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## Rural Industrialization And The Dilemma Of Reform In China

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# RURAL INDUSTRIALIZATION AND THE DILEMMA OF REFORM IN CHINA

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## Abstract

This paper is intended to illustrate a basic dilemma of economic reform in China and its consequences. Under the market-oriented economic reform in the 1980s, Chinese rural enterprises have been granted more autonomy and operate under limited market conditions. In the meantime, administrative reform and political decentralization have brought more power as well as more responsibilities to local authorities. Local leaders not only are concerned with squeezing tax revenues from the subordinate firms; they must also serve as caretakers for the members of their communities. Using extensive survey data and interview materials on Chinese local leaders and rural enterprise managers and workers, the author illustrates the dilemma that arises between enterprises autonomy and local government intervention in enterprise decision making. Then, it will argue that this dilemma is reflected not only in rural areas, but also in the state industrial sector and, more generally, in Chinese society as a whole. Finally, the author will show that this dilemma leads to the cyclical change of reform policy and is a source of potential social unrest and political instability in China and other command economies undergoing market reform.

## I. Data

A substantial portion of data for this study is drawn from the "1986-1987 World Bank-China Joint Survey on Chinese Town-Village-Private (TVP) Enterprises". This survey is the single largest and the most comprehensive data set on Chinese rural industries. The sample includes four Chinese counties: Wuxi County in Jiangsu Province, Nanhai County in Guangdong Province, Jieshou County in Anhui Province, and Shangrao County in Jiangxi Province, which represent different levels of political control and economic development. Some important factors were carefully considered in the sampling of firms, such as forms of ownership and management, industrial composition, profitability (including both profit-makers and loss-makers), firm size, technologies, and location within the county.[1]

The data set includes five sub-surveys: *The Enterprise Employee Survey, the Enterprise Director Survey, the Township Leader Survey, the Enterprise Qualitative Survey*, and *the Enterprise Quantitative*

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*Survey*. *The Enterprise Employee Survey* has 1,174 respondents and 112 variables, consisting of both factual and attitudinal information on each employee. It was administered to stratified random samples of workers from enterprise payroll lists in an average of a dozen firms in each county. Workers were assured that their responses would be kept confidential, and the method of administering the questionnaire ensured that in fact this was possible. *The Enterprise Director Survey* includes 117 factory directors and 175 variables. The questionnaire was filled out personally by enterprise directors and hence provides insights into their personal reactions and perceptions. *The Township Leader Survey* includes 67 township officials and 315 variables. This survey was administered partly by mail and partly in person. The response rate was, unlike the other questionnaires, lower than 100%. *The Enterprise Qualitative Survey* (170 variables, 115 cases) and *the Enterprise Quantitative Survey* (609 variables, 122 cases) were filled out by enterprise management teams and/or accountants.

This is a very comprehensive, multi-faceted, extremely useful and basically reliable data set. The sample is in most respects a very good one. Nearly 250,000 pieces of data have been computerized and serve as the main data base. The quantitative and qualitative data from reasonably large samples of enterprises, employees, and townships permit formal statistical and econometric analysis at almost any level of sophistication.

In addition to the survey data, interview notes are also used for this study. In May and June, 1991, I conducted interviews with 27 township leaders, village party secretaries, enterprise directors, technicians, and workers in Wuxi, Nanhai, Zhuhai, and Suzhou. The interviews were usually informal and took place at interviewees' houses. The average time of an interview was two hours and open-ended questions were asked. These interviews are useful in two ways. First, they directly helped me understand the daily operation of rural enterprises and their environment. Second, they helped me check the correctness of the results of my statistical analysis.

## II. The Development of Rural Firms and Their Environment

Since the 1970s, China has experienced rapid rural industrialization. In the 1980s, the development of medium and small scale local industries in rural areas was impressive. By the end of 1987, the gross value of output from rural enterprises was 52.4% of the total value of the 1987 agricultural output.[2] For the first time, the gross value of output from rural enterprises exceeded the gross value of farm output.

