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**THE DEVELOPMENT OF TOWNSHIP, VILLAGE, AND
PRIVATE ENTERPRISES: RURAL INDUSTRIALIZATION
IN CHINA, 1979-1989.**

By

Shin-Ray Lee

A THESIS

**Submitted to
Michigan State University
in partial fulfillment of the requirements
for the degree of**

MASTER OF SCIENCE

Department of Sociology

1992

ABSTRACT

THE DEVELOPMENT OF TOWNSHIP, VILLAGE, AND PRIVATE ENTERPRISES: RURAL INDUSTRIALIZATION IN CHINA, 1979-1989.

By

Shin-Ray Lee

The development of rural community enterprises (township, village, and private enterprises) is a very important part of the economic reform in China since late 1978. It has significantly increased personal income among rural residences, improved the structure of rural economy, absorbed a large number of rural surplus labours, and made an increasing important contribution to the national economic growth.

With the decentralizing macro-economic policy and its cellular community characteristic, the community enterprises are deeply attached to the interest of the community as an economic unit. Local governments and local enterprises thus are very close and rely mutually. On the one hand, it followed the route of rural industrialization rather than urbanization. On the other hand, the community as a whole will face a rather harder budget constraint which changes the basic principle of enterprises management and that is extraordinary in the socialist economic environment.

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Introduction

China, as a country with the largest rural population in the world, is facing with difficulties to a typical developmental problem that almost every developing country has to meet -- the transferring of resources from agricultural sector to industrial sector. According to the experiences of Western advanced countries and most other Third World Countries, to transfer productive materials, including capital, labour, land and so on, from the agricultural sector to the nonagricultural sector is the most significant turning point in the course of economic development. They always followed the route of "urbanization", by which the industry sector in the urban areas extracts the agricultural surplus values and absorbs the rural surplus labour as its primitive accumulation to promote the development of urban industry. However, this "dual economy" strategy -- urban industry and rural agriculture -- always produced some polarized tensions of structural inequality. The urban unemployment was getting serious while the rural sector met a shortage of labor. The distribution of wealth was further worsened both in the urban and rural areas. Therefore, unstable urban city and declined rural village seemed to be the unavoidable outcomes.

China, under its specific historical conditions, took another way to overcome this difficulty. That is to industrialize its broad rural areas. The development strategy emphasizing planning command, heavy industry, ideological mobilization, and egalitarian distribution has proved failure to a large extent. The leaders in China acknowledged that for China, without the modernization of rural areas, the modernization of the country is impossible. And without the enthusiastic peasant participation, the agricultural production is by no means to feed themselves and not to

mention to support the industrial development. Political and ideological mobilization can not work any more. The rice bowl everybody eats from has to be broken up.

The introduction of the production responsibility system in agriculture¹ since 1978 was the first and most important step on the way. The basic production unit turned back to the family household. Peasants were much more willing to work hard just because they could retain most outcomes of their labor inputs. They thus had the motivations to produce more and to accumulate for their better lives. The first mechanism of rural development has been triggered.

Next problem was how to transfer this agricultural accumulations, which included the surplus laborers, the funds, the purchase power and so on, to the industrial sector. China did not follow the way of urban industrialization but to industrialize the rural villages. Non-agricultural enterprises collectively owned by the rural communities are proliferating. They are pooling capital accumulated from the agricultural production and hiring labor from the large pool of surplus agricultural workers in the countryside to pursue industrial, building, service or commercial activities. Although they work at relatively low technological standards and with a rather small scale, these non-agricultural establishments constitute a new and vital social force in the Chinese countryside, likely to play an increasingly-important role in rural development and to contribute to the national economic development.

¹A practice in agricultural production by which the production team contracts all its farmland to individual households for separate cultivation. The contracted part of the output goes to the production team for unified distribution among the membership, and the rest is either share between the team and the contractor or granted to the latter as a bonus that they could sell on the local market.

In addition, China is probably the only major socialist country left after the collapse of Soviet block. The economic reforms in socialist countries in the past decade could be seen as the catalyst for the end of the communist regimes from certain perspective. However, so far, China seems to be the only exception. As a matter of fact, China has just begun to show its strong and vital strength in the world economy in recent years. An examination of the mechanism of this experience in general and the development of the non-agricultural enterprises in specific without any doubt is necessary and worthwhile.

This paper will first describe the historical background of the rural industrialization in China and the major contributions the local non-agricultural enterprises achieved in recent years. Then it will discuss the macro-economic environment and local-community structure for the development of those enterprises. Finally, focusing on the important role of local government, it will analyze the contradictions rooted in the organizational pattern of the development of these enterprises and indicate the possible alternatives for the development in the future.

Chapter 1 Historical Background of Rural Industrialization in China

First of all, there are three levels of rural communities in China. The *township* (formerly the commune²), presently the lowest level in China's government hierarchy, has an articulated government structure. The typical township has a population of 15,000-30,000. The *village* (formerly the brigade) is not a separate level of government but has certain governmental functions and a community structure. Villages generally have a population of 1,000-2,000. The *production team* is purely a loose community organization. As a result of the implementation of the production responsibility system in agriculture in the early 1980s, the production teams have lost most of the administrative functions. The average production team consists of about 30 households with a total of 150 people.

There are some ambiguities in the delineation of the TVPEs (Township, Village, and Private Enterprises) in China, but the broadest definition, which is increasingly popular, encompasses all nonagricultural activities in rural areas and small towns other than those on state farms. Some of them owned by community governments are referred to as *community enterprises*, and the others owned by individuals or partnerships are termed *private enterprises*. Community enterprises owned by township

²The people's commune, with production brigades and production teams as its subdivisions, constituted a system of collective ownership of the means of production at three levels: the commune level, the production brigade level, and the production team level. It was an economic organization and an agency of the state at the grass roots. During the period of 1979 to 1984, this system had been dismantled by the establishment of the agricultural production responsibility system. In 1984, the commune system was abolished officially. The administrative and economic functions were separated formally with the reestablishing of the rural administrative organization; and the commune and brigade enterprises were renamed the township and village enterprises as well.

and village are referred to as *township and village enterprises* (TVEs)³. Government units at the township level which are responsible for supervising township enterprises are referred to as *township industrial corporations* ⁴. They function like a board of directors in western enterprises. The headman of the village or production team, however in general, takes responsibility directly of the enterprises owned by village or production team.

Since the founding of the People's Republic of China there have been three stages of rural industrialization in China. The first came in 1958, when the people's communes were established and a nationwide industrialization campaign was launched. China, dizzy with the "victory of transformation" (nationalization and socialization of the economy), adopted the Great Leap Forward strategy and attempted to reach the "paradise" of communism by building the "golden bridge" of people's communes. Rural people's communes established a large number of commune and brigade enterprises to mobilize the whole nation's manpower, funds and materials to develop industry. By the end of 1958 commune and brigade enterprises in China employed 18 million people and yielded a total output value of Y6 billion. In the following year that figure catapulted to Y10 billion (Byrd and Lin, 1990b, p.9).

The second stage began in 1970 when the State Council, at a conference on agricultural development in North China, called on rural areas to speed up the mechanization of agriculture. Farm machinery factories set up by rural community governments spread all over China, further boosting the

³Occasionally township and village enterprises are discussed separately.

⁴They go under a variety of names, including township industrial corporations, township industrial and trade corporations, and township industrial association.

development of commune and brigade enterprises. Meanwhile, many urban plants, absorbed in the Cultural Revolution (1966-76), had stopped production. Market shortage became worse with each passing day, and some rural communities took advantage of this opportunity to set up firms. The output value climbed from Y9.25 billion in 1970 to Y27.2 billion in 1976 (Byrd and Lin, 1990b, p.10).

The third came after the Third Plenum of the Eleventh Central Committee in December 1978. It shifted the nation's focus to the reform of the economic system. Community enterprises entered a new era of rapid growth. Since 1978 the rural economic reform characterized with the production responsibility system was launched nationwide. Agricultural productivity increased rapidly. It provided a much better environment for the development of commune and brigade enterprises. Meanwhile, a great amount of rural surplus laborers need to be absorbed by the expansion of the nonagricultural sector. The output value was increased from Y43.9 billion in 1978 to Y101.67 billion in 1983. The average annual growth rate was 15.6 percent. Governments at all levels set up administrative bureaus to strengthen the management of these enterprises. In March 1984, the Central Committee and the State Council agreed to rename commune and brigade enterprises as township and village enterprises since the people's commune system had been abolished and a large number of partnerships and individual enterprises had come into being. Since then China's TVPE have flourished more than ever. In 1984 the output value of TVPE totaled Y171 billion, and the figure rose to Y273 billion in 1985 and Y845 billion in 1989. It was even more than Y1,000 billion in 1991.

