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# The Role of the Local State in China's Transitional Economy

Jean C. Oi

All states have a role in development, but this varies widely. The spectrum is defined at one end by the *laissez faire* minimalist state whose role is limited to ensuring a stable and secure environment so that contracts, property rights and other institutions of the market can be honoured. At the opposite end are the centrally planned Leninist states that directly replace the market with bureaucratic allocation and planning. Between these two extremes are the capitalist developmental states of Japan and the East Asian Newly Industrializing Countries (NICs) that are neither Communist nor *laissez faire*, but exhibit characteristics of both. The state plays an activist, rather than a minimalist, role; there is planning, but it is geared toward creating maximum competitive and comparative advantage for manufacturers within a market economy.

China's post-Mao economy suggests the emergence of yet another form of state-led development that is committed to growth and the market, but it is a developmental party-state with roots in a Leninist system and the Communist Party still at the helm. Like its once socialist counterparts in Eastern Europe and the former Soviet Union, China has increasingly abandoned central planning and moved toward market production. But unlike these states there has been little or no political reform and no headlong rush toward privatization, nor is there commitment to private property as in other developmental states.

China's is a distinctive form of state-led growth that I have termed *local state corporatism*.<sup>1</sup> The core of this growth is the massive upsurge in rural industry on the edges of agriculture and state industry. The state responsible for much of this growth is *local* governments that treat enterprises within their administrative purview as one component of a larger corporate whole. Local officials act as the equivalent of a board of directors and sometimes more directly as the chief executive officers. At the helm of this corporate-like organization is the Communist Party secretary.

China's reform experience is a story of path dependence altered by institutional change. The result is a hybrid strategy that utilizes capacities inherited from the Maoist state and forms found in capitalist developmental states. Whether others can replicate China's developmental experience

1. See my "Fiscal reform and the economic foundations of local state corporatism," *World Politics*, Vol. 45, No. 1 (October 1992), pp. 99–126, for further discussion of the term "corporatism." I am not concerned with the role of the central state in the vertical integration of interests within society as a whole. The corporation that I describe is constituted and co-ordinated by the *local* government, not the central authorities. For a useful discussion of this term as it specifically relates to East Asia, see Jonathan Unger and Anita Chan, "Corporatism, and the East Asian model," *The Australian Journal of Chinese Affairs*, No. 33 (January 1995), pp. 29–54.

depends less on historical legacy than on institutions. The issue is whether prospective reformers have the political capabilities that characterized the Maoist state and sufficient institutional incentives that will make it in the interests of those responsible for implementation to embrace economic development. China's reform experience is evidence for Douglass North's assertion that institutions "... are the underlying determinant of the long-run performance of economies."<sup>2</sup>

This article examines the constituent elements of China's local state corporatism. It shows that while the post-Mao state retains key features of the Maoist system, the decision to accommodate mandates of rapid economic development in a market context has resulted in a qualitatively new variety of developmental state and not merely a modified Leninist system. It seeks to uncover the lessons of China's recent economic development and ask whether these may be transferable to other transitional economies or developing nations.

### *The Maoist Legacy for Local Economic Development*

The existence of problems with the pre-reform system are not necessarily good predictors of reform success. The Maoist system was plagued by economic inefficiency but this same legacy provided the foundation that allowed post-Mao China to turn in short order into an economic dynamo. Once the Maoist system was modified to allow for local initiative and the proper incentives were introduced to channel local talent toward economic development, both the central and the local state were left with an impressive array of policy instruments and political capacity similar to that found in successful developmental states of East Asia.

Unlike late industrializing countries of Africa or Latin America that are often plagued by bureaucracies lacking experience or organizational capacity,<sup>3</sup> the Maoist bureaucracy was an elaborate network that extended to all levels of society, down to the neighbourhood and work unit, and in international perspective it exhibited a high degree of discipline.<sup>4</sup> Within each level there existed an impressive organizational apparatus that could effectively transmit the state's plans to the producers by issuing quotas passed down step-by-step through several layers of government bureaucracy. Unlike the Soviet Union where the strong ministerial system by-passed local governments and transmitted plans directly to their

2. Douglass North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990), p. 107.

3. On the importance of what is sometimes also called the maturity of a bureaucracy, see Dietrich Rueschemeyer and Peter Evans, "The state and economic transformation: toward an analysis of the conditions underlying effective intervention," in Peter Evans, Dietrich Rueschemeyer and Theda Skocpol (eds.), *Bringing the State Back In* (Cambridge: Cambridge University Press, 1985), pp. 44–77. A useful succinct statement on effective bureaucracy as key to capacity is by Stephan Haggard and Robert Kaufman, "The state in the initiation and consolidation of market oriented reform," in Louis Putterman and Dietrich Rueschemeyer (eds.), *State and Market in Development* (Boulder: Lynne Rienner, 1992), pp. 221–242.

4. See Martin King Whyte and William Parish, *Urban Life in Contemporary China* (Chicago: University of Chicago Press, 1984); and William Parish and Martin King Whyte, *Village and Family in Contemporary China* (Chicago: University of Chicago Press, 1978).

enterprises, the Maoist system decentralized economic and administrative power to the localities.

Ideology and the goals of state intervention, not an inherent failing in the policy instruments, undermined the capacity of the Maoist state to foster economic development. Chalmers Johnson highlighted this difference when he called Communist systems “plan ideological” and capitalist developmental states such as Japan “plan rational.”<sup>5</sup> Using similar policy instruments, the latter fosters market competition while the former, guided by a socialist ideology, replaces the market and fosters an egalitarian distribution of resources and income.<sup>6</sup>

China had an “industrial policy,” but its all inclusive rather than selective scope caused it to hinder rather than help economic efficiency. Unlike a “plan rational” economy where state intervention is limited by a commitment to private property and the market, the Maoist state closed free markets in 1957 and created a state monopoly for the procurement and sale of almost all goods and services. Each and every factory was told which products were to be made and in what quantity, what materials should be used, where the materials should come from, how much they should cost, and where these products should be sold and for how much.

