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**UNIVERSITY OF CALIFORNIA**

**Los Angeles**

**The Political Economy of China's Reforms:  
National and Provincial Policies toward Non-State Industry**

**A dissertation submitted in partial satisfaction of the  
requirements for the degree Doctor of Philosophy  
in Political Science**

**by**

**Hongyi Harry Lai**

**2000**

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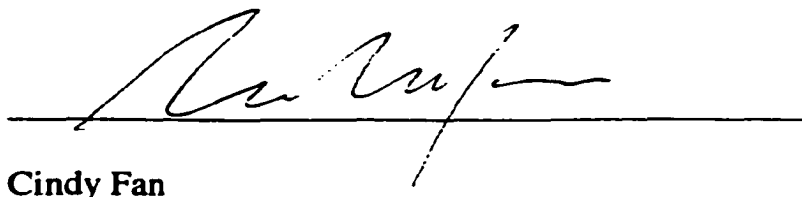
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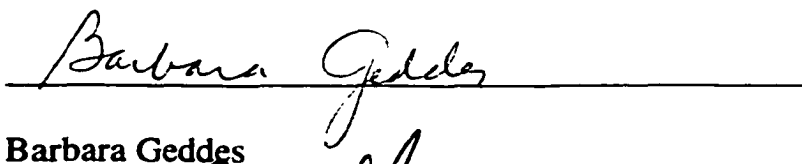
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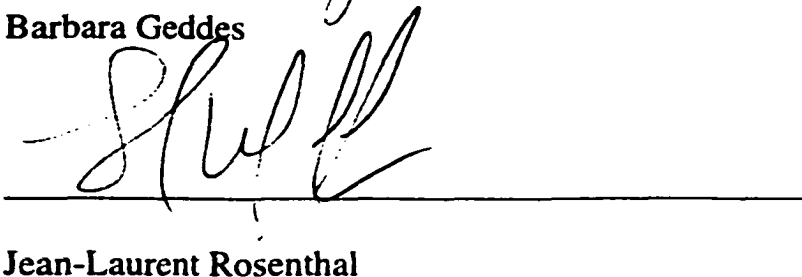
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2000

**To my father and mother, whose love has inspired me through  
these years**

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## **Acronyms and Abbreviations**

- AB-- Agricultural Bank, the bank for agriculture and rural enterprises since 1979**  
**BC-- Bank of China, lending and saving services in foreign currencies**  
**BICA— Bureau of Industrial and Commercial Administration**  
**BSLI-- Bureau of the Second Light Industry**  
**CBEs— Commune and Brigade Enterprises**  
**CCCCP— Central Committee of the Chinese Communist Party**  
**CCP-- Chinese Communist Party**  
**DSEs— Domestic non-state enterprises**  
**DNSI— Domestic non-state industry**  
**DNSS— Domestic non-state sector**  
**FDI--- Foreign direct investment**  
**FNSEs— Foreign non-state enterprises**  
**FNSI— Foreign non-state industry**  
**FNSS— Foreign non-state sector**  
**GDP— Gross domestic product**  
**GDDPPC-- Gross domestic product per capita**  
**GHC-- General Handicrafts Cooperative (*shougongye lianshe*), trade union of UCEs**  
**GNP— Gross national product**  
**ICB-- Industrial and Commercial Bank, the bank for industry and commerce and the cities since 1983**  
**IHEs— Individual household enterprises**  
**IHPEs— Individual household or private enterprises**  
**MLI-- Minister of Light Industry**  
**NPC-- National People's Congress (the legislature)**  
**NSEs— Non-state enterprises**  
**NSOI— Non-state-owned industry**  
**NSOS— Non-state-owned sector**  
**PBC-- People's Bank of China, China's central bank since 1983**  
**PCB-- People's Construction Bank, the bank for state construction projects since 1979**  
**PRC-- People's Republic of China, official name of mainland China**  
**RCCs-- Rural Credit Cooperatives (RCCs), a second lending and savings service in the countryside**  
**SEs-- State enterprises, the same as state-owned enterprises (SOEs)**  
**SEZ— Special Economic Zone**  
**SSB— State Statistical Bureau**  
**TVEs— Township or village-owned enterprises**  
**UCCs-- Urban Credit Cooperatives (UCCs), together with ICB, were the primary banking system for urban collective and private business**  
**UCEs-- Urban collective enterprises**  
**UCS-- Urban collective sector**

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When I started grappling with a quantitative study of the fascinating terrain of China's reforms, I had to search for an intellectual compass. With few signposts of statistical and political-economy works on Chinese reforms, my academic undertaking has been demanding and slow. To my satisfaction, I am able to identify unexplored puzzles, present an explanatory framework, test widely-applied assumptions, and shed some light on the origins of China's liberalization initiatives.

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- (forthcoming) "The Political Economy of China's Urban Reforms," in *Economic, Social and Legal Issues in China's Transition to a Market Economy*. Los Angeles: UCLA Center for International Business Education and the UCLA Center for East Asian Studies.
- (2000) "Reform in China's Provinces and the Sino-Soviet Comparison," presented at the Annual Meeting of American Political Science Association, Washington, D.C.
- (1999) "The Logic of Economic Liberalization: Opening China's Provinces to International Business, 1978-94," presented at the Annual Meeting of American Political Science Association, Atlanta.
- (1999) "Factor Endowments, Trade, and Growth of East Asia and Latin America, 1850- 1990", presented at the Annual Meeting of American Political Science Association, Atlanta.

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- (1999) *From Obscurity to Amazing Fame (Yiming Jingren)*. Beijing: Democracy and Construction Press, Beijing. A philosophical, methodical, and historical study of 1989 on fame.
- (1995) "Implications of Research on Constitutional Design for Future China". *The Chinese Intellectual (Zhishi Fenzi)*, Vol. 10 (Winter), No. 2, pp. 45-52.
- (1993) "Regional Patterns of Motion Sponsorship in China's National People's Congress," presented at the Annual Meeting of the Association for Asian Studies, Los Angeles.
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- (1988) "A Theory on Interests" (Liyi Lun). *Political and Administrative Sciences Newsletter (Zhengzhi yu Xingzhengxue Tongxun)*.

## **ABSTRACT OF THE DISSERTATION**

**The Political Economy of China's Reforms:  
National and Provincial Policies toward Non-State Industry**

by

**Hongyi Harry Lai**

**Doctor of Philosophy in Political Science**

**University of California, Los Angeles, 2000**

**Professor Ronald Rogowski, Chair**

The extent and timing of economic reforms differed markedly across China's provinces between 1978 and 1994. The national government pushed reforms hard in some provinces, hardly at all in others; and provincial governments varied considerably in their eagerness to embrace reforms. What explain these variations? Politics emerges, at both levels, as far more important than economic efficiency. The need to garner support from urban and rural consumers, I argue, drove national reform policies, and interest group strength (i.e., the size and clout of state versus non-state sectors) shaped provincial policies. This conclusion on the dualism of China's reform politics is reached by running



time-series and cross sectional regression tests on indicators of efficiency, revenue, political-support, and interest-group strength.

The national government, I suggest, was responsible for the performance of the regime. It adopted reforms primarily to regain the popular support eroded by Mao's traumatic politics and secondarily to generate economic growth. The provincial leaders were appointed by the national leaders and thus had no need to worry about popular support. Instead, industrial sectors that were well represented by the provincial governmental agencies could influence the provinces' reform policies. Politics and institutions shaped Chinese economic reforms.

Empirical studies of national and provincial reform policies between 1978 and 1998 buttress the above statistical findings. An empirical examination of the cycles of national reform and retraction indicates that reformist and conservative national leaders competed for meeting popular demands for growth versus low inflation, setting off boom and bust in reforms. A comparison of the reforms in two provinces reveals that the clout of non-state relative to the state sectors, economic structure, governmental efficiency, ideology, and geography led the provincial authority down the divergent reform paths. In addition, empirical studies highlight the role of institutional setup in shaping national and provincial policies.

Data analyses indicate that citizens in the ex-communist economies rate the performance of the governments in terms of economic performance. In this sense, by delivering the population economic windfalls through reforms, the Chinese Communists

have legitimized their monopoly of power. The dissertation also reviews the reforms for China since 1994 as well as the challenges ahead.

# **Chapter One: Reforms in the Transitional Economies**

## **1. The Debate on Economic Reforms**

This study sets out to explore the causes of reforms by testing major political economy theories in the inter-provincial differences in China's economic reforms between 1978 and 1994. I choose 1994 as the end year for statistical studies for a good reason: In the period of 1978-1994, as to be discussed in Chapters Two and Six, economy was largely decentralized, and provincial authorities exerted extensive influence over local economy. Nevertheless, I also examine reform policies in the years following 1994 in my dissertation. At the outset of this project, I will review the contending political economy arguments on reforms and China's liberalization, discuss my rationale for the research, and review the literature on economic policies.

Why does government undertake economic reforms? The conventional answer is to improve efficiency. Scholars, especially economists, argue that the government needs to reconstruct the economy if it wants to remove existing economic impediments and improve productivity (Prybyla 1990; Klaus 1990; Gomulka 1992; Lee 1991; Lavigne 1995). Following this economic interpretation of reforms, these scholars distinguish reforms, by the type of efficiency gains, between (a) macroeconomic policies aiming to enhance economic stability over fiscal, monetary, and exchange rate issues, and (b) liberalization policies targeting at structural reform and growth, such as the reduction of price distortions and state intervention (Rodrik 1996).

Reforms of the property-rights structure serve as a good example of the efficiency argument. According to neo-classical economics, property rights reward or punish people for their economic activities (Alchian and Demsetz 1972), affect allocation of resources (Furubotn and Pejovich 1974, 3), and define the relations among people (Campbell and Linberg 1990). Efficient property rights encourage individuals to invest and generate growth and benefits for society (North 1981, 6-7). By this criterion, property rights in state firms in ex-communist countries were noticeably inefficient. These firms had no effective owners to supervise their performance; the state's restriction of market entry of non-state firms enabled these firms to monopolize on production and sales. As a result, state firms had few incentives to cut costs and exercise financial discipline (Kornai 1980; 1990, 44-46; Adam et al 1992, 17-19, 27-28). The only solution, according to neo-classical economists, is that the ex-communist countries sell off state firms to private investors and introduce laws for private enterprises (Kornai 1990; Boycko et al 1993; Sachs 1993; Blanchard et al 1991; Peck and Richardson 1991; Aslund 1991). In Eastern Europe, notably in Czechoslovakia, Poland, and East Germany, reforms have assumed the form of massive privatization.

Studies on Chinese reforms also echo the efficiency argument. In comparing China and the Soviet Union, Huang (1994) argues cogently that the planning system in China was more rudimentary than that in the Soviet Union and was more likely to experience macroeconomic instability. Therefore, the Chinese were willing to search for alternative options through reforms. In his study of the changes of China's regional development strategy in the post-Mao period, Yang (1990) and Fan (1995) suggests that Mao's

egalitarian policies of investing heavily in the interior region failed to release the full potential of national growth. They argue that Deng encouraged greater investment in the coastal region in order to accelerate economic expansion.

A group of political scientists, however, point to the political conditions for reforms. As Samuel Huntington has argued, "Reform is rare if only because the political talents necessary to make it a reality are rare" (1986, 345). Bates and Krueger suggest that policy responses only weakly correspond to economic conditions (1993, 454). In the words of Perry and Wong (1985, 4), "[t]he deterioration in economic performance clearly pointed to a need for some type of reform. But the history of reform movements in other countries shows that implementation of reform does not follow automatically upon the heels of economic difficulties. In terms of politics, reforms demand an extraordinary degree of acumen and finesse." Even though the shock-therapy type reforms in Poland were implemented overnight, such an immediate and dramatic approach aimed at tapping on the overwhelming popular support for reforms at that time (Williams 1994, 554-55). Some scholars suggest that these reforms aimed at pre-empting the opponents of reforms from organizing in time (Winiacki 1997). Similarly, a scholar sees privatization in Eastern Europe as part of a political program to undermine the communist party (Walder 1995, 295). Therefore, the initiation and the progress of reforms are possible only when political conditions and leadership permit them.

Przeworski (1991) explores a political paradox that can account for the rarity of reforms despite common economic maladies around the world. He suggests that fixing a broken economic system will inevitably inflict short-term welfare losses on the

population. Reformers have to persuade a reluctant population to swallow a bitter pill of economic adjustment for sweet fruits of long-term improvement. As reform measures trigger economic agony, the population will be quick to blame the reformers and demand a change in the leadership.

Two solutions, namely, strong and democratic state approaches, have been proposed to evade this dilemma. The former suggests that the state should remain autonomous and free of pressure from the segments of population that suffer from reforms, until reform bears fruits and creates popular followings (Evans 1992; Haggard and Kaufman 1995; Williamson 1994). In a recent empirical study that parallels the writings of Olson and Becker, Hellman casts serious doubt on this autonomous-state approach. He suggests that short-term winners, in an effort to maintain their gains from partial reforms, are more likely to block complete reforms than losers. On the basis of his statistical tests on Eastern European countries, he proposes that more open political systems are more capable of overcoming the resistance of short-term winners and pushing reforms forward to benefit a larger segment of the population (Hellman 1998).

China's reforms constitute an intriguing case. An authoritarian Communist Party has steadily and progressively advanced the course of liberalization since 1978. Reforms have resulted in no less than an economic miracle: After suffering from underdevelopment, chaos, and warfare for over a century, one-fifth of the human race has witnessed a dramatic improvement in its welfare; China's closed and relatively backward economy has transformed into a rising international competitor and one of the largest world economies in purchasing-power terms. The Chinese reforms, however, depart

from the Eastern European pattern explored by Hellman, and appear to favor the strong-state approach. Given that the Chinese political system has neither been open nor responsive to electoral pressure, thus probably similar to the laggards in reforms among the Eastern European countries in Hellman's study, we should expect the Chinese economic reforms to have proceeded rather slowly. On the other hand, should the strong state argument be correct, we shall find that the Chinese state was free of concerns about popular demands. Hence China's reforms can be an interesting case for us to empirically test the strong and democratic state arguments.

Sinologists have indeed engaged in a similar debate on the causes of reforms. Two economic interpretations emerge as leading explanations. A conventional argument is that Chinese leaders initiated reforms in order to overcome acute economic problems. Naughton rejects this account and develops an incremental economic explanation for China's reforms. The leaders, he argues, experimented with tentative reforms in order to realign an economy that had been damaged by the Cultural Revolution. Subsequent economic issues, however, drove the leaders down the path of greater economic deregulations and opening (Naughton 1995, 59-96).

Favoring a political explanation, another group of scholars suggests that two political factors ushered in reforms. The first factor is public disappointment with economic performance during the Cultural Revolution (1966-76), reflected in stagnant growth of peasant income and shortage and rationing of food in the cities (Perry and Wong, 2-3; Harding 1987, 36-38; Hare 1988). The second factor is the fall of Mao's successor and the rise of pragmatic leaders led by Deng. New leaders launched reforms

and broke with the past economic policies as a way to introduce to the public their policy platform (Perry and Wong 1985, 7; Harding 1987, 39). Naughton, although favoring the economic argument, agreed that were Mao still alive no far-reaching reforms would have been possible (1995, 62).

Examining the sub-provincial level governments, Walder (1995) and Oi (1999) argue that institutional arrangement allowed local government (especially at the county, township or village level) to claim a share of the profits of local enterprises, especially rural enterprises. Local officials thus have a strong financial incentive to foster the growth of these enterprises.

Several studies propose that the Chinese authoritarian state tried to satisfy powerful interest groups. In one study, Shirk examines the institutional aspect of reforms and advances an interest-group interpretation. According to Shirk, heavy industry, its governmental representatives, and inland provinces opposed any weakening of economic planning and opening to international business. On the opposite end of the policy spectrum was light industry and supportive governmental agencies as well as coastal provinces (Shirk 1985). The Chinese reformist leaders played to their potential constituents, namely, the coastal provinces and light industry, and gained the upper hand in initiating and maintaining the reform process (Shirk 1993). A flexible institutional rearrangement in post-Mao China, she argues, enabled the bureaucrats to gain promotion through reforms. Sachs and Woo (1995) argue that larger non-state industry in China's provinces in contrast to the former Soviet Union constitutes a key pressure group for reforms, and helps to account for greater reforms in China.



Montinola, Qian, and Weingast (1995) propose that institutionalized decentralization helped to promote the reform course in China. They propose that the national government (the center) allowed the local governments to enjoy greater authority and larger claims for economic returns, stimulating competition among the local government for resources and economic advancement. By ceding economic authority, yet without transforming its political regime, a principal (the center) turned the agents (provinces) into reformists and supporters of liberalization.

These scholars make two indisputable points about China's reforms. First, Mao's death and Deng's rise to power made reforms possible. That is why reforms had never occurred under Mao's leadership. A question, however, still remains: Why did the new leadership led by Deng come to view the economic situation differently than did the Maoist leadership? As I shall argue in the coming chapters, a stylized reason is that Deng and other leaders realized that Mao's endless and traumatic political campaigns had exhausted the Chinese and that the party urgently needed to rebuild public confidence in the regime by improving the population's living standard.<sup>1</sup> Second, decentralization plays a key role in allowing reforms to take shape in the provinces and localities (Shirk 1993; Walder 1995; Oi 1999). Another key issue also arises: To what extent did the center's policies affect the provincial ones in the reform period? In Chapter 3, I analyze

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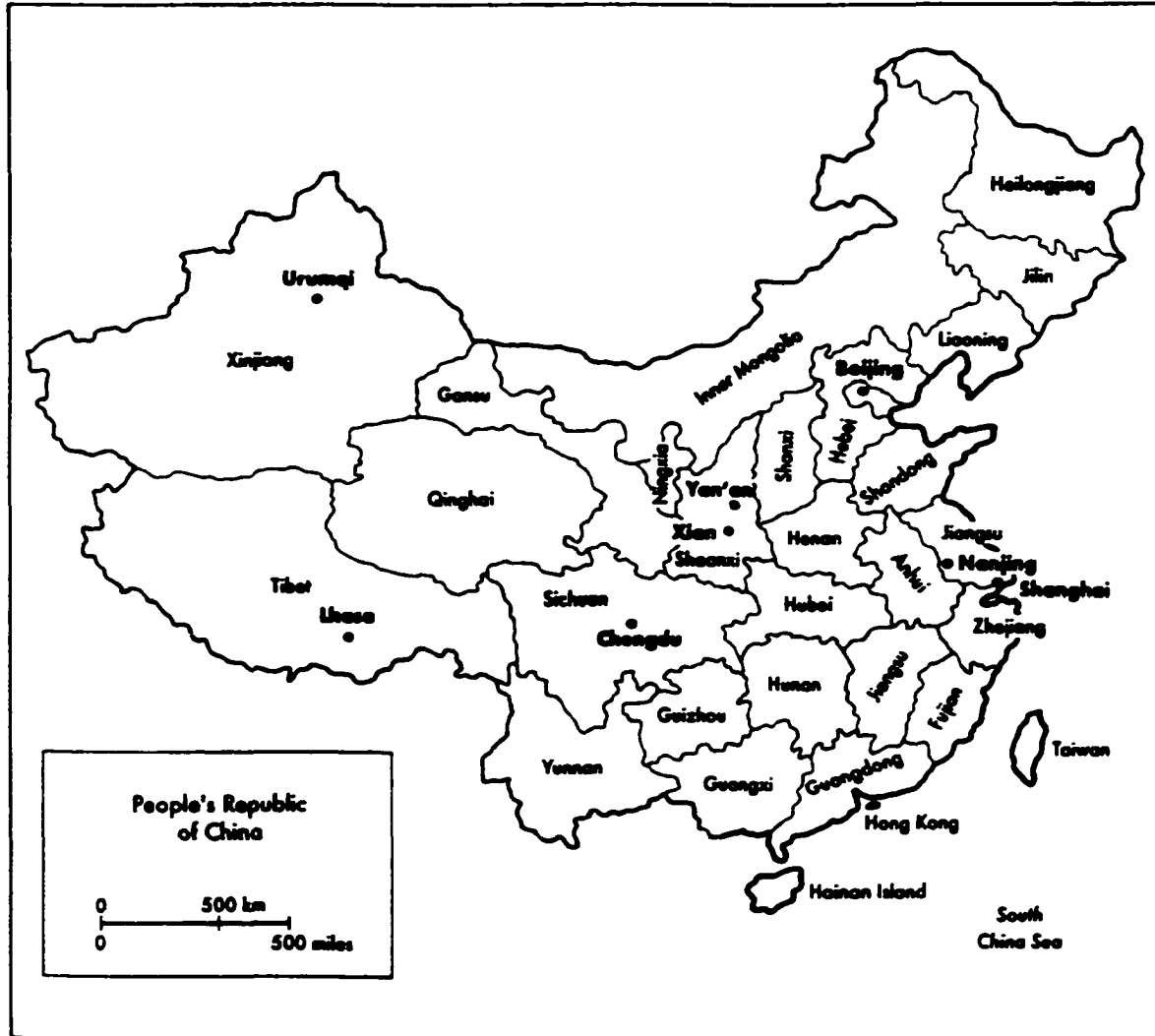
<sup>1</sup> A number of studies point out that a preceding economic crisis tended stimulate reform efforts (Haggard 1990, 29-32; Haggard and Kaufman 1995, and Bates and Krueger 1993, 452). As Bates and Krueger (1993, 454) correctly observe that an crisis and policy responses are merely weakly connected. In this case of China's reforms, the emergence of Deng-led leadership made it possible for the regime to see the severity of the economic crisis and undertake reforms.

the data on national and provincial policies, and uncover an interesting pattern of national influence on provincial policies.

Other than these two points, these scholars perceive different causes of China's reforms. The two economic explanations focus on economic predicaments and low efficiency in the economy. The political interpretation argues for the role of public discontent and low confidence in the Party. Walder and Oi advocate a revenue account of pro-reform local policies. Shirk emphasizes that sectoral groups have dictated reform policy making. These explanations aim at explaining reforms at different levels: the economic and political explanations attempt to account for reforms at the national level, the revenue explanation at the local level, and the interest-group story intersecting the national and regional or provincial levels.

A sensible study of the causes of China's reforms should thus cover as many of these factors and deal with at least two levels of government, such as national and provincial. Cases (instances of reforms) in the study should be large enough in number to allow for an adequate degree of freedom for identifying various alternative factors, and should have a wide variation to justify a statistical test. The study should also isolate potentially relevant factors of economic initiatives, such as differences in political progress. Such a study would be able to shed light on the relative strength of these contending arguments of China's reforms.