Table 1 The Development of the TVPEs in China, 1978- 1989

Years	Numbers (million)	Employment (million)	Output Value (billion)	GNP (billion)
1978	1.52	28.27	49.3	348.2
1979	1.48	29.09	54.8	387.9
1980	1.42	29.99	65.7	433.6
1981	1.34	29.70	74.5	462.9
1982	1.36	31.13	85.3	503.8
1983	1.35	32.35	101.7	562.7
1984	6.06	52.08	171.0	676.1
1985	12.22	69.79	272.8	833.0
1986	15.15	79.37	354.1	945.7
1987	17.45	87.76	474.3	1104.9
1988	18.88	95.45	701.7	1398.4
1989	18.68	93.66	845.2	1567.7

Source: Statistical Yearbook of China, 1990.

Chapter 2 The Social and Economic Achievements of the Development of the TVPE Sector

The proliferation and growth of the TVPEs have significantly increased personal income among rural Chinese people, absorbed a large number of rural surplus laborers, improved the structure of rural economy, and made an increasing important contribution to the national economic growth.

Increasing Personal Income

As a result of the reform in the rural areas since 1978, mainly the establishment of the production responsibility system together with the increasing the procurement prices of agricultural products, the income of peasant has begun to increase in an unprecedented speed. This first wave of income increase, as a necessary accumulation, made it possible to accelerate the growth of the TVPE. And the rapid development of the TVPE further pushes forward another wave of income increase.

During the first ten years of the economic reform, the personal income in rural areas has increased from Y134 in 1978 to Y463 in 1987. The average increase rate is more than 27 percent every year, while that figure in urban areas is only 21.1 percent. The rural-urban income gap has been reduced. Obviously, this is a rather successful case about income increase and distribution among the developing countries⁵

⁵Adelman and Sunding (1987) has presented Lorenz curve estimates for Chinese income distribution by period, 1952-1986. They concluded that the level of inequality in China is one of the lowest in the world. Although rural inequality increased after 1978, national inequality fell, due to a reduction in the rural-urban income gap.

**Table 2 Average Income Per Capita
(Yuan)**

Years	Urban area	Rural area
1978	316	134
1979	376	-
1980	-	191
1981	458	-
1982	495	-
1983	526	310
1984	608	355
1985	685	398
1986	828	424
1987	916	463

Source: Statistical Yearbook of China
1988.

From 1980 to 1983 the total wage of TVEs increased Y5.64 billion, which is equal to 5.3 percent of the total net income increase in the rural areas during the same period. That index rose to 12.9 percent in 1984 and 24.8 percent in 1985. If we calculated the total wage of the whole TVPE sector(including the private enterprises), the range of increase will be greater. The total wage of TVPE increased Y58.28 billion from 1985 to 1989, which is equal to 48.42 percent of the total net income increase in the rural areas. The TVPE sector becomes an increasing important resources of the personal income in the rural areas. It is estimated that in some areas, where the TVPE are developed well, more than 70 percent of personal income are came from the TVPE sector.

Absorbing the Rural Surplus laborers

Although the fast increasing productivity of agricultural work is a welcome process, the accompanying phenomenon of mass unemployment yet seems to be unavoidable. In the pre-reform collective economy the over-population of villages remained a hidden fact. The commune provided employment for

all the adult population in the villages, although at a low productivity level and low living standards. However, since the beginning of the reform, the strong financial interest of the family farm, and the relatively free labor market are bringing the redundant labour to the surface. Most intensive production will finally release labour who would seek employment in the nonagricultural sector or even immigrate to urban areas.

China is known for its large labor force. It was estimated that 534 million people would still be engaged in agriculture by the year 2000 of which perhaps 200 million will be surplus to rural needs (Li, 1986; Zhang, 1987). Such huge pressure to create new jobs is a major motive for the development of rural nonagricultural economy.

According to the experiences of Western advanced countries and most other Third World Countries, to transfer productive materials, including capital, labour, land and so on, from the agricultural sector to the nonagricultural sector is the most significant turning point in the course of economic development. They always followed the route of "urbanization", by which the industry sector in the urban areas extracts the agricultural surplus values and absorbs the rural surplus labour to promote the development of urban industry. However, this "dual economy" orientation -- urban industrial and rural agriculture -- was not always successful. On the one hand, the urban industry was not necessarily able to absorb the rural surplus labour. The problem of urban unemployment was getting serious while the rural sector met a shortage of labor at the same time. On the other hand, "urbanization" itself has certain external costs as well.

China took another way of overcoming these difficulties -- which is to "industrialize" the small towns and villages, more specifically, to develop the TVPE sector. Based on the experience of the 1980s, between 46 million

people (Han, 1987) and 52 million (Yu, 1987) transferred out of agriculture, and especially out of cultivation activities. Han estimated that some 64 percent shifted into rural industries located in villages and small towns, 19 percent into building and construction, 5 percent into transport activities, and close to 8 percent into services and commerce. By the end of 1978, 28.27 million rural surplus laborers in China were employed by TVPE. That figure increases with the average growth rate of 22.98 percent to 87.76 million at the end of 1987 (see Table 1). According to some estimates, during 1979-84, TVPE increased their total value of output by Y83.6 billion. In so doing, they used 6.9 million rural surplus laborers, which in effect, comparing that in the state-owned enterprises, substituted for Y28.1 billion of investment in fixed assets (Development Research Institute, 1986, p.11).

With continued economic reforms the future of rural enterprise in China is considered to be bright. Although there is a recognition that its capacity to provide employment is not unlimited, however, rural enterprises might absorb at least 25 to 35 percent of the surplus labor force constantly (Wu and Xu, 1990).

Improving the Structure of Rural Economy

Although the agricultural productivity has increased rapidly at about 8 percent a year as a result of the reform, the proportion of the gross agricultural output value to the rural gross social product value decreased significantly. There is a dramatic change in the composition of gross social product in China's rural areas. The share of crop cultivation dropped from almost half in 1980 to less than one-third in 1986. The share of other agricultural activities remained more or less constant. And the industry rose from less than one-fifth to more than 30 percent, nearly equal to the

share of crop cultivation. In 1987 the rural gross value of industrial output exceeded the value of agricultural output for the first time (Byrd and Lin, 1990b, pp.13-4). Construction, transport, and commerce rose modestly as a share of the total. The goal of "Industrializing" the small towns and villages in the rural areas has been achieved to an impressive degree.

Contributing to the National Economy

TVPE also made a great contribution to the development of national economy. In 1980, the output value of TVPE only created 15.15 percent of the GNP. However, with the rapid development of the TVPE, it grew up to 32.75 percent at the end of 1985 and 53.59 percent in 1989 (see Table 1).

TVPE also played an important role in the process of Chinese industrialization. The industrial output of the TVPE created only 10.4 percent of the national gross industrial output value in 1980, but it grew up to 18.8 percent in 1985, 23 percent in 1986, and almost 30 percent in 1989.

In addition, the contribution of the taxes from the TVPE to the national financial revenue is also getting magnified. It increased from Y2.2 billion in 1978 to Y36.46 billion in 1989, which is equal to 13.4 percent of the total taxes revenue of that year.

Chapter 3 Causes of the Rapid Development of Rural Enterprises in China

Although the development of the TVPEs was generally rapid, there were, however, sharp ups and downs. The output of TVPE industry as a whole rose and declined twice since 1979 (Du, 1990, p.47). The fluctuations were so large and the cycles so short that the stability of the entire urban and rural economy was affected. These swings were obviously related to the changes in government policies toward rural industries and the situation of the urban and rural economies.

The development of rural industry in recent years can be divided as two phases by the critical year of 1984: 1978 to 1983 and the period since 1984. There were important changes in government policies, economic reforms, and the urban and rural economies between the two phases.

First, there were constant arguments as to whether the unfettered growth of TVCEs would be efficient and compatible with socialism until 1984 when all the government institutions, from the highest authorities down to grass-roots departments, decided to fully support TVPE enterprises. Second, the household production responsibility system in agriculture was universally implemented by 1983, and by 1984 new reforms were needed in rural areas. In addition, the output of agricultural products increased greatly after 1978. By 1984 there was even small trade surplus in grain and cotton. Since 1984 crop production has stagnated (Du, 1990, p.48).

In the period before 1984, the growth of TVPE industries was initially stimulated by the development of agriculture. After 1984, depending upon the expanding market, a self-supported progress of TVPE industries began.

1978-83: The Initial Stimulus from Agriculture

The growth of rural industry has all along been closely related to the conditions in agriculture. For example, the growth of township and village industry has been in inverse proportion to the amount of rural arable land per person⁶. It is clear that shrinking agricultural resources were the initial force behind the development of TVPE.

In the twenty-five years between 1952 and 1977, China's rural population grew by 55.6 percent, whereas the total area of arable land fell by 130 million mu⁷. Arable land per member of the rural population dropped from 3.29 mu to 1.85 mu. During the same period, the agriculture's share of the national income fell from 57.7 to 37.1 percent. Yet the proportion of agricultural labor in the national total increased from 82.6 to 84.2 percent. The productivity of peasants and land in rural areas thus worsened instead of being improved.