China, like East Asian NICs, had the power to “get the prices wrong,” but price setting was to ensure inflation control and an equal distribution of goods and resources within a socialist ideological context, not to provide manufacturers a comparative advantage in a competitive world market.<sup>7</sup> Production did not hinge on costs or on sales but on the plan as determined by the planning agencies. The plan determined demand and set strict limits on consumer choice.

Maoist bureaucrats could be mobilized to action, but Maoist ideology distorted incentives when it devalued expertise not accompanied by political loyalty, or “redness.” Words and actions became manifestations of political attitude – what was then termed *biaoxian*. Expression of such attitudes became intertwined with economic performance and were measured by ability to meet and exceed economic quotas.<sup>8</sup> Pressure to exaggerate economic performance contributed to the massive famine

5. Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford: Stanford University Press, 1982); his more recent views on the Asian capitalist model and the role of the state in the economy are summarized in his “Capitalism: East Asian style” (1992 Panglaykim Memorial Lecture, Jakarta, 15 December 1992); other recent works include Robert Wade, *Governing the Economy: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990).

6. Richard Applebaum and Jeffrey Henderson, “Situating the state in the East Asian development process,” in Richard Applebaum and Jeffrey Henderson (eds.), *States and Development in the Asian Pacific Rim* (Newbury Park: Sage Publications), pp. 1–26, try to refine Chalmers Johnson’s distinction between plan rational and plan ideological by further dividing systems into “market ideological” and “market rational.” China remains in the “plan ideological” quadrant.

7. On the NICs “getting the prices wrong,” see Alice Amsden, “A theory of government intervention in late industrialization,” in Putterman and Rueschemeyer, *State and Market in Development*, pp. 53–84.

8. Examples of this in rural and urban areas can be found respectively in Jean Oi, *State and Peasant in Contemporary China: The Political Economy of Village Government* (Berkeley:

during the Great Leap Forward as rural cadres exaggerated production and sought to outdo each other in the sale of grain to the state, even when their own village populations had little or no grain for consumption.<sup>9</sup>

### *Changing Incentives Transform the Maoist System*

Perhaps because of the dismal performance of the state in managing economic development during the Maoist period or because of the image of Communist cadres as likely opponents to reform, some have glossed over or ignored the fact that much of China's post-Mao rapid rural industrialization has been due to the work of local governments. Some observers have lumped all rural firms together as "non-state firms,"<sup>10</sup> portray them as "semi-private," or use them to indicate a "capitalist revolution" in China.<sup>11</sup> Such characterizations misrepresent the character of these enterprises and mis-identify the crucial actors in the process of China's economic reforms. Township and village enterprises, which are the most economically significant portion of rural industry, are not privately owned, nor are they forms of hybrid privatization,<sup>12</sup> but forms of government ownership.

Without question, a growing private sector exists; some township and village enterprises are indeed "fake collectives" – only using the collective label for protection and economic benefit.<sup>13</sup> But to suggest that all rural industry is partially or secretly "private" misses the essential character of the process that has spurred China's rapid rural industrialization. In the early to mid-1980s, when China's rural industry started its rapid growth, prospective private entrepreneurs, with the memory of the persecution of private enterprise during the Maoist period still fresh in their minds, were unsure of the political winds and whether policies would change. As in other countries, when the risks and costs are too great for private individuals, it was the state, in this case China's local

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*footnote continued*

University of California Press, 1989) and Andrew Walder, *Communist Neo-Traditionalism: Work and Authority in Chinese Industry* (Berkeley: University of California Press, 1986).

9. Thomas Bernstein, "Stalinism, famine, and Chinese peasants: grain procurements during the Great Leap Forward," *Theory and Society*, Vol. 13, No. 3 (May 1984), pp. 339–377.

10. See, for example, John McMillan and Barry Naughton, "How to reform a planned economy: lessons from China," *Oxford Review of Economic Policy*, Vol. 8, No. 1 (1993), pp. 130–142.

11. This view is most clearly articulated in Minxin Pei, *From Reform to Revolution: The Demise of Communism in China and the Soviet Union* (Cambridge, MA: Harvard University Press, 1994), especially ch. 3.

12. The partially private nature of these firms has been suggested by Victor Nee. See, for example, his "Organizational dynamics of market transition: hybrid forms, property rights, and mixed economy in China," *Administrative Science Quarterly*, No. 37 (March 1992), pp. 1–27. This is also suggested in his earlier work, Victor Nee and Sijin Su, "Institutional change and economic growth in China: the view from the villages," *Journal of Asian Studies*, Vol. 49, No. 1 (February 1990), pp. 3–25.

13. Liu Yia-Ling, "Reform from below: the private economy and local politics in the rural industrialization of Wenzhou," *The China Quarterly*, No. 130 (June 1992), pp. 293–316.

governments, that had to step in and assume the entrepreneurial role and start rural industry.<sup>14</sup>

It is not surprising, however, that many would overlook the role of local government in rural industry. The institution of “the contract responsibility system” masks the heavy involvement of local officials in the crucial decision-making concerning these collectively-owned rural enterprises. Contracting suggests a degree of autonomy and allocation of property rights that simply is not present. In contrast to agriculture and land, the property rights of township and village firms remain in the hands of local governments. The contract responsibility system decentralized the day-to-day management of collective industry, but most managers are employees rather than independent entrepreneurs.<sup>15</sup> Those who contract enterprises are provided with lucrative incentives, bonuses, housing and other perks to be efficient and increase production, but the major decisions regarding the enterprises remain the purview of the local officials, most importantly the village Party secretary or the township economic commission and township heads. These are often the same individuals who were in office during the Maoist period. What has changed is not necessarily the personnel, but the incentives that are embedded in the institutions that shape the actions of officials.