Figure 1.1: A Map of China's Provinces, 1993



## **2. Inter-Provincial Variation in Reform Policies as a Research Focus**

### **Inter-provincial variation in reform policies**

Variations in reform policies among China's provinces supply rich data for testing theories on reforms for a number of reasons.<sup>2</sup> First, as scholars agree, reforms differed widely in Chinese provinces (Ma and Fang 1991; Shu et al 1992; Jin and Chen 1996; Goodman 1989; Goodman and Segal 1994; Linge and Forbes 1990). Regional differences in economic policies arose both from the center's different policies regarding the provinces (Cheung et al 1998, 6-10; Yang 1990; Huang 1996; Solinger 1996) and the efforts by the provincial leaders (Huang 1996; Cheung et al 1998). Some provinces were so bold in reforms that they went beyond the limits set by the center, whereas others remained far behind national guidelines for reforms. A Cantonese slang best summarizes the most liberal province's creative adoption and circumventing of the center's policies regarding reforms, referred to as the traffic lights. It said: "Drive fast at the green light; drive slow at the yellow light; take a detour at the red light."

Second, similar to and even more than the states in the U.S., provinces are highly important implementers of reform policies due to the considerable size of the provincial

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<sup>2</sup> Provinces refer to provincial level units, including provinces, centrally administered cities, and autonomous regions. Refer to Figure 1.1 for a map of the provinces. The center (*zhongyang*) refers to the national Communist Party that incorporated the Politburo, Secretariat, and the organs of the Central Committee, as well as the national administration, including the State Council (a large consortium of the most important administrators) and its commissions, ministries, bureaus, and leadership small groups (Lieberthal and Oksenberg 1988, 138; Cheung et al 1998, 3). The national authority or national government also refers to the same institutions. The provinces and provincial authority refer to the provincial party and administration.

population and the political prominence of provincial leaders (Cheung et al 1998, 6-11; Lieberthal 1995, 165-66). Given China's continental size and its large population, the size of its provinces ranges from that of a mid-sized country to more than most nation-states (Cheung et al 1998, 7-8). Therefore, the center had to rely on the provincial authority to govern the population. Provincial party committees and provincial administrations were the key transmitters of the orders and directives from the Central Party Committee or Politburo and the State Council respectively. The center often gave provincial leaders leeway to interpret or implement the center's policies in accordance with local conditions (Lieberthal *ibid*; Cheung et al 1998, 7-8). The center also allowed provinces to represent sub-national units exclusively in the national decision making bodies (Cheung et al 1998, 7-8).

Third, reforms in China's provinces started under similar political and economic systems, and were free from potentially complicating factors, such as differences in the political and economic systems. Prior to the reforms, all the provinces were governed politically by a non-elected Communist Party and a hierarchical bureaucracy, and economically by the command economy. Since the reforms from 1978 onwards, the provinces have experienced changes in the command economy to varying extents, yet little change in the structure of the Party and the hierarchy of the bureaucracy. As the Chinese political system has remained closed since the reforms, factors other than democratization would have been responsible for differing reform policies in Chinese

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Provincial party secretaries headed the provincial party, and governors were in charge of provincial administration, officially referred to as the provincial People's Government.

provinces. In contrast, some of the former Soviet republics and a number of the Eastern European countries have changed their political and economic systems much faster than did others. One may attribute differentiated paces of economic liberalization in the former USSR and Eastern Europe to their different progress of democratization. The lack of democratization in reforms in China's provinces keeps the Chinese case analytically simple and expedites my efforts to pinpoint relevant variables.

Fourth, available data on twenty eight of the thirty provinces allow for regression tests to examine a range of possible factors. Should the number of provinces be much fewer, regression analyses may be inappropriate, qualitative studies should be used instead, rendering it difficult to rule out alternative explanations or a variety of potentially relevant factors.

### **Policies toward non-state industry**

The Chinese leaders have liberalized the economy without privatizing it. They have allowed non-state sectors to enter the market, yet have not privatized state enterprises on a massive scale. With the state's approval of market entry in 1978, non-state sectors have expanded rapidly and have profoundly changed China's economy. Non-state sectors are composed of collective firms (owned by local groups or governments and dominated by rural enterprises), foreign-owned or joint ventures, private business, and mixed sectors. Although non-state sectors accounted for 22.4% of the gross industrial output in 1978, they primarily went after profits, filled the product gaps left by state firms (McMillan and

Naughton 1993, 132), and were more dynamic than state firms because of more effective oversight by their owners. Non-state firms have energized the economy, made a larger contribution to growth than state firms (Gelb et al 1993, 111), and served as a new engine for China's economic growth. By 1994, non-state sectors produced 62.7% of the gross industrial output. This share increased to 74.5% in 1997 (SSB 1998, 431).

The center encouraged a number of provinces to expand their non-state sectors earlier and faster than other provinces through its opening of the provinces and selection of cities for urban reforms. Nevertheless, provinces differed in their adoption of the center's tolerance toward non-state economy, resulting in varying paces of expansion of non-state sectors and the economy in the provinces.

By testing the major political-economy explanations on inter-provincial differences in the central and the provincial reform policies, this project tries to address the following inadequacies in the existing literature. First, the existing literature has not paid sufficient attention to the inter-provincial variations in the central and provincial policies toward non-state industry, despite the above-stated significance of non-state economy. Second, few quantitative studies have been conducted on this topic.

### **3. Four Models of Economic Policies**

The political-economy literature becomes a natural tool for me to analyze China's reforms, because I have been imbued with political economy for years, and more importantly, because the literature contains rigorous and effective models of

governmental economic policies, and because these models parallel the above arguments on China's reforms. The political-economy literature therefore provides a sound theoretical framework for the test. Four primary models, namely, efficiency, revenue, popular support, and support from interest groups, emerged as prevalent paradigms on the interaction of politics and economics. Each model interprets governmental policies respectively in terms of the government's pursuit of economic efficiency, revenue, popular support, or support from the influential interest groups. It is useful to overview the efficiency, revenue, popular support, and interest-group models.

The first group of scholars believes that the government's economic policies (Eggertson 1990, 321) as well as the institutional design (Rogowski 1987), aim at improving economic *efficiency* and welfare of the society. This view parallels the above efficiency interpretation of reforms.

A second group of scholars, most of whom were economists and political economists, hold that the state uses economic policies as a tool to maximize its net *revenue* income (Mueller 1979, 153; North 1981). A successful predator, however, should discern different revenue-remitting potential of each major segment of its population and charge them different prices for the public services she provides. A shrewd revenue collector would exploit her "goose" mercilessly yet still allow it to lay golden eggs. This theory is widely applied in studies of the government, ranging from historical studies of changes in property rights (North 1981), to modeling of the U.S. bureaucracy (Miller and Moe 1983).



A third group of scholars views the government's policies as its efforts to win *popular support*. This view rests on two assumptions. Firstly, a government, or political leaders, is primarily interested in keeping their political power. Secondly, they need a certain degree of popular support in order to maintain their power. These two assumptions are frequently made in studies of democracies or policies in democracies. They include Peltzman's (1976) well-known model of economic regulation and a large body of literature on political business cycle associated with elections.<sup>3</sup> Several scholars, though playing down their acceptance of the above two assumptions, argue that Chinese leaders introduced reforms in order to regain popular confidence in the regime, which had been damaged by Mao's traumatic political campaign and depression of personal consumption (Lieberthal 1995; White 1992). The post-Mao era leaders have to satisfy the economic needs of the population in order to minimize the risks of popular uprisings and erosion of popular allegiance to the regime.

Contrary to the above model, the last group of scholars maintains that *interest groups*, instead of the general public, shape the government's economic policies. This model rests on a theory advanced by Mancur Olson (1963). Since a policy may affect small interest groups more than the general public, it is easier for these small groups to organize and lobby than large segments of population (Olson *ibid*). As a result, interest groups may exert greater influence on the policy than the public (Frieden 1991; Rosenthal 1990). This theory finds a wide appeal in many studies of policies in both democratic and

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<sup>3</sup> Market and Britton (1992) review the literature.

authoritarian countries, which suggest that the government may court a few political groups at the expense of the general population (Alvarez et al, 1991; Bates 1981). Bates (1981), for example, shows that in tropical African societies the state subsidized a small yet well-organized group comprising of urban residents, bureaucrats, and industrial owners by heavily taxing the majority of the society, namely, the poorly-organized and dispersed farmers. Susan Shirk (1985) also demonstrates that through the governmental agencies heavy industry put strong pressure on the center to block reform initiatives, whereas light industry exerted influence on the state for reforms.

Political economists have applied these models to recent economic adjustment in the recent years increasingly frequently (Shirk 1985; Przeworski 1991; Geddes 1994; Huang 1996; Hellman 1998; Treisman 1998). Sinologists frequently make assumptions and observations about national reform policies, and even about the stance of provincial or local leaders toward reforms (Cheung et al 1998; Walder 1995; Oi 1999; Shirk 1985), which parallel those of the four models. Nevertheless, few published studies try to apply these models rigorously to China's reforms.<sup>4</sup> In addition, only a few attempts have made to test quantitatively these models in the context of reforms. This project applies the four political-economy explanations to the center's differentiated policies toward non-state economy in the provinces and the provinces' differing policies toward non-state industry. I hope to evaluate the contending arguments on economic reforms and on economic

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<sup>4</sup> One may expect reasonably that these explanations also help to account for both the center's and provinces' formulation of reform policies, since Provincial party committees and provincial administrations represented respectively the Central Party Committee or Politburo and

policies, shed more light on the causes for reforms and economic policies, and advance conclusions for further examinations.

#### **4. A Synopsis of the Dissertation**

My research explores the political-economic causes for markedly differing extent and timing of economic reforms across China's provinces. It tries to address the following questions: Why did the national government push reforms hard in some provinces, hardly at all in others? Why did provincial governments vary considerably in their eagerness to embrace reforms? Drawing on the data on the twenty eight provinces, I run time-series and cross sectional regression tests on indicators of efficiency, revenue, popular-support, and interest-group strength. Politics emerges, at both national and provincial levels, as far more important than economic efficiency. *The need to garner support from urban and rural consumers, I argue, drove national reform policies, and interest group strength (i.e., the size and clout of state versus non-state sectors) shaped provincial policies.*

The national government, I suggest, was responsible for the performance of the regime. It adopted reforms to regain the popular support eroded by Mao's traumatic politics. The provincial leaders were appointed by the national leaders and thus had no need to worry about popular support. Instead, industrial sectors that were well

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the State Council in the provinces, and since the four explanations capture the most common political and economic factors that motivate government economic policies.

represented by the provincial governmental agencies could influence the provinces' reform policies. *Therefore, the institutional arrangement shaped the logic of Chinese politics, and politics commanded Chinese economic reforms.*

The following chapters dwell on the issues brought up in this introductory chapter. Chapter 2 (“The Context, Approaches, and Setting of China's Reforms”) outlines the economic, political, and institutional contexts of Chinese reforms. First, Chinese leaders adopted reforms to overcome economic irregularities. They promoted non-state sectors to reduce the dominance of relatively inefficient state and heavy industry, opened the provinces to international business break out of economic autarky, and extolled rural enterprises to industrialize largely rural China. Second, even though the center (the national Communist Party and government) retained its political control over the provinces, its economic decentralization empowered the provincial leaders, allowing them to interfere in local taxation and bank lending in an effort to promote local non-state industry between 1978 and 1994.

Chapter 3 (“The Logic of National and Provincial Reform Policies”), a core chapter, examines differentiated national and provincial policies regarding reforms in individual provinces. This chapter addresses two questions: Why did the center adopt different policies toward individual provinces? What caused provinces to pursue reforms at different paces? It presents the patterns of these policies, sets up four political-economic explanations, describes data measures and test methods, and discusses test results.

The need to gain support from urban and rural consumers, I argue, drove national reform policies, and interest group strength (i.e., the size and clout of state versus non-

state sectors) accounted for provincial policies. The centralized political structure exposed the center and the provinces to distinctively different constituents and thus caused them to behave in different ways. As the population held the center responsible for their economic welfare and political stability, the center adopted reforms in order to regain popular support that was undermined by Mao's traumatic politics. The provincial leaders were appointed by the national leaders and were thus insulated from popular pressure. Instead, they were susceptible to the influence of industrial sectors that were well represented by provincial governmental agencies.

This conclusion is reached by testing what I labeled the efficiency, revenue, popular-support, and interest-group explanations. In addition, national selection of cities for urban reforms, and especially national opening of provinces, is found to have encouraged provinces to promote the largest non-state sector, namely, rural enterprises, but not the smaller non-state sectors.

While statistical tests support the hypothesized role of the interest groups in provincial reform policies, only a clear empirical study of provinces can reveal whether and how interest groups shaped reform policy-making in the provinces. For this reason, I examine the change of national reform policies over the years in Chapter 4 ("Dynamics and Cycles of National Reform Policies"). I suggest that the reform process had gone through cyclic rises and falls. Reform-oriented leaders opted for fast growth through liberalization, yet usually drove up inflation and triggered widespread discontent. A conservative wing of the leadership then would emphasize macro stability and economic planning, reducing not only inflation but also the growth rate. Then, reformists would

renew economic liberalism to accelerate growth. Factions among the top leaders' were eager to appeal the population's conflicting desires for growth and macroeconomic stability, generating the cycles of policies. The cycles affected the national policies toward non-state sectors (rural, urban collective, private, and foreign enterprises), as well as national and local taxation and bank lending.

As an attempt to verify the empirical validity of statistical findings on provincial policies, I also compare the making of reform policies in Shandong and Jilin Provinces during 1978-1994 in Chapter 5 ("The Making of Reform Policies in Two Provinces"). Although sharing numerous similar economic conditions prior to 1978, the two provinces followed divergent paths of reforms. The study finds that the pre-existing regional balance between state and non-state industries had a profound impact on provincial policy-making. Thanks to a larger state industrial sector, Jilin Province adopted a more restrictive policy toward non-state sectors, and maintained a larger yet less efficient bureaucracy that serviced the state sector and hindered the non-state sectors. All of these factors led to slower reforms there. Other than the size of the state and non-state sectors, the unemployed population and the center's policies shape both the rationality and behavior of officials in both provinces. The notion of structured rationality seems useful in accounting for empirical politics.

Chapter 6 ("China and The Political Economy of Transition"), the concluding chapter, explores the implications of this research for the studies of political economy, especially the political economy of reforms, the relations between institutions and rationality, and the logic of economic policies and popular support under authoritarian

regimes. I also review the reform policies in China since 1994, and point out major tasks in China's reforms in the coming years.

Popular approval ratings of the governments in China and other ex-communist economies, as statistical tests reveal, depend greatly on economic performance. This finding reveals the surprising relevance of pocket-book politics outside the western industrialized countries (Chapter 5 elaborates on this point). The Chinese leaders thus had been wise to improve the living standard of the population through reforms in order to garner its support. In China, a number of provinces already had a considerable non-state industrial sector, and, under its pressure, favored reforms. A popular-support-conscious center then was able to expand reforms in the large country through devolving economic but not political power to the provinces. The Soviet Union may have opened the regime and decentralized its political power to overcome local resistance against reforms due to overwhelmingly large state industry. As central control rapidly eroded in this large and ethnically diverse nation, anarchy and an economic fiasco ensued. Since 1994, China has deepened the reforms of central-local relations, state enterprises, and its banking, taxation, and fiscal systems. While its gradual and patient approach has paid off in the past and may continue, China has yet to summon the political consensus and courage for more painful reforms.

## **Chapter Two: The Context, Approaches, and Setting of China's Reforms**

### **1. Introduction: Arrangement of the Chapter**

This chapter discusses the context of and approaches to China's economic reforms, and presents the central-provincial relations. It highlights both historical and institutional contexts under which policies toward non-state industry evolved in the provinces. These contexts will both provide the background information for the reform policies analyzed in the coming chapters, and help to account for a number of analytical treatments in the following chapters.

Section 2 (right after this introduction) of the chapter reviews the historical contexts, as well as subsequent changes in China's economy that the following chapters will examine or bring up in discussion. The re-reform Chinese economy was characterized by the state-sector dominance of the industry, autarky from the world economy, a predominantly rural society, and considerable decentralization. The post-Mao leaders tried to transform the economy by shifting to a diversified ownership structure, onward-looking development (or the Open Policy), and rapid industrialization of the countryside (promotion of rural enterprises and local settlement of the peasants), and by adopting a gradual reform strategy. Due to limited length, Section 2 elaborates only on the first and last changes, namely, the entry of non-state sectors and the gradualist reform strategy. The following chapters will analyze closely the entry of non-state sectors.



Dwelling on the decentralized feature of the pre-reform Chinese economy discussed in Section 2, Section 3 of this chapter reviews the national-provincial political and economic structures during the reform period. The thesis in that section is that with economic decentralization during the reform period, the provinces were able to influence provincial bank lending and taxation regarding non-state enterprises. Therefore, as to be specified, my studies of the variation in provincial reform policies and selection of the indicators for these policies are justified.

## **2. The Context and Approaches of Reforms**

### *Features of the Pre-Reform Chinese Economy*

**The central role of the state and heavy industry** When the Chinese economic reform started in 1978, the Chinese economy resembled in essence the Soviet command economy. *The state replaced individuals as the owners of property for production, and replaced market as the coordinator of economic activity.* The state not only owned most of the enterprises<sup>1</sup>, but also set production targets and price products for them, appointed their managers, financed the state firms in red, and guaranteed the lifetime tenure of their workers. In addition, the state controlled the allocation of most production inputs, and

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<sup>1</sup> Marxism, the official ideology in the communist countries prescribes that property for production be publicly owned. However, it would be impossible to seat or place the population at a meeting of the board of director of the enterprises. As a result, the state, run by the leaders, the ruling party, and the bureaucracy, exercised the ownership rights over public enterprises on the behalf of the people.

ran the bank, foreign trade agencies, and wholesale and retail systems. As the next section demonstrates, state ownership caused inefficiency in state enterprises.

Using its control over investment, prices, and taxes and revenues, the state promoted heavy industry that produced raw materials and machinery for the final-goods firms. In order to generate large financial and material inputs for heavy industry, the state squeezed surplus from agriculture by keeping low prices for agricultural goods and keeping high prices for manufactured goods. The state also suppressed household consumption, and diverted much of revenue income in various sectors into investment (Naughton 1993, Table 1.3, 31). As planners intended, this big-push strategy initially led to rapid industrialization, as one that the Soviet Union witnessed in its post-WWII recovery under Stalin. Over years the drawbacks of this strategy became apparent. Returns from investment in heavy industry were declining, consumer-goods industry (light industry) was kept artificially small, and consumer goods were of poor quality and inadequate in quantity. The living standard of the population stagnated for decades. Reforms of state enterprises and expansion of light industry through redirecting investment and promoting non-state sectors became increasingly imperative over time.<sup>2</sup>

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<sup>2</sup> Compared with industry, agriculture was much smaller in terms of output, and agricultural production was more dispersed. The state still exercised control over its production, product price, and output disposal. In 1978 the gross output value of farming, forestry, animal husbandry, and fishery amounted to about one-third of that of industry, even though the former sectors employed four times as much as labor did industry and transportation combined (SSB 1996b: 143; 145; 132). *Rural collectives*, namely, groups of peasants who resided in the same area, owned property and output of agriculture. The state still retained its key role in rural economy through several means. First, peasants were organized into People's Communes, a basic rural administrative unit that also carried political, economic, social-control, and social welfare functions. Second, the state set prices for agricultural products, specified output targets

**Autarky** China pursued an inward-looking developmental strategy from the 1960s to the late 1970s. During the 1950s, foreign investment in China was limited to four joint enterprises with the Soviets and one joint enterprise with the Polish (Guo et al 1993, 1412). These enterprises were respectively in petroleum, metal, aviation, ship-building, and shipping industries (ibid). The Chinese took over the four Sino-Soviet joint ventures in 1954. Thus between 1955 and 1978, China was nearly free of foreign direct investment (FDI) (ibid, 1412-13; Reardon 1998, 498). During this period, tensions created a rift in China's relations with the U.S. and the USSR. Mass introduction of investment from the Eastern and Western blocs was politically inexpedient. As a result, the Chinese turned to economic nationalism, emphasized self reliance, and opposed FDI for it implied economic colonialism (Guo et al, ibid).

Foreign loans, a politically less sensitive form of foreign capital, played a minor role in development, especially between 1960 and 1976. Between 1950 and 1960, loans from the Soviet Union, totaling 1.274 billion rubles, constituted most of the foreign loans in China. During the 1960s and 1970s, China's foreign capital other than direct investment was mostly down payment for sellers' credit to purchase equipment from Western Europe and Japan (Guo et al, ibid).

**Limited urbanization** The planned economy in China differed in two aspects from the Soviet prototype. It had a large rural component, and was more decentralized and rudimentary. Most of the Chinese population resided in the countryside. In 1978 and

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in the form of quota grains, and supplied most of main agricultural inputs, such as fertilizers, seeds, and tools.

1994 the sheer majority of the population lived in the countryside, and 71% of the labor force worked in agriculture (Qian and Xu 1997, 43). In 1978 China had 83,000 state-run factories. In addition, China had 100,000 collective factories, most of which were small rural enterprises (Naughton 1995, 40). Rural factories accounted for 22.5% of total employment and 9% of the gross industrial output (Qian and Xu 1997, 50). Thus, in the course of the Chinese reform, urbanization and industrialization would occur simultaneously. Inflow of rural labor into industry would generate growth (Sachs and Woo 1994) in non-state economy, rural enterprises in particular.

**Decentralization** The planned economy in China was also more decentralized than were the Soviet and the Eastern European counterparts due to less sophisticated bureaucracy, less skillful labor, and Mao's policies and political campaigns. The highly centralized command economy required intensive coordination between different economic sectors and regions. The latter built on several factors. A sophisticated bureaucracy would draw up the economic plans, a developed infrastructure would help to exchange information and goods, and skilled labor help to execute the plans. Since the 1950s when China started to mold its command economy, its bureaucracy and infrastructure were less developed, and its labor was less skillful than in the Soviet Union. Mao Zedong's impulsive calls for immediate accomplishment of communism and industrialization during the Great Leap Forward in the late 1950s ran into passive resistance by the ministries in Beijing. Mao had to push them aside. In the mid-1960s, Mao launched the Cultural Revolution and mobilized the Red Guards to attack the bureaucracy and the educational system. At times Mao tried to counter the resistance

from the central bureaucracy by devolving economic authority from the center to the localities in the late 1950s and in the early 1970s (Wang and Hu 1993, 11-15, 33-35). Mao's numerous political campaigns since the 1950s also hindered the emergence of advanced infrastructure and skilled labor (Naughton 1993, 39-40).

As a result, prior to the start of reform, the Chinese planned economy was more decentralized and less comprehensive than the Soviet counterpart. In the Soviet Union, the central government controlled basic industrial commodities, such as coal, rolled steel, and cement. In China local governmental enterprises produced over 40% of coal, 25% of the finished steel, and 50% of cement (ibid, 42). In 1979 only 791 goods were under the national planning in China, whereas the production of 1.2 million goods were included in the Soviet economic planning in the late 1970s (Qian and Xu 1997, 51). While the enterprises under the Soviet central government encompassed industry, those under the Chinese counterpart produced less than half of the industrial output prior to 1978 (Wong 1987). Under a decentralized economic system, China's reform-minded leaders could delegate to the provinces greater power in managing and taxing their local economy without disrupting development. In return, the provinces supported the reform agenda.

