



The University of
Nottingham

China Policy Institute

Briefing Series – Issue 56

**Public Private Partnerships in China:
Making Progress in a Weak Governance Environment**

Cheng CHENG and Zhengxu WANG

December 2009

China Policy Institute
School of Contemporary Chinese Studies
International House
The University of Nottingham
Jubilee Campus
Wollaton Road, Nottingham
NG8 1BB, UK
Email: CPI@nottingham.ac.uk
Website: www.chinapolicyinstitute.org

The China Policy Institute, part of the School of Contemporary Chinese Studies at The University of Nottingham, was set up to analyse critical policy challenges faced by China in its rapid development. Its goals are to help expand the knowledge and understanding of contemporary China in Britain, Europe and worldwide, to help build a more informed dialogue between China and the UK and Europe, and to contribute to government and business strategies.

Executive summary

1. Public Private Partnership (PPP) refers to the cooperation between government and the private sector to provide public services, particularly in the areas of public infrastructure.
2. From the 1980s to the mid-1990s, China witnessed the formation of an initial legal and policy framework for PPP. From 2000 to the present day, PPP in China has been largely characterised by international projects and huge investment input.
3. PPP can help to resolve the conflict between the strong demand for public infrastructure and shortage of public funding. Since China's 1994 tax reform, financial pressure has pushed local governments to seek private investment for the development of public infrastructure.
4. PPP in China is facing many challenges, one of them being fragmented legal and administrative frameworks which result in a complex regulatory regime.
5. State dominance is another obstacle, due to which the power of private parties in PPP is often impaired.
6. While there are also growing webs of intimate relationships between the private sector and local government, these are characterised by personal ties and reciprocal favouritism.
7. State monopoly also limits public participation. With the state control over society, the public is blocked from participating in public policy-making.
8. The development of civil society has resulted in an expansion of public expression, particularly through the Internet, as well as other forms of public participation.
9. Ineffective governance and corruption often impede the development of PPP as well. Frequent changes and inconsistencies in policies also weaken the government's credibility.
10. The role of PPP will continue to expand as China's economy grows. A more comprehensive and integrated regulatory regime is anticipated, anchored by a comprehensive BOT (Build Operate Transfer) law.
11. It is a long way still for PPP to develop into a new form of governance and a new relationship between the government, the private sector and the public.
12. Further development of PPP will depend more on comprehensive institutional improvement, particularly in terms of public accountability, legislation and government capacity.

Public Private Partnerships in China: Making Progress in a Weak Governance Environment

Cheng Chen and Zhengxu Wang *

Two Stages of PPP Development in China

1.1 Public Private Partnership (PPP) refers to an arrangement whereby private parties participate in or provide support for the provision of infrastructure. A PPP project results from a contract between government and a private entity to deliver public infrastructure-based services¹. In European countries, the UK led the progress of PPP through the Private Finance Initiative (PFI) model, and was followed by Ireland, France, Spain and the Netherlands, all of whom used concessions. On the American continent, the models of PPP also evolved in Canada and the USA. Developing countries in Africa and the Asia-Pacific area have also seen the use of PPP, particularly through the model of BOT².

1.2 PPP/BOT was transplanted into China in the 1980s, when there was a huge need for infrastructure for rapid economy development. It has been used as an approach to relieving public finance burden especially in the area of public infrastructure. However, institutional weaknesses still exist as obstacles to the development of PPP. Institutional improvement is required for PPP to play a more important role in public service provision.

* Dr. Cheng Chen is a graduate of the School of Government and Society, University of Birmingham. Dr. Zhengxu Wang is Senior Research Fellow and Research Coordinator at the China Policy Institute of the School of Contemporary China at The University of Nottingham.

¹ There are various definitions for PPP. In the broadest sense, PPP can be defined as any cooperation between public sector and non public sectors, including not only the private sector but also NGOs to meet public good. Here the definition of PPP is restricted to the area of private participation in the public infrastructure.

² Grimsey and Lewis, *Public Private Partnerships: the worldwide revolution in infrastructure provision and project finance*, Cheltenham: Edward Elgar, 2004.

1.3 From the mid-1980s to the mid-1990s, PPP witnessed its first stage of development in China. The Shenzhen Shajiao B power project was the first successful BOT project under cooperation with a Hong Kong company. In the mid-1990s, the first BOT boom took place in many provinces of China. The BOT projects in this period were mostly in the power and water sectors, such as the Laibin B power project in Guangxi province, the Chengdu water project, and the Changsha power project.

1.4 Since then, BOT has caught the attention of China's government with its advantages of relieving financial burden, attracting investments and improving infrastructure development. As shown in Table 1 below, this period also witnessed the establishment of the initial PPP/BOT legal framework in China. A series of policies and statutes were issued and carried out by different government departments to regulate the boom in PPP projects.