The most conspicuous change in China's rural areas since 1978 has been the adoption of the production responsibility system. It is a reform that greatly increased farmers' enthusiasm and stimulated agricultural production. As a result, the production suddenly increased. It has been growing by about 8 percent a year, far exceeding the population increase which has been slowing down. In Wuxi county, for example, the agricultural productivity increased 1.7 times from 1980 to 1985. This not only resulted in the suddenly increased peasant income, but also in the food supply of the cities. Basically, the difficulty of feeding the huge population has been overcome.

This policy, however, aggravated the situation of surplus agricultural labor. New rural economic policies that encouraged a diversified economy

⁶See Du (1990), p.48.

⁷1 mu = 0.0667 hectares.

in the countryside were as significant as the production responsibility system. Policies that discouraged rural labor from shifting to nonagricultural activities were basically abolished, and the movement of farmers into nonagricultural activities was accelerated.

The transfer of rural surplus labor to nonagricultural activities involved several important factors, especially the capital, labor, materials and the marketing activities by enterprises.

(1) Capital

Initially, the accumulation of funds for investment in nonagricultural activities was related to the unusual growth of agricultural income. This growth stemmed partly from the increase of agricultural production and partly from the rise of procurement prices which in fact meant a return of industrial profits to agricultural sector. During the years between 1978 to 1982, the state procurement prices for agricultural products rose by 50-100 percent. In 1978-80 alone the rise in procurement prices enabled farmers to reap Y46 billion in additional net income (Du, 1990, p.51).

From 1978 to 1983, farmer's average per capita income in China increased 132 percent from Y133.6 to Y309.8. In Wuxi county during the same period, it rose from Y124.4 to Y412.7, an increase of 232 percent. An increase in farmers' bank savings accompanied the rise in their income. In Wuxi, a county with high income, the total amount of rural bank deposits increased by 486 percent and individual deposits rose by 600 percent between 1978 and 1983. The growth of rural deposits therefore helped expand local banks' supply of funds and has been a positive force in the development of TVPE. For the country as a whole, the year-end outstanding balance of loans extended to TVCEs increased from Y1.5 billion in 1977 to

Y7.35 billion in 1982, a rise of 390 percent. The growth of farmers' income also added directly to the supply of funds for TVPE industry (Du, 1990).

(2) Labor

In rural China the basic unit of economic accounting is the household. When land was contracted according to head count, it did not matter whether a household member was engaged in agricultural activities or not, since the land could be farmed by other members of the family. As a result, the opportunity cost of a farmer's turning to industrial activities was practically zero (Du, 1990., p.53).

There were also large discrepancies between personal income from agriculture and from work in TVPEs. In 1980 rural per capita income from agriculture was Y166, whereas per capita income in TVPEs was Y398. In 1985 these figures rose to Y351 for agriculture and Y726 for TVPEs. At the same time, the per capital income in the urban areas was only Y685. This comparative advantage of income in TVPEs to a large extent mitigated the pressure of migration from the rural areas to the urban cites. TVPE industry at this stage thus faced an abundant supply of labor, which promoted its development.

(3) Materials

After 1978 the planned procurement of agricultural products by the state shrank even while farm output grew. This situation stimulated the growth of TVPEs that used agricultural raw materials. Between 1978 and 1983 the output value of such type of TVPEs increased by 254 percent.

Meanwhile, the adjustment of the country's national industrialization strategy also enabled TVPEs to receive some materials subject to monopoly

distribution under the state plan. TVPEs were also allowed to get some semi-finished products by sub-contract with state enterprises.

(4) Marketing

All along, TVPEs have been sensitive to market trends because they have had no access to state commercial channels. Consequently, the TVPE industry has to place strategic emphasis on sales. On the one hand, they encouraged the widespread participation by enterprise staff in obtaining supplies and promoting sales. On the other hand, the salaries of sales are generally several times higher than the average salaries for all other employees and may even exceed a factory director's salary because of large bonuses.

In addition, TVPEs face an environment in which structural reforms in state enterprises are just starting. It provides an opportunity for TVPEs to shift part of the state enterprises' profits into their own hands by means such as giving sales commissions, paying sales agents, and making out blank invoices. These factors have enabled TVPEs to occupy a substantial share of the market for many industrial goods. Furthermore, because of the widespread of the shortage of the factors of production and the consumer goods, the entrepreneurial TVPEs have thus taken this opportunities to take up the slack, meet the demands, and get their market share (Gold, 1989).

1984-Present: Market Expansion and Self-Supported Progress

The TVPE development in the early stages depended heavily on the financial support from agriculture and on the extraordinary growth in the supply of production inputs from agriculture. But by 1984 agriculture could

no longer effectively support the growth of the TVPE. Community governments began to take part of TVPE industrial profits to subsidize the prices of agricultural products. Competition for labor also became a serious problem in some areas. The impetus given to TVPE industry by agriculture has obviously fallen short of needs.

Despite all these problems, TVPE industry not only did not shrink but achieved even higher growth rates after 1984. The main factors pushing the growth during this period were the self-development of TVPE industry and the changes in the microeconomic policies which institutionalized the support of local governments to the TVPE industry. There are three phenomena worth to note: the burgeoning of private economy, the changes of the supply of funds, and the changes in the products market.

(1) The Burgeoning of Private Economy.

The Central Committee's Document No. 1 of 1984 allowed private firms to hire workers and relaxed restrictions on them, the private economy thus became an important element in the rapid development of TVPE industry. By the end of 1988, 91.58 percent of the total number of TVPEs has been private enterprises although most of them are very small in size. 48.73 percent of the employees of the TVPEs was hired by the private enterprises among them. The proportion of the value for the output of private industries to that of the total TVPE industries was 24.25 percent. But the weight of private enterprises in transport and commerce sector in the total TVPEs has reached 76.55 percent.

First of all, the development of private enterprises can improve the efficiency of resource allocation. Since private enterprises are more likely than community enterprises to employ labor-intensive production

techniques, their substitution of labor for capital is even more evident. This processes also contribute to the geographically balanced development (Lin, 1990, pp.173-75). Some local authorities in economically underdeveloped regions, in drawing up their development scenarios, have pinned their hopes on relaxed political controls and on encouragement of the private economy. In the first few years after 1978, the government depended almost solely on community enterprises to push rural industrialization. But the gaps among different regions, instead of narrowing, widened alarmingly as a few relatively developed areas took advantage of their rich financial resources, abundant human talents, and favorable geographic conditions and enjoyed rapid rural industrialization while the backward areas could hardly get off the ground. The blossoming of private enterprises in all areas since 1984 has helped narrowing the gaps among regions and has offered new hope for solving the problem of regional imbalances as the rural industrialization progresses.

(2) The Changes in the Supply of Funds.

The second element that spurred the rapid development of TVPE industry after 1984 was the changes in the supply of funds. The 1984 policy of supporting the growth of TVPEs led to a considerable relaxation of restrictions on bank loans and a consequent credit inflation that directly augmented the supply of funds to TVPEs. The national rural loans in 1984 and 1985 increased almost by 60 percent.

In 1985, the central government tried to control the bank loan quotas in rural areas to moderate the pressure of inflation. This policy seriously affected the volume of credit extended to TVPEs. TVPEs began to search for new sources of funds, including local residents and cooperative

investments. According to statistics made available by Wuxi's Agricultural Bank, 65 percent of the money pooled by local TVPEs was obtained by squeezing bank savings. It meant that even if the bank's loans were tightened, the funds from local residents were still reaching TVPEs without passing through the banking system (Du, 1990, pp.58-59).

The self-accumulation capacity of TVPEs was also expanding. Between 1980 and 1985, the total profits used to expand production in TVPEs rose by 68.5 percent. And the share of this investment on total profits rose from 49.7 to 51.4 percent. Despite the reduction of agriculture funds in the capital of TVPEs in 1984 and 1985 as well as the returning of part of the profits of TVPEs into agriculture, the total supply of funds was enlarged owing to the improvements in the functioning of financial markets and greater self-accumulation by TVPEs. In 1985, TVPEs all over China mobilized more than Y10 billion from these sources.

(3) The Changes in Product Market.

The changes in product markets were perhaps a more important factor in the speedy development of TVPE industry during this period. First of all, the inflation caused by the loss of macroeconomic control in 1984, which created an excessive growth of demand for investment and consumer goods, provided an important stimulus to TVPEs. Meanwhile, reform in the system of mandatory purchases and sales by the state in urban areas allowed TVPE products to enter urban commercial channels on a more stable basis.