### *Approaches to Economic Reforms*

In light of the above features, the post-Mao leaders tried to reform the economy by promoting non-state firms and the market, opening up China to the world economy, rapidly industrializing the countryside, and adopting a gradual reform strategy. Most of

these changes centered around the entry of non-state sectors. The entry of non-state firms encompasses several far-reaching transformations. First, it weakened the dominance of underperforming state enterprises (the first prereform feature). Second, rural enterprises emerged as the largest non-state sector, as China's predominantly rural population (the second pre-reform feature) moved into non-agricultural sectors, and as the government encouraged the peasants to settle locally. Third, foreign firms set foot in China, ending China's inward-looking development (the third prereform feature). The following discussion will focus on the entry of non-state firms and the gradualist reform strategy.

**Diversification of ownership structure** One of the most far-reaching reforms that the Chinese government has adopted since 1978 is to allow non-state sectors to expand. Since this research examines non-state industrial policies, it is worthy to clarify categories of ownership and discuss their performance. Table 2.2 summarizes the main differences between state and main non-state sectors.

*The state sector* comprises enterprises controlled by national and provincial governments. At the beginning of reforms, the state sector dominated industry, producing 77.6% of the gross industrial output in 1978. This share, however, ranged from 61.3% to 93.8% between provinces, as indicated in Table 2.1.

Non-state sectors (ownership) were another category that is frequently employed in the literature on Chinese reforms. *Non-state sectors* (NSSs) consist of enterprises set up by local groups, local governments, individuals, foreign nationals, or jointly by these groups. Correspondingly, the following non-state sectors can be further differentiated-- collective, private or individual, foreign, and mixed ownership. *Collective enterprises*

were controlled by low-level rural units or organizations, such as villages, townships, and county, as well as low-level urban units, such as neighborhood committees and city organizations. Two types of private business, private enterprises and individual household enterprises, existed in China. *Private enterprises* were owned by individual Chinese citizens, and employed a certain number of workers. *Individually-owned enterprises, or individual-household enterprises (IHEs)* were run by and employed members from the same family, and had no outside employees. *Foreign enterprises* refer to enterprises owned solely by foreign nationals or jointly with the Chinese. *Mixed sectors* comprise of enterprises jointly run by the state, collective, individual, or foreign owners. At the beginning of reforms, non-state industry was dominated by collective enterprises. In 1978, collective firms remained the primary non-state sector, accounted for about 22.4% of national gross industrial output. Again, this share varied widely from 6.2% to 38.7% between provinces (Table 2.1).

Vaguely specified ownership, excessive welfare, and extensive state intervention created numerous operational problems for state enterprises, including substandard management, embezzlement of state-owned property, inflexible production plans, weak performance incentives, redundant workforce, and high welfare costs. These problems caused the state-owned sector to perform worse than did non-state-owned sectors. The progress of reforms drove this point home. To begin with, no motivated board directors supervised state enterprises. Managers, workshop directors, or sales staff of state enterprises had lifetime tenures. Managers answered to bureaucrats at relevant governmental agencies, who were busy with their own governmental work and could only

devote a portion of their time to the enterprises. Bureaucrats were not rewarded for their careful supervision of enterprises. They might even conspire with the managers, accepted bribes, and turned a blind eye to state enterprises. Incompetent managers would merely be transferred from one enterprise to another. In addition, the state seldom monitored change in the values of property of the firms. Lack of supervision also allowed the managerial staff to expand beyond control, draining resources of state enterprises. Thus, because of ineffective supervision, the manager and the staff of state firms were under little pressure to improve their performance. They were even tempted to embezzle public property.

The state's patriarchal generosities and excessive regulations imposed additional burdens on state enterprises. Acting as an advocate of the interests of the working class, the communist state in China granted lifetime tenure to employees in the state sector. Furthermore, it provisioned for them comprehensive social welfare ranging from free or inexpensive housing to childcare, and eventually raising labor and production costs. In order to sustain a communist economic ideal of no unemployment, the government would provide state enterprises in the red with financial assistance, and allowed few of them to go bankrupt. Since inefficient firms could not exit the market, they continued to consume resources. Finally, cumbersome regulations by the state (a theoretical owner of state enterprises) also prevented state enterprises from responding in time to demand and supply of products. With these numerous obstacles, the productivity of state-owned firms stagnated over years and generated mediocre returns despite tremendous state inputs. Thus reforms of state firms became necessary.



Table 2.1. Share of State and Non-State Sectors in Gross Industrial Output (Provincial total = 1)

Area	1978 State	1978 Non-State (Collective)	1994 State	1994 Non-State
Nationwide	0.776	0.224	0.373	0.627
<i>Coastal Region</i>				
Beijing	0.827	0.173	0.444	0.556
Tianjin	0.807	0.193	0.353	0.647
Hebei	0.718	0.282	0.328	0.672
Liaoning	0.825	0.175	0.428	0.572
Shanghai	0.917	0.083	0.424	0.576
Jiangsu	0.614	0.386	0.199	0.801
Zhejiang	0.613	0.387	0.161	0.839
Fujian	0.741	0.259	0.32	0.68
Shandong	0.676	0.324	0.245	0.755
Guangdong	0.678	0.322	0.217	0.783
Guangxi	0.789	0.211	0.429	0.571
Hainan	0.825	0.175	0.500	0.500
<i>Central Region (Interiors)</i>				
Shanxi	0.781	0.219	0.437	0.563
Neimengu	0.791	0.209	0.654	0.346
Jilin	0.789	0.211	0.624	0.376
Heilongjiang	0.831	0.169	0.693	0.307
Anhui	0.799	0.201	0.188	0.812
Jiangxi	0.782	0.218	0.371	0.629
Henan	0.741	0.259	0.348	0.652
Hubei	0.773	0.227	0.444	0.556
Hunan	0.750	0.250	0.444	0.556
<i>Western Region (Interiors)</i>				
Sichuan	0.814	0.186	0.371	0.629
Guizhou	0.811	0.189	0.698	0.302
Yunnan	0.805	0.195	0.734	0.266
Xizang	0.765	0.235	0.786	0.214
Shaanxi	0.842	0.158	0.579	0.421
Gansu	0.938	0.062	0.746	0.254
Qinghai	0.824	0.176	0.840	0.160
Ningxia	0.830	0.170	0.708	0.292
Xinjiang	0.891	0.109	0.752	0.248

Sources: SSB 1990b; 1996b.

Table 2.2. Major Forms of Ownership in China and Their Exposures to Market

<b>Ownership</b>	<b>Owners</b>	<b>Exposure to Market</b>	<b>Activities Regulated by Market</b>
<b>STATE</b>	<b>National and provincial governments</b>	<b>Low</b>	<b>Pricing and sales of a portion of the products; a portion of the inputs</b>
<b>NON-STATE</b>			
<b>Collective</b>	<b>Local government or institutions, townships, villages, groups, and urban street management committees</b>	<b>Moderately high</b>	<b>Production inputs including raw materials and much of needed capital; employee wages; sales of products</b>
<b>Private (individual)</b>	<b>Individuals (private enterprises), or families (individual household enterprises, or IHEs)</b>	<b>High</b>	<b>Most aspects of business</b>
<b>Foreign</b>	<b>International investors or along with Chinese collaborators</b>	<b>High</b>	<b>Most aspects of business. Some enterprises needed to obtain capital and material inputs and sell some of their products at international market</b>

The collective sector, and especially private and foreign enterprises, strove harder for higher productivity. Collectives-owned firms stand as an intermediary between private and state ownership. The local corporations or groups and the local government at the city or township level were usually the owners of collective firms. These owners raised the funds, found raw materials, and recruited managers and employees. They also assist these firms in selling their products. In return, they claimed a portion of their profits. While collectives-owned firm might benefit from the help from the local government, they also had to make decision, compete, and survive under considerable market pressure. In the 1980s they had

to obtain about half of their capital and most of their raw materials through market and have to sell about half of their product directly on the market (ERICSSA 1987: Part III; Nee 1992; Ma 1983: 35-63). In addition, collective firms will have to exit the market if they run into losses. Between 1988 and 1990 very few, if any, state enterprises closed down. In contrast, 500,000 township enterprises were eliminated and 2.8 million people lost their jobs (State Commission 1993: 74). While reducing noticeable wastes in their operation, collective enterprises also generously reward managers and workers for their good performance and punish them for sloppy work. Private and foreign enterprises were exposed to the market signals and pressures to a greater extent. They had to purchase their raw or physical materials, recruit labor, produce, and sell their products at the market. Greater exposure to the market stimulated a faster increase in productivity of these non-state sectors.

Studies of state and collective industrial enterprises supplied evidence for the above argument. As Table 2.3 shows, collective enterprises surpassed state enterprises in a variety of aspects—their growth rates in gross output (Q), labor force (L), fixed assets (K), total factor productivity (A), and all factor productivity. Even though most of the output and employees of state enterprises were generated by large- and medium-sized enterprises, state enterprises still trailed large- and medium-sized collective-owned enterprises in these aspects. Overall, collective firms performed above the average level, whereas state enterprises did well below that level. Furthermore, non-state sectors could also provide employment, diverse products, and affordable prices for the population.

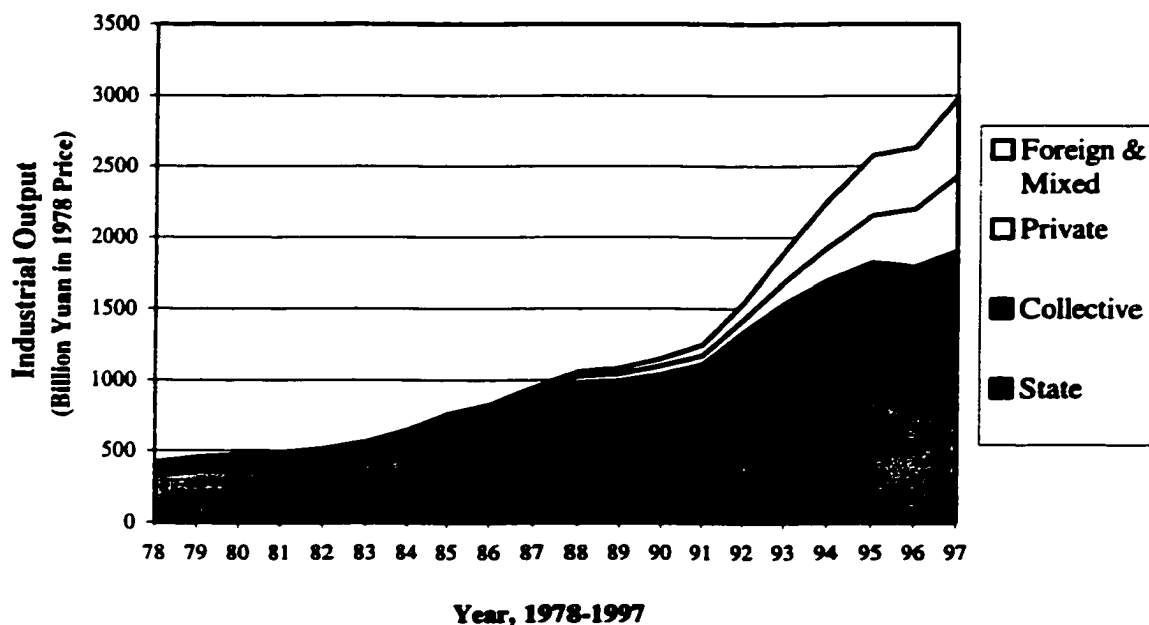
**Table 2.3. Average Growth Rates of Productivity of Industrial Enterprises at the Township or above Levels with Independent Accounting (in Percentage)**

<i>Types of Enterprises</i>	<i>Type of Productivity</i>	<i>1980-88</i>	<i>1978-92(a)</i>	<i>1978-92(b)</i>
1. State	Q	8.77	7.84	8.55
	L	3.44	2.87	2.87
	K	10.96	11.63	11.63
	A	1.57	0.59	1.30
2. Collective: 1) All	Q	18.98	16.81	15.42
	L	7.61	5.54	5.54
	K	18.83	17.84	17.84
	A	5.76	5.12	3.73
2) Large- and Medium-Sized	Q	12.85	12.18	12.93
	L	4.12	5.04	5.04
	K	11.22	13.16	13.16
	A	5.18	3.08	3.83
3. Average (State and Collective Enterprises)	Q	11.80	11.07	11.07
	L	5.24	4.16	4.16
	K	12.15	12.70	12.70
	A	3.11	2.64	2.64

Source: Lu 1997: Table 3.

Notes: Q, L, K, A are respectively growth rates of the gross industrial output, employees, fixed assets after depreciation, and total factor productivity. A is computed using the formula  $A = Q - 0.5L - 0.5K$ . Data for 1978-88 are at a constant price. Data for 1978-92(a) are computed using official gross output deflators, and data for 1978-92(b) are calculated using deflator indexes for the gross output of all the enterprises.

**Figure 2.1. Industrial Output by Ownership, 1978-1997**



These constitute the economic basis for the state's reform policies of tolerating or even promoting the growth of non-state sectors. The state's economic liberalization helped to diversify ownership structure. The share of non-state sectors in industrial output rose from 22.4% in 1978, to above 62.7% in 1994 (SSB 1990b; 1996b: 145). This share surpassed that of the state sector in 1993 for the first time (SSB 1996b: 145). In 1994 the share of the collective sector in industrial output increased from 22% in 1978 to 37.7%, and even surpassed that of the state sector (37.3%). Meanwhile, the shares of the private sector and foreign and mixed ownership rose from virtually zero in 1978 to respectively 10.1% and 14.8% (Figure 2.1). The rate of increase in the share of non-state sectors in gross industrial output, however, varied across provinces, ranging from 61.1% in Anhui

to -2.4% in Qinghai (Table 2.1). Economic gains, as to be discussed later, do not always result in reform policies.

**A gradualist path** Dramatic democratization and privatization of the state sector that swept several Eastern European countries overnight has not taken place in China. Instead, the Chinese leaders adopted an incremental approach. Politically, by devolving economic power to localities, the Chinese leaders turned provincial officials into agents of reforms, and evaded the task of democratization. Economically, the Chinese state expanded incrementally rural, urban collective, and private sectors, introduced foreign investment, and increased external trade. Two reform measures exemplify the gradual nature. First, the state permitted collective, private, foreign, and mixed ownership to expand gradually outside the state plan into dominant sectors. Meanwhile, the state scaled back its intervention in the state sector, leaving enterprises more room for operation. Second, the state, in deregulating prices, introduced a dual-tracked price system. During a transitional period, state prices that did not reflect either supply and demand or production costs would co-exist with market prices that did take into account these factors. In addition, the marketplace would be allowed to price an increasingly greater amount and number of the goods. Gradual price reform allowed market prices to evolve, and gave enterprises and consumers ample time to adjust. Should the state have freed the prices overnight, demands and purchases of goods could have plummeted, and a severe depression would have followed. Even though the dual-tracked price system did breed corruption and distortions for years, it had prevented worse consequences, namely, growth collapse and popular dissatisfaction with the overall reform program.

### **3. The Central-Local Setting**

Taking advantage of a decentralized economy (the above fourth feature of pre-reform economy), national reformists reconstructed central-provincial institutions, transformed provincial officials into advocates of reforms, and avoided a challenging task of democratizing the regime in order to remove bureaucratic resistance to reforms.

Central-provincial political, fiscal, and banking structures shaped the provinces' policy options. The political structure refers to the power relationship between the center and the provinces and the extent of the power of provincial leaders over provincial officials and cadres. The fiscal and banking structures respectively defined the leverage that provincial leaders had over taxation and bank lending in the provinces. The following paragraphs examine how these structures worked. An important following conclusion can be drawn: The center had retained its control over the appointment of provincial leaders as well its ability to initiate changes in central-local structures; provincial leaders and government, on the other hand, could carve out provincial reform policies, including taxation and bank lending policies which could affect non-state sectors. Therefore, it makes sense for me to treat provincial bank loans to rural enterprises and provincial tax rates on non-state sectors as indicators of provincial policies toward non-state sectors in the following chapters. It also makes sense for me to address the question "what provincial factors caused provincial governments to follow different trajectories in their reform course?".

### *Central-Local Political Structure*

The central-local power structure rests on four principles-- party dominance, the center's control of appointments, reciprocal accountability, and overlapping control of provincial agencies. First, the CCP was the leading political force. Administrative bodies at each level were subject to the leadership of the party organization at the same level. At the national level, for example, the State Council abided by decisions by the Politburo, the highest party organ, while at the provincial level the provincial government sought approval of major policies from the provincial party committee. Since the Thirteenth Party Congress of 1987, the party has left daily administrative affairs to governmental branches,<sup>3</sup> and retained approval over strategic decisions by administrative agencies. The party also exercised its influence over the government through the nomenklatura system, which will be discussed below. The (first) party secretary and the head of the administration were formally the two most powerful figures at each level.<sup>4</sup> For instance, the provincial party secretary and the governor were respectively the No.1 and No.2 posts in the provinces.

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<sup>3</sup> See Baum 1996, 220.

<sup>4</sup> At the national level, this is true largely after 1994. Deng was the most influential leader in China between 1978 and 1994, even though the most important post he held was the Chairman of the Military Affair Commission until 1989. It was only after 1994 that Deng, who was around 90 years old, relinquished his control over the military and final say in major decisions to his successor, the General Party Secretary Jiang Zemin.



Second, the structure is hierarchical, for the center appointed leading provincial officials. The party filled the key positions of the provincial party branch and government. A list of these positions was called nomenklatura (Lieberthal 1995, 209). Between the mid 1950s and 1983, the CCP had ex-ordinary control over local officials and politics. It followed a two-rank-down nomenklatura system, and appointed both provincial and prefectural party and governmental officials as well as heads of provincial departments (ibid, 210-11; Huang 1995, 10). Since 1984, the central CCP simplified the nomenklatura system to one-rank-down, and trimmed the appointments from 13,000 to 7,000 (ibid). This change thus restricted the center's appointment to only top provincial officials including provincial party secretaries and governors. The principle of democratic centralism of the CCP permitted a limited amount of discussion prior to making of the policy, yet required provincial party cadres to support decisions by the party leadership.

Central appointment power was more limited than it appeared, for national leaders needed the support from provincial leaders for their policies. A study finds that no provincial First Party Secretaries had been purged during the four years of 1983-86, whereas thirteen were ousted in the twelve years of 1971-82 (Tong 1989, 25). In other words, the number of purges has declined from 1.08 during the period of 1971-82 to 0 during that of 1983-86.

The center's reluctance to resort to the strong-arm measure may lie in the principle of "reciprocal accountability" in Chinese politics, as Shirk suggests (1993).<sup>5</sup> This

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<sup>5</sup> This argument stems from Shirk's view (Shirk 1993, 81). Nevertheless, her view seems to work better for major policies than major political posts. Zhao Ziyang replaced Hu Yaobang

principle means that national and provincial leaders depend on support from each other in order to remain in their posts. As stated above, the center held the final power in appointing the key provincial posts. On the other hand, appointment of any major national posts, such as a Politburo member and the Party General Secretary had to garner the support of the central committee, the party elders, the military leaders, and the paramount leader before being appointed (Shirk 1993, 81). In addition, any major national policy agenda could be adopted only when the Party Central Committee, the party elders, the military leaders, and the paramount leader all backed it up. The provincial leaders made up the largest block in the Central Committee and were the ultimate executor of the national policy. It is likely that, as Shirk (1993) argued, national reformists, such as Deng, Zhao, and Hu, made substantial economic concessions to the provinces so that the provinces would stick to the former's economic reform agenda.

Third, provincial governmental agencies were subject to leadership of several bodies, especially that of provincial leaders, further complicating and weakening the center's control of the provinces. Any provincial agencies, including the tax department and banks, had to answer to three bosses-- the provincial party, the provincial government, and the national governmental agency.<sup>6</sup> This multiple control was designed as checks and balances between institutions, and prevented any of them from becoming

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as the Party General Secretary in 1987, Li Peng was appointed as the Premier in the same year, and Jiang Zemin replaced Zhao in 1989 mainly due to the support of the party elders and Deng, the pre-eminent leader. The other institutions and leaders seemed to play a minimal role. See Baum 1996 for detailed discussion.

<sup>6</sup> Lieberthal (1995, 169-70; 192-218) supplied an in-depth discussion on this issue.

too powerful. It posed difficulties for governmental agencies, however. The first two bosses wanted the provincial agency to address local needs, whereas the national agency was preoccupied with both national concerns and professionalism of its local branch. Shandong Provincial Party Committee and Shandong Government, for example, would like Shandong Provincial Taxation Department to offer enterprises generous tax holidays and help stimulate growth in Shandong. The Taxation Bureau in Beijing, however, would insist that its Shangdong branch should collect a considerable amount of taxes.

Among these three bosses, the provincial party and government shared interests over their provinces and usually would prevail over the national agency. The reasons are subtle. First, the provincial party, through its organizational department (the party personnel department), nominated candidates for provincial nomenklatura, and affected the career of the officials of provincial agencies.<sup>7</sup> Second, the provincial party and government controlled the budget of provincial agencies and had influence over a great variety of local institutions. They thus could determine the welfare of the provincial officials as well as his/her family members who were employed in institutions or enterprises in the provinces. Thus the provincial leaders could muddle in the affairs of provincial tax agencies or banks.

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<sup>7</sup> The root of the problem was the party's dominance over the political system. The central party allowed the provincial party committee to dominate provincial agencies in order to ensure its control of the localities as well as implementation of its policies. Nevertheless, the local party dominance weakened leadership of the national ministries over provincial governmental agencies.

Overall, the center seemed to have kept political localism in check, as it did during Mao's era, thanks to its control over the appointment of top provincial leaders. One may well argue that the longer the tenure of provincial top leaders, the more likely they could develop their local power base and an entrenched interest in the province, even to the extent of disregarding the center's policies (Huang 1996, 113). The average tenure of provincial party secretaries and governors after 1983 had both lengthened only very modestly. That for party secretaries increased slightly from 3.34 to 3.52 years, and that for governors from 3 to 3.12 years. This fact that provincial leaders turned over only slightly less often in Deng's era than in Mao's era suggests that the center still held a political leash over localism. As to be discussed later, the center was also able to change national-local structure at its own initiatives. Nevertheless, the other side of the coin is that the provincial leaders, as noted, became very influential in local economic affairs.

### *The Banking System*

Between the mid 1950s and the start of reforms, the bank in China was highly centralized. It served both as an accountant for most enterprises and institutions and as a cashier for investment detailed in the central plan. All enterprises, work units, and groups had to make their transactions at the state bank. In addition, the national bank controlled allocation of all loans. Banks at each level would pass credit strictly within the confines of the central plan (Gao et al 1993, 409-10; Naughton 1995, 28, 255-56).