**Table 1. The Development of Industrial TVP Firms and State-run Industrial Firms, 1978-88**

| Year | # of firms (million) | | | | # of employees (million) | | | | Total output (billion yuan) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | TVP | | State | | TVP | | State | | TVP | | State | |
| | # | %change | # | %change | # | %change | # | %change | net | %change | net | %change |
| 1978 | .79 | | | | 17.3 | | 31.4 | | 38.5 | | 328.9 | |
| 1979 | .77 | -3.4 | | | 18.1 | 4.6 | 32.1 | 2.2 | 42.4 | 10.1 | 367.4 | 11.7 |
| 1980 | .76 | -1,2 | | | 19.4 | 7.2 | 33.3 | 3.7 | 50.9 | 20.0 | 391.6 | 6.6 |
| 1981 | .73 | -4.3 | | | 19.8 | 2.1 | 34.9 | 4.8 | 57.9 | 13.8 | 403.7 | 3.1 |
| 1982 | .95 | 30.9 | | | 20.7 | 4.5 | 35.8 | 2.6 | 64.6 | 11.6 | 432.6 | 7.2 |
| 1983 | .74 | -21.6 | | | 21.7 | 4.8 | 36.3 | 1.4 | 75.7 | 17.2 | 473.9 | 9.5 |
| 1984 | 4.81 | 546.8 | | | 36.6 | 68.7 | 36.7 | 1.1 | 124.5 | 64.5 | 526.3 | 11.1 |
| 1985 | 4.93 | 2.5 | .94 | | 41.4 | 13.1 | 38.2 | 4.1 | 182.7 | 46.7 | 630.2 | 19.7 |
| 1986 | 6.36 | 28.9 | | | 47.6 | 15.0 | 39.6 | 3.7 | 241.3 | 32.1 | 697.1 | 10.6 |
| 1987 | 7.08 | 11.4 | .98 | | 52.7 | 10.7 | 40.9 | 3.3 | 324.4 | 34.4 | 825.0 | 18.3 |
| 1988 | 7.74 | 9.2 | .99 | 1.5 | 57.0 | 8.2 | 42.3 | 3.4 | 452.9 | 39.6 | 1036.1 | 25.6 |

*Numbers of firms before 1984 only include township and village firms. Sources: Statistical Yearbook of China, 1989, p. 111, pp. 245-7, p. 261, and p. 265.*

Table 1 shows the rapid development of the TVPs in China after 1978. The number of TVPs, the number of employees hired by the TVPs, and the total output by the TVPs all grew much faster

than the state-run sector, although the total output by TVPs in 1988 was still less than half of that by the state-run firms. Between 1985 and 1988, the average annual growth rate of output was 38 per cent for the TVPs, but only 18.5 per cent for the state sector.

Table 1 also shows the fluctuations in TVP development, particularly in the number of TVP enterprises. Large numbers of rural surplus workers and the relatively simple and labor-intensive jobs may have led to violent downward movements in prices and profits, which, in turn, may have affected the development of the TVPs.[3] Further, direct administrative restrictions and indirect measures, such as tax increases, may have caused fluctuations in the TVP sector.[4]

TVPs generally operate under more market-oriented conditions than state-run enterprises. More than 75 per cent of the sample TVPs had 10 per cent or less of their principal raw materials allocated by government planning. About 60 per cent of them had 10 per cent or less of their annual output value targets specified in plans handed down by village, township, county, and higher-level governments. In 1980, of the 106 million yuan of total output value in Wuxi County Mechanical Factory, only 8 per cent was produced according to plans, and 92 per cent was based on market demand.[5] Often, what the sample TVPs refer to as "planning" is quite different from government directive planning. It only consists of reference targets or orders from state commercial units. Further, the money economy is well established in TVPs' operations. Unlike many state firms which engage in barter exchange, TVPs carry out their transactions primarily through money exchange. For example, only 7 per cent of the sample firms reported getting any raw materials through barter-like exchange, and only 6 per cent obtained electric power in this way.[6] Moreover, unlike the state-run firms, TVPs have no captive markets for their products and therefore face more competition. More than 70 per cent of the TVP directors in the sample said that their firms faced fierce competition in product markets. Competition and the lack of captive markets have made TVPs outward-oriented. Eighty-five per cent of the firms in the sample had tried to market their products in other localities. More importantly, the competitive market environment has put pressure on TVPs to do well and to be efficient and flexible. Mistakes are unlikely to be tolerated and the budget constraint is relatively "hard". Seventy-seven per cent of the directors in the sample said that they would be penalized if their firms failed to make a profit. Among those who would be penalized, 80 per cent would either be fired or their salaries and bonuses would be cut.