With the development of TVPE industry and the expansion of nonagricultural activities in rural areas, a new process of income generation has emerged in rural areas. The number of families who earn a

'dual income' (Kornai and Daniel, 1986) is growing: part of it coming from agriculture, another part from TVPE sector.

The growth of farmers' income further brought about an increase in consumption and changes in the consumption structure. Between 1978 and 1989 the total value of retail sales in rural areas of China grew by 463.61 percent. The annual growth rate of the consumption level of rural residents was even 8.3 percent higher than that for urban residents.

The growth of farmers' income since 1978 has enabled them to enter the consumption goods market. Rural growing demand stimulated the growth of TVPEs that manufacture consumer goods or provide services, thus creating a new source of income for rural residents and further spurring their demand again. Rapid production increase in TVPEs that produce consumer goods also stimulated the development of firms that manufacture investment goods and further increased rural income as well. While creating income for the rural population, TVPE industry was building up an ever wider market for itself. These chain effects have become more and more conspicuous since 1984.

Chapter 4 Decentralization: The Macro-economic

Structures for the Development of the TVPEs

China's planning and supply system differs from those in other socialist countries in several ways. First, the scope of Chinese central planning is limited. Local rather than central authorities control the production of many key materials. It results in a number of separate planning and allocation subsystems. Second, an increasing proportion of China's industrial output is allocated through the local governments rather than the central plan. Meanwhile, enterprises are often allowed (or forced) to sell some of their products on the market. Third, the proportion of extrabudgetary funds is growing dramatically during the past decade. And the fourth, multiple channels of supply give rise to multiple prices for the same product. This is one of the most unusual features of the Chinese system which reinforced the characteristic of bargaining economy. However, the discretionary power is not decentralized into the individual enterprises directly. Sometimes there are "leakages" through that process - local governments rather than the enterprises gain more power.

The Decentralization of Material Allocation

In the 1950s, as part of its planning model, China adopted the Soviet material-allocation system. Under this system, production materials are divided into three categories. Category I comprises the widely used, key materials under direct allocation by the State Planning Commission. Specialized key materials under Category II are allocated by central industrial ministries responsible for their productions. These two categories, along with manufactured consumer goods allocated by the Ministry of Commerce, constitute the centrally planned industrial

productions. Category III goods include less important goods that are subject to allocated by local governments (Tidrick, 1987, p.176).

China allocated fewer goods centrally than the former U.S.S.R. In 1981, there were 837 category I and II products in China, compared with about 65,000 in the U.S.S.R. Some of this difference was due to the broader categories that Chinese used. However, although Soviet and China might cover similar proportions of industrial outputs, without any doubt, Soviet planning was much more detailed and correspondingly comprehensive and complex than Chinese.

In fact, the scope of Chinese central planning is even narrower because not all goods in Category I and II were entirely controlled by the central government. In general, materials flowed downward to production enterprises according to their level of administration. Therefore, although Category I and II are supposed to be allocated by central government, they are in fact distributed by different level of local authorities.

The first round of decentralization came with the rash "Great Leap Forward" movement in 1958. It was dramatic but rather brief: 87 percent of the enterprises were decentralized to local (mostly provincial) control. More importantly, since its extremely ambitious but scattered programs of development, the system was changed from unified allocation at the national level to coordination at the provincial level (Wong, 1985, pp.257-59).

During the Cultural Revolution period (1966-1976), the dismantling of the planning apparatus and attacks on bureaucracy and "economisim" further weakened central planning. The disruption of planning work was extremely serious during the Cultural Revolution. Because of political struggles in the State Planning Commission, annual plans were not even formulated for 1967 and 1968. In June 1970, nine central government

control agencies were merged into the "State Planning Revolutionary Committee" which had 610 staff members, only 11.6 percent of the staffing level of the original separate agencies (Deng *et al.*, 1984, p.131).

Furthermore, in accordance with the policy of self-reliance and self-sufficiency, the central government had to make a number of concessions in the material allocation system to encourage local investment which put control over very substantial amounts of resources into local hands. This policy of self-reliant industrialization at the local level had a fundamental impact in China's economic system. By the end of the Cultural Revolution, the Chinese economy was very much decentralized. With the balance between center and localities, the power has shifted significantly toward the latter.

Because ownership or administrative control of enterprises normally confers the right to allocate their outputs, local governments, for example, allocated the following shares of category I products in 1980: coal, 46 percent; steel, 42 percent; nonferrous metals, 36 percent; lumber, 18 percent, and cement, 71 percent (Tidrick, 1987, p.176). China thus deviates markedly from the ideal central planning model in which all productions in categories I and II are under central control and outputs would allocated in blocks to local governments for distribution to their categories III producers.

Increasing use of the market has also narrowed the scope of central planning in China. Beginning with the period of adjustment and reform in late 1970s, many products originally subject to central allocation were allocated through market sales by enterprises (self-marketing). This is partly the first step toward the market reform and partly a practical response to the imbalance of supply-demand after adjustment policies

which slowed the growth of heavy industry and expanded investment in light industry.

The Growth of the Extrabudgetary Funds

China's highly centralized public finance system dates back to 1950. In March of that year the Central Committee issued two resolutions containing detailed regulations for the state financial management system. Except for some local taxes and a few small income items that could be retained by local governments to offset certain expenditures, all income was concentrated in the hands of the central governments. Similarly, all outlays (except local supplementary expenditures) were included in the state budget. In subsequent years this "uniform income and outlay" system underwent several changes, but it was not until 1980 when China began to break away from overcentralization and excessively strict control and to off more financial autonomy to local governments.

Even under the centralized system, some local governments funds were mobilized and utilized outside the state budgetary controls. At first these extrabudgetary funds included only a few items and were very small. Some townships, villages, and departments of local government tried to use their own production and business operations to help finance rural education, cultural activities, administrative expenditures, and the like.

In 1953 extrabudgetary funds in China as a whole were equivalent to only 4 percent of the state budget, but the figure climbed to 8.5 percent in 1957 and to 20.6 percent in 1960. Readjustments by the state caused the figure to drop to 14.5 percent by 1966, but it then rose again and reached 31.0 percent in 1978. As economic reforms and decentralization of authority took hold,

the figure jumped to 59.1 percent in 1981, 83.3 percent in 1985, and 89.7 percent in the end of 1987.

The Bargaining Economy

The primary objective of the economic reform in China is to "break the habit of enterprises eating from the 'big rice pot'." According to the economics of shortage developed by Janos Kornai, socialism is, in its "classical" form, a resource-constrained system (Kornai, 1979). It is the bottlenecks of production and not the buyers' demands that delimit production. If one of the resources proved to be a bottleneck momentarily, other resources will be idle at the workshop. There is shortage of the resource presenting the bottleneck, and slack of the complementary resources. Therefore, shortage and slack are not mutually exclusive phenomena, considering the whole of production and a long period, but are necessarily concomitant.

This shortage phenomenon occurred in the socialist countries was caused primarily by a particular kind of collective working attitude by which since the rewards have nothing to do with the efforts, the workers doesn't care how to use resources efficiently. Therefore there is no financial discipline at all. This is about whether a firm's budget constraint is "hard" or "soft". The budget constraint is "harder" if the growth of the firm depends on its own financial position. And the budget constraint is "softer" if the growth of the firm is not tied to its present and future financial situation. In the latter case there is no failure; the firm survives even when investment entails grave losses. It is because the losses are almost automatically compensated by the state since its paternalistic role of the state under socialism. Therefore the firm's demand becomes almost insatiable and the resultant inflationary pressure generated by this uncontrollable expansion drive have

necessitated administrative interventions. With this political guarantee, whether the firm performs good or not is not important any more. This formulates a vicious circle of shortage (Wong, 1986) --so long as shortage persisted, exercise of financial discipline was unlikely, and so long as enterprise operated in the absence of a hard constraint, autonomous mechanisms were in gear to drive the economy toward shortage.

Furthermore, compared to other socialist countries, plans in China are often ill-defined, with slack or negotiable targets. Under the origin economic system, plan targets are the subject of protracted negotiation. Unlike the former U.S.S.R., Chinese output targets are generally set below the production capacity. Chinese enterprises have considerable room for maneuver.

On the one hand, because the enterprise has no objectives of its own and only passively completes those set by the state, it often adopts two methods to complete the ordered assignment easily: first, it conceals its production capability from the state or underreports it. And second, it asks the state for more inputs. As a result, either the state-set goals are met, but with added inputs, or the higher goals that originally could have been met now cannot be.

On the other hand, in China, with the introducing of self-marketing policy, enterprises may be given production targets with no guarantee that their outputs will be allocated through plan. And materials supplied through plan allocation may fall far short. Therefore, although Chinese production output targets may be taut with respect to material allocations, the supply channels outside the central plan usually enables enterprises to obtain enough supplies to meet their targets (Tidrick, 1987).