During the reform era of 1978-94, the banking system was restructured along the principles of division of labor and greater operational autonomy. First, a central bank (the People's Bank of China, or PBC) was created in 1983, so were functional banks, such as the Industrial and Commercial Bank (ICB, created in 1983), the Agricultural Bank (AB, 1979), the People's Construction Bank (PCB, 1979), the Bank of China (1979), and six secondary branches, and five regional stock-holding banks (Gao et al 1993, 409-20; Naughton 1995, 133; Huang 1996, 41-45). Several banks deserved explanatory notes for their role in lending to non-state sectors among the bank branches. The AB, along with Rural Credit Cooperatives (RCCs) that it supervised, managed funds and loans for agriculture and savings in the countryside, and acted as key public lenders to rural enterprises. The Bank of China provided lending and saving services in foreign currencies, and became a major domestic official lender for foreign enterprises. Urban Credit Cooperatives (UCCs), together with ICB, were the primary banking system for urban collective enterprises, private business, and IHEs (Gao *ibid*, 414-15, 428).

The state tried to make the banks more market-oriented through measures. First, the bank raised unreasonably-low lending and saving interest rates for ten times between 1979 and 1991 to keep capital costs more in line with the market level. Second, bank branches were allowed to charge interest rates within a range of 20 percent of those published by the PBC. Third, the state allowed bank branches to lend in accordance with their saving deposits in 1981. In 1984, the state required enterprises and institutions to first make deposits before obtaining bank loans in order to prevent bank branches from over lending. Fourth, the state induced material incentives of the banks in improving

their performance by allowing them to retain 35 percent of their profits and to apply 10 percent of their profits toward employee bonuses and welfare (Gao et al 1993, 439-46; Huang 1996, 42; Naughton 1995, 255-59).

### *Fiscal and Tax Systems*

The tumult during the Cultural Revolution compelled the leaders to resort to strict recentralization in 1968. Since 1971, however, the state again abandoned total centralization and embraced revenue sharing and adjusting sharing rates (Wei 1996, 330, 332; Gao et al, 238-41). The fiscal structure, however, was still considerably centralized.

The arrangements in Mao's era oscillated between strictly centralized fiscal control and substantial local fiscal autonomy. The former might help to ensure national public goods, including low inflation and long-term investment projects such as infrastructure and education. However, it tended to reduce the incentives for the provinces to generate revenue and use available resources to stimulate local development. Local fiscal autonomy might stimulate local economic growth. When the local government had pervasive control over local economy, it would allow local bureaucrats to indulge in short-term-profitable investments such as manufacturing of consumers' goods, ignore long-term investment, engage in local protectionism to protect inefficient local firms, force local banks to lend to inefficient projects, and distort market mechanisms.

As stated above, the post-Mao leaders, however, were concerned with winning the local political support, rather than a delicate balance between fiscal centralization and

local autonomy. The top leaders tried to court support from the provinces by handing them greater control over their revenue. With greater local fiscal autonomy, the provinces had greater incentives and resources to stimulate local economic growth. Nevertheless, at times the provinces, as stated, over-invested in manufacturing of consumers' goods for short-term profits, used protectionist measures to fend off outside competition, keep afloat inefficient plants, and allow the banks to accumulate debts. The result was excessive investment with low returns for the money from the center and high inflation at the national level, yet reasonable returns for the provincial coffer.<sup>8</sup>

Between 1977 and 1979, national leaders experimented with several revenue-sharing schemes under which the localities would retain an annually-adjusted portion of revenue and decide on their own expenditures. Details of the schemes are provided in Tables 2.4 and 2.5 in Appendix. Since the schemes evolved over time on a tortuous course, it will be time-consuming to come up with a precise summary. Broadly speaking, each scheme shared the following two components-- first, division of fiscal revenue bases into central base, local base, and the shared base between the two, and second, the methods of dividing the shared revenue between the center and localities. The localities included primarily the provinces and later line item cities. A tug of war between the localities and the center had evolved around the amount of submission by the relatively

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<sup>8</sup> For a thorough discussion of local investment zeal, refer to Huang 1996. The center resorted to stern austerity programs periodically to cool off local investment rush. Contrary to local fiscal autonomy, strict fiscal centralization stifles local incentives in overseeing growth. Well-structured central supervision, however, can help provision national public goods, including long-term investment projects such as infrastructure and education and low inflation

developed provinces. Many China scholars agreed that the provinces might have benefited more and obtained a greater share of overall government revenue than did the center under the fiscal arrangements between 1981 and 1993.

### *Considerable Provincial Economic Leverage*

Provincial leaders would take note of the center's policies because the center had the power to dismiss provincial leaders, because the party discipline obligated them to obey national decisions, and because national policies, given the political-economic cycles, would change periodically. When (and only when) provincial leaders went against the policy trend blatantly, their career would be at risk. The pressure for complying with the center's policies, however, placed squarely on all provinces, and did not induce one province to be more reform-oriented than others.

On the other hand, since national leaders looked to the provinces for support of their policy platform, and since provincial leaders dominated provincial agencies, provincial leaders could interpret national policies as they saw fit and formulate measures that they claimed to help execute the center's policies. They could even resist national decisions covertly. Thus responses to national policies could vary significantly across provinces. During the retrenchment, for example, some provinces would respond more

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and macro-economic stability. Prior to 1994, the center largely ignored this type of central control.



enthusiastically than other provinces to calls by national conservative leaders for strengthening the state sector and containing non-state sectors (Young 1997, 153).

Take the provinces' influence over banking and taxation for an example. Provincial banks and tax-collecting departments were supposed to follow the instructions of their national offices. In restoring the Agricultural Bank in January 1979, the State Council declared that the national office of the AB supervised the provincial AB over functional matters, and could appoint, dismiss, and transfer its local officials (Gao et al 1993, 410). The center also granted the national office control over provincial taxation agencies. The State Council's "Regulations on Taxation Management System" in November 1977 stated that only the Ministry of Finance could authorize tax reduction and exemption for any sector and manufacturers of cigarettes, wine, sugar, and wrist watches. The provinces could reduce and exempt taxes on county-run small enterprises that supported agricultural production and on rural enterprises in financial difficulties (ibid, 316-17).

Despite these clear national directives, the provincial party and government were able to bring provincial taxation agency and banks to their knees. Since the Communist party was the sole ruling party in China, clean party record and party endorsement were a key factor in advancement (Huang 1996, 43). Through the nomenklatura system, the provincial party committee largely determined careers of provincial officials, including those in provincial banks and taxation department. Not surprisingly, the State Council stated in January 1979 that the provincial party supervised the party and ideological work of the provincial AB (Gao et al 1993, 410). Provincial government could also influence the supplies of resources and services for provincial agencies, such as the supply of water

and electricity, housing, recruitment of bank employees, and education of their children (ibid). In addition, through its extensive power network, provincial government affected the promotion and welfare of family members of bank and taxation officials, who worked in the institutions and enterprises in the provinces. Thus the provincial party and government could hold officials at provincial banks and taxation bureau hostage, coercing them to adopt lending and taxation policies more favorable for enterprises in the provinces, despite their adverse impact on national interests (Huang 1996, 43-4).

Provincial banks thus paid greater attention to local planning commissions than state priorities in deciding on bank loans (Naughton 1995, 258-59; Shirk 1993, 184; Jia and Lin 1994, 51; Huang 1996, 43-4). Local government was able to obtain bank loans to support the rapid growth of local non-state enterprises if they liked (Huang ibid, 44). As late as the early 1995, the center was still warning the provinces against single-mindedly pursuing local interests and contriving countermeasures for national financial policies (*China's Finance and Banking Yearbook* 1995, 12).

Absence of a national tax agency, or the equivalent of Internal Revenue Services in the U.S. in the localities crippled the center's efforts to collect taxes. The center thus fell back on local taxation agency to collect taxes. Under the strong arm of local party and government discussed above, the provincial tax bureau was often purposefully lax in tax collection efforts, or passed out tax holidays for enterprises and tax payers at the gross violation of national policies (Huang 1996, 56-7; Jia and Lin 1994, 96). Directors of State Taxation Bureau hinted at the rampancy of the problem at national tax affair conferences or in their speeches to taxation officials between 1979 and 1994. In their

speeches in 1979, 1981, 1985, 1986, and each year between 1988 and 1993 they criticized unauthorized tax reduction and exemption by local leaders (*China Taxation Yearbook* 1993, 75, 79, 93, 101, 105, 113-14, 123, 129, 131, 152, 155, 189, 15; 1994, 236, 227). As a result of sluggish tax collection, enterprises could keep more profits for themselves and for redevelopment. More resources would be retained in the localities for expansion of local economy, and to benefit local officials and population.

Given national leaders' heavy reliance on provincial leaders' support for their agenda, they were reluctant to dismiss rule-breaking provincial leaders. Only periodic shifts in national policies, evident in the above political-economic cycles, might cause provincial leaders to moderate their indulgence with local economic agenda. They could still resist the center's program implicitly. Provincial leaders thus made the final calls in provincial lending and taxation policies in the period of 1978-94.

## Appendices: Fiscal and Taxation Schemes in China since 1977

### 2A. Central-Local Fiscal Arrangements between 1977 and 1994

1977-1979	<p><b>Fiscal Experiments:</b></p> <p>1. Remitting provinces            1) Six provinces (Hubei, Hunan, Zhejiang, Fujian, Hebei, and Beijing) followed contract-sharing scheme in 1977. Ten other provinces (Shaanxi, Zhejiang, Hunan, Gansu, Jiangxi, Fujian, Shandong, Jilin, Heilongjiang, and Beijing) retained a fixed portion of their revenue for three years, shared increased revenue with the center, and determined their expenditure on the basis of their revenue in 1978. 2) Jiangsu retained 42% of its revenue for four years; revenue of Sichuan was classified into central, provincial, and shared revenue categories, and its expenditure central and provincial expenditures. Guangdong would remit a fixed amount of revenue to the center each of the following five years, starting from 1979.</p> <p>1. Subsidized provinces            1) Seven underdeveloped provinces (Guangxi, Neimenggu, Xinjiang, Ningxia, Tibet, Yunnan, and Qinghai) would remit a fixed amount of revenue to the center, and retain the rest of their local revenue. 2) Fujian received a fixed amount of subsidy from the center each of the following five years, starting from 1979.</p>
1980	<p>“Dividing Revenues and Expenditure, and Multilevel Contracting” (<i>huafen shouzhi, fenji baogan</i>)</p> <p>1. Remitting provinces            1) Fifteen provinces retained a fixed portion of their revenue for five years and shared increased revenue with the center. Revenue sources were divided into central fixed, local fixed, and fixed-rate shared. 2) Beijing, Tianjin, and Shanghai shared all their revenue with the center at an annually-adjusted rate and were under the center’s tight control. 3) Jiangsu, Guangdong continued the scheme during 1977-79.</p> <p>2. Subsidized provinces            1) The seven subsidized provinces of 1977-79 and Guizhou retained all local revenue, and received subsidies from the center with an annual increase by 10%. 2) Fujian continued the scheme of 1979.</p>
1985	<p>“Dividing Tax Categories, Verifying Revenues and Expenditures, and Multilevel Contracting” (<i>huafen shouzhi, heding shou zhi, fenji baogan</i>)</p> <p>1. Revenue was divided into central fixed, local fixed, and shared income.</p> <p>2. Remitting provinces whose fixed income exceeded their expenditures would submit a fixed amount to the center. Guangdong followed the previous scheme.</p> <p>3. Breaking-even provinces whose fixed income could not cover their expenditures were allowed to retain a larger portion of shared income.</p>

	<p>4. Subsidized provinces whose fixed and total shared income failed to cover local expenditure received a fixed amount of subsidy from the center. Fujian followed the previous scheme.</p> <p>5. Revenues and expenditures and retention ratios would be determined on the basis of those of 1983. The retention ratios and amounts of remittance and subsidies would be valid for five years.</p>
1988	<p><b>Modified 1985 arrangements</b></p> <p>1. The center handed over thirteen small taxes to the localities, including the taxes on private and small business and bonuses of state enterprises.</p> <p>2. Instead of fixing the retention or sharing ratios and the amounts of remittance for five years, the center increased the remittance from 12 remitting provinces and three line item cities in the following three ways. 1) Six provinces and four line item cities had a fixed quota of remittance, and shared with the center the remainder of revenue within a specified level. 2) Three line item cities shared with the center target and additional revenues. 3) Remittance of two provinces increased each year. In addition, three provinces (Shanghai, Shandong excluding Qingdao, and Heilongjiang) would deliver a fixed amount out of their surplus residuals in their pre-determined revenue income and expenditure.</p> <p>3. Subsidized provinces. Sixteen provinces, when revenues approved by the center exceeded their expenditures, would receive a fixed amount of subsidies from the center.</p>
1994	<p><b>Tax sharing system (<i>fenshui zhi</i>)</b></p> <p>1. The localities would first have to remit a large portion of their revenue to the center. The center would return part of their remittance to the localities, called tax repayment (TR), <i>shuishou fanhuan</i>, subject to the growth of the tax revenue.</p> <p>2. Tax repayment of 1993 (TR1993) was calculated using the following formula: <math>TR_{1993} = \text{consumption tax (CT)} + 0.75 \times \text{value-added tax (VAT)} - \text{transfer from the center}</math>. For the coming years, if tax revenue increased, TR for the current year would be computed using the following formula: <math>TR = TR_{1993} + 0.3 \times [\text{CT increase} + 0.75 \times (\text{VAT increase})]</math>. If tax revenue declined, TR would be reduced accordingly.</p> <p>3. VAT was made the primary tax, applying to all turnovers, replacing the product tax as well as the business tax on numerous services.</p> <p>4. Local tax bureau was divided into national and local tax offices. National offices would collect the VAT and CT and give 25 percent of the VAT to the localities.</p>

Sources: Wei 1996; Gao et al 1993, 239-241; Wong 1997, 31-5.

## 2B. Sources of Central, Local, and Share Revenues

Central Fixed Revenue	Local Fixed Revenue	Central-Local Shared Revenue or Related Changes
1980		
Income of enterprises owned by the center, and tariffs	Income of enterprises owned by the provinces, as well as salt tax, agricultural tax, industrial and commercial income taxes, and local taxes	Industrial and commercial taxes, income of enterprises that were previously owned by the localities and currently owned by the center (80% of which went to the center, and 20% localities)
1985		
Income and adjustment taxes, business taxes on Railway Ministry, main bank branches, and insurance companies, income of military industrial enterprises, subsidies for surplus purchase and increase in purchase price of grain, cotton, and edible oil; special fuel tax; tariffs; product and value-added taxes collected by the customs, special adjustment tax, taxes on foreign and joint ventures in ocean oil exploration; purchase of state bonds; funds for key state energy and transportation constructions	Income and adjustment taxes on local state enterprises; contracting fees of local state enterprises; revenue from contracting out local enterprises; income tax on collective enterprises; losses of locally-run grain and sales and procurement enterprises; motor vehicle and boat license fees; urban real estate tax; butchery tax; cattle sale tax; trade fair sale tax; contract tax, agricultural and husbandry tax, land usage tax, real estate tax, vehicle and boat usage tax, tax for urban maintenance and construction, fees for late tax payment and overdue taxes	Product, value-added, business, resources, construction, and salt taxes, personal income tax, tax on bonus of state enterprises, taxes on foreign and joint ventures
1991		
		Construction tax was renamed direction adjustment tax on fixed investment; income taxes on China-foreign joint investment and

		management enterprises and on foreign enterprises were combined into income tax on foreign investment projects and foreign enterprises
1994		
Business, income, and urban maintenance and construction taxes on and profits from Railway Department, main banking branches, and insurance companies; profit remittances by and income tax on center-owned state enterprises, local and foreign banks, and other financial business; consumption tax; tax refunds to external trade enterprises; tariffs; consumption and value-added taxes collected by the customs	Business tax; income tax on and profits from local state enterprises; personal income tax (incorporating income taxes on private enterprises and IHEs); urban land usage tax; stamp tax; motor vehicle and boat usage tax; butchery tax; contract tax; agricultural and husbandry tax; tax on agricultural special products; tax on alternative use of arable land; tax on inheritance and gifts; land value-added tax; usage fees on national land	Value-added tax (extended to incorporate the product tax; 75% going to the center, and 25% localities); resources tax (incorporating salt tax; most of it would be retained by the localities, with the exception of ocean petroleum tax); and stocks and bonds taxes (divided evenly between the center and localities).

Sources: Luo and Ao 1996, 58-62, 82.

## Chapter Three: The Logic of National and Provincial Reform Policies

This chapter examines national and provincial reform policies. It follows patterns in these policies, proposes four political-economic explanations, describes data measures and test methods, and discusses test results. Since national policies differ from provincial ones, national and provincial policies will be analyzed separately. Mixing the two levels of policies could otherwise create confusion. The following questions will be addressed: First, which factors caused *the center* (i.e., three national institutions: the Communist Party, the government, and the legislature) to adopt different policies toward individual provinces? Second, which factors caused provinces to pursue reforms at different paces? Third, which model best accounts for national policies, and which for provincial policies? Fourth, did national policies affect provincial policies?

I argue *the need to garner support from urban and rural consumers drove national reform policies; interest group strength* (i.e., the size and clout of state versus non-state sectors) *influenced provincial policies*. Therefore, the popular support model seems to best explain national reform policies, and the interest group model provincial reform policies. This conclusion is reached by running time-series and cross sectional regression tests on indicators of efficiency, revenue, popular-support, and interest-group strength.

*The center*, I suggest, was responsible for the performance of the regime. It *adopted reforms to regain popular support that was eroded by Mao's traumatic politics*. *The provincial leaders were appointed by the national leaders and did not need to worry*



about popular support. Instead, *they were subject to the influence of industrial sectors that were well represented by the provincial governmental agencies.*

National selection of provincial areas for urban reforms, and especially national opening of provinces, seems to have encouraged provinces to promote *rural enterprises*. National urban reform policy, a half-hearted reform initiative, however, tended to prompt the provinces to raise taxes on two smaller non-state sectors, namely, private and foreign business.

## **1. National Policies regarding Reforms in the Provinces**

### **Opening up the provinces and selecting provincial areas for urban reforms**

Two national reform policies could have shaped provincial reform policies.<sup>1</sup> First, the center selectively opened provinces for international business. Since 1978, the center had made a number of cities and counties into “Open Cities or Counties.” The center granted these Open Cities or Counties the privilege of adopting favorable tax, license registration, and export policies concerning the foreign investors. It also bestowed upon them easy access to capital and resources, and the authority to approve large foreign investment projects and substantial imports of foreign equipment. The Open Policy virtually transformed Open Cities and Counties into a bridgehead of reforms, offering them greater access to the international market. In sum, the policy could have encouraged

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<sup>1</sup> For further discussion of central-local relations, please refer to Shirk (1993), Jia and Lin (1994), Yang (1994; 1990; 1991), Wong (1995; 1997), Chung (1995), and Solinger (1996).

an outward-oriented development of these provinces, an inflow of outside resources into these provinces, and profound economic changes throughout China.<sup>2</sup>

Second, the center also selected cities in the provinces to experiment with numerous urban reform initiatives, such as re-structuring municipal administration, overhauling the state industrial and service sectors, and exercising jurisdiction over their adjoining counties. This reform measure would offer the potential to expedite the exchange of capital and labor, as well as other resources and goods between the cities and their neighboring counties, facilitating the division of labor between these localities. Skilled technicians and equipment could be transferred quickly from enterprises in the cities to those in the counties. As a result, rural industry in these counties might grow faster. It was also believed, with extended authority, cities could do more to promote urban non-state sectors. Lastly, the center granted a dozen of cities the status of line-item cities by separately listing them along with provinces in the national economic plan. A main goal of this national initiative was to encourage the line-item cities to participate in urban reforms (Gao et al 1993, 201). To build up the reform momentum at the local level, the central government decentralized economic decision-making power, and promoted local experiments with reform initiatives.

It has been argued that the center favored some provinces in adopting reform policies, but thus far empirical work on which provinces benefited the most has been lacking analytical rigor (Solinger 1996; Reardon 1995; Shirk 1993). Statistical tools can

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<sup>2</sup> Discussion of China's Open Policy can be found in the following works: Crane (1990), Lardy (1992), Reardon (1994; 1998), Shirk (1996), the World Bank (1994), Howell (1993), Yang (1990), Wong (1991), Womack and Zhao (1994), Vogel (1989), and Solinger (1996).

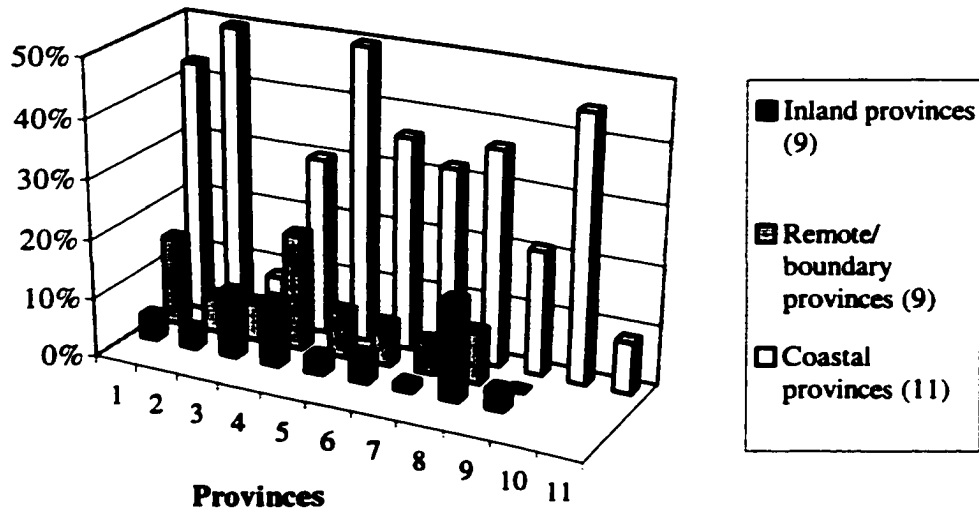
provide us with a more accurate estimate of the inter-provincial differences. The two national policies can be measured respectively by the share of Open Cities and Counties and that of the cities (including the line-item cities) for urban reforms in gross provincial industrial output.<sup>3</sup> Both graphic displays of the measures of the two national policies (Figures 3.1 and 3.2) and ANOVA tests suggest that there exist extraordinary differences in these two national policies (Table 3.1). The national government seemed to adopt different policies regarding non-state industry in the individual provinces, allowing some provinces to have more localities open to international business and the market or to engage in deeper urban reforms.

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<sup>3</sup> These two measures are preferred over shares of these cities in the total number of cities in the provinces, or the share of these cities in provincial population for a number of reasons.

First, cities in China varied widely in the size of their population (from millions to a few tens of thousands) and in their economic output. Therefore, treating each city as equal, as does the share of the cities selected for faster reforms in the total number of cities, is inaccurate. Second, since my research focuses on reforms of the industrial sectors, since the industrial labor forces accounted for less than 40% of the population, and since finite breakdowns of population by employment in each city and county are not available, the share of these cities in provincial population is not reliable either. This measure also biases against economic explanations and for political explanations. Finally, the Chinese officials and scholars seemed to pay considerable attention to the share of these cities in provincial industrial output in making the policies. When explaining these reform policies, officials and scholars always pointed to the share of these cities in the industrial output of a province. The government officials and policy analysts also justified the selection of open areas in terms of their weights in national industrial output. Their statements indicate that the government did use the share of the cities in industrial output as a yardstick in deciding on the cities for experimental reforms.