Although TVPs operate under certain market conditions, they do not have complete autonomy. Township and village firms are owned by community governments. Some large "private" firms in Jieshou are registered as collective firms. Many private enterprises in Jieshou and Nanhai also have close personal ties with local governments,[7] which can encourage and support different types of private enterprises. Although enterprise directors make day-to-day managerial decisions, such as work assignments and technical decisions, community governments have control over many important decisions, such as new investment, new product development, decisions on appointment and dismissal of enterprise managers and their wages and bonuses. Community governments also make important financial decisions, such as pooling enterprises' after-tax profits for investment and directing bank loans and credit cooperatives to particular investment projects, cushioning subordinate enterprises from short-term fluctuations and risks, serving as a short-term financial intermediary by transferring funds from enterprises with surpluses to those with deficits, and facilitating the issuance of short-term bonds to local residents.[8] For example, a soda drink factory in Jishan Township, Zhuhai, had been losing money. The Township had an electronics factory and a textile factory which were highly profitable. Officials in this Township were able to use the profit from the electronics factory and the textile factory to subsidize the soda drink factory. The latter became a kind of welfare factory for the Township in which to place the local disadvantaged and those who would not be able to find a job otherwise, rather than a profitable enterprise in its own right.[9]

However, community governments also serve to provide many benefits and protection for TVPs. This is reflected in TVPs' dependence on communities for capital and land. Capital is mobilized locally and reinvested locally. Almost all directors in the sample felt that the main benefits of their firms' location were administrative protection by the community government and ease of arranging land acquisition. And they would not consider relocation of their firms.

The close relationship between TVPs and their communities is also shown in the personal ties between TVP employees and their communities. Jobs in TVPs are filled locally. Ninety per cent of the TVP employees in the sample lived 10 li or less from work. Eighty-nine per cent were from the same

county before joining their firms. Sixty-five per cent of the sample workers reported that their best friends were in the same township. Nearly 80 per cent reported that they had contact with their colleagues outside of work. Most workers were still closely connected to agricultural work. Only 9 per cent of the employees' families subcontracted some land to others, and more than 90 per cent of workers' families were still farming on all the land they contracted from the government. The half-industrial and half-agricultural nature of their work indicates the strong bond between TVPs workers and their rural communities.

Another feature of TVPs is job security and egalitarian income distribution. Ninety-one per cent of the workers surveyed said that it was not possible to lose their jobs. TVPs directors often feel pressure from the community government to keep a high level of employment. One enterprise director in Nanhai told me: "The most difficult people to deal with are the ones from my own village. You can't fire them; you can't make them work too hard either."[10] Although there is great inequality in income distribution among different regions,[11] community governments often use administrative measures to hold down variation in pay among TVPs within the township and among workers within TVPs.[12] In *the Employee Survey*, only a small percentage of the respondents thought income gap was very great among workers (7 per cent) and between workers and technicians (7 per cent), although more employees (13 per cent) perceived a great income gap between workers and enterprise leaders. A majority of the respondents thought that the income gap among workers (58%), between workers and leaders (51%) and between workers and technicians (54%) was either relatively small or that there was no difference.

Employment security and egalitarianism in income are due to several reasons. First, the tightly knit communities generate strong feelings of sharing among their members. No one should be left out and everyone should have a job. Second, the tightly knit communities also leave little room for privacy and individuality. Income differentiation among individuals and households becomes known to neighbors quickly and causes jealousy. If one is making too much more money than the others, that one may have a hard time dealing with the jealous and hostile neighbors. Finally, job security and income egalitarianism would be impossible without local governments' intervention in enterprise decision making, and local governments may be motivated to intervene for different reasons: they may intervene under the socialist principle of equality, they may be concerned with the well-being of their communities, or, they may act to consolidate power and support in their own communities.

In short, rural industrial firms have developed rapidly under reform. As compared with state-run firms, rural TVP firms are more flexible and competitive. They operate under more market-oriented conditions and are subject to harder budget constraints. At the same time, under reform and decentralization, local governments have also gained more control over decision making in their own localities. Local officials not only use this power to extract more revenue from their subordinate enterprises, but also to redistribute income and to provide job security to the members of their communities. As I will show later, the growth of enterprise autonomy on the one hand, and the increasing ability of the local government to intervene on the other, form a basic dilemma of reform in China.

## III. The Critique of Reform

The reform programs in China have been criticized by both western scholars and Chinese reformers as half-way measures. First, it is argued that market mechanisms do not seem to be replacing planning. For example, some key inputs were not available on the market. "It was planners' decisions about how much to allocate rather than market forces that governed enterprises' behavior. In other cases, inputs may have been available on the market, but plan allocations at lower prices met all of an enterprise's requirements. In such cases it was also planners' decisions that determined enterprise behavior".[13] Second, it is argued that the relaxation of central financial control has not been accompanied by effective indirect controls over the domestic economy in the matter of bank loans, for example, low-interest loans with very generous were provided terms by the banking system to enterprises for investment. According to one critique, in the final quarter of 1984, bank credit was up 164 per cent over the previous year, but little attention was paid to the likely economic returns from projects and the banks did not effectively exercise control as they lacked the experience and

