3.1 Introduction

This chapter presents a political economy analysis of the development of China's state investment system and its response to reform. Political economy analysis as used here means that the focus of the analysis is on the orientation, interests and interest conflicts among the different economic authorities and agents, and on showing how these have shaped the processes of concrete investment decision-making, financing and implementation. The main focus is on fundamental forces and interaction mechanisms shaping the investment system rather than on the miscellaneous policy details and related shifts. The conflicts of interest have existed not only between central and local governments, but also among different bureaucracies of the same rank (mainly planning, fiscal, banking and specific industrial bureaucracies). On the other hand, there has been widespread collusion among local government agents, locally run enterprises and local branches of state banks, as well as between enterprises and their immediate supervisory agencies. All aim to avoid project approval requirements and procedures and to obtain loans outside the credit plan. The complicated interaction between interest conflicts and strategic collusion has shaped the correlation between the recurring cycles of decentralization and re-centralization and the investment cycles led by local or central government. Hopefully, this political economy analysis will help to understand the reasons for ubiquitous growth drive and investment hunger, how growth drive is translated into investment boom, and what induces the central government to initiate retrenchment campaigns and to reinforce these campaigns by ad hoc administrative measures and Party discipline.
Chapter 3

The chapter is set up as follows. Section 3.2 overviews the history of the state investment system. Sections 3.3 to 3.5 present the basic characteristics of the project approval system and the relevant changes in approval power distribution. These sections also describe how governments at different levels control financing resources by formal credit plans as well as by informal measures. The fundamental function of the material supply system and its change during the reform period are also described. Section 3.6 analyses the worsening of the soft budget constraint in state-owned enterprises and the consequent investment hunger. Section 3.7 examines the development drive and investment hunger of local governments. The key conclusion, i.e. that insatiable investment demand exists at all levels and in both pre- and post-reform periods, is summarized in section 3.8.

3.2 A Historical Overview of the State Investment System

In the standard model of the centrally planned economy, control of the investment process is far more strictly centralized than day-to-day production. Following the implementation line of the national economic plan, the national plan distributes investment funds among the various ministries in the course of the planning and decision-making process. The disaggregation of funds proceeds from the top downward through the hierarchy of national economic control to the state-enterprise level. The quotas are set in value terms and are usually broken down into a few main items of expenditure, such as construction, purchasing machinery and equipment, etc. For some priority projects, decisions are made separately. The centre determines what the installation will produce, what technology it will use, where it will operate, when it should be ready and how much it should cost. Following the formation line of the national economic plan, starting from the enterprises, the subordinate institution in the hierarchy of national economic control makes initial proposals and comments on drafts. If necessary it can ask for a target to be amended during the implementation of the plan (Kornai 1992: Chapters 7 and 9, Naughton 1986: Chapter 4, Eckstein 1977: Chapter 4). In spite of the enormous influence of central planners over the economy, planners' investment decisions are not automatically and exogenously imposed. Rather, planners must struggle with insufficient information and clumsy indirect measures of control to generate the