**Figure 3.1: National Policies of Opening Provinces for International Business: 1978-94 (averaged share of open areas in gross provincial industrial output of 1980, 1982, 1986, 1990, and 1993)**



**Figure 3.2: National Selection of Cities for Experimental Urban Reforms (averaged share of these cities in gross provincial industrial output of 1984, 1988, 1990, and 1992)**

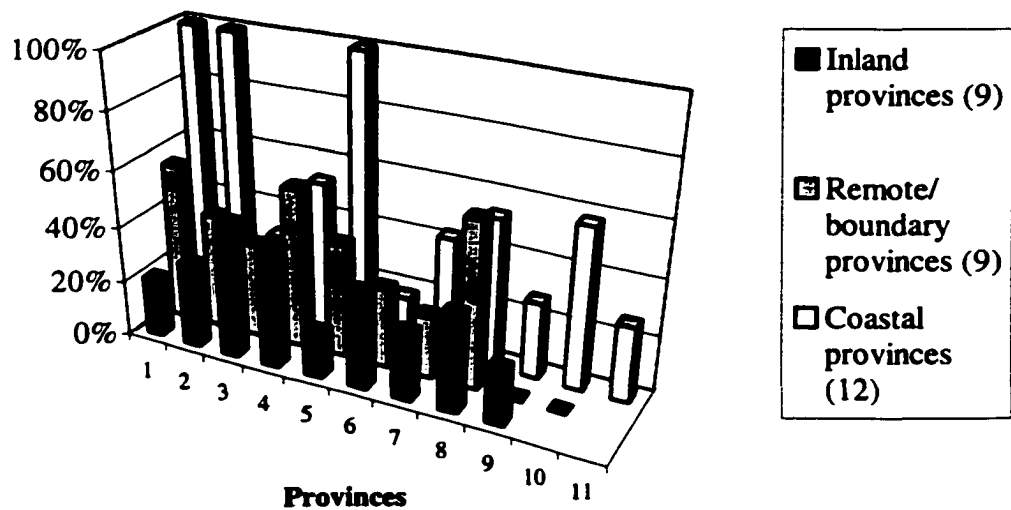


Table 3.1: Results of the ANOVA Tests on Variation in National Policies toward Individual Provinces

<i>Policy</i>	<i>National Opening of Provinces</i>	<i>National Policies on Urban Reforms in the Provinces</i>
Policy measures	Share of Open Cities and Counties in provincial industrial output	Share of the cities for pilot reforms and the line item cities in provincial industrial output
F score (and significant levels in parentheses) of the differences between the provinces	4.58 ( $7.02 \times 10^{-9}$ )	272.63 ( $1.2 \times 10^{-53}$ )
Nationwide share	17.95%	42.99% (28 provinces)
Years	1982, 1986, 1990, and 1993	1988, 1990, and 1992
Number of provinces	29	30

Notes: The ANOVA methods test inter-provincial differences for the policy variables in the years indicated. Calculation of the nationwide data (last row) and the ANOVA test on national opening of the provinces exclude Tibet and Hainan due to the lack of data. The nationwide data of opening of the provinces are computed by averaging these provinces in 1980 and the indicated years, and that of urban reforms in the provinces in 1984 and the indicated years. As to be stated later, the regression analyses of both national policies use only the indicated years so as to observe the effect of provincial characteristics in an earlier year on national policies in a later year.

Sources: See sources for the data on the dependent variables.

### The efficiency, revenue, support and interest-group explanations

To address the first and third questions concerning regional variation in China's reform efforts, I will consider the usefulness of four models employed frequently in the literature of political economy. In the following discussion, each explanation will be summarized first, and then be elaborated upon later. At the end, **testable hypotheses** (in

italics) for each model are formulated in China's context. Each of these models points to a distinct reason that might have motivated Chinese national leaders to undertake regionally differentiating reforms between 1978 and 1994.<sup>4</sup>

One aspect of Chinese reforms is worth noting prior to the discussion of the four explanations: Scarce resources affected the choice of national and provincial leaders in reforms. The legacy of a shortage economy and the rapid expansion of the economy created a scarcity of economic resources such as physical and human capital and raw materials in China between 1978 and the early 1990s.<sup>5</sup> The command economy operates strictly on the basis of planned targets and administered distribution of resources. Unexpected shocks such as natural disasters and poor weather disrupt plans by reducing agricultural outputs and the production of raw materials or inputs for other firms. As Karnoi (1980) suggests, to guard against such uncertainties, firms under planned economy hoard raw materials, causing frequent shortages in production inputs. Even though China had embarked upon a course of reforms since 1978, the production and distribution of raw materials was still heavily influenced by economic planning in the 1980s. More importantly, the state kept prices of raw materials low even into the late

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<sup>4</sup> These models imply that leaders knew what they wanted from their policies. The popular support model, for example, suggests that leaders tried to obtain popular support for the regime through reforms. Leaders, however, did not know in advance which policy would best serve their goals. They experimented with reform initiatives before implementing them on a larger scale. For this reason, the course of Chinese reforms, as scholars observe, has been incremental (Naughton 1995). By studying key factors in the models, whose magnitude varied over years, these four models aim to capture the evolutionary reform efforts over a considerable period of 1978-94.

<sup>5</sup> See Wong (1986a) for a discussion on shortage of inputs in state enterprises up to 1985 due to the soft-budget constraints.

1980s, depriving raw-materials suppliers of much-needed funds for expanding production. China's rapidly expanding economy also increased the demand for raw materials and further aggravated the existing shortfall of raw materials.

Due to the lack of raw materials or capital, many state and non-state enterprises had to scale back their production from 1978 to the early 1990s.<sup>6</sup> Such a scarcity of resources served as an empirical backdrop for growth, revenue, and probably support models.

### *The Efficiency Explanation*

The efficiency explanation suggests that the government is primarily interested in industrial growth and that the center attempts to maximize growth across the provinces through defining the pace of provincial reforms. Through opening up provinces selectively, or through choosing discretely cities in the provinces to experiment with urban reforms, the growth-oriented national government distributes directly or indirectly resources among the provinces, and generates the highest industrial growth possible.

National leaders tried to create a large industrial sector when designing their provincial reform policies. Since industry was the biggest sector in national economy in China, a large industrial sector in the country would substantially increase both the global

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<sup>6</sup> Toward the mid 1990s, market mechanism played a greater role in regulating supplies and demand, and the bottlenecks in the supplies of raw materials and energy and in transportation had eased dramatically. However, for the reform period prior to the early 1990s, a scarcity of resources was common.

prestige and influence of the Chinese leaders. In addition, industrial growth would supply the national party and administrative offices with better equipment and more resources.<sup>7</sup>

The center could help expand industry in the provinces through granting the provinces greater access to resources and greater authority in economic decision making. The greater the exposure to world economy and the faster urban reforms a province was allowed to experience, the more resources it would acquire from other countries and even other provinces, and the faster industry in the province could develop.

The provinces with better infrastructure (such as tele-communication and transportation) and human capital (such as education and research facilities) and closer to the coast could use their resources more efficiently than did the others. A well-developed communications system in the provinces would lower the transportation and information costs for the enterprises. A good educational and research system could produce skilled workers and raise technology and productivity. Provinces near the coast enjoyed easy access to harbours, convenient entry into the world market, and countless opportunities to obtain international capital. The world market would also put more pressure on these provinces to improve economic efficiency to maintain their exports. Therefore, the provinces with a better infrastructure and educational system and closer to the ocean would grow faster after reforms.

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<sup>7</sup> Some may even argue that with industrial growth it would also be easier for materialistic national leaders and officials or their family members and friends to capitalize on their access to resources and accumulate personal wealth.



The national government therefore had two alternatives. It could choose to encourage the provinces to implement identical reforms and obtain similar amount of resources. In contrast, it could concentrate its reform efforts in the provinces that were inherently more productive.<sup>8</sup> From an efficiency point of view, the latter seemed to offer the national government greater chance for the highest growth.<sup>9</sup> *A growth-oriented national government would therefore encourage more reforms in provinces with ocean ports, a developed transportation system, an advanced tele-communication infrastructure, and a highly literate population.*

### *The Revenue Explanation*

The revenue explanation maintains that the national authority was primarily concerned with their revenue and that their reform policies were geared toward maximizing their revenue income. State industry constituted a major revenue source for the center. Reforms in provinces would increase competition, and induce state industry to improve its efficiency, to reduce their reliance on the state's financial support, and to

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<sup>8</sup> Some scholars may suggest another option-- allow the provinces to adopt as many reforms and obtain as many resources as they could. This option could be efficient only when the function of returns from reforms was identical across provinces, which was not the case.

<sup>9</sup> Thanks to Mao's egalitarianism, the center made a comparable amount of investment in the coastal and interior provinces for decades in Mao's era. It turned out the returns per unit of investment were much higher in the coastal than the interior regions. Yang (1990) argued that Deng and the pragmatists had tried to rectify Mao's inefficient idealistic policies since 1978.

sustain their revenue contribution to the state. The center would encourage faster reforms in the provinces with a larger state sector, for it would gain greater fiscal returns.

State industry remained the primary revenue base for the national and provincial governments. Upon the start of reforms, the state sector dominated industry in all provinces, with some provinces having a higher concentration of state-run industry than others. Prior to the reform era and in the years thereafter, the government controlled the revenue of the state sector and collected more revenue from state than from non-state industry. In his well-known study on the evolution of China's reforms, Naughton noted that state industry was a focal point of economic system in China and served as a "cash cow" for the state. In 1978 the total tax and profit created by modern industrial sector, most of which was state industry, amounted to a quarter of GNP (Naughton 1995, 34).

Naughton observes:

"Virtually all of this [total tax and profit] was remitted to the [state] budget, and most of that was channeled back into industry. But even after all state involvements in industry are subtracted, industry [which was predominantly owned by the state] remitted a net 6% of GNP to the budget...Even after the concentration of development policy on industry is taken into account, state industry remains an important source of aggregate saving for the economy as a whole" (Naughton, *ibid*; my own brackets).

Other than the dominant position state industry occupied, two factors also help explain why state industry remained a key revenue source for the government. The first reason is that by the nature of their ownership, the government could monitor financial records and assess the taxes on the state enterprises more easily than it did to the non-state ones. The second reason was that the government lacked organizational means to collect taxes from the newly-emergent non-state sectors. This task was further

complicated by the large number of and the relatively small size of non-state industrial enterprises. A lack of an apparatus to collect taxes on the non-state sectors and the continued offering of favorable tax treatments hampered the tax revenue from these sectors well into the 1990s. Therefore, the Chinese government still receives most of its revenue from state industry. The comparatively small amount of revenue collected from the non-state sectors can be called the *small revenue return from reforms assumption*.

Change in the government's revenue from industry between 1978 and 1992 also supports the small-revenue-return assumption. In 1978 the revenue income from non-state industry constituted roughly 12.5 percent of the national industrial revenue, while that from state industry constituted about 87.5 percent. Even though non-state industry produced 48.5% of the gross industrial output in 1992, it contributed only 30.6 percent of the government's revenue. On the other hand, state industry generated 51.5 percent of industrial output and 69.4 percent of the government's revenue (SSB 1990b, 15; 1996b, 145; 1998, 433). *As late as 1993, 15 years after the start of the reforms, out of the total taxes from industry, 70.5 percent came from the state sectors* (SSB1994, 380-81). Therefore, despite their dramatic growth, the non-state sectors remained a minor contributor to state revenue.

Due to poor management, the productivity of state industry began to decline around the start of the reforms. Concurrently, the state industry revenue contribution to the governments also declined. To maintain their revenue income, the governments had to increase the efficiency of state industry. One practical option was to allow non-state industry to grow and compete against state industry. This required the loosening of

strictures on non-state industry. This can be done in an incremental piecemeal, as opposed to a dramatic, immediate fashion. Since state industry had been and would continue to be the primary source for the government's revenue, the provinces with larger state industry would strengthen their revenue base after reforms. Gradual and controlled entry of non-state industry would force state enterprises to cut costs, increase their efficiency, and improve their performance in order to maintain their position in the sectors.

By introducing gradual reforms, such as a combination of entry of non-state sectors with de-regulation of prices and reforming the banking system, the state could reap a number of benefits. First, its largest source of revenue, state industry, could remain intact, or expand. Second, state industry would still maintain their leading role in economy yet would improve their efficiency after the introduction of competition. They would still be competitive, earn profits, and contribute to the government's revenue. Third, the state would reduce a variety of fiscal expenses for supporting the state enterprises, such as low or zero interest loans, debts, and price subsidies. Therefore, *the center would adopt more reforms in the provinces with a larger state industrial sector*, hoping larger, more efficient state industries would generate more revenue.<sup>10</sup> A larger state industrial sector refers to a larger share of state industry in the provincial industrial output.

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<sup>10</sup> Failure to adopt reforms would only endanger the major revenue base of the government. The government might also enjoy an expansion of the revenue from non-state industry, a secondary revenue source. However, as discussed earlier, state industry would remain the largest fountain of the state's financial inflow over a decade later.

### *The Popular-support Explanation*

The popular support model postulates that the government would implement policies to benefit the key segments of the population and gain their support. By introducing reforms, the Chinese government hoped to provide less expensive and better-manufactured commodities for consumers as well as jobs for the unemployed in exchange for their political support. Reforms, as Perry and Wong (1985) argue, aimed at preventing discontent and potential upheavals among these two groups and thereby strengthening the government's control. It follows that the center would try to stimulate more reforms in the provinces where a greater portion of its population consumed manufactured goods, or was hunting for jobs.

In Maoist China, the government maintained its political control either through communist ideological indoctrination and coercion of the population down to the grass-root level. Even though non-state industry was dynamic and responsive to the needs of the consumers, it was unable to reach its growth potential because the state viewed it as a dangerous bourgeois influence and severely restricted its entry in the market. Meanwhile, the government diverted a large portion of the profits of state industry away from consumption into re-investment. Personal consumption was depressed, often also with nation-wide surveillance. The government spent a tremendous amount of resources and manpower on ideological campaigns, and removed most forms of materials incentives for the employees of state enterprises. These measures also prevented the economy from

unleashing its full potential. In this sense, Mao controlled the population by sacrificing economy for political orthodoxy.

Development during the late period of the Cultural Revolution shattered the rosy Chinese dream of ideological purity and caused them to turn away from political campaigns. In 1971 Lin Biao, Mao's designated successor and an outstanding organizer of the Cultural Revolution, was reportedly killed in an airplane crash while flying to the Soviet Union. According to the Party version of events released after the plane crash, Lin tried to assassinate Mao and stage a coup. The Chinese who enthusiastically participated in the Cultural Revolution were shocked at this dramatic political turnaround and subsequently lost interest in the ideological and political campaigns (Lieberthal 1995, 117). After Mao's death, pragmatic Chinese leaders led by Deng, whom suffered from the Cultural Revolution, rejected Mao's massive ideological campaigns of attacking the party and administrative apparatus and emphasizing ideological purity over economic development. With politics full of deceitful twists, many Chinese became disenchanted with political campaigns, skeptical of the Party's rhetoric, and more concerned with their own personal economic welfare. With reduced ideological control and freer flow of information, many Chinese were awakened to the harsh reality that their Asian neighbors that were as underdeveloped as mainland China in the late 1940s, namely Japan, South Korea, Taiwan, and Hong Kong, had industrialized successfully. The living standards in these economies were on a par with or not far behind that of the Western countries. In contrast, after decades of zealous political movements, the Chinese remained impoverished. This sharp contrast

between China and its neighbors further caused the Chinese to focus on their material lives (ibid, 127).

Through advocating reforms in the provinces the national government hoped to meet the economic needs of the population. As Lieberthal observed in his classic textbook on Chinese politics: “Events during the 1970s had so eroded the legitimacy of the Chinese Communist party that a new source of confidence in the party’s right to rule would have to be found.” Hence “Deng argued” “that the party’s only hope was the utilitarian principle that it could consistently deliver the goods” (ibid). Without the support of the population, the authoritarian Chinese government would have to resort to pure coercion and ideological indoctrination. These measures were not only costly, but might also fail when the population's discontent grew too massive to be controlled. To satisfy the popular desire for a higher living standard, the party and government at the national and provincial levels were compelled to reform the economy and to focus on economic development (Dittmer, 1984).<sup>11</sup> Consumers of commodities and the unemployed constituted two major groups of the population. Let us discuss these groups one by one.

1) Consumers. As discussed above, after Mao's death, the state tried to meet the popular demand for a higher level of personal consumption by introducing industrial property rights reform. The Chinese industry had two major sectors. Heavy industry

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<sup>11</sup> Around 1978 when reforms were launched, the state had two choices-- It either did little to improve the people's material lives and allowed its legitimacy to be further undermined, or reformed to improve its image. It reasonably chose the latter. Several years after the reforms, many problems, such as low prices for agricultural products and rising inflation, unemployment, and corruption, became more apparent, triggering off popular discontent. However, slower paced reforms would have led to a more dangerous outcome.

produced goods mainly for corporations, such as metals and machinery, while light industry manufactured commodities for household consumers. During Mao's years, the state, under the influence of communist economic planning, promoted a fast growth of heavy industry at the expense of light industry. It also forced high savings by suppressing personal consumption. Therefore, during Mao's era personal consumption of manufactured goods had stagnated, though industry had grown considerably.

To meet the population's demand for better and affordable consumers' goods, the state adopted a number of reform policies. It encouraged the growth of light industry, overhauled state firms, and removed its previous restrictions on non-state industry. These measures expanded the light industrial sector, making industrial economy more competitive, and providing the population a larger variety of manufactured commodities at affordable prices. The number of consumers, or the consumption capacity in a province depended on the average income level of its population. The consumption pattern in China for the past decades reveals that as the income level went up, the Chinese, after they covered their food costs, had more disposable income available to purchase manufactured goods. The higher the income level in a province, the more consumers, the greater demand for manufactured goods, and the deeper the reforms implemented in the province to satisfy these consumers.

2) Urban and rural unemployed. Under Mao, the state tried to reduce the pressure for employment from the growing population by prohibiting peasants from leaving their land, by forcing urban young people (the high-school graduates) to work in the countryside, and by making agriculture and state enterprises employ excessive labor. After reforms started, several factors led to a sharp increase in the unemployed population. Firstly, the state had



allowed urban young people whom Mao forcefully sent to the countryside to go back to their home cities. Secondly, after the rural reform, agriculture had become more productive and employed less labor, generating surplus labor. Thirdly, as a result of continued population growth more and more young people entered the job market. Pressure had mounted on the state to create new jobs for these unemployed groups without resorting to Mao's unpopular and inefficient measures. Failure to solve the problem would lead to political unrest. The unemployed and rusticated youth, for example, actively participated in the Democracy Wall Movement during 1978-79 as well as large demonstrations and appeals in Beijing and Shanghai in 1979 (Baum 1996, 71, 76).

Most of the employment opportunities, however, were in non-state industry. State industry had fixed wages and was committed to provide its employees with generous social welfare from inexpensive housing to childcare. If state enterprises employed all the job seekers, the state banks and coffer would be severely strained. In addition, state enterprises would then be hampered by excessive labor and suffer a sharp decline in their productivity and profits (Gao et al 1993, 1668). As a result, the state had to remove its restrictions on non-state sectors, and allow the unemployed to work in these sectors with less social welfare and in many cases lower wages.<sup>12</sup> These measures would inevitably allow the

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<sup>12</sup> Official historians suggested that these considerations prompted the center to grant the entry of non-state sectors since 1978 (Gao et al 1993, 1668; Tang 1998, 221).

Non-state sectors' ability in creating jobs can be understood in the microeconomic terms of the effects of wage hikes on employment. For an employer who had a limited amount of capital available, say, \$100,000 for hiring the employees, he could hire only 20 workers should the government mandated him to raise their annual salaries to say \$5,000 per person (Scenario A). State enterprises in China were in Scenario A, for the state required them to provide a certain level of welfare (such as housing), healthcare, and social services (including childcare) for their

sectors to compete with the formerly monopolistic state firms. Competition would bring down the prices of industrial goods relative to people's income and improve the welfare of consumers. The more urban and rural unemployed a province's population, the greater popular pressure the national and provincial governments would feel to adopt reforms to create jobs for them.

A third hypothesis can be drawn from the previous observations. *In the provinces with a greater demand for industrial goods (measured by the per capita income level) and a higher unemployment rate, the popular pressure on the national government for the growth of non-state industry would be higher, and the center would encourage more reforms in these provinces.*

#### *The Interest-Groups Explanation*

This explanation suggests that national reform policies are the result of the influences of the interest groups, or industrial sectors with a stake in reforms. In considering the extent of reforms it would encourage in the provinces, the center would weigh the relative influences of two sets of opposing interest groups in the provinces, namely, state versus non-state industry, and heavy versus light industry.

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employees. On the other hand, if an employer was allowed to pay his workers a lower wage, say, \$2,000 a year, he could have hired 50 workers (Scenario B). Non-state enterprises in China were in Scenario B, for the government had only minimal wage and welfare requirements on them. Therefore, the hidden costs for hiring each worker were much higher in state than non-state enterprises. The employment capacity was therefore much larger in non-state sectors.

China's industry consisted of two main sectors, heavy and light industries. In terms of ownership, industry consists of state and non-state industries. These four industrial groups constitute major interest groups in reforms. These interest groups were aware of the positive or negative impact that reforms would have on them, and therefore would favor or resist reforms accordingly. Through their control of economic resources, these sectors could influence the government's reform policies. Scholars have suggested that interest groups shaped China's reform policies. Susan Shirk demonstrates in her empirical analysis (1985) that the government was subject to the influence of heavy industry. The latter marshalled substantial economic resources, and was capable of exerting considerable pressure through governmental agencies (such as the Ministry of Machine Building) for favorable policies. Sachs and Woo (1995), on the other hand, argue that employees of state enterprises in China and Eastern Europe and the former Soviet Union (EEFSU) received heavy subsidies and refused to leave the jobs for non-state sectors. They suggest that the larger state sector in EEFSU generated stronger resistance to reform.

Reforms implied two economic adjustments that would affect these sectors differently. First, as a component of reforms, the state removed its restrictions on non-state industry and allowed the market to play a greater role in the economy. Second, after reforms the state would inevitably replace its planning mechanism and heavy-industry-oriented developmental strategy with a market-oriented developmental strategy that emphasized balanced growth of heavy and light industries.

If the above first adjustment occurred, non-state industry would grow rapidly because it is more efficient. In addition, after the removal of state's excessive regulations,

popular demands for consumers' goods, which were depressed under Mao, would surge.

Light industry that produced consumers' goods would consequently grow rapidly.