*Institutional change and the rise of rural industry.* More significant than past problems is the bureaucratic capacity of the regime and whether the problems that exist on the eve of reform can be corrected with institutional adjustment. For China the issue was not whether its bureaucracy was capable of generating economic growth but whether it had the incentive to do so. At the local levels, the constraints of the state plan and Maoist fiscal system provided localities with little inducement to generate additional revenues. Localities were required to turn over all or most of the revenues generated within the locality to the upper levels, which in return provided budget allocations for expenditures. What surplus remained within the locality was subject to higher-level approval before use. Localities had incentives to try to extract as much bureaucratic slack as possible from the upper levels in the form of larger budget allocations, not to initiate growth.

Institutional changes paved the way for China’s successful economic reform.<sup>16</sup> The post-Mao reforms marketized the economy and instituted

14. The classic statement is by Alexander Gershenkron, *Economic Backwardness in Historical Perspective* (Cambridge, MA: Harvard University Press, 1962).

15. For a description of the variations in contracting, see my “The fate of the collective after the commune,” in Deborah Davis and Ezra Vogel (eds.), *Chinese Society on the Eve of Tiananmen* (Cambridge, MA: Council on East Asian Studies, Harvard University, 1990), pp. 15–36.

16. In this study I adopt North’s definition of institutions as “a set of the rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals in the interest of maximizing the wealth or utility of principals.” This definition focuses attention not only on existing structures, but also on policies, such as reform initiatives, adopted at the Centre and passed on to the local governments for implementation. Douglass North, *Structure and Change in Economic History* (New York: Norton, 1981), pp. 201–202.

changes that removed constraints on local government autonomy and injected strong economic incentives for local government to be entrepreneurial. Combined with their already extensive bureaucratic power, local governments were well situated to launch rapid economic development. Two of the most important institutional changes that prompted local governments to become entrepreneurial and develop rural industry were the decollectivization of agricultural production and fiscal reform. Both affected fiscal flows and revenue retention. The household responsibility system for agricultural production stripped village governments of the rights to income from the sale of agricultural produce. Officials in villages without a significant non-agricultural economy were left with empty coffers and little salary for themselves except for whatever fees or surcharges they could extract from their villagers. Fiscal reforms, as I have detailed elsewhere,<sup>17</sup> clearly defined the localities' share of the tax revenues and granted them the rights to the fiscal surplus, or residual, which the literature on agency theory posits as the most important mechanism for facilitating hierarchic control. The Chinese case illustrates the general point that "... under a range of conditions, the principal's optimal incentive structure for the agent is one in which the latter receives some share of the residual in payment for his efforts, thus giving him a direct stake in the outcome."<sup>18</sup>

The institutional changes made local governments in China fully fledged *economic* actors, not just administrative-service providers as they are in other countries.<sup>19</sup> Local governments in Maoist China also had authority to make investment decisions; the difference is that with the reforms local governments had to bear the *risks* as well as enjoy the benefits that come with entrepreneurship. The fiscal reforms hardened the budget constraint of county and township government; decollectivization of agriculture made villages heavily dependent on village industry for an independent income.

If investment decisions are made poorly, this directly affects the operating budget of the local government and the bonuses of the officials within it. The debt of a township or village factory becomes the debt of the level of government that owns the factory. Unlike the large state-

17. The essential ideas are laid out in Oi, "Fiscal reform and the economic foundations of local state corporatism." For a more detailed statement see Jean C. Oi, *Rural China Takes Off: Incentives for Rural Industrialization* (University of California Press, forthcoming). By property rights I refer to the bundle of rights over property that includes the right to sell the property, the right to the income from the property and the right to manage the property. Harold Demsetz, "The structure of ownership and the theory of the firm," *Journal of Law and Economics*, Vol. 26 (June 1983), pp. 375–390. However, in this study I focus primarily on the rights to income. For a theoretical statement on this aspect of property rights as an incentive, see Yoram Barzel, *Economic Analysis of Property Rights* (New York: Cambridge University Press, 1989).

18. For a summary of this point in the principal–agent literature see Terry Moe, "The new economics of organization," *American Journal of Political Science*, Vol. 28, No. 4 (November 1984), pp. 739–777.

19. Richard Bird makes a similar point about the difference between Communist and non-Communist local governments. See his "Intergovernmental finance and local taxation in developing countries: some basic considerations for reformers," *Public Administration and Development*, Vol. 10 (1990), pp. 277–288.

owned factories in urban areas, there is no one at the higher levels who will bail them out and subsidize their losses. If a township or village enterprise goes into the red, the money to keep it running comes directly out of local coffers; at most one might get an extension from the bank, if a loan is involved, but increasingly those at the higher levels controlling the loans also have become much more cautious in lending out limited funds and give them to those most likely to succeed (see below).

On the other hand, if investments are made wisely, local governments can meet expenses, keep a portion of the extra tax revenues (at the township and county levels) and enjoy larger amounts of extra-budgetary non-tax revenues. It is the rapid growth of the extra-budgetary revenues that has made township and village enterprises such a lucrative source of income for local governments and why they are so enthusiastically promoted.<sup>20</sup>

*A corporate form of local economic growth.* China's local development is distinguished by its reliance on existing bureaucratic networks and structure. Each level has its own goals, resources and accounting, but the levels are intimately connected. Hierarchy and obligations are explicit; those at the lower levels are subject to the directives of the higher levels; and those at the lower levels turn over to those at the higher levels a portion of their revenues. As part of a larger whole, each level has the opportunity to draw on the resources of the larger corporate body; and any one company is not dependent only on its own resources.