Furthermore, enterprises know that in the end they can always change unreasonable targets. Such targets have been changed even in the last week of December. Sometimes, they have been eliminated altogether. However, bargaining over plan targets is not completely one-sided. Targets may also be raised in the last few days of the year, usually to offset a shortfall by another enterprise. In such a case, the enterprise understands that it is doing its superiors organization a favor to be reciprocated in the future (Tidrick, 1987, p.183).

After 1979, according to the policies of reducing the scope of administrative control, devolving decision-making authority to lower-level units and improving incentives of enterprises, the number of plan targets handed down has been reduced further. However, the rate of "profit remittance", which is a device to link bonuses and workers' welfare expenditures to enterprises profitability, remained highly negotiable. This was culminated in the "profit-contracting system", where "contracts" were set each enterprises through annual negotiation (Wong, 1986).

Multichannel Allocation and Multitiered Prices Structure

Enterprises in China are able and forced to obtain such goods as steel and coal through channels other than central allocation. These other channels are fed from two sources--the production of local enterprises outside the central system, and the self-marketed outputs of state enterprises within the system. Obviously the importance of these two channels is getting more and more significant.

Multiple pricing is an inherent feature of the multiple sources of supply. For most key producer goods, there are several prices (usually in ascending order): the centrally controlled allocation price, the floating price for self-

marketed outputs, the locally controlled allocation price, and the negotiated price in markets of various localities. Thus the prices of the final products are also negotiable because the proportion of inputs that an enterprise buys at each price is flexible to some extent.

It is clear that, as low-priority claimants in the hierarchical system of material allocations, local enterprises faced serious shortfalls in meeting production requirements and had to turn to market channels for much of their supplies with higher prices. Meanwhile, because most of their outputs were not included into the state allocation plan, these local enterprises had to sell their products on the market with higher prices.

The result is an "abnormal" situation where "whatever is under state control is sold at unified state allocation prices, which are fairly low, and whatever is not state-controlled is inferior but sold at high prices." (Wong, 1985). When supply exceeds demand and prices are falling, small plants are cutting prices to compete, while large state plants operating with fixed state prices again find their hands tied. Therefore, high-cost production by small, inefficient outside-plan production will be more profitable.

As a result, multiple prices create a strong incentive to divert goods from low-priced state allocations to higher-priced market sales. This will leave a rather large room for the enterprises of corruption or other forms of behavior that may discredit reforms or harm long-term development.

However, multiple pricing is a first step to full market allocation. First, the higher market prices will provide an incentive for the enterprises to respond to the demand-supply situation as soon as possible. On the other hand, this system also provides a more competitive environment for the state enterprises to enhance their efficiency. It also enables enterprises that

have failed to obtain enough materials because of mistakes in allocation to buy critical inputs although with higher costs.

In summary, with the demise of the central control and the growing of the extrabudgetary funds, the fundamental qualifications for market transaction were initiated. The lower the level of administrative hierarchy, the weaker the influences of the central government and the smaller the weight of the plan budget in their operation. Meanwhile, the more autonomous the local governments and enterprises enjoy, the more pressure they feel about the profits and losses, and much the "harder" budgetary constraint they have to deal with. That is, a majority of local enterprises have to sell their products in a buyers' market but face a sellers' market for the raw and semifinished materials they want to buy (Zhang and Zhang, 1987). This is a major feature of the environment of the macroeconomic structure for the development of the TVPEs.

The Leakage of Decentralization

For the reform planners, the problem faced in China was how to decentralize and give greater autonomy to microeconomic units for responding the objective economic situations immediately while retaining essential political control and ensuring that social and ideological constraints are not violated. However, given the multiple levels of decision-making, decentralization is a complex process that can generate a number of possible outcomes. A reduction in the scope of central planning does not necessarily mean a shift to market allocation⁸.

⁸See Wong (1987).

Defining decentralization as a shift of decision-making power from the top toward the bottom, with "+" indicating gains and "-" indicating losses, Wong enumerate five different outcomes in a three-level economy as follows:

Table 3 Leakage of the Decentralization

	1	2	3	4	5
Central units	-	-	-	-	-
Intermediate units (Local government)	-		+	+	+
Primary units (Enterprises)	+	+	+		-

Source: Wong, (1987), pp.95-96.

In the best case (type 1), decision-making power is transferred from both the central and local governments to the enterprises. In the worst case (type 5), "positive intermediation" occurs, where the intermediate units of governments gain at the expense of both the central government and the enterprises. Between the best and worst cases are scenarios where "leakage" occurs, with local governments usurping some or all of the decision-making power passed down by the central government (types 3 and 4).

Previous decentralizations of the Chinese economy (especially during 1958 and 1970) were of type 4 ("administrative decentralization"). While post-Mao reforms have broken decisively from that tradition by transferring much greater decision-making power to enterprises, there has also been a good deal of "leakage" to the intermediate units. In fact, Wong argued that decentralization through 1983 was closer to type 5 than type 1. In the more recent period, market pressures have eroded local control in some respects,

but much remains to be done to ensure that reforms continue to make progress toward the objective of increasing enterprise autonomy. However, decentralizing reforms, which originally aimed to sever the particularistic ties that bound enterprises to administrative units and to break down the barriers to resource flows, have had the paradoxical effect of strengthening the ties between enterprises and local authorities.

The community governments not only have all the administrative functions, but also have some actual autonomy and represent to a great extent the common interests of their community members. They are thus akin in many ways to nation-states, albeit tiny in size. But they differ in one fundamental point from national governments that their financial means for functioning are virtually limited. One of their main economic policy instruments is to establish and develop community enterprises.

Chapter 5 Cellularity: The Local-Community Structure for the Development of the TVPEs

There are two local structural conditions for the development of the TVPEs should be noticed: their ownership structures and their cellular community characteristics. These significant features are, on the one hand, the consequences of certain historical legacies and local policies before, and, more importantly, they are the conditions of the effects for the implementation of further reform policies in the future on the other hand.

Behind the Hierarchical Collective Ownership

In general, there are three broad categories of TVPEs: community enterprises, partnerships, and individual proprietorships. The former two are defined as collective enterprises by the government. According to Marxist analyses of capitalism, the contradiction between the effective socialization of production on the one hand and private ownership on the other was the most general and fundamental contradiction of the capitalist mode of production. Therefore, the collective sector was seen as a transitional form from originally private to finally state ownership⁹

The direction of policies in China from 1949 to 1978 was consistent with this approach. However, since 1978, there has been a shift in thinking to the extent that many economists and policy-makers no longer see the collective sector as just transitional, but as an enduring form with distinct advantages in certain areas of the economy. They justified collective ownership as a component of public ownership system which is the essence of the socialist mode of production. To develop TVCEs was even considered

⁹See Lockett (1988)

as a mean to consolidate and advance public ownership and further to realize socialism in China. Ironically, from the standpoints of many "capitalist economists", the operation of community enterprises system was seen as an important concession to market economy, and proved that the capitalist economy is somewhat superior to the socialist economy. However, according to the official explanations, the existence of market was an acceptable part of socialism, and it did not equal to capitalism. These arguments partly came from the diverse "versions" of different socialist who used the same terms to implied different meaning, and partly reflected the government's efforts to ideologically justify some of its policy implementation.

In addition, the line between state ownership and collective ownership is also ambiguous. In China, theoretically, state enterprises belong to the whole people of the country, provincial enterprises belong to the whole people of the province, county enterprises belong to the the people of the county, and township enterprises belong to the members of the township. However, in fact, the enterprises (except private enterprises that mushroomed in recent years) belong to administrative structures at various levels. In this respect, there is no difference between state-owned and collective enterprises. Those TVCEs are essentially "ministate" enterprises, but the "state" to which they belong are community governments, which supervise the enterprises through their industrial corporations.

According to the official classification, the line between these two types of enterprises is set by where the funds come from. If the funds of the enterprises are supplied by the central government's budget, then those enterprises are defined as state-owned enterprises. If the funds are

collected by the local governments, no matter they are provincial, county, or township governments, those enterprises would be defined as collective enterprises. In general, the proportion of enterprises included in the central plan declines as moving down the administrative hierarchy. In other words, the lower the level of administration, the smaller the weight of state-owned sector. At the level of township, which is the lowest level of local administration, there is almost no enterprises received funds directly from central government, and all those owned by township governments will be collective enterprises.

Since each category of firms is attached to a unit in the administrative hierarchy which has a clearly defined rank, there is also a hierarchy of firms. The higher the grade of a firm, the more preferential treatment and resources it gets from the government and hence the stronger feeling of security it has. The lower the status of the enterprises, the more directly is the firms' profits linked to the performance of the firms and the "harder" the budget constraint they face. State enterprises and their employees enjoy the most privileges--preference in the allocation of material inputs and bank loans at low interest rates, lifetime employment, and so on. The collective enterprises are treated, in contrast with private enterprises, preferentially with respect to taxes, interest rates, and fiscal assistance.