As a result, non-state and light industries would compete with the formerly monopolistic state sector for resources, market, and profits. It was true that a larger portion of state enterprises were in heavy industry than were non-state enterprises. Given the previous dominance of state sectors in industry, however, a significant number of state enterprises would still be competing against non-state enterprises, especially in light industry. Moreover, because of limited resources, as stated earlier, non-state sectors and light industry would draw away capital, raw materials, and energy needed by state heavy industrial complexes. As late as 1990, state enterprises charged that non-state enterprises which were predominantly in light industry siphoned off their supplies of raw materials and energy, and caused them to cut down on production.

If the second adjustment occurred, in other words, if the state revised its development strategy, it would no longer invest disproportionately in heavy industry that produced goods for corporations. It would instead invest more in light industry, and allow the population and local government institutions to decide where to invest part of their savings or capital. With an expanding market of consumers' goods due to the state's reduced controls over consumption and the movement of capital, both state- and non-state-owned light industry would attract a large share of the capital available in the

society. Heavy industry would lose its previous economic clout, easy access to capital, and favorable treatment by the state.<sup>13</sup>

In summary, reforms would allow the non-state sectors and light industry to grow much faster. It would also put an end to the protected and favorable status as well as the guaranteed market and profits for heavy industry and state industry. Therefore, non-state industry and light industry would favor and lobby for reforms, while state industry and heavy industry would oppose and lobby against reforms.

These groups could influence national policies through translating their economic power into political clout. The above interest groups controlled considerable economic resources, employed millions of workers, and made significant contributions to the government's revenue. The status, welfare, and revenue of some major governmental departments, such as the Ministry of Light Industry and the Ministry of Machine Building (largely heavy industry), depended on the growth of these sectors. These departments would try to advocate the interests of their respective sectoral clients. These groups could command the attention and favorable policies from the government. The national government, in contemplating how fast it should push the reforms in each province, would have to consider the positions of the above interest groups. However, these interest groups were on the opposite sides over reforms. A bigger interest group would carry bigger economic clout and political weight and would shape the reform policies to

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<sup>13</sup> In her study of Wuhan City, Solinger suggests that heavy industry had little appeal for the foreign investors because of its price control over inputs and products and its energy inefficiency (1996, 7). It follows theoretically that heavy industry would not support the Open Policy as enthusiastically as did light industry.

its advantage. As a result, *the national government would adopt more reforms in the provinces with large light industry and large non-state sectors (measured by their shares in the industrial output), because the industrial groups' support for reforms would be stronger.*<sup>14</sup>

This hypothesis presents two potential versions of the model. One version suggests that the varying clout of non-state- versus state industry would cause the pace of reforms to vary among the provinces. It can be called an *ownership version* of the interest group model. As stated, *non-state sectors include rural enterprises (owned by groups of peasants, or township- or village- level authorities or institutions), urban collective enterprises (owned by urban groups and institutions, or low-level urban authorities), private business (household or private enterprises), and foreign enterprises.* The other version (*sectoral version*) postulates that the size of light versus heavy industry accounted for the provincial reform policies. The above hypothesis implies that both versions will be supported in the upcoming tests.

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<sup>14</sup> As discussed above, at the beginning of reforms, productivity in state industry stagnated, and the performance of non-state industry was more vigorous. Therefore, even though the state sector dominated industry prior to reforms, its strength was declining, whereas that of non-state sectors was gaining. Two possible causes could have triggered the start of reforms against this backdrop. First, the government adopted reforms as a convenient approach to overcoming irregularities of the planned economy. But once it accidentally embarked upon the reform course, economic forces drove it toward further reforms. This is implied in Naughton's study (1995). Second, the government probably realized that non-state sectors had a great potential for growth and could help it to buy the support from consumers by supplying them inexpensive consumers' goods. It sided with the rising groups, namely, non-state industry, undertook reforms, and avoided being swept out by popular discontent. In addition, since non-state industry was more efficient in utilizing its resources than state industry, reforms would allow the government to collect efficiency gains. Nevertheless, the national government promoted reforms at different paces in individual provinces. The interest group explanation does provide us a possible explanation.

### *Differences and Similarities between the Models*

The four scenarios all agree that national leaders were concerned with their political power and control. However, no agreement exists among these explanations over which factors are the key source of political power. For the efficiency explanation, the factor is the size of industry; for the revenue explanation, the amount of revenue income; for the support explanation, the support from the consumers of daily-used goods and the unemployed; for the interest-group explanation, the support from industrial sectors whose interests were at stake in reforms.

Hence, these explanations lead to competing predictions about the extent of reforms in different provinces. Most of these predictions are related to the economic characteristics of the provinces. According to the efficiency explanation, the national government, because of its concerns with the returns from resources invested in the provinces, would promote more reforms in the provinces with better educational and research facilities and better infrastructure. The revenue explanation suggests that the national government would encourage more reforms in the provinces with a larger state industrial sector to invigorate its primary revenue contributor. The support explanation hypothesizes that the national government would enact more profound reforms in the provinces with a greater demand for industrial goods for households and a higher unemployment rate. Finally, the interest-group explanation postulates that the national

government would adopt more reforms in the provinces with larger non-state industry and light industry.

## **Data and methods for statistical tests on the four models**

### *Years Selected for Data Collection*

For logistical reasons this chapter uses data of selected years between 1978 and 1994. This research covers a sixteen-year period of 1978-1994, and examines six to eleven independent variables, and six dependent variables in 27 to 29 provinces. As a China specialist (Naughton 1995) noticed, Chinese reforms at the national and provincial levels evolved over the decades after the start of reforms. Time series data over the course of reforms will yield much richer results than data for a single year. Measures of some of the variables of each year, however, require calculation of several indicators. Therefore, collecting data for each year will be too time-consuming. The lack of data in certain years makes this task even less possible. Instead, it is necessary to select years.

As pointed out in Chapter Two and by Hu (1994), Shirk (1990), and Naughton (1995), China's reforms of 1978-1994 witnessed several cycles. Upswing periods were marked by bold reform initiatives across the provinces, coastal provinces in particular, whereas in the downturn periods, mild economic reforms and conservative politics were the norm in the provinces, especially the interior provinces. Given the peculiar political-economic cycles and the ebb and flow of some reform initiatives, random selection of years may not be appropriate. Randomly selected years may well over-represent upturns



or downturns of the cycle, and will bias against a certain set of provinces, or a set of independent variables. In addition, as stated, data on several years are not available, further complicating the random selection method. This research uses instead the mid year in the major up-and-down periods of reforms. Meanwhile, discretion is exercised in peculiar situation. In the analyses, 1982 is used for the down period of 1981-83, 1986 (if not available, 1985) for the up period of 1984-1988, and 1990 for the down period of 1989-91, and 1993 (if not available, 1994) for the up period of 1992-94. The year 1980 is chosen for the up period of 1978-80; data on 1978 and 1979 are either unavailable, or incomplete. Data on the independent variables for these years were collected.

### *Dependent Variables*

The two dependent variables used in my models are national opening of the provinces and national selection of cities in the provinces for urban reforms. The former is measured by the share of the Open Cities and Counties in each province *in the gross provincial industrial output* in 1980, 1982, 1986, 1990, and 1993. As stated, the center granted these localities greater access to foreign investment than it did to others. The national selection of cities for urban reforms is measured by the share of the cities selected for urban reforms and of line-item cities in gross industrial output in each province in 1988, 1990, and 1992.<sup>15</sup>

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<sup>15</sup> 1988 is the first year when a published list of the cities for urban reforms is available. 1992 is chosen for information on cities for urban reforms is hardly available after 1992.

### *Independent Variables*

Explanatory variables, drawn from the above hypotheses, are the political-economic characteristics of *each province*. These variables and their measures, arranged by the explanations, are reported in detail in Table 3.2. Since the measures of variables from the efficiency and interest-group models are more complex than those from other models, the following brief discussion focuses on the variables from *these two* models.

*The efficiency explanation:* This explanation has four variables. Transportation access and tele-communication development gauge the quality of infrastructure in a province; the distance between the province and the nearest ocean harbor reflects provincial accessibility to the international market, and literacy rates capture the quality of human capital and of educational system in the province. *Transportation* is measured by indexes of transportation system, computed in a way described in Table 3.2. When a province had an ocean harbor, its distance from the coast is coded as zero. When the province did not have an ocean harbor, its distance from the coast is the length of the railway from the provincial capital to the nearest ocean harbor.<sup>16</sup>

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<sup>16</sup> Data on the provinces' distances from the nearest major harbor come from Jin and Chen 1996, 59 and *China Transportation Maps* 1979, 134. Distances in 1979 are the same as those in 1994 for all provinces. Since there is no railway connecting Tibet's capital Lhasa to other cities, Lhasa's distance from the nearest major harbor Shanghai is the sum of the route by air between Lhasa and Xi'an and that of the railway route between Xi'an and Shanghai (Jin and Chen, *ibid*).

**Table 3.2. Independent Variables and Their Correlation with National Policies as Predicted by the Four Explanations**

Explanations	Variables	Measures	Correlation with National Policies
Efficiency	Transportation access	(length of railway, highway, and waterway in kilometer times adjusted by share of each route in national turnover volume of goods)/ provincial area in 1000 square kilometers, logarithmic transformation	+
	Coastal access (Distance from the coast)	Distance in kilometers between a province and the closest major ocean harbor by train, logarithmic transformation	-
	Tele communication	Phones per 1000 residents, logarithmic transformation	+
	Literacy rate of the population	The literacy rate at a population sampling or census	+
Revenue	Size of non-state industry	Share of non-state industry in provincial industrial output; equivalent to 1- size of state industry	-
Popular support	Urban consumption level	Consumption per non-agricultural resident in 1980 Chinese yuan, logarithmic transformation	+
	Rural consumption level	Consumption per non-agricultural resident in 1980 Chinese yuan, logarithmic transformation	+
	Urban unemployment rate	Officially registered unemployed labor/ total urban labor	+
	Rural surplus labor rate	The portion of rural labor that worked outside the locality on a temporarily contractual basis	+
Interest Groups	Size of non-state industry	Share of non-state industry in provincial industrial output	+
	Size of light industry	Share of light industry in provincial industrial output	+

Notes: + positive; - negative.

*The interest-group model:* The measures of the variables in the models can be expressed in the following equations: The size of non-state industry = 1 – the size of state industry; the size of light industry = 1 – the size of heavy industry. The two variables, the sizes of non-state and light industry, can capture the relevance and significance of these four interest groups because of their above relations with the other two variables.

A possible concern is that the variables of provincial consumption levels from the popular support model would naturally correlate positively with the measure of the national policies, that is, the share of areas selected for opening or urban reforms in provincial industrial output. This concern is not an issue, however, for the two following reasons. First, while the center had opened up a large portion of coastal and developed region by 1988, it did not open the inland and underdeveloped region until 1992. The center played a dominant role in the opening of provinces. Second, major cities took up a much larger share of provincial industrial output in less developed provinces. If the center treated all provinces equally by picking the same number of cities in each province to open to international business or to adopt urban reforms, the share of these cities in the less developed provinces would be larger, despite the fact that their per capita consumption levels were lower. In 1988, for example, the provincial capital city produced 10.7% and 25.9% of gross industrial output in coastal and developed Jiangsu and Guangdong Provinces respectively, and a whopping 49% and 58.8% in interior and underdeveloped Gangsu and Qinghai Provinces (*China's Urban Statistical Yearbook* 1989, 167-76; SSB 1989, 269). Suppose that the center introduced the Open Policy or urban reforms in the capital of these four provinces, the share of the cities selected for

reforms, or the measure of these two national policies would be much higher in the inland and underdeveloped provinces than the coastal and developed ones. Then the provincial per capita consumption level might even be inversely related with the measure of national policies regarding provincial reforms.

### *Data Transformation*

Data transformation is a standard procedure in econometric analysis. Consumption levels tended to rise at different rates across provinces and over years. After weeks of intensive labor, the measures of rural and urban consumption per capita were converted from the original data in current prices into 1980 constant prices. This conversion will help to avoid the above-described problem. New problems, however, still arise. The dependent variables (policies) and several independent variables (literacy and shares of non-state and light industries in gross provincial industrial output) are measured in percentages. Raw economic data on a number of independent variables, on the other hand, have a relative wide range. Transportation access ranges from 4 to 770, the distance from the coast 0 to over 3900, numbers of telephones per 1000 residents from 1.3 to 114, urban consumption per capita from 340 to 1400, and rural consumption per capita from 135 to 1100. The range of these variables is much larger than the percentage data on the other variables. Differing data ranges might cause their regression coefficients to vary significantly in size. In econometric analyses, a standard routine is to take logarithmic transformation of the raw data before regression tests. Ten-based

logarithmic transformation was completed, reducing the size of the data of these variables closer to the percentage data of other variables, better than a natural logarithmic transformation or dividing of the raw data by 100.

### *Determining the Explanatory Power of the Models*

Table 3.2 summarizes the predicted correlation between explanatory and dependent variables. To make a broad and general evaluation of the explanations and to pinpoint the causes for different reform policies, I will regress the measures of two national policies on all the independent variables simultaneously. I will then use the regression results to evaluate each of the four models. If the dependent variables have a statistically significant association with the above variables from only one of these hypotheses, only this hypothesis can explain the extent of reforms.

These regression results will help me determine which explanation is most relevant. Suppose the national reform policies are significantly and positively associated only with transportation access, the number of telephone per 1000 residents, and the literacy rate, but negatively with the distance between the province and the closest major ocean harbor, and they are either insignificantly or negatively associated with the independent variables from other hypotheses. Then I will accept the efficiency explanation and reject the other explanations. Similarly, I will favor only the revenue explanation if both the national reform policies in a province are statistically significantly associated only with the size of state industry. I will endorse only the support explanation if only industrial consumption

per capita and the unemployment rate can explain the national reform policies. Finally, only the interest group explanation will be accepted if only the size of light industry and that of non-state industry, not the independent variables from other hypotheses, explain the national reform policies.

Less-than-clear-cut results may call for a more nuanced solution. First, what conclusion can be drawn if not all the variables from one explanation are associated with the dependent variables in the way predicted by the explanation? The answer is additional thought beyond the numbers. Suppose that transportation access and the distance from the coast satisfy the predictions of the efficiency explanation in the test, but phones per capita and literacy rates do not. Such a result would indicate that this explanation has received moderate, not full support in the test. Suppose again that the correlation of the urban consumption level and rural unemployed with the dependent variables supports the prediction of the support model, but that of the rural consumption level and urban unemployed turns out to be the opposite of the prediction of the model. Since most of the Chinese population lived in the countryside, rural consumers and the urban unemployed outnumbered urban consumers and the rural unemployed. Hence the test would provide limited support for this explanation. To put it succinctly, it indicates that the government aimed at gaining support from only a small portion, not the majority of the population. Similarly, a mixed finding could occur within the interest-group model because it consists of two parts. Suppose that only the size of non-state industry is significantly correlated with the dependent variable in the direction as predicted by the interest-group explanation, and that the size of light industry is either not, or is correlated

in a direction opposite to that predicted by the explanation. In such a case, the light-industry (sectoral) explanation will be rejected, and the non-state industry (ownership) explanation will be accepted.

The most effective explanation for regional variation in Chinese reforms can be identified on the basis of the results from the data analysis. In cases when more than one explanation is supported by the tests, the relative explanatory power of these models could be judged by the substantive importance of variables in each model significantly correlated with reform policies, the coefficients and significance levels of these variables, and the number of reform policies each hypothesis can explain.

A detailed discussion on the test methods is included in the Appendix.

### **Findings of the tests: causes of national reform policies**

Tests were conducted on each of the two national policies. The results, summarized in Table 3.3, reveal several relevant factors in these two national reform policies. The national government tended to open up provinces with more or richer urban and rural consumers, better tele-communication infrastructure, and to a lesser extent, provinces closer in proximity to ocean harbors and with a larger light industrial sector. Several observations regarding the center's motivation can be drawn from these results. First, in implementing its Open Policy in the provinces, the center seemed to be concerned with obtaining support from urban and rural consumers. In addition, it was moderately interested in producing higher growth by opening up provinces that had better tele-



communication infrastructure and that were closer to the coast. The concentration of light industry only marginally contributed to the center's granting of a province access to the international market and investment.

On the other hand, the provinces where the center introduced urban reforms possessed a larger state industrial sector, as well as a higher level of telephone density and rural consumption. They also tended to lie within close proximity of ocean harbors.

Finally, on balance they tended to have a marginally better transportation system, more rural surplus labor, and unexpectedly, a lower literacy rate. Several implications can also be extracted from these results. In executing urban reforms in the provinces, the center apparently tried to maximize its revenue. To a lesser extent, it probably tried to induce support from rural consumers and rural surplus labor. It attempted to reap the benefits of higher growth by authorizing more urban reforms in provinces closer to the coast, with better tele-communication and marginally better transportation. However, this attempt seemed to be weakened by its selection of provinces with a lower literacy rate for urban reforms.

Scholars on China widely believe in the significance of the distance from the coast in national policies toward the provinces. The above tests indicate that the distance from the coast only marginally accounted for the national opening of the provinces, and does increase a province's chance for being selected by the center for urban reforms.

Table 3.3: Results of Regression of National Reform Policies on Variables from the Four Explanations (Coefficients and in parentheses standard errors)

Model/ category	Variables	National opening of provinces	National policies on urban reforms in the provinces
Efficiency	Transportation	0.045 (0.050)	0.085+ (0.049)
	Harbor	-0.035+ (0.022)	-0.070**** (0.020)
	Phones	0.176* (0.075)	0.172** (0.064)
	Literacy	-0.193 (0.14)	<u>-0.224*</u> (0.093)
Revenue	Non-state industry	0.184 (0.21)	-0.735**** (0.121)
Support	Urban consumption	0.566* (0.29)	0.342 (0.233)
	Rural consumption	0.432* (0.21)	0.345* (0.145)
	Urban unemployment	-0.307 (0.80)	0.323 (1.051)
	Rural surplus labor	0.711 (1.17)	0.718+ (0.401)
Groups	Non-state industry	0.184 (0.21)	<u>-0.735****</u> (0.121)
	Light industry	0.292+ (0.18)	0.036 (0.179)
Other statistics	Constant	-2.56*** (0.70)	-1.087 (0.821)
	Panel AR (1) coefficient	-0.0003	0.404
	Pr>Chi2(10)	0.0000****	0.0000****
	Log likelihood	124.78	168.17
	Case	28 x 4	28 x 3
	(provinces x year)		

+ : Z score significant at 0.10 level; \* : significant at 0.05 level; \*\* : significant at 0.01 level; \*\*\* : significant at 0.005 level; \*\*\*\* : significant at 0.001 level; underlines: significant yet contradicting the model.

Tests use cross-sectional and time-series regression with Panel-Corrected Standard Errors (PCSE), correction for heteroscedasticity (HETERO), and a common first-order autocorrelation coefficient (AR1). Values of national policies in a later year are regressed on the data on the provinces from the four models in an earlier year. For example, the measure of national policies in 1982 is regressed on the provincial variables in 1980. In this way, the provincial variables of an earlier year, or the center's consideration of these variables, could have affected the national policies in a subsequent year, but not the other way around. The reason is that the event of 1980 could have caused that in 1982, but not conversely.

Among the four models, *the popular support model receives the clearest and unambiguous support of the tests.*<sup>17</sup> Rural consumption levels, a proxy for the size of rural consumers who made up a large segment of the provincial population, could account for the variation in both national reform policies. The other models receive weaker support than does the popular support model. The efficiency model is confirmed in one test, and receives mixed support in another. The revenue model is supported strongly and clearly by one test. The sectoral version of the interest-group model finds weak support with one test, while the ownership version of the interest-group model is rejected soundly by the other. It therefore seems that the popular support model best explains both national reform policies, followed by the efficiency, revenue, and interest-group models in that order.

Historical accounts suggest that the top national leaders indeed focused mainly on popular support in launching the reform programs. Deng, the paramount Chinese leader during 1978-1997, admitted in October 1984 that he was a layman over economic issues and that he had spoken about them from a political point of view (Deng 1993, 77). His remarks before and after 1984 indicate that he pushed for reforms in order to secure popular support for the communist regime. Back in the summer of 1978, months before the official start of reforms, Deng told the provincial and local leaders of the Northeast to concentrate on economic construction, stating boldly: "We have devoted to revolution for decades, and have built socialism (communism) for decades. By 1978, the average

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<sup>17</sup> Italics here indicate an emphasis. In other cases they may refer to particular terms. In the discussion of the models of reform policies, italics signify hypotheses.

monthly wage of workers is only forty to fifty yuan, and most of the countryside is still in poverty. What kind of socialist advantage is that?" (Deng 1993, 11). He declared in December 1978: Should the Communist Party fail to implement reforms, modernization and communism would be buried (Tang 1998, 89). In March of 1990, Deng commented on the slow economic growth during the post-Tiananmen retrenchment in front of the major national leaders:

"Some countries run into problems. A fundamental reason is that their economies cannot grow, that their living standards decline, and that their people have to live a thrifty life. Why do the people support us now? It is because development has occurred in the past decade and because development is noticeable. Suppose the economy grows at four or five percent, or even two to three percent, what kind of consequence it will lead to? The consequence will not only be economic, but also essentially political" (Tang 1998, 417).

Even Chen Yun, a staunchly conservative economic specialist and the second most powerful leader in Deng's governing coalition, echoed Deng's view in his speech at the CCP Central Committee Work Conference in April 1979:

"If people don't have enough to eat and are not adequately clothed, you can offer a million excuses...But no matter how many they are or how good they are, nobody will listen ...They feel they have been waiting thirty years and now have to wait another thirty years...Unless we win the confidence of the entire country there can be no resolution" (Baum 1996, 78).

Both the leading reformer and conservative agreed that the Chinese Communist Party should raise the living standard of the population in order to continue to command popular support and maintain its control. Politics, rather than economics, caused the Chinese leaders to choose the reform path.

## **2. Provincial Reform Policies**

### **Inter-provincial differences in reform policies**

Both China scholars and provincial leaders have acknowledged the different policies in the provinces under the Center's leadership. The Chinese perceive that coastal provinces, especially southern coastal provinces pushed for bold reforms whereas the others acted cautiously.<sup>18</sup> At the meetings of provincial leaders or in publicized reviews of the implementation of the reform policies in the provinces, party and government leaders of some provinces admitted that provincial and local officials were reluctant to adopt the reform policies. For example, the Party Secretary of Jilin Province stated at a meeting of provincial leaders in November 1992: "Over many issues regarding reforms and development we have lacked the courage and boldness. Instead, we sought stability and avoided trouble. While other (provinces) had acted, we were still hesitating and debating. While other provinces had succeeded, we were still waiting and looking on. We could not even implement the good methods and experience which we initiated due to hindrance of (conservative) ideas" (*Jilin Yearbook* 1993, 2). In contrast, a few of the other provinces took advantage of the center's relaxation and implemented reforms as fast as the Center could tolerate. As a result, a wide discrepancy existed between the Center's and provincial policies. Even when the center promoted reforms among the provinces, the provinces responded in various ways. To borrow from a popular political saying in China: "Whenever

superiors announce a policy, subordinates come up with a counter-policy” (*Shang you zhengce, xia you duice*). The provinces had the final say in their reform policies.