Village, township and county-level governments comprise the local corporate state directly responsible for the dramatic growth of rural enterprises in China.<sup>21</sup> These are the levels where officials have a direct role in fostering the development of rural enterprises, both collective and private. The careers and salaries of officials at these levels are directly affected by the performance and growth of their rural enterprises. The governments of these levels control the revenue flows from local economic development.

Somewhat akin to a large multi-level corporation, the county can be seen as being at the top of a corporate hierarchy as the corporate headquarters, the township as the regional headquarters, and the villages as companies within the larger corporation. Each level is an approximate equivalent to what is termed a "profit centre" in decentralized management schemes used in business firms.<sup>22</sup> Each successive level of government is fiscally independent and is thus expected to maximize its economic performance. In this sense, China is coming closer to the NIC

20. For details of why this is the case, see Oi, *Rural China Takes Off*.

21. This view contrasts that put forth by Qian Yingyi and Xu Chenggang who stress the independent and self-sufficient ability of townships and villages in the development of rural enterprises. Qian Yingyi and Xu Chenggang, "Why China's economic reforms differ: the M-form hierarchy and entry/expansion of the non-state sector," *Economics of Transition*, Vol. 1 (1993), pp. 135–170.

22. See Harrison C. White, "Agency as control," in John W. Pratt and Richard J. Zeckhauser (eds.), *Principals and Agents: The Structure of Business* (Boston: Harvard Business School Press, 1985), pp. 187–212.

model of development where subsidies are given to those that are judged to have the best potential or are already judged to be the best in a particular field. Like a profitable company or division within a large corporation, a highly industrialized township or village will command positive attention, be listened to at corporate headquarters and have its leaders promoted up the corporate hierarchy. It will also have more leverage to be “innovative” in its implementation of rules and regulations.

But unlike any multinational corporation or East Asian NIC, the local Communist Party secretary plays a key role in economic decision-making. But this is not Communist politics as usual. Subject to the same incentives as other local officials, Communist Party secretaries in the most industrially developed areas of the countryside are at the helm of their area’s economic development. The precise role that they play varies with level of government. They are most visible at the village level where they often can be found personally intervening in the economic decision-making of the village’s enterprises. They often chair the board of directors of the industrial management committee.

*China’s Decentralized Developmental State: Adapting Maoist Institutions for a Transitional Economy*

Post-Mao institutional changes blended the entrepreneurial and governmental roles of local governments. This has had economic and political consequences. The Maoist legacy provided the political capacity for the local corporatist state, but the adaptation of this legacy to maximize local economic and political interests through rapid economic development has created a system qualitatively distinct from the original. In one sense, local officials have simply modified the Maoist system to adopt preferential allocation of resources in line with many of the successful late industrializing states. In another sense, however, the entrepreneurial interests of local governments have compromised their role as agents of the central state.

*Using bureaucracy to facilitate market production.* Within a local corporatist context local officials turn the administrative bureaucracy – of which they are a part – into a free channel for information and resources to facilitate market production. Rural enterprises are not entities with limited resources and avenues for information, as would be the case in a Western market system. Using information and contacts that they develop beyond the locality through their routine conduct of administrative work, local officials can provide an array of essential services to their local enterprises. This might include raw materials, but increasingly, it has become important for information about new products, technology and markets for finished goods.

The degree to which officials get involved in product development, market research and the acquisition of technology suggests that this is not the usual provision of bureaucratic service, but the activity of an entrepreneurial developmental state. The commission on science and tech-

nology or the rural enterprise management bureau, for example, spends much time and energy to represent local industries at higher-level key agencies to acquire technology, materials and funding. Officials from these county agencies may personally accompany factory managers to the higher-level bureaus to facilitate access to inputs and services. The daily routine of cadres at the county level is filled with trips to the prefecture, even to Beijing, on behalf of specific enterprises. A diary of one official from a Shandong county rural enterprise management bureau shows that during a one-month period in May 1988, he made six trips to Ji'nan, the provincial capital, one trip to Beijing, three trips to other townships and six trips to various villages.

The flow of ideas is now two-way; individual enterprises are free to do their own market research and development of product lines. But local governments remain important for facilitating the actual implementation of these ideas, regardless of the source. Local cadres use their expansive connections and bureaucratic position to secure information that will serve local economic growth, particularly as China enters the more competitive international market.<sup>23</sup> Here one sees how having a developed and experienced bureaucracy works to China's advantage. Embedded in the administrative hierarchy, the branches of the information network automatically multiply the higher one goes in the bureaucracy.

*Using administrative power to fund corporate growth.* By retaining property rights over a key portion of local industry – the township and village enterprises – local governments are able to go one step beyond what most industrial policies have the capacity to achieve: apart from directly appointing managers, they can redistribute income among different sectors and enterprises within the local corporate state. They use their power to extract profits directly from township and village-owned enterprises, and have thus developed a corporatist strategy that pools resources and debt. They can take revenue from one enterprise and use it to develop another through an informal process of “borrowing” and redistribution of debt. Local authorities may require enterprises with substantial profits to pay ad hoc surcharges, often termed “loans” or “rent paid in advance.” In one township, for example, the local government took 400,000 *yuan* and 200,000 *yuan* in two separate years from its wealthier enterprises.<sup>24</sup> This provides local enterprises as well as local governments with an additional source of investment funds.