administrative power to refuse lending.[14] Third, although profit was emphasized over production volumes, many enterprises raised profits through bargaining with the bureaucracy for lower tax rates or by getting hold of larger allocations of low-priced raw materials from the central planners. Thus, Chinese enterprises were still operating in a bureaucratic rather than a market environment.[14] Finally, at the individual level, the re-introduction of bonuses and incentive wages has not been successful in improving labor incentive and productivity. Bonuses quickly became a fixed part of wages. Laaksonen reported that the average bonus was 25 per cent of the basic wages--ranging from 7 to 50 per cent. The percentage of time wages in state sector wage bill decreased from 85 per cent in 1978 to 49 per cent in 1988, but only 11.7 per cent of the total is paid as bonuses directly related to output, such as piece rates or above-quota premiums.[15]

It has also been pointed out that decentralization of control at the center has strengthened the power of the local governments. Local authorities have consolidated their hierarchical control over the enterprises under them at the very moment when the center was trying to achieve a greater measure of decentralization of economic decisions by giving more autonomy to enterprises."It could plausibly be argued that industrial feudalism has been reinforced rather than weakened by the system reforms".[16] One study of the development of Chinese rural industries complains that rural industries are by no means autonomous and the industrial bureaus at the town and village levels remain the primary decision making units which control the allocation of funds, loan applications, investment decisions, labor and land, aside from setting profit targets, wage ceilings, and a variety of other parameters that determine the incentive structure for enterprise operations.[17] A survey of the enterprises in Yuanping County in Shanxi Province found that 61 per cent of the directors or managers in these enterprises were still appointed by higher level bureaus.[18] Press reports often complain of excessive levies on rural enterprises, with local officials treating enterprises as their "cash registers." In addition to the various taxes paid to the state, rural firms are often subjected to a variety of local levies. In an investigation of Yueyang County in Hunan Province, it was found that during 1984, rural enterprises paid an average of 51 per cent of their after-tax profits to the township governments and industrial bureaus.[19] The survey on the township enterprises in Yuanping County in Shanxi Province found that these enterprises paid 70 per cent of their after-tax profits in 1980, 97 per cent in 1984, and 91 per cent in 1985 to township governments.[20] Nationwide, in 1984 rural enterprises handed over 44 per cent of their after-tax profits to township and village governments for use in social expenditures and for various levies.[21]
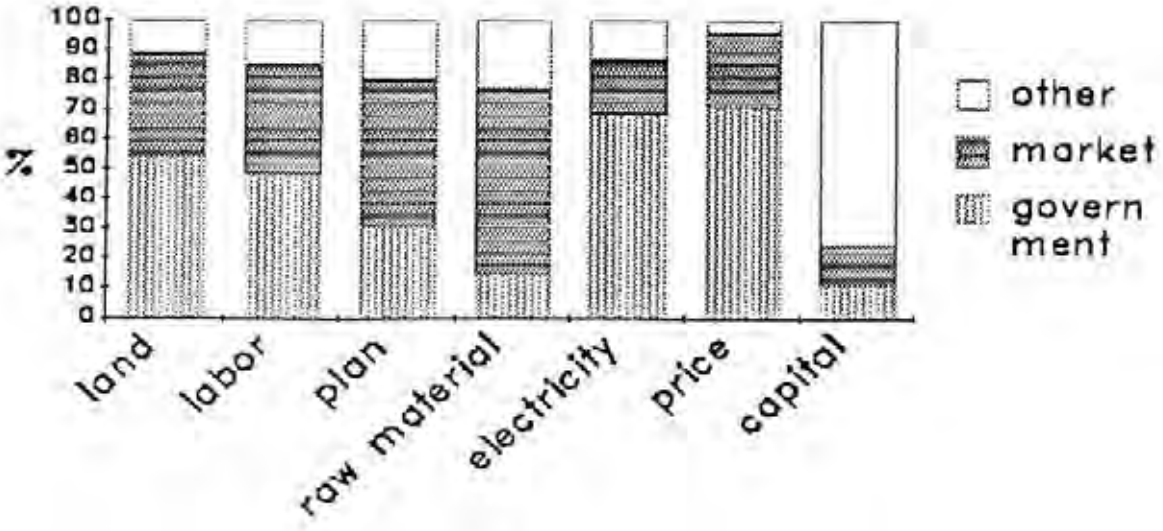
Figure 1 Production Resources & Activities through Market & Government Planning