Statistical analyses can provide us with a reliable test on perceived interprovincial differences in the implementation of the reform policies. Quantitative data on the bank lending by rural banking system to rural enterprises and collective industry, taxation on rural enterprises, taxation on the private sector, and taxation on foreign enterprises will be used to assess these differences. The following corresponding measures on the four policies are adopted. The measure for the first policy is the share of provincial bank lending to rural enterprises and collective-owned industry in total loans of the agricultural banking system. The measures for the remaining three policies are tax rates on rural industry, private sectors, and foreign enterprises respectively. Table 3.4 summarizes these measures. The higher the share of rural enterprises and collective industry in the loans of the agricultural banking system in the province, and the lower the taxes in relation to the output of these sectors, the more resources these non-state sectors would have for their investment and growth. The provincial government could use these variable leverages to promote or restrain the non-state sectors.

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<sup>18</sup> For more information on provincial reform policies, refer to Cheung et al (1998), Yang (1991), Goodman and Segal (1995), and Schroeder (1992).

**Table 3.4: Measures of the Provincial Policies toward Non-State Industry**

Policies toward Domestic Non-State Industry	Policies toward Foreign Non-State Industry
Share of rural enterprises and collective-owned industry (primary no-state sectors) in total loans of agricultural banks and rural credit cooperatives in 1980, 82, 86, 90, and 94	
Tax rate for rural industry-- ratio of taxes to the output of township- or village-level rural industry (rural enterprises in 1988) in 1988, 1990, and 1992	
Tax rate for private business-- ratio of income tax on the individually- or privately-owned sectors (a secondary non-state sector) to their sales between 1990 and 1993	Tax rate for foreign business-- ratio of income tax on foreign enterprises to actually-used foreign investment: 1990-94

As stated earlier, provincial governments were able to use their leverage to influence the lending and taxation policies. They could recommend the nominees for the directors of the provincial banks and taxation agencies, control supplies of utilities for these agencies, and influence the welfare of the family members of officials of these agencies (Huang 1996, 43-4). Provincial governments were able to arrange bank loans and set the effective tax rate for the non-state sectors. Therefore, provincial governments could help define the pace of growth of collective-owned industry, private sectors, and foreign enterprises.<sup>19</sup>

<sup>19</sup> This was true as late as 1994.

Measures of these policies are plotted on the above charts to depict the variation among provinces (Figures 3.3-3.6).<sup>20</sup> A visual examination of these charts reveals sharp inter-provincial differences in provincial reform measures, with the exception of taxes on rural industry. ANOVA tests corroborate this finding (Table 3.5). As far as taxation on private sectors is concerned (Figure 3.5), Shanghai was an outlier for its relatively high taxation and might have skewed the ANOVA results on inter-provincial differences. An ANOVA test without Shanghai is run to explore this possibility. The result still points to very impressive variation among the provinces (significant at a fortieth decimal point).

A closer examination of these charts also reveals that with the exception of provincial lending, coastal provinces did not possess a clear edge over inland and remote provinces in their taxation on rural, private, and foreign enterprises. In addition, the differences among the coastal provinces and among the remote provinces on all four policies were remarkable. Provincial reform efforts in inland provinces seemed to be more uniform, especially in their taxation on rural enterprises.

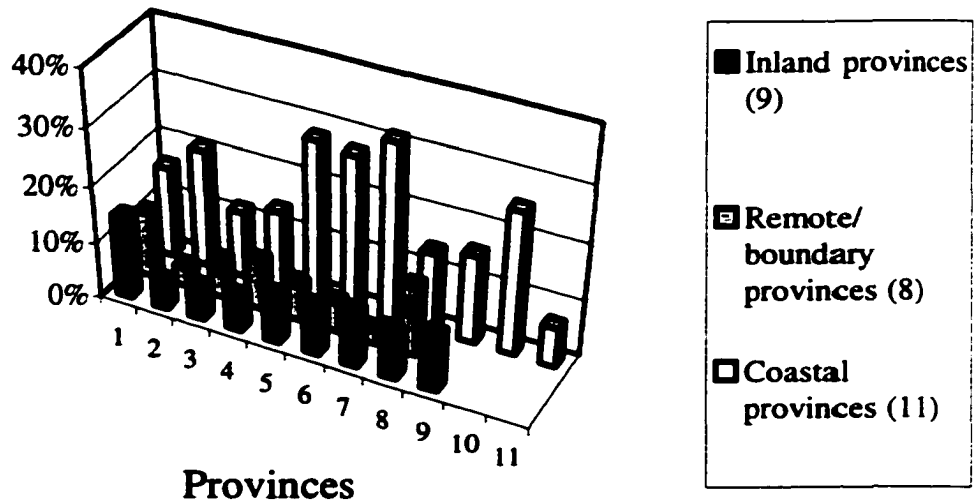
These test results give rise to three questions. The first is which political-economic factor or model helps to explain the above lending and taxation efforts by the provinces in promoting the non-state sectors? The second question is whether the distance from the

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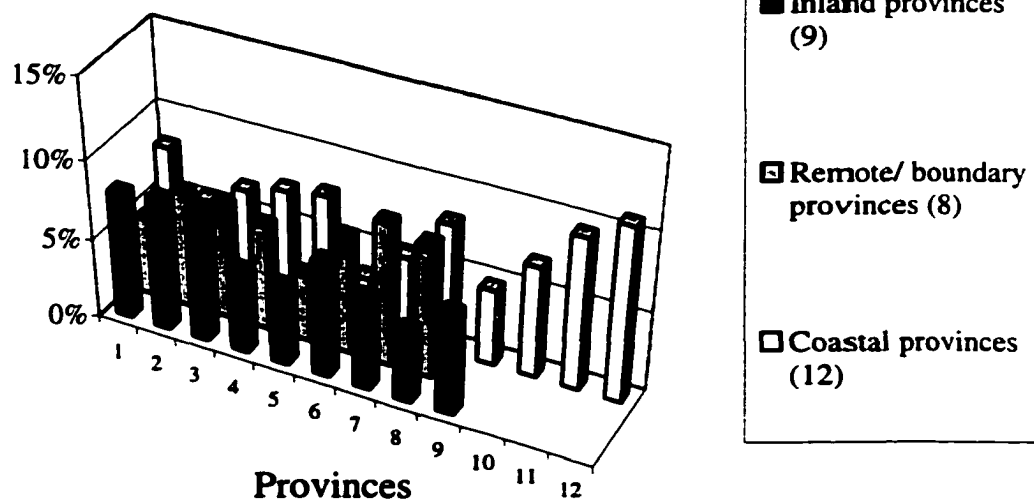
<sup>20</sup> In Figure 3.4, the ratio of national, provincial, and local taxes to the output enterprises averages that of township and village enterprises in 1988, and that of township and village industrial enterprise in 1990 and 1992.



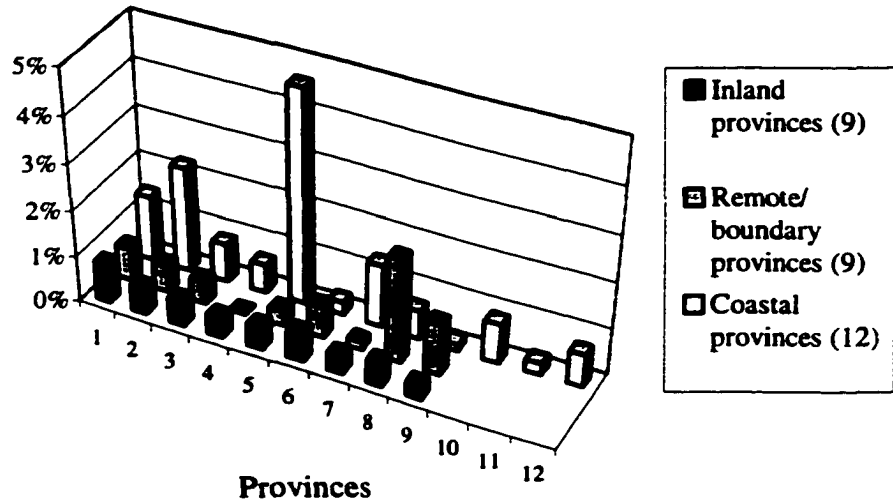
**Figure 3.3: Provincial Bank Loans to Rural Enterprises and Collective Industry: 1978-94** (averaged share of these loans in total loans of Agricultural Bank of 1980, 1982, 1986, 1990, and 1992)



**Figure 3.4: Averaged Ratio of National, Provincial, and Local Taxes to the Output of Township and Village (1988) Industrial (1990 and 1992) Enterprises**



**Figure 3.5: Ratio of Income Taxes on Private Sectors to Their Sales: 1978-94 (average of 1990-1994)**



**Figure 3.6: Ratio of Income Taxes on Foreign Enterprises to Investment at the Enterprises (average of 1990-94)**

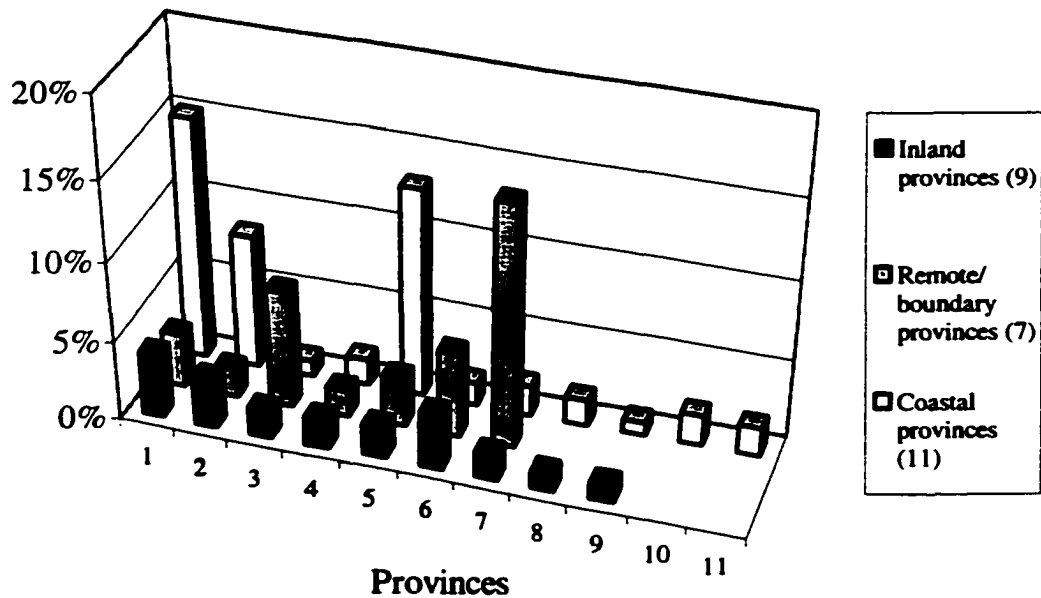


Table 3.5: Results of ANOVA Tests on Variation in Provincial Governmental Policies toward the Non-State Sectors

Policy	Provincial lending to rural enterprises and collective industry	Provincial tax collection on rural industry	Provincial tax collection on private sectors	Provincial tax collection on foreign enterprises
Policy measures (annual average)	Share of loans to rural enterprises and collective industry in total loans of agricultural bank and rural credit cooperatives	Ratio of taxes to the output of rural industry (rural enterprises in 1988)	Ratio of taxes to the output of private sectors	Ratio of income tax on foreign enterprises income tax to actual foreign direct investment
F score (significant levels in parentheses) of differences between the provinces	2.54 (0.00034)	0.66 (0.884)	80.12 ( $7.31 \times 10^{-53}$ ) {without the outlier: 44.84 ( $1.85 \times 10^{-40}$ )}	4.25 ( $2.99 \times 10^{-8}$ )
Nationwide share or ratio	12.29%	6.81%	0.83%	3.96%
Years in the data	1980, 1982, 1986, and 1993	1988, 1990, and 1992	1990-94	1990-94
Number of provinces in the data	28	29	30	28

Notes: The ANOVA analyses test the differences in the four policy variables between the provinces in the years indicated. Tests on provincial lending to rural enterprises and taxation on foreign enterprises exclude Tibet and Hainan, and that on taxation on rural industry excludes Tibet. The nationwide data are computed by averaging these provinces.

Sources: The same for the data on the dependent variables.

coast was a significant factor in the provincial reform policies? The third is since the center favored a differentiated, instead of a uniform pace of reforms in the provinces, how did the national policies influence reform efforts of the provinces?<sup>21</sup> Two steps will be taken to address each of these questions. To answer the first and second questions, the above four political-economic explanations will be applied to provincial policies. Hypotheses will be drawn from these explanations on how given political-economic factors caused the provinces to embark on reforms. Tests will be run on these hypotheses. Separate tests will be conducted to assess the effect of national policies on provincial ones.

#### **The Efficiency, revenue, support and interest-group explanations**

As the above four models are derived from a body of literature on governmental policies, they can, with slight modification, help to explain reform policies that we have observed. This does not, however, rule out the possibility that different explanations account better for national and provincial policies. *Much of the explanations on national policies, such as their logic as well as the assumptions of scarce-resources and small fiscal returns from non-state sectors after reforms, are modified to make them applicable to provincial policies.* Only the efficiency explanation will differ from the one used to

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<sup>21</sup> Solinger (1995), for example, suggests the national opening of provinces favored the coastal provinces and held back the progress of reforms in inland provinces.

evaluate national policies. The following discussion will review these models briefly.

**Testable hypotheses** (in italics) for each model are also formulated below.

### *The Efficiency Explanation*

This explanation assumes that provincial leaders aimed at maximizing growth in designing reform policies, because a large industrial sector would enhance the leaders' political influence, prestige, income, and chances of being promoted into a higher position. Since the mid-1980s, several leaders of provinces with a large and fast growing industry were promoted to prominent national positions. Li Ruihuan, for example, whose reform initiatives improved the lives of residents in Tianjin, became one of the national party leaders in the late 1980s. Jiang Zemin, the former Party Secretary of provincial-level Shanghai City, became the head of the national Communist Party in 1989. Zhu Rongji, the former mayor of Shanghai, became a vice premier in 1991. Jiang Chunyun, the former governor of fast-growing Shandong in the early 1990s, was later promoted to a vice premiership. Finally, with an expanding industry these provincial leaders or their family members or friends would have more opportunities to translate their access to resources into private gains.

Two slightly different versions of the efficiency model may follow. The first version, which can be termed the infrastructure-driven efficiency model, maintains that the quality of infrastructure and human capital as well as the distance from the coast largely conditioned potential economic returns from reforms. Provincial leaders would pursue

reforms to a point that matched the quality of infrastructure of the provinces. Beyond this point, reform policies would become sub-optimal and would not generate further growth. Provinces with inadequate infrastructure and human capital and that lay far way from the coast would still end up with slow growth even after bold reform efforts. The logic of this version resembles that of the efficiency explanation of national policies. The infrastructure-driven efficiency model suggests that *provinces with better infrastructure and human capital and closer to the coast would carry out reforms more quickly.*

The second version, which can be called the reform-driven efficiency explanation, holds that provincial policies affected economic returns from reforms in a province much more than did the quality of infrastructure and human capital and the distance of a province from the coast. Provincial reform policies could improve the business environment and attract the inflow of resources into the provinces, setting the pace for provincial development. National and provincial leaders might disagree over the pace of reforms in individual provinces. National leaders, as stated above, would strategically favor some provinces over the others to maximize national returns from the reform program. In contrast, the provinces would all opt for bold reforms and compete for the largest share of resources available. As a result, *the variation between the reform policies adopted by each provincial government would be minimal.*<sup>22</sup> *Therefore little correlation should exist*

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<sup>22</sup> Even the less developed provinces, this model suggests, could create a friendly environment for investment through reform initiatives, such as building needed infrastructure. Such a favorable environment would check the flight of capital, skilled labor, and materials out of the provinces, and even attract resources for the growth of non-state industry. In addition, given their lower level of development, these provinces had the potential to produce higher growth than did the other provinces, as implied by the convergence theory in development

*between reform policies on one hand, and transportation, communication, and the literacy rate in the provinces, as well as the distance between the provinces and ocean harbors on the other.*

### *The Revenue Explanation*

This explanation maintains that provincial governments were primarily concerned with their revenue and that their reform policies served their purpose of maximizing their revenue income. Provincial governments would try to generate revenue by sustaining their major revenue base and reducing the costs of financing the state sector.

While the state sector dominated industry in all provinces at the outset of the reform period, some provinces had a larger state industrial sector than others. As demonstrated in the discussion on national policies, the government had easier access to book records of and collected more revenue from state industry than the non-state sector prior to the reforms and in years directly after the reforms. Prior to reforms, state enterprises, especially those inefficient ones, received low- or zero- interest loans and subsidized raw materials from the government. After reforms provincial governments could reduce these financial supports to state enterprises, and increase revenue income. In a province with a larger state industrial sector, the provincial government's revenue would be in a better

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studies (Barro and Sala-i-Martin 1991). Infrastructure was not a concern exclusively for undeveloped provinces. Even developed provinces had to invest in infrastructure in order to accommodate a large volume of goods and a large number of passengers. These provinces spent heavily on the construction of highways, railways, and phone systems after 1978.

shape after reforms. Larger state industries mean a larger share of state industry in the provincial industrial output. *Provincial governments would therefore make greater reform efforts in the provinces with a larger state industrial sector.*

#### *The Popular-support Explanation*

This model postulates that the government would implement policies to benefit the key segments of the population and gain their support. By introducing reforms, the Chinese government hoped to provide less expensive and better-manufactured commodities for consumers as well as jobs for the unemployed in exchange for popular support. Therefore, reform policies were targeted at preventing discontent and potential upheavals from these two groups and thereby strengthening the government's control.

This reasoning leads to the following hypothesis. *In the provinces with a greater demand for industrial goods (measured by the income level in the provinces) and a higher unemployment rate, the popular pressure on the provincial governments for the growth of non-state industry would be higher, and the governments would adopt more reforms.*

#### *The Interest-Groups Explanation*

This explanation suggests that reform policies are the result of the influences of the interest groups, or those industrial sectors with the greatest stake in reforms. These groups could command the attention and obtain favorable policies from provincial



governments. However, these interest groups stood on the opposite sides of the debate over reforms. While non-state and light industry would benefit from reforms and therefore supported these efforts, state and heavy industry would suffer from reforms and resisted these initiatives. The bigger the interest group, the greater its economic clout and political weight, and the more likely it could shape the reform policies to its advantage.

Consequently, *in the provinces with large light industry and large non-state sectors (measured by their shares in the industrial output), the industrial groups' support for reforms would be stronger, and provincial governments would adopt more ambitious reforms.*<sup>23</sup>

Again, this above hypothesis combines two potential versions of the model. The ownership version suggests that the influence of non-state versus state industry could lead to different provincial reform policies. The sectoral version implies that the size of light versus heavy industry accounted for the provincial reform policies.

### **Dependent and independent variables and statistical tools**

As noted, the dependent variables are the four provincial reform policies. The first one is provincial bank lending to rural enterprises and collective-owned industry, while

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<sup>23</sup> Refer to an earlier footnote (in the discussion of national policies) for possible causes of the start of reforms.

the latter three are taxation on rural industry, private sectors, and foreign enterprises respectively (Refer to Table 3.4 for details and measures of the policies).

The independent variables and their measures are the same as those for national reform policies. Table 3.6 summarizes these provincial policies, dependent variables, and predicted correlation between the provincial policies and the dependent variables. The statistical tools and criteria for determining the strength of each explanation are the same as those in the tests on national reform policies. In the test, provincial policies in a later year are regressed on provincial variables from the four models in an earlier year. This design will estimate the effect of provincial variables on provincial policies, for the event of the earlier year could affect that of the later year, not conversely. Table 3.7 summarizes the regression results.

As stated, a separate test will be run to examine the effect of national policies on provincial reforms. Therefore, the following test does not include national policies along side with variables from the four models to explain provincial policies. The reason is that variables from the models might well be correlated with national policies, rendering it operationally and analytically difficult to separate out effects of national policies.

The reform-driven efficiency model predicts no correlation between the variables in the model and provincial policies. It also predicts no significant variation between provinces in their reform policies. Tests on this efficiency model will be discussed later.

**Table 3.6: Independent Variables and Correlation with Provincial Policies as Predicted by the Four Explanations**

<b>Explanations</b>	<b>Variables</b>	<b>Provincial Lending Policies</b>	<b>Provincial Taxation Policies</b>
<b>Efficiency (Infrastructure-driven version)</b>	<b>Transportation access</b>	<b>+</b>	<b>-</b>
	<b>Distance between the province and the coast</b>	<b>-</b>	<b>+</b>
	<b>Tele-communication</b>	<b>+</b>	<b>-</b>
	<b>Literacy rate of the population</b>	<b>+</b>	<b>-</b>
<b>Revenue</b>	<b>Size of non-state industry</b>	<b>-</b>	<b>+</b>
<b>Popular support</b>	<b>Urban consumption level</b>	<b>+</b>	<b>-</b>
	<b>Rural consumption level</b>	<b>+</b>	<b>-</b>
	<b>Urban unemployment rate</b>	<b>+</b>	<b>-</b>
	<b>Rural surplus labor rate</b>	<b>+</b>	<b>-</b>
<b>Interest Groups</b>	<b>Size of non-state industry</b>	<b>+</b>	<b>-</b>
	<b>Size of light industry</b>	<b>+</b>	<b>-</b>

Notes: + positive; - negative.

Table 3.7: Results of Regressions of Provincial Reform Policies on Variables from the Four Explanations (Coefficients, and in parentheses, standard errors)

Model/ category	Variables	Loans to rural enterprises & collective industry	Taxation on rural industry	Income tax on private business	Income tax on foreign firms
Growth (Infrastruc- -ture driven)	Transportation	0.043* (0.021)	-0.009 (0.006)	<u>0.006+</u> (0.004)	-0.042 (0.052)
	Harbor	-0.016 (0.010)	-0.004 (0.003)	<u>-0.004*</u> (0.002)	-0.002 (0.011)
	Phones	0.024 (0.032)	<u>0.019+</u> (0.011)	0.003 (0.004)	-0.012 (0.032)
	Literacy	<u>-0.157*</u> (0.077)	-0.008 (0.031)	-0.001 (0.007)	-0.027 (0.153)
Revenue	Non-state industry	<u>0.310****</u> (0.096)	<u>-0.033+</u> (0.019)	<u>-0.035****</u> (0.010)	<u>-0.244****</u> (0.071)
Support	Urban consumption	0.142 (0.123)	-0.067 (0.043)	0.00004 (0.014)	-0.041 (0.115)
	Rural consumption	0.177* (0.086)	-0.039 (0.025)	0.012 (0.010)	0.130 (0.109)
	Urban unemployment	-0.527 (0.338)	-0.268 (0.221)	0.006 (0.067)	-1.304 (0.842)
	Rural surplus labor	0.162 (0.385)	<u>0.252*</u> (0.115)	0.025 (0.028)	<u>0.869****</u> (0.234)
Groups	Non-state industry	0.310**** (0.096)	-0.033+ (0.019)	-0.035**** (0.010)	-0.244**** (0.071)
	Light industry	0.043 (0.085)	-0.003 (0.033)	0.006 (0.013)	<u>0.197+</u> (0.118)
Other statistics	Constant	-0.718* (0.344)	0.367*** (0.127)	-0.018 (0.038)	-0.033 (0.300)
	Panel AR (1) coefficient	-0.025	-1.044	0.871	0.585
	Pr>Chi2(10)	0.0000****	0.0000****	0.036*	0.0001****
	Log likelihood	236.47	13.26	467.49	339.45
	Case (PROV x YR)	28 x 4	28 x 2	28 x 3	27 x 4

+: Z score significant at 0.10 level ( $p < 0.1$ ); \*:  $p < 0.05$ ; \*\*:  $p < 0.01$ ; \*\*\*:  $p < 0.005$ ; \*\*\*\*:  $p < 0.001$ ; underlines: contradicting the model.