At one level this looks like rent-seeking: there is a flow of revenue from the enterprises to the local government, above and beyond standard tax assessments. However, and perhaps more importantly, there *also* is a substantial flow of funds and support services *from* the local government *to* the enterprises. This is a constraint or an inducement of the corporatist

23. See Jean Oi, “Cadre networks, information diffusion, and market production in coastal China,” paper prepared for the World Bank Project on “Explaining Growth: Chinese Coastal Provinces and Mexican Maquiladoras,” 1994, for details of these networks and how they provide information to local enterprises.

24. China interview 72388.

system, depending on whether the enterprise receives or gives. Rather than having a negative impact on China's rural enterprises, the extraction of profits from them seems to be an important mechanism that allows local governments to facilitate corporate growth. As the holders of the rights over income flows, local governments can decide, much like a corporation, how to use the profits from its various enterprises and how to redistribute income. It is more appropriate to call this profit-taking from factories to pay for expenditures and reinvestment, not rent-seeking.

Like a large corporation, villages and townships may use the profits of their richer enterprises to see poorer ones through a down-turn in the market or to start new enterprises from the profits of the more prosperous ones.<sup>25</sup> Profits may also be used to subsidize and bear necessary corporate overheads, including supporting industries that are not particularly profitable to provide jobs for the village's surplus labour force or because the enterprise carries prestige and thus gives "face" to the village.<sup>26</sup>

Theoretically, the debt is the responsibility of the guarantor of the loan, but because most loans are guaranteed by the economic commission or by the village government, the debt burden is divided among the remaining collectively-owned enterprises. Interviews reveal that in a number of localities when a collective enterprise fails and defaults on its loans, the debt is paid off by the other enterprises regardless of the specifics of the contracting system. In one Shandong township in 1987, four enterprises closed, leaving a debt of 120,000 *yuan*. The economic commission had funds to repay 60,000 *yuan* to the bank, but the remainder of the debt was divided among the other enterprises.<sup>27</sup>

This collective financing and debt repayment system softens the budget constraint that firms would otherwise face, but it is also a reason why township and village enterprises have been able to grow with limited funding. Each new enterprise does not have to raise all the funds it needs for its start-up operation – it can borrow funds from sister enterprises within the local corporate community. The fiscal health of an enterprise depends not only on its own internal sources of wealth and the credit that it can mobilize, but also on the financial resources of the corporate state of which it is a part. This cumulative, corporate financing offers a way to sidestep the need for outside financing. It is feasible because many of the village and township enterprises start out on a relatively small scale.

*From equal treatment to preferential allocation.* The local corporatist state uses Maoist policy instruments and institutions but the aims for which they are used and their application are significantly changed. A key difference between local state corporatism and its Maoist antecedent is

25. As might be expected, this direct redistribution is limited to collectively-owned township and village enterprises. The private sector might benefit from redistribution by official loans, but it is unlikely that local governments would pay the debts of the private sector.

26. See, for example, "Township enterprises should also implement reform," *Jingji cankao*, 18 November 1987, translated in Joint Publications Research Service, *China Report* (hereafter JPRS-CAR) 88-005, 18 February 1988, pp. 20–21.

27. China interview 17788.

selective targeting of enterprises for development. Subsidies are no longer given equally or to all. In this sense, China has switched to a strategy similar to targeting found in the industrial policies of the East Asian NICs. Local governments use the “carrot” characteristic of the administrative guidance found in Japan, that is, preferential allocations as an inducement for independently-owned firms to conform to state-set strategies of economic growth. However, as suggested above, local governments in China go further to maintain direct rather than indirect influence and intervene in the internal affairs of their township and village enterprises. In this sense, they may be closer to the role that government plays in the direction of the state-owned enterprises in Korea that have played such an important part in that country’s economic success.

Under local state corporatism those most likely to receive this assistance are the ones deemed most capable of generating maximum benefit for the corporate good.<sup>28</sup> To this end, local governments have begun to rank enterprises to determine the level of services and assistance each will receive from the government and its affiliated institutions.

There are two types of selective allocation. The first grew out of the remains of national planning that still existed when rural industry began its rapid growth in the mid-1980s. Privileged access is given to favoured enterprises of items that are rationed and for which the prices are the lowest. In the past, this included anything from steel to cement to lumber. The amounts of inputs allocated to the rural areas under the plan are extremely restricted, if they exist at all. Localities make use of what remains of central allocations to further local control, but they have little discretion with regard to production materials, which are usually earmarked for specific enterprises that are producing for the national plan. By the late 1980s this was almost non-existent. The most that a locality can hope for is access to state-supplied goods that are sold at higher than rationed prices, but lower than market prices.

The second and more common type of selective allocation is privileged access to inputs that are not rationed, but simply scarce. Over time different items have fallen into this category. Fuel oil, electricity and various raw materials have topped the list. These allocations are similar to those made under administrative guidance, except that in places such as Japan the goods and resources are usually provided at below market prices. In China, this is privileged access to goods that are secured and sold at *market* prices. Like the privileged access that comes from using connections and “going through the back door,” what is being given is not necessarily a cheaper price, but the chance to be first in line to buy the best available items at the posted prices. In the Chinese rural industrial context preferential access means having the chance to buy the

28. It should be noted, however, that the corporate good is defined more broadly than mere economic interests and profits. It may include such social interests as providing employment, but increasingly this hinges on profitability, competitiveness, and growth.

one ton of steel that the material supply bureau was able to procure at a favourable *market* price. It might also mean the opportunity to be hooked up to the special electric generator the township installed to provide its most important industries with uninterrupted power. As the market economy continues to develop, this type of selective allocation of raw materials is decreasing in importance, but it may still make a difference in an enterprise's profit margin.