However, The transfers and changes in enterprise ownership forms also occurred in recent years¹⁰. As a consequence of the production responsibility system, community enterprises in difficulty can now be sold or leased to private industrialist. Owners of private enterprises can also sell their enterprises or have them raised to community enterprise status. For

¹⁰See Luo (1990).

example, some local governments, especially those in the relatively backward areas, encouraged private industrialists to help start or manage firms that are nominally registered as township enterprises. Some successful private industrialists also felt pressure to abandon their ownership rights of their firms and let them become township enterprises (Luo, 1990, pp.162-64). By this process the local government could have a profitable community enterprise and increase the employment. For the employees, it could secure their jobs. And even for the owners themselves, they want their enterprises to be promoted to collective status partly because they believe they would not be able to maintain true ownership of the assets anyway and partly because the consequences of change in enterprise is advantageous for the founders and their families. For example, the founders may become government cadres, and their families are officially recognized as permanent urban residents and are able to enjoy many privileges not shared by rural residents. Similarly, a township enterprise may, through transfer of its assets to the state, have its status raised to that of a state enterprise operating under higher level of authorities. Under such circumstance the status of enterprise workers will be raised correspondingly. However, the ownership of a TVCE cannot be transferred to another government of the same rank because workers of all enterprise are residents of the same township or village and therefore cannot be transferred.

In addition, a host of enterprises jointly run by township or village governments and private industrialists has emerged recently. The establishment of these joint public-private enterprises was motivated by a common desire for mutual benefit based on contracts of equality rather than on responses to political pressures. This is an event of tremendous

importance in China's rural industrialization. In certain areas, some private industrialists have even established joint operations with state-owned enterprises. This tendency of joint ventures among different type of ownership are expected to be more prevailing in the near future. The ideological insistence of ownership thus will be less and less important.

Cellular Structure of the Rural Community

The most important traditional characteristic of China's rural communities is their "parcelized" and "close" structure. It was G. William Skinner's important early work on traditional Chinese marketing system that had first given currency to the idea of a cellular pattern of organization of the rural periphery¹¹. Skinner had used this insight to emphasize not the discreteness of the rural cells he sketched, but rather the means of their linkage into quite far-flung networks, which, through commerce and social intercourse, brought about an integration between urban and rural socioeconomy before the revolution.

Audrey Donnithorne (1972) later revived the concept of cellularity to characterize what she saw as the relative fragmentation of the Chinese economy in the wake of the Cultural Revolution's attacks on the central party/state bureaucracies.

Shue (1988) further clarified and elaborated this notion of cellularity or parcelization of the peasant periphery. She plotted an argument that state penetration and control of rural society under Mao was more uneven and less complete than is often imagined by scholars. In the sphere of political and administrative integration, it appeared that the center's seemingly

¹¹See Skinner (1964; 1971).

deepest penetration of the periphery was in fact buffered through a crisscross network of horizontal and vertical offices that actually institutionalized, within the state structure, the segmentation of the rural periphery. And the very tension between center and locality continued to pervade Chinese society. In the sphere of economic integration, it appeared that the state center itself deliberately pursued policies strengthening the vertical segmentation of the periphery, finding in the ideal of self-reliant, comprehensive, but locally bounded economies, with the campaign slogan of "dividing the kitchen to cook and feed yourself", a possible way out of its awesome economic development dilemmas.

In 1958, the people's commune movement swept all over rural China. The economy and administration of a given area were put under a single organ, the commune, which was invented to fulfill all the functions of everyday lives such as production, distribution, and socialization. This utopian experiment did not make economic sense and eventually led to disastrous consequences. Between November 1961 and February 1962 the basic economic unit was degraded first from the commune to the brigade and then to the next lower level, the production team, which normally contained twenty to thirty households. This is to restore order in the economy while retaining the commune framework. Two aspects of this pattern of local governance worth pursuing¹². First, it saw a continued fusion of political authority, economic power, and social status within a small, highly integrated rural community. Second, it permitted only a very localized sphere of influence and authority to be exercised by any individual of rural elites. This parcelized but complete pattern of local governance is

¹²See Shue (1988), p.114.

the basic feature of the cellular structure of rural community during Mao's era¹³.

Recent reforms have changed this system somewhat by restoring the township as the lowest level of government in rural areas and by allowing much greater scope for economic activities and for the accumulation of assets by private individuals. However, local community retain their cohesiveness and have a significant role in the local economy. It was partly the legacy of the commune system, and partly was the result of the incapability of the central government to control the resources in the local areas.

This structure are also manifested in and reinforced by the financial relationship of the township. The revenue of township governments falls into two categories. Budgetary revenue, which are allocated by the next higher level government, belongs to the government fiscal system and is generally used for specified purposes such as salaries of state employees, administrative expenditures, and operating expenses. Extrabudgetary revenue, which is generated by the business operations and other activities of township governments included supplementary industrial and commercial taxes, supplementary agricultural allowed by the central government, and so on, is at the disposal of the township governments. As the state budget can only provide subsistence to township governments,

¹³Shue further traced back to the local social and economic context in the imperial China to make an insightful contrast between the old Chinese gentry and the contemporary rural cadres. From their structural similarities, Shue suggested that the traditional features of segmental but self-sustained rural community had been remained and reinstitutionalized as a cellular pattern in a different form to fulfill the similar functions, that is, to extract agricultural surplus and to maintain the political and social order. See Shue (1988), pp.73-121.

extrabudgetary revenue becomes the guarantee for their effective functioning.

During the people's commune period and even earlier, the community government collected funds locally for the central government. In return, the central government allocated budgetary funds to community government through a top-to-bottom process. In this sense the township government could not be regarded as having independent finances and budget. But as a grass-roots organ of state power, if it did not have some discretionary resources at its disposal, it could not function effectively. So, during the prereform period the township government always tried to control some resources for meeting local needs, and it used them for exchanges with lower-level communities -- brigades and production teams. This kind of exchange brought the township government some financial income outside the state budgetary system. But this primitive financial relationship could hardly meet the needs of ambitious township governments, which strove to organize production themselves or to control some profitable entities. Rural industrialization was considered the best choice to achieve that goal.

When agricultural property was dispersed under the production responsibility system, most township governments experienced a short-term "anemia" in their extrabudgetary finances (Song and Du, 1990). Therefore, they did not use the same principle to their subordinate industrial assets which was operated in the form of commune and brigade enterprises. On the contrary, they encouraged their development under the base of community ownership. The share of commune and brigade enterprises in the assets of rural communities thus did not decrease but increased to varying degrees. One important consequence is the enlarging

proportion of industrial wealth in township property. Income from industrial production is thus the chief source of township revenue in most areas, and it is estimated that the income from agriculture only accounts for 19.1 percent on average of sample townships' extrabudgetary revenues (Song and Du, 1990, p.348). This was a critical turning point both for the rural industrialization and the relationship between the local governments and local enterprises. There began a funds self-support circulation -- township governments got revenues from township enterprises and then reinvest in those enterprises. According to a sample survey conducted by World Bank, direct and indirect investment by township governments accounted for more than 30 percent of the startup funds for township enterprises. And the profits handed over by township enterprises constituted more than 38 percent of township government revenues (Song and Du, 1990, p.349). The community enterprises have become a indispensable part of local financial structure. Meanwhile, it also facilitate to achieve to goal of financial self-reliant and independence.

The strict residential regulation system also has had an obvious effect to prevent large-scale rural-rural or rural-urban migration for further strengthening this structure. After 1988, the government began to relax the strict controls over residential change. Those peasants who could provide their own staples and who could prove that they had resources to establish an enterprise, could gain permission to move to towns, especially at the areas where the government can not handle the surplus laborers floating out of the agricultural sector. As a result, many individuals shifted to towns and cities to start up individual enterprise. The organized recruitment of workers from the villages by enterprises located in the urban areas was also occurred (Wu and Xu, 1990). However, mainly because the

close financial relationship between local governments and their community enterprises, the government, especially at the level of township government, will do as much as possible to reserve all the resources, including the human resources, for the development of their own community enterprises. In the previous years of the reforms, local protectionism flourished in some places. To protect their backward industries, some regions have blocked the inflow of products from other regions. Certain raw materials (such as tobacco) of a given region must first be used by enterprises in that region, with restrictions on their transfer to other regions, and so on.

In theory, if the productive resources are still impeded by local governments, the areas with more resources, which included better geographical position, longer experiences of industrial development, more natural and human resources, and even more technological and market information, the rural industrialization will be much successful. Those areas without such advantages of resources thus will develop much slower. The regional imbalance will be worse.

However, the mushrooming of private enterprises in local areas since 1984 has had a positive impact on the regional structure of China's TVPE sector and has begun to contribute toward reducing regional imbalances in the development of TVPEs (Lin, 1990; Wang, T., 1990). For those economically backward areas, although the proportions of TVCE employment and gross revenues in the whole TVPE sector dwindled, those of all TVPEs expanded since the prosperous growth of private enterprises.

