goods requires that the governing body have a revenue source—namely taxation.

To explore a bit further the connection between ownership and tax revenue, one might consider a simple model of collective action. In his seminal work, Olson (1965) suggests that individual effort exerted in pursuit of a group's collective interest is likely to decline as the group grows in size, owing to the increasingly diffuse nature of the potential benefit to be derived. Application to the case under study leads to an interesting twist—under collective ownership there is less incentive to engage in tax avoidance, as the returns to any particular individual resister are small. Privatization, by definition, confers the share claim to a (typically) small, and in any case well-defined group of owners. Moreover, private ownership eliminates the tacit, if not explicit expectation that production surplus be used to support the community, in some way, whether through reinvestment in productive activities, service provision, or redistribution in favor of disadvantaged members. Given a clearer and no doubt larger share claim to profits, the incentive to engage in tax avoidance is expected to rise as assets are shifted to private ownership.

I hypothesize a negative relationship between privatization and tax remittances, leading privatization to have a negative impact on local government's ability to provide public goods, all else equal. Though I am aware of no systematic study of the question I have framed, there is evidence in the literature for the negative correlation that I predict (Zhang, *et al.*, 2004; Whiting, 2001). Preliminary results of a collaborative project I am conducting with Yi Hongmei provides further statistical support—namely, that the presence in a village of a collectively owned rural enterprise significantly increases local public goods investment, while the presence of a privately-owned enterprise is insignificant.

In order to test my hypothesis further, I propose a project that involves two research stages. The first phase includes assembly and analysis of panel data. Nationwide panel data, spanning the most recent 15 years of economic reforms, can be obtained through published sources, and most of the statistical yearbooks needed are already in my possession. I currently have complete sets of *Zhongguo Tongji Nianjian*, *Zhongguo Xiangzhen Qiye Nianjian*, and various other relevant yearbooks from 1990 through 2004, and many through 2005. I will make a trip to China in the early summer of 2007 to update my sources and to explore additional data sources. Data from sample

surveys would provide a nice complement to information from published sources. For instance, the Ministry of Agriculture's RCRE village survey data could support analysis of village spending and income in about 300 villages (selected nationwide) going back as early as 1991, and collected most recently in 2005. I have been in contact with Professor Pan Suwen, at Texas Tech University, who has conducted analyses of these data, about potential collaboration, and he has responded favorably. There also may be opportunity for further collaboration on this question with Yi Hongmei (of the China Center for Agricultural Policy), using her data set of 100 villages.

I will utilize a variety of indicators of rural public goods provision, measured at the province level, including primary and secondary school enrollments, health care facilities, and social support efforts as dependent variables, in each case examining whether they are correlated with the share of the province's rural enterprises owned collectively (versus privately). Of course I will control for other relevant factors, such as population, income, sectoral composition of output (percent share in agriculture), enterprise profitability. The dependent variables, and general province characteristics, can be obtained from *Zhongguo Tongji Nianjian*. Share of enterprises owned collectively and enterprise profitability are available from *Zhongguo Xiangzhen Qiye Nianjian*. If possible, I would also like to include local government access to state bank credit as an independent variable in the regression.¹ Because the panel data set I assemble will have multiple years of observations on each of China's 27 provinces and autonomous regions, I will be able to hold constant any observed or unobserved characteristics of the province that remain fixed over the period under study. To put another way, my measurement of the effect of privatization on public goods provision will net out any systematic relationship between privatization and public goods across provinces that arises due to particular conditions or characteristics of the provinces themselves. To that end, my

¹ This variable, as well as enterprise profitability, are intended to control for other mechanisms through which privatization might influence local government finance—positively, through shedding of loss-makers and increased profitability derived from improved enterprise performance (see Kung, 1999 and Li and Rozelle, 2003) or negatively through the elimination, coincident to privatization, of local governments' privileged access to state bank credit borrowed in the name of their collectively-owned enterprises (see Ong, 2006; Brandt, *et al.*, 2005; and Park and Shen, 2003 for further discussion).

study will avoid the sort of bias that might result from working with a cross-sectional data set representing only a single point in time.