What remains scarce is credit, which also falls under the second type of selective allocation. As the growing literature on the state and economic development points out, credit control is one of the most essential policy instruments that a government can possess to shape industrial growth.<sup>29</sup> China, like many of the East Asian NICs, is a credit-based rather than a capital-based system that allows for co-ordinated intervention necessary for an effective industrial policy. Until the reforms private loans were prohibited, as were private banks. Firms did not sell stock to raise capital; they looked to the government for their capital, as well as for all their operating budget. The state exclusively decided development through its allocation of credit and capital, as it did with other production inputs.

The emergence of private and semi-private financial institutions in the post-Mao period has weakened the hold of the central state over credit, but local authorities continue to maintain a fairly strong hold within their localities. The primary reason for this is that local governments are themselves indirectly responsible for and control a number of the sources of credit outside the official banking system that have emerged in the post-Mao period, and which are out of the reach of central regulation.<sup>30</sup> Local governments have continued to use their control over credit provided by the central state banking system as well as the newly emerging non-bank funds to shape local enterprise development. But they are becoming much more tight-fisted with credit, particularly those amounts that fall outside central bank control. Local bank branches and savings and loan co-operatives have incorporated a performance standard as a criterion for distribution to maximize returns on existing funds available within their locality.

From the mid-1980s, county officials began to rate enterprises annually to determine the fixed capital credit as well as the financial services available for each one at the local bank or savings co-operative. Enterprises with a credit rating (*haiding e*) are accorded the quickest approval for loans within their prescribed credit limit; automatic approval is guaranteed from the township savings and loan co-operative or the local

29. See, for example, John Zysman, *Government, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca: Cornell University Press, 1983); on the East Asian NICs see the work by Robert Wade. One of the best short statements is his "The role of government in overcoming market failure: Taiwan, Republic of Korea and Japan," in Helen Hughes (ed.), *Achieving Industrialization in East Asia* (Cambridge: Cambridge University Press, 1988), pp. 129–163.

30. See Oi, *Rural China Takes Off*, for details.

branch of the Agricultural Bank without county approval.<sup>31</sup> Moreover, once an enterprise is designated important, local governments try to ensure credit to it, especially during periods of centrally-mandated retrenchment when bank credit is greatly reduced and restricted. There are at least three ways this has been done.

The first is the misappropriation (*nuoyong*) of earmarked funds to those uses that will bring the highest returns – namely support for rural industry. Unfortunately for those who still farm, the funds misappropriated are often those sent by the central state through the Agricultural Bank earmarked for the procurement of agricultural products. The result has been the IOU problem, where peasants must wait for payment when they sell their grain or cotton to the state. Not all governments have engaged in this, but judging by the number of reports of IOU problems, the practice is not isolated.

A second and more legitimate way to provide increased credit for local enterprises is to license non-bank credit institutions to circumvent central regulations that restrict the lending of local banks. These institutions have only limited funds, but they too provide a crucial alternative in periods of tight credit.

A third way is to grant small loans from bureau funds. Counties, through their various bureaucratic agencies such as the tax bureau, the finance bureau and the science and technology commission, have funds they directly lend to favoured enterprises. Although banks are still the major sources of credit, local government bureaus may unilaterally provide no- or low-interest loans to help certain industries. Again, these amounts are not large, but they can be significant, particularly if a factory needs circulation funds to purchase raw materials. These sources of support and funding are critical when the upper levels of government try to rein in growth by cutting credit, as was done in the 1988–89 retrenchment. Such actions indicate an increasing divergence of interests between the Centre and the localities and the increasing ability of the local levels to circumvent central regulations.<sup>32</sup> Local governments, formally agents of the central state, are increasingly becoming principals in their own right.

*From regulators to advocates.* Granting property rights over local enterprises to local governments distorts the role of the latter as agents of the central state. On the one hand, the increased fiscal pressure to be entrepreneurial has meant that local authorities must be more vigilant to ensure that the factories make the best use of resources. But in practice this may also mean that they become more lax in their role as agents for the central state. With the transformation from administrators to en-

31. China interview 22688. In the rural areas, the major bank at the county level serving peasants and rural enterprises is the Agricultural Bank (*nongye yinhang*). Below the county, however, there are the branches of the Agricultural Bank, known as a business office (*yingye suo*), and the credit co-operatives (*xinyongshe*).

32. A more detailed discussion and description of other mechanisms are in Oi, *Rural China Takes Off*.

trepreneurs, local governments are shifting from regulators to advocates of their local enterprises.

The local corporate state continues the Maoist practice of planning and monitoring, but the new institutional incentives increasingly encourage local officials to carry out their regulatory functions to maximize local rather than national interests.<sup>33</sup> Local governments regulate the activity of contracted enterprises through plans and targets, even though China has moved away from central planning.<sup>34</sup> Targets for profit, output and revenue for township and village enterprises are formulated and transmitted by the bureau for the management of rural enterprises. The county finance bureau issues to its townships quotas for revenue, with built-in growth rates based largely on the number and performance of the township and village industries.

Enterprises, like bureaus and other government agencies, are required at the county and township levels to submit a large number of reports, either monthly, bimonthly, quarterly, semi-annually or annually. An extensive reporting system characteristic of the Maoist period continues to be used at these levels.<sup>35</sup> All township enterprises are required to send reports to the township economic commission which then submits them to the county, along with those from other parts of the township government.

But the established capacity of government to monitor its own enterprises is now used to realize *local* industrial policy. Together with maintaining ownership, local governments can more easily limit management autonomy, use enterprise profits, ration credit, and allocate investment opportunities and key inputs.<sup>36</sup> The owner-regulator relationship to township and village enterprises also explains why local governments are willing to invest so much time and effort in promoting these enterprises. The risks for local governments are fewer. For example when county governments invest in township or village enterprises they are in essence dealing with their subordinate levels, not with independent entrepreneurs. This differs from other developing countries, where there are two separate elites, each with its own basis of power.