1.5 However at the end of the 1990s, public funds were invested in infrastructure under the positive financial policy of China. Furthermore, the central government started to demolish illegal BOT projects in local places. The first wave of BOT investments had ended by the end of 1990s.

1.6 The second wave of BOT started in the early 2000s with the re-emergence of a bottleneck effect of infrastructure on economic development. This huge gap was hard to fill solely by public finance and therefore provided a chance for the use of BOT/PPP in the infrastructure area again. In this second trend, PPP was given more support in the forms of legislation and policies.

1.7 At the same time, there were also two prominent policies directing PPP development. One was *The Method of Managing Urban Public Utility Concessions* (2004), which lays

down specific legal directions for urban infrastructure³. The other important policy was *The Decision on reforming investment scheme* (2004). This was the first of policies which relaxed the approval procedure for private investment and opened more sectors to investment.

1.8 The infrastructure areas further opened to PPP under the *2005 Opinion of the State Council* which encouraged and supported the development of non-state-owned economy (hereafter The Opinion). This document was the first central government policy to allow the entry of the private sector into the area of power, communications, railway, airline, and petroleum. Furthermore, The Opinion asked for improvements in the legal framework to support the private sector's participation in the area of public infrastructure.

1.9 Such favourable policies and statutes have resulted in another boom for PPP since the 2000s. Compared with the first stage, PPP development in the second stage is more international and complex. For example, in Beijing, almost half of the Olympic sports areas were constructed using the PPP/Concession format; PPP was also applied to the Yizhuang natural gas project, the No. 5 underground project, and the Beiyuan waste water project in Beijing.

³ Following the method, the DoC formulated the standardized contract documents for concessions in this area, which facilitated the application of the method in an effective way. This effort is similar to the Standardisation of PFI Contracts in the UK for Private Finance Initiative projects.

Table 1: Relevant policies and legal documents for PPP promotion in China throughout the two stages

Date	Title	Content relevant to PPP/BOT
1995	Circular of the Ministry of Foreign Trade and Economic Cooperation Concerning Absorption of Foreign Investment by Means of BOT (Ministry of Foreign Trade and Economic Cooperation, 1995)	These are two particular policies to regulate BOT. These two policies form the legislative platform for the first BOT project in China: Laibin B Power project.
1995	Circular concerning approval of foreign investment concession project (promulgated by Committee of Planning, Ministry of Power, Ministry of Transportation, 1995)	
1995	Circular of State Administration of Foreign Exchange concerning domestic projects seeking finance abroad (promulgated by State Administration of Foreign Exchange, 1995)	These two circulars dealt with the issue of foreign exchange in BOT projects.
1997	Temporary measures to manage project finance abroad (State Administration of Foreign Exchange, Committee of Planning, 1997)	
1999	Tendering and Bidding Law	This law is applied to all of the tendering and bidding activities in P.R. China, excluding Hong Kong and Macau.
2001	Circular of Committee of Planning concerning promotion and instruction of private investment (Committee of Planning, 2001)	This policy showed that the domestic private sector is permitted to invest in sectors in which foreign investors have rights to invest.
2004	Directory of foreign investment in China industry (National Development and Reform Commission, 2004)	Outlines the list of industries which foreign investors are encouraged, limited or forbidden to invest in. Most of the infrastructure industries are on this list.
2004	The method of managing urban public utility concession (Department of Construction, 2004)	Specified policy for urban public utility. Set up the range of concession, the conditions for bidders, the framework of concession content and the period.
2004	Decision on reforming the investment scheme (2004)	Encourage private investment in infrastructure, public facilities and other sectors which are not forbidden by law. Encourage private participation in profitable public infrastructure projects by way of own investment, joint venture and project finance.
2005	The opinion of the State Council regarding encouraging and supporting the	First central government policy allowing the entry of the private

	development of non-state-owned economy (privately-owned economy).	sector into the areas of power, communication, railway, airline and petroleum. Furthermore, the opinion asked for the improvement of legislation to support private sector's investment, construction and operation in public infrastructure.
N.A	Temporary measures of foreign investment in concession (BOT) project (Committee of Planning, uncompleted)	Particular regulation for BOT, but it is still in the approval process.

Source: compiled by the author based on sources from Bellier and Zhou (2003); Sun Chao and Shen Wei (1997); Cai Yi (2000)⁴

Promoting PPP in China

2.1 Fiscal constraints of governments around the world since the end of the last century have weakened the traditional role of government in providing public services and managing the economy. China is not exceptional of this difficult situation. The main driver of PPP in China is severe and continuing fiscal pressures to which governments have been subject. PPP is therefore seen as an efficient approach to relieving their financial burden through private financial input.