In the ideal model, production responsibility and material allocation are hierarchical. In China, there is a contrasting cellular model of separate, almost self-contained industrial systems at several levels (Tidrick, 1987,

pp.176-77). Therefore the Chinese system is a amalgam of hierarchical planning, cellular planning, and markets. Both the hierarchical and cellular models have a build-in tendency toward autarky. In the hierarchical system, ministries strives for self-sufficiency. In the cellular system, each geographical planning unit tries to be self-contained. Ministerial self-sufficiency, or departmentalism, is a feature of most socialist economies, but regionalism to this degree appears to be a distinctive Chinese phenomenon.

Chapter 6 Role of Local Government: The Formation of Quasi-Planning System

These decentralized and cellular conditions gave birth to China's mode of rural industrialization: "leaving the land but not the village, entering the factory but not the city." TVPEs have not yet completed the split from farming and as a result they keep in close contact with the traditional rural social framework -- the community. Most TVPE workers still maintain the right to own and control land. Many are still engaged part-time in agricultural production. This incomplete shift of farmers to nonagricultural activities is characteristic of China's rural industrialization. Industrialization has moved ahead while urbanization has lagged behind. The newly created industrial organizations are still clinging to traditional agricultural structures.

The Contradictions in the TVPE Organizations

There exist deep-rooted contradictions in the organizational structure and the ownership systems of TVPEs. First, since the system of community ownership inherently inhibits the flow of labor and capital, communities or regions with full employment will ignore the opportunity cost for the whole society and turn to capital-intensive investments, high social welfare, and high consumption, thus reducing the efficiency of capital utilization and making a fair distribution of income impossible in the national sense. The standard of living enjoyed by people in some of the townships and villages has approached or even exceeded that of local urban residents. This may contribute to fair distribution of income within these areas, but it means a greater inequality between them and rural regions that lack opportunities for industrial development. Large investments in scattered public facilities

and infrastructure also reduce the potential economic benefits from urbanization and concentration.

Under the status stratification system of TVPEs, many leaders of grass-roots units work as government officials and simultaneously represent the owners of community enterprises. This combination of two roles in one person inevitably gives rise to serious political and economic interference. Political pressure from the top often causes encroachment on economic interests, which can lead to distortions of economic information, gross violations of law and discipline, and widespread corruption.

The dependence of TVPEs on administrative organs and on administrative protection of their interests and property rights also hampers gravely the optimal development of their organizational structure and makes it difficult to use organizational and technical innovations to benefit from the expanded local economy and specialized production. Many enterprises in recent years have been criticized for pursuing short-term interest and taking advantage of loopholes in the system. Instead of striving to raise productivity and lower costs in order to increase profits, many enterprises resort to raising prices, lowering the quality of products, and engaging in speculative trading, black marketeering, and even fraudulent practices. Many enterprises also fail to fulfill their sales contracts with the state in order to sell more in the free market or in the black market at higher prices. In addition, as Walder (1987, pp.33-36) observed that some enterprises distribute all their profits indiscriminately as bonuses to the workers, thereby fueling 'bonus inflation' while disregarding the need for accumulation and reserve funds.

Meanwhile, the dispersed regional development pattern will lead to a shortage of working capital and irrational distribution of industries, and

TVPEs in general will suffer the consequences of being uncompetitive and uneconomically small in scale as long as the local governments still tried to impede the flow of factors of production. It will further constitute the source of investment failures and of destructive and excessive competition.

Some observers thus argued that the TVPE development, as a realistic path to restructuring the rural production and transferring surplus agricultural labor to nonagricultural activities, is only one phase in the process of rural industrialization and is linked to particular historical conditions. From a long-term perspective, especially based upon the assumptions of neo-classical economics, with the deepening of economic reforms in urban and rural areas, a generalized market for factors of production will emerge, and TVPEs will be included in the modern economic system on the basis of an organized, rapid growth of urbanization. And with the rapid development of TVPEs, the administrative interference will affects those enterprises adversely. Therefore, the township governments should cut down their management and control of local township enterprises.

The Formation of Quasi-Planning System at Local Level

However, as Byrd and Zhu (1990, p.105) has suggested that the relevant unit in the TVPE sector is the township or village rather than the enterprise. The most basic organizational characteristic of TVPEs is their dependence on the rural community, as reflected in the deep involvement of community governments in enterprise management. For quite a long time it will be necessary for the local governments to involve and control, directly or indirectly, the operations of some enterprises and to realize community goals through concerted efforts with enterprises.

In the process of rural industrialization the township government took on twofold role. On the one hand, they are essentially ministates that provide a whole range of public and social services and set policies and regulations within their jurisdictions. The instruments available include the establishment and ownership of TVCEs, decisions of community government expenditures, a considerable degree of influence over the lending decisions of the local banking system, and the encouragement as well as support of different types of private enterprises. However, they cannot engage directly in deficit financing. That is, their expenditures may not exceed available funds (which include transfers from higher levels of government and from TVPE as well as the portion of locally collected taxes allotted to them). Hence, they face a relatively hard budget constraint.

On the other hand, they are also profit-oriented economic entities that might compared with holding companies, investment corporations, or headquarters of loosely controlled multidivisional corporations. They tend to be intimately involved in decisions on important investments, the establishment or dismantling of firms, significant changes in product lines, the appointment of enterprise management, managerial compensation, and bonuses.

This organizational structure, along with the increased funds at the disposal of community governments and the weakening of central controls have created a foundation for the establishment of local protective quasi-planning system. These systems provide benefits for enterprises, particularly those established by community governments, so that they can be counted on to turn over taxes, fee, and profits. In a sense that the quasi-planning system operates like a traditional planning system except their size. It tries to infiltrate every link in the operations of the enterprise, from

personnel, finances, and materials to production, supply, and marketing. But community governments can no longer impose inflexible administrative restraints on enterprises as before. The extent to which they can control or support local enterprises is limited by their own capabilities. Regulations enforced by community government's quasi-planning is effective only where the administrative system is highly developed or where the community government is skillful in organizing the economic activities. The administrative capabilities of township governments vary greatly, and so does the effects of their quasi-planning system.

In a macroenvironment where supplies of and demand for inputs and energy are not balanced, community governments' desire for goods and materials is a clear indication of their concern for the development of their enterprises. In recent years the materials supply departments of city and county governments have often obtained needed inputs through exchange. The materials bureau of Wuxi County is outstanding in this regard. Of the materials sold through the purchase and sales companies of the bureau in 1985, only 5 percent were from the state planning system (Song,1990, p.398). The rest were obtained by exchanging materials with or investing in units that produce goods in short supply, such as steel and electricity. Although raw materials obtained through exchange or investment are more expensive than those assigned by the state plan, the costs are still lower than buying on the market, and the supply is more regular. Therefore firms under various forms of ownership try their best to be admitted into the quasi-planning system.

It is almost impossible for the township governments to get inputs from the central planning system, but they can obtain some materials through their subordinate departments (industrial companies or administrative

offices for TVPE administration), through multilatera exchanges or investments, or even through personal relationships. In addition, township governments can obtain from the county materials department medium-price raw materials -- inputs priced between the market price and the state plan price.

The supply of favorably priced inputs by community governments to subordinate firms is a mean of compensating for overtaxation and creating a more favorable environment for them. But community governments need additional control measures if they want their enterprises to keep bringing in revenues and at the same time to have good prospects for development. The allocation of workers and appointment of managers gives local officials substantial leverage for influencing enterprise behavior. In addition, in the absence of national capital markets, the local governments continue to exercise significant control over the allocation of investment finance. Fiscal decentralization has transferred the funds collected from enterprise profits and taxes to local coffers. During 1979 to 1984, profit retention rates were set at low levels of the bureaucracy, and the rates were subject to negotiation between enterprises and their supervisory agencies. Under this system, the welfares of workers and managers were determined by how much profits the enterprise retained. And these welfares became very much dependent on the goodwill of local officials who held the authority to set profit-retention rates for the enterprises.

Beyond setting the retention rates, local officials had a good deal of control over the level of after-tax profits through their price and tax-setting authority. In order to allow small-scale, local enterprises to cover costs, which were always higher because their inputs were procured at higher (market) prices, local governments were allowed to set higher "temporary"

prices for local products. And since the growing gap between market and state prices during the first phase of reform, the price-setting authority of local governments is increasingly significant.

While the rates for both income and industrial-commercial taxes were standardized nationwide, local governments in fact had substantial power to change them. When an enterprise ran into financial difficulties, it could turn to tax authorities for help, by asking for temporary tax reductions or even exemptions.