Rather than the predatory role that some might assume, and unlike some political systems where local governments maintain a detached

33. For further discussion and documentation of this point see *ibid.*, especially chs. 5 and 6.

34. Local plans may or may not be mandated by upper-level quotas. Provinces send plans to the prefectures, which send them to the counties, which then send them to the townships. For example, the county still sets annual procurement quotas for agricultural goods, such as grain and cotton, and allocates the agricultural tax to the townships. Each of the specialized banks are given growth quotas for deposits by the prefectural banks. Both of these are mandated by centrally-set targets. In addition, localities, from the province on down, also set annual industrial production and fiscal targets which are not necessarily dictated by upper-level directives.

35. Only at the village level is the required preparation of reports attenuated. Townships are the administrative superiors of the villages, but townships seem only to have loose control over their villages, especially the highly industrialized, wealthy villages.

36. Christine Wong makes a similar point. See her "Interpreting rural industrial growth in the post-Mao period," *Modern China*, Vol. 14, No. 1 (January 1988), pp. 3–30.

distance from business interests, a distinctive feature of local state corporatism is that local governments and the bureaucracies that constitute them see it as part of their duty to lobby on behalf of their enterprises to maximize the interests of the local corporate state, which directly impinges on their individual well being.<sup>37</sup> Local officials routinely manipulate regulations to allow local enterprises to receive the maximum tax advantages and exemptions.<sup>38</sup> This keeps more revenue within the locality and adds to the competitive advantage of the enterprises, which also means that of the locality. Similarly, banks may exempt enterprises from penalty interest payments or extend the repayment period.

Under a local state corporatist system, the relationship between banks, finance and tax offices, and county, township and village officials is very close.<sup>39</sup> Local officials at the county level help secure large loans for township and village-owned enterprises. Bureaus sometimes provide services well outside their administrative domain. For example, the county tax bureau not only collects taxes and gives tax concessions, but helps enterprises train accountants and find scarce technical personnel, a pressing problem facing rural industry. It may use its connections to influence other agencies, such as banks, to bend the rules in favour of a particular enterprise. The tax bureau may allow an enterprise to repay the bank loan before taxes are assessed, in order to provide some guarantee to the bank that the enterprise can repay the loan.

*Implications of the Chinese Experience: The Role of Government in a Transitional Economy*

The Chinese model, while emerging from a distinctive Leninist system, holds a number of useful general lessons about reform for transitional and late industrializing economies. The first is that one cannot make broad assertions about government intervention and markets. As Wade has noted, different governments have different "capacities to guide the market."<sup>40</sup> In the wake of disastrous state-led development in centrally planned economies such as the former Soviet Union and Eastern Europe, there has been a rush to get government out of the economy, but a minimalist state is not necessarily the answer. The goal should be more effective government. Instead of thinking that there must be either state or market, one should instead look at the interaction of state and market

37. For a differentiated view of the rent-seeking character of different states, see Peter Evans, "Predatory, developmental, and other apparatuses: a comparative political economy perspective on the Third World state," *Sociological Forum*, Vol. 4, No. 4 (1989), pp. 561–587.

38. The reasons for this have to do with the access that local governments have to non-tax revenue. Details are laid out in Oi, "Fiscal reform and the economic foundations of local state corporatism." Further discussion is in Oi, *Rural China Takes Off*.

39. Some have criticized this relationship as too close. See, for example, "Township enterprises should also implement reform," translated in JPRS-CAR 88–005, 18 February 1988, pp. 20–21; also Xu Hao and Wang Qingshan, Research Department, Agricultural Bank of China, "China's rural financial markets: current situation and strategy," translated in JPRS-CAR 88–002, 5 February 1988, pp. 54–57.

40. Wade, "The role of government in overcoming market failure," p. 130.

and the adjustment of state actions.<sup>41</sup> As a number of observers have pointed out, even in the classic statements of *laissez faire* economics, there is a crucial role for states to play.<sup>42</sup> The recent case of China shows a regime that has evolved from bureaucratic stagnation to rapid entrepreneurial growth. The state-led growth that is occurring now in China is quantitatively and qualitatively different from that found in the Maoist period. Not all state intervention is Leninist, as the experience of the NICs has also shown.

The Chinese case points to the importance of path dependence, but it also cautions that this cannot be determined by looking at such factors as ideology or regime type. China, the former Soviet Union and East European states were all centrally planned Leninist systems, but China evolved into a distinctive decentralized form that, when coupled with the proper incentives, allowed its local officials quickly to play an entrepreneurial role. It is questionable whether local governments in the Soviet Union, even given the proper incentives, would be in as strong a position to generate economic growth quickly. When the Soviet planning system reached directly from the Centre to the enterprises, bypassing local governments, it left local officials with few resources and economic managerial skills. This plus the dissolution of the federal union and the instability of the Centre make the task of generating economic growth at the local levels distinctively different.

China's experience suggests that one should disaggregate the "state" into its component parts to distinguish between levels of government and the incentives for different levels to perform. There is a need for strong state capacity, but this capacity should exist at both the local and the central levels.

My argument lends credence to those theories that point to the importance of providing reformers with room to manoeuvre and insulation from an onslaught of political demands from society at large.<sup>43</sup> Unlike the USSR, which undertook political reform before beginning the task of economic restructuring, and unlike the weak authoritarian states of Africa and Latin America, China maintained its ability to rein in economic activity after reforms began. Not only is the political strength of a regime on the eve of reform crucial to determining its capacity to structure economic change, but a regime must also ensure that it retains sufficient capacity to control the course of reform. Unlike the former Soviet Union, China has tenaciously held on to its political power to decide the *content* and *speed* of reform.