2.2 However, in many countries it is the central government that takes initiatives in promoting PPP, while in China local governments are more eager to attract private finance in local areas under the existing central government policies. The underlying reason is the institutional change in the central-local government financial relationship since the 1994 tax sharing reform.

⁴ Bellier, Michel & Zhou Yue Maggie, *Private Participation in Infrastructure in China*. World Bank Working Paper No.2. Washington D.C: The World Bank, 2003; Sun Chao and Shen Wei, "Disputes in application of BOT investment in our country and legal analysis thereof". *China Legal Science* (Zhongguo Faxue) vol.1, 1997; Cai Yi. "An analysis of some legal problems of the BOT investment manners". *Modern Law Science* (Xiandai faxue) vol. 22, iss. 6, 2000, 82-85.

2.3 After the 1994 tax reform, taxes on most items are collected by the central government, while the expenditure responsibility is left at local level. As a result, the expenditure responsibilities of local governments have become excessive and unsustainable. Local infrastructure development bottlenecks have resulted as on the one hand rapid economic development requires the improvement of infrastructure; on the other hand the tax reform limits the local revenue income that can support construction.⁵

2.4 Under this pressure, seeking private investment has become popular in many provinces, as it may be the cheapest way to attract private capital while the local government itself does not need to do anything more than to provide some policy guarantees. To attract private capital, many local governments offer guarantees and incentives to private investors, e.g. a guaranteed rate of return.

A Fragmented Regulatory Regime

3.1 Although China has made massive progress in PPP promotion, the legal framework is still inadequate as to result in a piecemeal approach. Firstly, China has not yet put in place a special law to deal with PPP/BOT. In China, legal considerations for PPP have to rely on fragmented legal and administrative decisions at central and local levels. These policies and statutes usually deal with different aspects and result in a complex legal situation⁶.

⁵ Ma Jun, *Intergovernmental relations and economic management in China*, NY: St.Martin's press, 1997; Wong, P.W. "Central local relations revisited: the 1994 tax sharing reforms and public expenditure management in China". *China Perspective* 31,2000, p. 52-63.

⁶ Taking the road sector as an example, a PPP/BOT project has to involve different laws and statutes. For example, Road Law (2004), Tendering and Bidding Law (1999), Land Management Law (2004), Contract Law (1999) and Regulation on the administration of toll roads (2004) if it is a toll road project, and Decision on reforming investment scheme (2004) if it involves domestic private investment. There are also other laws and policies to address the aspects of environmental protection and construction quality management which are also relevant to a road project.

3.2 Secondly, this piecemeal approach easily causes conflicts in practice. For example, the first two statutes on BOT projects conflict with each other in the aspects of risk allocation and government guarantees. Another conflicting aspect is also reflected in the discontinuity between central government policy and local government statutes. For example, although central government forbids government guarantees in attracting private investment, in some local areas, government guarantees are used to attract private funding.

3.3 The debate on whether China needs a comprehensive PPP/BOT law to bring to an end this piecemeal approach still ongoing. The issue of a new policy, *The Temporary Measures for Foreign Investment in the Concession (BOT) Project*, was claimed to be on the agenda of the Committee of Planning, but nothing is conclusive yet. If this statute is issued sometime in the future, it will be the first special BOT/Concession legislative document in China.

State dominance in partnership

4.1 Along with an inadequate legal framework under the piecemeal approach, there is also the issue of superior powers of government in any project process. The legacy of the planned economy is the dominance of the state in every aspect of society. This feature is even more prominent in PPP, which claims to connect the public sector, the private sector, and the public via a partnership through the legal contract approach.

4.2 The dominance of the state is firstly seen in the bureaucratic power of policy decisions which overwhelm legislative and judiciary powers. Although legal reform has been undertaken in China since economic reform started, serious constraints on its effectiveness arise out of the Party's determination to retain political control. Law and the courts are still expected to be secondary to Party-state control.

4.3 One example can be seen through the fragmented approval process of PPP, in which the power of approval is distributed throughout various government departments, which makes the BOT decision making process cumbersome. It implies that the right to decide on a project is fully controlled by the government. The power of a private investor is limited during the bureaucratic process of obtaining project approval.

4.4 Another example is seen in the secondary status of legislative and judiciary powers⁷. The fact that courts hold secondary power in China's system obviously provides little support in ensuring the effectiveness of the contract mechanism on which PPP turns. With state control of the courts, the private sector cannot be protected by the contract mechanism.