I expect to complete acquisition and assembly of my data during the summer of 2007 and begin the empirical estimations, arriving at a preliminary set of results in the fall. In addition to preparing a summary of the main results, I will utilize this time to read relevant Western scholarship on the topic, particularly focusing on the public finance literature concerning tax policy design and tax collections management—an area that I have not previously explored. I anticipate making a second trip to China in spring semester of 2008. Ideally I will spend a full semester in China, in residence at the Johns Hopkins-Nanjing University Center for Chinese and American Studies, but final plans are contingent on the arrangements I am able to make for my daughter's schooling. In any case I hope to have an extended stay at the Center during spring 2008 of at least several months.

Having a research base in Nanjing, the capital of Jiangsu province, provides an extraordinary opportunity for me to advance my research. Jiangsu has long been a center of dynamic rural enterprise activity and the southern part of the province is known especially for its strong orientation towards collective ownership (Ho, 1994). A full 87 percent of the province's rural enterprise gross output was derived from collectively owned enterprises in 1990, yet by 2003 this figure dropped to just 6 percent (*China Township and Village Enterprise Yearbooks*, 1991 and 2004). Exploring the local budgetary impacts of such a steep decline in collective ownership, in addition to the ways in which local officials have managed their tax collections during this period, will enhance the understandings I am able to reach through my quantitative data analysis. My tools of investigation will include interviews with local officials and policy researchers, reading of Chinese language scholarly journals and popular press reports, and, if data permit, a case study of Jiangsu at the county- or township-level that complements the nationwide study. The opportunity for extended scholarly interaction is of particular value as it allows me to deepen established collaborative relationships as well as to extend my network and lay groundwork for future research endeavors. The knowledge I gain through these exchanges also will inform my final quantitative analysis of the data. I will return to the empirical work by mid-spring, to revise and refine specifications of

my variables and my empirical model as needed, subsequently completing manuscripts for journal submission during summer 2008.

My primary set of research contacts in Nanjing are with Zhong Funing and Zhu Jing, Chair and Professor of Economics, respectively, at Nanjing Agricultural University. The three of us currently are co-authoring a paper that explores regional variation in China's grain policy and its effects on farmers' consumption outcomes. Zhong has written previously on public goods provision in rural China (Lin, Liu, and Zhong, 1997), and both Zhu and Zhong have considerable knowledge about local conditions and implementation of policy that will contribute substantially to the proposed research. I am in on-going contact with them, and they are enthusiastic about future collaborations. From my student days at the Hopkins-Nanjing Center (class of 1987-88), I know there are other good resources for me to utilize in Nanjing, including Nanjing University itself, as well as the Jiangsu Academy of Social Sciences.

This project is a natural extension of my previous work on economic reform policy and its impacts, and provides opportunity to blend divergent aspects of my interest and expertise. On the one hand, the trajectory of China's rural industrial enterprises has long been at the heart of my research agenda. My dissertation and early publications explored their influence on rural labor markets, household income, and gender differences in employment and wages (Hare, 1992; Hare, 1999). A subsequent consulting assignment with the Asian Development Bank led to publication of work examining the sectors' regional growth patterns (Hare and West, 1999). More recently, I have turned my attention to the analysis of reform processes--that is, the examination of their private efficiency gains alongside some broader social implications, completing investigations of land reform policies in Vietnam (Hare, 2006) and China (Hare, Yang, and Englander, forthcoming). Collectively, my previous body of research demonstrates successful utilization of data from both sample survey and published sources, yielding meaningful insights that are of interest to scholarly and policy audiences.

Building on the knowledge I have acquired through the previous work, the proposed research offers multiple opportunities for my growth as a scholar. I expect the project will yield a set of two or three scholarly articles—the more general empirical results being of interest to such audiences as *Journal of Public Economics*, *Economics of*

Transition, or *Journal of Comparative Economics*, while the richer descriptive exposition suitable for interdisciplinary journals with a focus on China, such *China Journal*, *Modern China*, or *China Quarterly*. Less tangible though equally important benefits include broadening of my expertise about China's reform policies and practices, exposure to a new area of the economics literature (public finance), and experience in using the latest methods for analyzing panel data. This expansion of my skills and knowledge will transfer directly to courses I teach, and it will form the foundation of future research endeavors.

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