Aside from the profits and taxes control mechanisms, local officials also continue to exert substantial influence over bank lending, since the regional structure of the banking system placed bank officials at the mercy of local officials. In general, township governments take the view that local bank funds form part of the community capital base, and they participate in important lending decisions. One example is that the township banking system are not allowed to lend money freely to enterprises outside the township

With local governments continuing to exercise control through these informal mechanisms, economic reforms in the post-Mao period have left enterprises with a "dual dependence." (Wong, 1987) Not only are enterprises forced to be more responsive to market pressures, they also remain highly dependant on the administrative bureaucracy to provide vital support.

However, the contradictions are getting more and more evident. First, the market represented by a single township or even a single county is far too small to serve most manufacturing firms adequately, and restrictions against "imports" or other trade barriers are difficult to enforce. Second, community governments have limited financial resources and face a hard

budget constraint. TVPEs may be able to draw on community resources to cushion the short-term impact of adverse changes, but this cannot continue very long. Third, community governments with a significant number of firms are typically in charge of a "conglomerate" of different activities and lines of business, even though two or three of them may account for much of total outputs. The asset specificity of these firms is low -- that is the capital assets can easily be switched to production of other goods. This has given the enterprises great flexibility and allowed them to leave stagnating or declining activities and move rapidly into the most profitable activities. However, with the rapid growth of the TVPEs, they have become involved in industries with higher asset specificity. If asset specificity indeed increases, it will become more difficult for TVPEs to engage in their old method of adjustment. Other ways of adjusting to adversity will have to be relied on to a greater extent, or the flexibility, efficiency, and profitability of the TVPE sector will suffer. In this regard, capital intensification, technological improvement, and acquisition of market information will become greater and greater important.

Without any doubt, the Chinese rural communities are no long as isolated cells as it was in the prereform period. A great amount of small towns is emerging and prosperous as the centers of TVPEs on the one hand, and as the mediations between the big cities and the villages in their wide vicinities on the other.

Most liberal economists always considered the governmental interferences as the very sources of the failure of the economy. The economic reforms everywhere in the socialist countries in this decade as reflected in the steps of marketization and deregulation seem to support their arguments. However, in practice, the government support and the

market mechanism sometimes can function very well simultaneously under certain historical circumstances. The successful developments of Japan, South Korea, and Taiwan give us good examples about that. In fact, contracts, property rights, commercial law, and the whole sphere of privileges, rights, and freedoms relating to merchants are still relatively absent in recent China, while these, in the modern or Western sense, are the basis of market predictability and continuity. Under these circumstances, together with the incomplete function of factor market, government's activities did not impede the flow of resources, but rather were very conditions of its circulation and predictability.

It is easy to criticize the system of Chinese TVPEs as backward by making a simple comparison with the organization and property rights of enterprises in Western societies. But China's unique cultural traditions, as well as its specific societal conditions, are the legacy of its history. China has no way out but to take these restrictions into account as it seeks the right path and tactics for its advance toward modernization. Actually, so far, taking its East-Asian neighbors as its model for development seems to be a better choice than following the route of Western developed countries or its East Europe counterparts.

Conclusion – The Dilemma of "Dual Dependence"

Early reformers in socialist countries, including China, advocated to incorporate the market mechanism into central planning for more . The government will regulate the market mechanism by manipulating investment credits, amortization rates, depreciation allowances, interest rates, prices, wage structures, and other macroeconomic controls. For them, with the correct mix of plan and market, the market mechanism would not generate spontaneous economic processes but instead would serve as an instrument to reduce the transaction costs of central planning. In short, early reformers believed that the most efficient governance structure for socialist economic economies was a combination of market and central planning. However, in practice, it is very hard to define what the better combination between bureaucratic regulation and market allocation is, especially in a concrete economic unit -- the enterprise.

According to the experience of Hungarian reform process, Kornai (1989, pp.32-94) criticized this extreme confidence in the harmonious, mutually correcting duality of plan and market. Instead, he suggested that partial reforms both perpetuated problems of the prereform economy and created new distortions and imbalances. The command economy was replaced by a hybrid economy operating in a condition of "dual dependence" (pp.40-44) in which the economy is coordinated by both vertical bureaucratic and horizontal market relationships. Kornai concludes from the Hungarian experience of partial reform the without a decisive shift from plan to a structure of market governance, there can be no escape from the dilemma of dual dependence.

Is this argument of partial reform by Kornai applicable for the Chinese economic reform, especially with respect to the close relationships between

local government and local enterprises? What is the characteristic of the "dual dependence " structure for the organization of the TVPEs?

The essence of dual dependence, however, is the continued dominance of hierarchical forms of coordination over the enterprises and the debilitation of the market mechanism by persistent and pervasive bureaucratic microinterventions. According to Kornai's analysis, despite giving a greater role to the market, if some of the critical decisions -- entry, exit, investment, prices and wages, output, credit -- still depend more on processes internal to the planning structure than the market, the problem of the soft budget constraint, shortage economy, and investment fever of the prereform socialist enterprises which based upon the paternalism will persist in the postreform economy.

With this respect, the dual dependence structures of the TVPEs in China are different. Since the decentralization of the resource allocation and the hierarchical status of enterprises, the lower the level of administrative hierarchy the enterprises attach, the weaker the influences of the central government on the enterprises and the smaller the wight of the plan budget in their operation. Meanwhile, the more autonomy the local governments and enterprises have, the more pressure they feel about their profits and losses, and much the "harder" budgetary constraint.they have to deal with. In Kornai's model, because paternalist role of the government, the enterprises will face a soft budget constraint. But in China, it is the local community as a whole -- including the local government and local enterprises -- to be a proper unit about budget constraint. The local enterprises really depend on the local government. And the local government really control the local enterprises to a great extent. But they as

a whole are conditioned in a rather harder budget constraint which made a significant difference with Kornai's analysis of socialist economy.

First, the capacity of local government to allocate resources is limited. Although protectionism has occurred in some places, local government, with its limited resources and small jurisdiction, can not guarantee the survival of all its community enterprises. The managers of the local enterprises as the quazi-officials are rather conditioned by the budget constraint and pushed to response it rationally.

Second, local enterprises are dependent on the local government in the sense that local government, representing the interest of the whole community, tries to obtain input materials and expand output market for its subordinate enterprises. Without any doubt, local government can coordinate the needs of most small-size local enterprises and have more access to outside resources than the local enterprise itself.

Third, local government itself also feels the pressure of market competition indirectly. Because the close financial relationship between local government and local enterprises, the profitability of the local enterprises will affect the revenue of the local government immediately.

Therefore, the dual dependence structure of the TVPEs in China is not only in the sense that the resources are allocated both by planning and market, but most importantly, the local government and local enterprises have to depend each other to survive and prosper in the severe "harder" budget conditions. If it is the case, this dual dependence, although still in the form of the interweaving of polity and economy, has indeed take an important step to break up the vicious circle of shortage economy.

Most liberal economists always considered the governmental interferences as the very sources of the failure of the economy. The

economic reforms everywhere in the socialist countries in this decade as reflected in the steps of marketization and deregulation seem to support their arguments. However, in practice, the government support and the market mechanism sometimes can function very well simultaneously under certain historical circumstances. The successful developments of Japan, South Korea, and Taiwan give us good examples about that. In fact, contracts, property rights, commercial law, and the whole sphere of privileges, rights, and freedoms relating to merchants are still relatively absent in recent China, while these, in the modern or Western sense, are the basis of market predictability and continuity. Under these circumstances, together with the incomplete function of factor market, government's activities did not impede the flow of resources, but rather were very conditions of its circulation and predictability.

From a long-term perspective, especially based upon the assumptions of neo-classical economics, some observers argued that with the deepening of economic reforms in urban and rural areas, a generalized market for factors of production will emerge, and TVPEs will be included in the modern economic system on the basis of an organized, rapid growth of urbanization. And with the rapid development of TVPEs, the administrative interference will affects those enterprises adversely. Therefore, the township governments should cut down their management and control of local township enterprises.

However, rural industrial development will, for a fairly long time to come, continue to be an essential part of China's rural development. Nevertheless, as the experience of many other countries shows, urbanization is a unavoidable and necessary process. A development strategy that pushes rural industrialization as an entire substitute for

urbanization might prove costly. In view of the difficulties that face TVPEs, it is necessary to consider how to speed up urbanization over the medium term. A new urbanization policy is needed as the precondition for reforming urban-rural relationships, the institutional system for urban and rural enterprises, and other systems.

It is impossible in the near future to pull down the barrier between urban and rural areas and effect a relatively free flow of population. Policy should therefore focus on improving the coordination and management of TVPEs. A pressing task is to set up new types of investment and monetary institutions instead of personal relationships to serve as efficient policy instruments and means of coordination. China, a big country with a rich cultural heritage, cannot indiscriminately copy the experiences of foreign countries. Designing and realizing the TVPE system of the future will require a fairly long period of experimentation.

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