4.5 However, it is interesting to see that besides state dominance in the public private relationship, there are growing webs of intimate relationships between businesses and local governments especially when the local authorities have been driven by economic reform to closely connect with the private sector. Lacking constraints from the legal system, these relationships are characterised by personal ties and reciprocal exchanges of favours and benefits. In a vicious circle, they weaken the force and impact of legal rules.

4.6 The dominance of state is not only reflected in public-private relationships, but also in state-society relationships. A by-product of long-term state monopoly is limited channels for public participation. With state control over society, the public is blocked from participating in public policy. Moreover, when government forms a reciprocal

⁷ Lubman (1999, p.3) argued, one of the dictates of this state dominance ideology is 'the failure to raise the position of the judiciary system from its current level; it remains at the same level as other bureaucratic hierarchies of the state and lacks authority over them'. More details see Lubman, S.B, *Bird in cage: legal reform in China after Mao*. Stanford: Stanford University Press, 1994.

relationship with business, the lack of public participation easily results in the sacrifice of public interest for the economic benefit and performance of governments.

4.7 On the other hand, pure state control of the public is gradually changing with the development of a civil society. In the last 30 years, the Party-led reform has protected the vested interests of the powerful while cultivating a middle class which has become the potential strength of civil society⁸. This pluralism is characterised by an expansion of channels for public voice, particularly the Internet, although formal channels such as the media are still under state control.

4.8 In short, this feature of state dominance in the power relationships between the government, the private sector and the public obviously contradicts the ethos of PPP, with the state taking the place of the contract mechanism to allocate responsibility and risks and therefore controlling the relationship with the private sector. Public accountability can be impaired when the public has no voice in public services, especially when the public sector and private sector form a reciprocal partnership.

Weak government capacity in PPP

5.1 Government capacity is another challenge for PPP in China. Given the weak legal framework and the legacy of state dominance, the success of a PPP project depends greatly on the performance of government, particularly the local authorities. However, experiences of PPP have exposed the problems of weak government capacity -- particularly government effectiveness, corruption, and trustworthiness.

⁸ More discussion see Hook, B, *The individual and the state in China*. New York: Oxford University Press, 1994.; Goodman, D.S.G and Hooper B, *China's quiet revolution: new interactions between state and society*. New York: St.Martin's press,1994. Gries, P.H and Rosen, S, *State and society in 21st century China*. New York: Routledge Curzon, 2004.

5.2 Government effectiveness and corruption have been recognized as huge obstacles to PPP progress. In a comparative study of 75 countries, the 2001 Global Competitiveness Report ranked China significantly worse than the median country based on government effectiveness and far worse than India. Given the inadequate legal environment and the cumbersome approval process, the use of PPP in China has relied on the support of government which in turn has created even more room for corruption.

5.3 Furthermore, the Chinese government is also weak in terms of trustworthiness and reliability. Many local officials tend to make policies to achieve short-term interests during their tenure in office. These policies may not be compatible with central government policies and are therefore easily changed or cancelled. Private investors therefore require a special insurance—a support letter from the upper-levels of government, although this is still another form of promise which can be broken anytime at the government's will.

The future of PPP in China

6.1 Based on the above discussion of the progress and obstacles of PPP, this paper projects that the use of PPP will gradually increase. With rising demand for public infrastructure under economic development, PPP as an alternative public service provision approach, compared to the conventional government provision, will become more popular. Furthermore, more comprehensive institutional improvements are required for PPP to play a more important role in public service provision.

6.2 Two trends are anticipated here in the future development of PPP. First, a comprehensive BOT law will be set up as a single piece of legislation regulating PPP. This effort will bring to an end the fragmented state of legal guidance in PPP. Second, with strong policy encouragement to improve domestic enterprises, more financial

sources will become available within the domestic market. This will be a win-win situation for China, as it benefits not only the government but also the domestic private sector.

6.3 Moreover, PPP can play a more important role than the role of rescuing public finance.

Partnership has been regarded as a new form of governance and the recommended new relationship between government, the private sector and the public. This ideal relationship can be achieved against a good governance environment

6.4 In China, as the institutional weaknesses have existed for a long time and are unlikely to be eradicated overnight, it is a danger that partnership will be misused for the benefits of certain interest groups. For example, PPP could become a reciprocal partnership between the government and the private sector, undermining the public interests. More efforts should be made in policy and regulation to prevent this from happening.

6.5 Further development of PPP depends on more thorough institutional improvements, particularly in the following aspects. Public accountability must be improved through opening up PPP decision-making and providing sufficient channels for public voices to be heard. The government's capacity to manage PPP must be enhanced and a rational attitude to promote PPP must be maintained. Legal institutions to guide the appropriate actor interaction in PPP must also be completed.