41. A useful discussion of this general point is in Dietrich Rueschemeyer and Louis Putterman, "Synergy or rivalry?" in Putterman and Rueschemeyer, *State and Market in Development*, pp. 243–262.

42. See, for example, Paul Streeten, "Markets and states: against minimalism," *World Development*, Vol. 21, No. 8 (August 1993), pp. 1281–98; and Kiren Aziz Chaudhry, "The myth of the market and the common history of late developers," *Politics and Society*, Vol. 21, No. 3 (September 1993), pp. 245–274.

43. See, for example, Rueschemeyer and Evans, "The state and economic transformation," pp. 44–77; also Haggard and Kaufman, "The state in the initiation and consolidation of market oriented reform."

A practical lesson to be learned from the Chinese experience may be that reforming regimes should not be too quick to judge incumbent bureaucrats when trying to reform, merely because they have been associated with poor economic performance. In China it is the Communist Party first secretaries who are leading much of the rural industrialization. Institutional context and incentives matter. The Chinese case suggests that reformers need to craft incentives that will make it in the interests of those in bureaucracy and those involved in production to see reforms succeed. In China, altering fiscal flows and property rights overcame the inertia that many associate with Communist officialdom.

This also suggests that more is needed than just incentives for successful economic growth. Producers are not left to fend for themselves in the market context. The growth that is occurring in China is based on a corporatist strategy that spreads risks and resources to maximize local community interests. This gives competitive advantage to local enterprises. In today's modern economic environment infrastructural support needs to be defined more broadly than roads and the provision of electricity to include the provision of market information and technology.<sup>44</sup>

The success of local governments as entrepreneurs suggests that privatization is not the only way to stimulate economic growth. However, this is not to say that government ownership is the best or should be the only form of enterprise. China's continuing success may also be due to the fact that as development has progressed, local officials have provided increasing support to private enterprise. As has been shown elsewhere, by the late 1980s a strong public-private co-operation was developing, resulting in what some have called a symbiotic relationship between the private enterprises and local officials.<sup>45</sup> This growing public-private co-operation brings China closer to the successful developmental state model of the East Asian NICs.

A decentralized strategy does not come without costs. As is common in late industrializing countries, there is a tension between the need to decentralize and the deteriorating effect this has on the need for a strong central state. But apart from the usual problems, there is an additional twist to the Chinese case. The policy instruments that have effectively allowed local governments to pursue preferential allocation and targeting are linked to a strong central state. The question is whether the localities can continue to grow in power without fatally damaging the strength of the Centre. Perhaps one of the best outcomes would be a

44. North, *Institutions, Institutional Change and Economic Performance*, especially pp. 76–77.

45. See Dorothy Solinger, "Urban entrepreneurs and the state: the merger of state and society," in Arthur L. Rosenbaum (ed.), *State and Society in China: The Consequences of Reform* (Boulder: Westview Press, 1992), pp. 121–142; David Wank, "From state socialism to community capitalism: state power, social structure, and private enterprise in a Chinese city," Ph.D. dissertation, Harvard University, 1993; and his "Private business, bureaucracy, and political alliance in a Chinese city," *The Australian Journal of Chinese Affairs*, No. 33 (January 1995), pp. 55–74. Liu Yia-Ling, "Reform from below," also points toward such an alliance.

formalized and institutionalized division of power along the lines of a federal system.<sup>46</sup>

There is also a lack of economic co-ordination that comes with decentralized economic development.<sup>47</sup> While it has been shown that China continues to exhibit a lack of regional specialization,<sup>48</sup> this problem may be mediated by the information that flows through the vast government bureaucracy to the local enterprises. The government-owned foreign trade corporations are probable sources that will help interpret the export market. Neither the enterprises nor their local governments operate blindly in a vacuum. One also would expect that competition will shake out the market.

Finally, a number of questions leave open the sustainability of Chinese economic growth. One has to ask whether the reason why China's reforms have succeeded to the extent that they have and why the local decentralized developmental state has been able to lead this success is the type of production undertaken by rural industry. Much of the production, particularly at the early stages, required relatively little expertise and start-up cost; entrance barriers were low. This allowed individuals who only a few years earlier were in the fields to adapt fairly easily to industrialization. This may also explain why China has been able to pursue a developmental state strategy without an elite central bureaucracy of the type that exists in Japan and Singapore. For other countries with less room for growth on the fringe of the economy or for other countries trying to generate growth through the development of more sophisticated products, China's decentralized strategy may be less suitable. For China itself, the question is how long local elites can spearhead rapid economic growth. Part of the problem may be alleviated by the provision of technology through joint ventures and the information diffusion through the bureaucratic network, but a major challenge for China's reformers is to ensure that those who now have the incentive will continue to have the institutional and technical support necessary to continue their entrepreneurial efforts. Institutional change created the necessary environment for successful reform to begin and growth to occur, but continued institutional change is necessary to ensure that growth continues down the right path.

46 See Gabriella Montinola, Yingyi Qian and Barry R. Weingast, "Federalism, Chinese style: the political basis for economic success in China," *World Politics*, Vol. 48 (October 1995), pp. 50–81.

47. See, for example, Christine Wong, "Central–local relations in an era of fiscal decline: the paradox of fiscal decentralization in post-Mao China," *The China Quarterly*, No. 128, (December 1991), pp. 691–715; and Christine Wong, "Fiscal reform and local industrialization: the problematic sequencing of reform in post-Mao China," *Modern China*, Vol. 18, No. 2 (April 1992), pp. 197–227.

48. Anjali Kumar, "Economic reform and the internal division of labor in China: production, trade, and marketing" (Washington, D.C.: The World Bank, March 1994).