Tests use cross-sectional and time-series regression (XTGLS) with Panel-Corrected Standard Errors (PCSE), correction for heteroscedasticity (HETERO), and a common first-order autocorrelation coefficient (AR1).

## **Causes of provincial reform policies**

Table 3.7 summarizes the regression results of the four *provincial policies* on the *independent variables* from the four *models*. The results suggest the following tendencies in the provincial policies. First, the provincial agricultural banks were more likely to *lend to rural enterprises and collective-owned industry* when the province had large non-state industrial sectors, a high level of consumption in the countryside, and a more developed transportation system. These results favor the ownership version of interest-group model, the popular support model, and part of the efficiency model. On the other hand, the provinces with *low* literacy rates tended to lend *more* to these non-state sectors, contradicting both versions of the efficiency model, which predicted more lending in the provinces with a higher literacy rate.

Second, the provincial governments would collect higher *taxes on rural industry* when the non-state industry was small (confirming the ownership-oriented interest group model), when rural surplus labor was large (puzzling), and to a less extent when tele-communication was relatively developed (again puzzling). The popular support model predicts that provincial taxation on rural industry would be lighter when rural surplus labor was large and subsequently would exert greater pressure on the provincial governments for new jobs. The test seems to indicate that this is not the case. The infrastructure-driven efficiency model envisions a negative correlation between the level of provincial taxation on rural industry and tele-communication. The reform-driven efficiency model, on the other hand, foresees no correlation between efficiency variables and provincial reform

policies. The test uncovers a positive correlation in both instances, running contrary to the logic of both versions of the model.

Third, the test reveals the provinces would collect more *taxes on private business* when non-state industry was small (supporting the ownership version of interest group model), when the province was close to ocean harbors (puzzling), and to a lesser extent, when the province had densely-distributed transportation routes (puzzling). The infrastructure-driven efficiency model envisions a negative correlation between the level of provincial taxation and the density of transportation routes, and a positive correlation between taxation and the distance from the coast. The reform-driven efficiency model, on the other hand, foresees no correlation between efficiency variables and provincial reform policies. The above test results on the provincial taxation on the private business (i.e., a positive correlation with the transportation system and a negative correlation with the distance from the coast) lead to rejection of both versions of the model.

Fourth, the provinces tended to access lower *taxes on foreign enterprises* when non-state industrial sectors were large (confirming again the ownership version of interest group model), when rural surplus labor was small (puzzling), and probably when light industry was smaller (puzzling). The popular support model predicts lower taxes only in the presence of large rural surplus labor, and the sectoral version of the interest group model does so when the province had a large light industrial sector. The above test findings weaken both models. The test finds no significant correlation between the efficiency variables and taxes on foreign enterprises. This finding supports the reform-driven efficiency model.

The above tests all point to one explanation: Through their influence, *relatively large non-state industry seemed to have succeeded in securing more loans from and lighter taxation by the provincial governments.*<sup>24</sup> Factors other than the size of non-state industry were unable to account for all the provincial policies at the same time. *Proximity to the coast did not seem to contribute to provincial reforms.* Ironically, it appears to even lead to higher taxes on the private sector in the provinces.

In addition to the influence of non-state industry relative to that of state industry, individual factors seem to drive provincial policies in particular ways. The provinces lent to rural and urban collective enterprises in a likely attempt to buy the support from rural consumers. Although these provinces might try to capture high economic returns from good transportation, they defeated their purpose of achieving high growth by their heavy lending to collective enterprises where the literacy rate was low.

The provinces tended to impose higher taxes on rural enterprises when the rural surplus labor was high. In this way, the provinces reduced available jobs for the unemployed rural population. Therefore, provincial taxation on rural industry discriminated against the very constituents who would benefit most from jobs and extra income in rural industry. Furthermore, the provincial governments might raise taxes on

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<sup>24</sup> By design the level of taxation on non-state sectors do not necessarily correlate with the size of the state sector positively. In the provinces with a large state sector, provincial governments would be able to collect more revenue from state industry and needed not extract heavily from non-state sectors. Furthermore, these provinces could lower the tax rate on the fledging non-state sectors to encourage their entry into the market and pressure state industry to improve its efficiency. The test results suggest that these provinces did forego good opportunities to expand their non-state sectors because of the presence and pressure of large state industries. Recall the above puzzling findings that provinces with a large state industrial sector

rural industry when a developed tele-communication infrastructure signaled likely rapid development of rural industry. The provinces failed to tap into the growth potential of rural industry.

The provinces collected taxes diligently from private business when the provinces had a developed transportation system and were located adjacent to the coast. They therefore failed to take full advantage of the growth potential of the provinces.

The provincial taxation on foreign enterprises also biased against rural surplus labor. In addition, it seemed that heavy industry, instead of light industry, might have pressed the provincial governments to reduce taxes on foreign enterprises. This weak finding ( $0.10 < p < 0.05$ ) contradicts Shirk's sectoral version of the interest-group model.

### **Effects of the national policies on the provincial policies**

The question that naturally follows from these test findings is did the national policies affect the provincial policies? The above tests suggest that ownership-based interest groups, namely, the clout of state versus non-state industry seems to account for provincial reform policies. Provinces might have also adopted these policies because the center directed them to do so. Given the highly centralized power structure in China, the center could act as an "umpire" of major provincial policies and pressure the provinces to adopt particular policies. The center's supervision of the provincial policies, however,

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would impose higher taxes on rural and foreign enterprises even when rural surplus labor was high, or when abundant labor supplies favored an expansion of the non-state sectors.



might have been complicated by the complexity and difficulty of policing thirty provinces, determining actual (versus stated) provincial policies, and identifying and imposing penalty on the provincial leaders and officials who deviated from central directives. To address the above question on the effect of national policies on provincial initiatives, a statistical analysis is a useful tool. In the following tests, the provincial policies of a given year are regressed on the two national policies in a previous year.<sup>25</sup> The regression method is similar to that in the previous tests. The results are summarized in the following table (Table 3.8).

*National designation of open areas* in the provinces seems to have led to *increased provincial lending to rural enterprises and collective industry*, and probably *lower provincial taxation on rural industry*. As Table 3.8 shows, the coefficients measuring the effect of national policies on provincial taxation on private and foreign business have a correct sign and are not significant. Hence, in contrast to conventional wisdom, the national Open Policy *did not have a significant impact* on provincial taxation on these two sectors. This finding is surprising. The center opened the provinces to the international markets and business so that the open provinces could promote and attract foreign enterprises and pursue liberalization faster. The tests reveal, however, that the provinces with a greater openness adopted a more favorable tax treatment of primary non-

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<sup>25</sup> Only national and provincial policies are included in the tests. If the variables from the four models are also included, it will be difficult, as stated, to determine the effect of the national policies on provincial policies due to multicollinearity between the national or provincial policies with these variables.

state sectors (collective sectors in the rural or urban area), but not necessarily that of the smaller non-state sectors (private and foreign sectors).

The findings on national selection of cities for urban reforms in the provinces indicate an anticipated positive effect and two unexpected negative effects. *The national urban reform policy had only marginally contributed to lower taxes on rural industry in the provinces.* The context of urban reforms may help to shed light on the effect. The center allowed the cities selected for urban reforms to have greater authority over counties and collective industry in the cities. The test confirms this marginally positive effect. On the other hand, *provinces involved more deeply in urban reforms seem to impose heavier provincial taxation on private and foreign sectors.* This suggests that these provinces seem to be less supportive of private and foreign enterprises. National policy toward urban reforms in the provinces seems to hurt, rather than help provincial reforms regarding private and foreign business. Susan Shirk, for example, quoting a Chinese economist, regards this national policy or similar national policies as letting the localities to exercise more power and collect more benefits (1993, "Conclusion"). The tests indicate that *comprehensive urban reforms might have operated more like a local entitlement program than a liberalization platform.*

**Table 3.8: Regression Analyses of the Effects of National Policies on the Provincial Policies (co-efficients in the cells, standard errors in parentheses, and significance levels for z score in + or \*)**

National Policies	Provincial loans to rural enterprises and urban collective industry	Total taxes on primary rural industry	Income taxes on private sectors	Income taxes on foreign enterprises
Opening to the World Economy	0.127*** (0.041)	-0.026+ (0.014)	-0.00006 (0.0018)	-0.023 (0.023)
Urban Reform	0.053 (0.035)	-0.025+ (0.013)	<u>0.026****</u> (0.0076)	<u>0.118***</u> (0.042)
Constant	0.133**** (0.015)	0.082**** (0.0056)	-0.0045 (0.0035)	-0.016 (0.019)
Pr>chi2	0.0001	0.0006	0.0023	0.018
Log likelihood	228.46	235.77	305.99	240.32
Chi(2)	18.81	14.70	12.19	8.03
AR(1) coefficient for all panels	0.513	0.096	0.879	0.368
Number of provinces in the sample	28	28	28	27
Years of provincial policies	1986, 1990, 1992, 1994	1988, 1990, 1992	1990, 1992	1990, 1992, 1994
Years of the national Open Policy	1982, 1986, 1990, 1993	1982, 1986, 1990	1986, 1990	1986, 1990, 1993
Years of national urban reform policies	1984, 1988, 1990, 1992	1984, 1988, 1990	1988, 1990	1988, 1990, 1992

+: Significant at 0.10 level; \*: significant at 0.05 level; \*\*: significant at 0.01 level; \*\*\*: significant at 0.005 level; \*\*\*\*: significant at 0.001 level; underlines: negative effect; blank: insignificant. Tests use cross-sectional time-series regression with first-order autocorrelation and correction for heteroscedasticity. Tentative data on national urban reform policies in 1984 are also included in two tests to increase the number of observations.

Despite these surprising findings, the study on the effects of national on provincial policies lends support to *a political approach* to China's reforms. Recall the early test findings on the causes of national policies. The center opened the provinces mainly to garner support from rural and urban consumers and secondarily to generate higher growth at coastal or more developed provinces. It selected the provinces for urban reforms chiefly to maximize revenue and probably win the loyalty of rural consumers and unemployed. Given these intentions it is not surprising that *the open provinces and probably the provinces selected for urban reforms would single out collective industry, especially rural enterprises as the beneficiary*. For the center, collective industry, as the largest non-state sector, delivered more consumers' goods to the population, and supplied more jobs to the rural unemployed than did private and foreign business. The collective sector could play a pivotal role in securing the consumers' support for the national government. In crafting their reform policies, the provinces could have felt the pressure from collective industry more acutely than from the other smaller non-state sectors. In contrast, private and foreign sectors employed a far smaller segment of the population and furnished a much smaller portion of consumers' goods. They earned much less attention from the center and the provinces because of their relatively small size and social contribution. They could not pressure provincial government with the same intensity as the collective sector.

### **3. Conclusion: The Effectiveness of the Models and the Logic of Reforms**

Among the four explanations on *provincial policies*, *the ownership version of the interest-group model* receives the clearest support in the tests (Tables 3.7 and 3.9). Three tests (provincial lending and taxes on private and foreign sectors) strongly support this version of the support model, and one test (taxes on rural industry) provides weak support ( $0.10 < p < 0.05$ ). All the other models do not fare well. The popular support model is confirmed in only one test (provincial lending), yet rejected in two tests (taxation on rural industry and foreign enterprises). The efficiency model scores mixed results in one test (provincial lending), and is rejected in the other two tests (taxes on rural industry and private business). Weak evidence against the sectoral version of the interest-group model turns up in one test (taxes on foreign firms). The revenue model is rejected significantly in three tests (taxes on rural industry, private sectors, and foreign enterprises) and weakly in one test (provincial lending to rural enterprises and collective industry) ( $0.10 < p < 0.05$ ).

Evaluation of the efficiency model is less straightforward. *The efficiency explanation of provincial policies has two versions*. Furthermore, we cannot treat the test results on its individual variables separately due to the following reason. When the government was genuinely interested in improving efficiency, the four variables in the model should be supported, and not rejected by the test. For example, if the “transportation access” and “the distance from the coast” variables are supported and if the variable of “literacy rates” or that of “tele-communication” is rejected, the validity of the entire efficiency model is cast into doubt.

*The efficiency model can better account for the national policies than it does to provincial policies (Tables 3.9 and 3.10). The efficiency model is supported by the test of the national Open Policy, and scores slightly mixed results in the test of national urban reform policy. Both the infrastructure-driven and reform-induced efficiency models can barely explain the provincial policies (Tables 3.9 and 3.10). The infrastructure-induced efficiency model is supported marginally only once (taxes on rural industry), receiving mixed results in one test (provincial lending to collective enterprises), and being rejected in two tests (provincial taxation on private and foreign business) (Table 3.9). Therefore, this version can be discredited. The reform-induced efficiency version does better than does the infrastructure-driven version. Despite the relative success of the variables of “tele-communication”, “coastal access”, and “literacy” in the regression tests of provincial policies (Table 3.10), the reform-induced efficiency model fails three of the four ANOVA tests on inter-provincial differences in reform policies. Three of the provincial policies (provincial lending, income tax on private business, and income tax on foreign business) reveal significant inter-provincial differences, contradicting the model's prediction of uniform reforms across provinces. The overall explanatory power of this model on reform policies is accordingly weak.*

Again, the tests on national and provincial policies and on the effect of the former on the latter point to *a political explanation of China's reforms*. Recall the results of tests on national policies. *Among the four models, the popular support model best explains the national reform policies, followed by the efficiency, the revenue, and the interest-group models. The ownership-based interest-group model is most capable of explaining*

*provincial reform policies.* Therefore, it seems that *the national government was more concerned with support from larger groups of constituents.* It tried to court both urban and rural consumers in adopting the Open Policy and attempted to buy off rural consumers and rural surplus labor through its urban reform policy. Both groups in these two policies constitute a large segment, if not a majority of the population. In addition, *the center, through encouraging reforms in provinces with better tele-communication and closer to the coast, seemed to be more interested in generating economic returns than were the provinces. The center thus focused on politics without losing sight of economics.*

*The provincial governments were primarily concerned with much smaller interest groups, namely, non-state and state industrial sectors.* Most of the population was employed in the agricultural sectors, and industry employed a relatively small portion of the population. Returning to the effect of the national policies on provincial reforms, the provinces seemed to comply with the center's reform directives only when they involved collective enterprises. As the largest non-state sector, the collective sector could help the center to buy off the consumers, and was capable of putting strong pressure on the provincial governments. Hence when a non-state sector was large and could affect the welfare of a large segment of population, the government would treat it more favorably.

Why did the national and provincial governments have different *core constituencies*? In formulating their reform policies, why did the provinces pay most of their attention to the state versus non-state owned industrial sectors? Why was the center most concerned with support from large segments of the population, rural consumers in particular? The answers may lie in *the centralized power structure* of China. The Central

Communist Party and national government had the final power to choose between economic development and ideological indoctrination, between reforms and retrenchment, between opening up and self reliance, between equalized and preferential regional development, and between honest government and rent-seeking. They also had the power to appoint and dismiss top provincial leaders, namely, the party secretary and the governors, even though they avoided frequently dismissing provincial leaders during the reform era. Therefore, the population held the central Communist Party and the national government accountable for their economic well being, sense of security, and political stability. When the national government and the communist party failed to deliver the goods, the population would cast a vote of non-confidence by distancing themselves from the Party and the government and by becoming critical of the party-state. The center, recognizing this constraint, paid close attention to the economic and moderate political demands of the population, and tried to appease consumers and the unemployed through reforms.

The provincial party and government, on the other hand, did not need to concern themselves with the popular support for the Communist regime; they were appointed by the center, rather than elected by the people. Major economic sectors, through their representatives at the provincial or local governmental agencies, were able to generate intense pressure on provincial policies. The status and welfare of provincial governmental agencies depended much on well-being of the sectors. As a result, these agencies and officials would try to protect their clients by pressuring the provincial governments to look out for the interests of the latter in provincial policies. Hence the



provincial leaders, in formulating property-rights reform policies, gave most of their attention to industrial sectors based on ownership, rather than the provincial population. In sum, the national and provincial governments designed their own reform policies to garner support from their respective core constituents that were delineated by the political structure. Politics commanded Chinese economic reforms.

Table 3.9: A Summary of the Results of the Regression Tests on the Four Models

Model	Variables	Net test result	National open policy	National policy on urban reforms	Provincial loans to rural enterprises and collective industry	Taxes on rural industry (primary non-state industry)	Income taxes on private sectors	Income taxes on foreign enterprises
Efficiency	<i>Transportation</i>	S		S	(Infrastructure- S	driven	Efficiency R	Model)
	<i>Harbor</i>	S	S	S			R	
	<i>Phone</i>	S	S	S		R		
	<i>Literacy</i>	2R		R	R			
Revenue	State Industry (= 1 - non-state industry)	3R		S	R	R	R	R
Political Support	Urban Consum	S	S					
	Rur Consum	3S	S	S	S			
	Urb Unemploy	0						
	Rur Unemploy	R		S		R		R
Interest Group	Non-state inds	3S		R	S	S	S	S
	Light Indus	0	S					R

S: support at the test ( $p < 0.05$ ); S: marginal support ( $0.05 < p < 0.1$ ); R: rejection at the test ( $p > 0.05$ ); R: marginal rejection ( $0.05 < p < 0.1$ ); 0: neither confirmation nor rejection; 2S: Supporting evidence turns up twice at the tests.

Table 3.10: A Summary of the Results of the Tests on the Reform-Driven Efficiency Model on the Provincial Policies

Tests on the Model's Two Assumptions	Variables	Net test result	Provincial loans to rural enterprises and collective industry	Taxes on rural industry (primary non-state industry)	Income taxes on private sectors	Income taxes on foreign enterprises
Little inter-provincial variation		<b>2R</b>	<b>R</b>	<b>S</b>	<b>R</b>	<b>R</b>
No correlation of efficiency variables with provincial policies	<i>Transportation</i>		<i>r</i>	<i>s</i>	<i>r</i>	<i>s</i>
	<i>Harbor</i>		<i>s</i>	<b>S</b>	<i>r</i>	<i>s</i>
	<i>Phone</i>		<i>s</i>	<b>R</b>	<i>s</i>	<i>s</i>
	<i>Literacy</i>		<i>r</i>	<b>S</b>	<i>s</i>	<i>s</i>
Test results on both assumptions		<b>R</b>	<b>R</b>	<b>S</b>	<b>R</b>	<b>0</b>

This model predicts no significant inter-provincial variation in reform policies. It also predicts no correlation between the four variables and provincial policies. The table summarizes results of tests on these assumptions.

In the row "Little inter-provincial variation", S stands for insignificant inter-provincial variation in reform policies at ANOVA tests and support for the model, and R significant variation at the tests and rejection of the model.

In the rows of four variables from the efficiency model, s stands for support for the model (no correlation between the efficiency variable and provincial policies) at the test ( $p < 0.05$ ), *s* marginal support ( $0.05 < p < 0.1$ ), *r* rejection ( $p > 0.05$ ), *r* marginal rejection ( $0.05 < p < 0.1$ ), 0 neither confirmation nor rejection, and 4s support for the model at the tests for four times. The test results are from the tests on the *four models* on the provincial policies (Table 3.7).

The first assumption fails three of the four tests on provincial policies. The four variables from the efficiency model satisfy the second assumption in two tests, and receive mixed results in two tests. The net test results are computed using  $S = 4s$  and  $R = 4r$ . The net result of the tests on two assumptions of the model leads to a rejection of the model.

## **Appendix: Methods for Testing the Explanations**

Tests of the explanations would have to cope with a variety of problems typical in multivariate econometric analysis using time-series and panel data. These problems, discussed in greater detail below, are complex, and consequently, the choice of tools requires careful deliberation.

*Simultaneous effects between independent and dependent variables* Various measures are taken in data analyses to avoid potential problems. The first potential problem is simultaneous effects of dependent variables on explanatory variables in regression, or the reverse effect of the dependent variables on the explanatory variables. To isolate the effect of explanatory variables on dependent variables, values of the dependent variables in a later year are regressed on explanatory (independent) variables in an earlier year. For example, the 1982 measure of the national Open Policy is regressed on the 1980 provincial independent variables. The rationale is that provincial factors in 1980 could have caused national opening of the provinces in 1982, but not the other way around because of time sequence. Therefore, the test results reflect the effect of provincial characteristics on national policies, and exclude the "feedback effect." If the measure of national opening of the provinces in 1980 is regressed on provincial indicators of 1980, the result could be a mutual interaction of these factors in 1980.<sup>26</sup>

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<sup>26</sup> A few econometricists and political scientists use granger causality methods to determine whether the chain of causation between explanatory and dependent variables, or to determine whether a variable in the model is exogenous or endogenous. Greene, in a widely-used textbook on econometrics, expresses his skepticism over a clear distinction between exogeneity and endogeneity: "Unfortunately, this neat classification is of fairly limited use in macroeconomics,

*Cross sectional and time-series data, heteroscedasticity, and autocorrelation* In the analysis of cross sectional and time-series data (panel data) the choice of tool becomes very time-consuming. The problems confronting researchers include the number of cross sections relative to time periods, the magnitudes of these numbers, heteroscedasticity, autocorrelation, and multicollinearity.<sup>27</sup> Since, most of the data in this research involve 28 to 29 provinces in five years, cross-sectional time-series regression is an ideal tool. Heteroscedasticity is a potential problem in cross-sectional data, and autocorrelation is a typical concern in time-series analysis. Economists often avoid ordinary-least square (OLS) and employ the Park method (generalized-least square (GLS)), feasible GLS (FGLS), fixed- or random-effect models, and two-staged least square (2SLS) regression to handle these problems in their panel data analyses. Some political scientists have also adopted GLS and 2SLS in their research.

Careful statisticians have noted in recent years that most of these non-OLS tools have very limited utility in finite panel data. As Beck and Katz (1995; Beck et al 1993) point out, GLS regression, including the Park method and 2SLS, tends to lead to overconfidence in estimates of standard errors in typical cases of political studies. This is

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where almost no variable can be said to be truly exogenous in the fashion that most observers would understand the term" (Greene 1997, 713). Statistical scholars, such as Professor John Londregan at the Department of Political Science at UCLA, also have doubts over granger causality.

<sup>27</sup> After lengthy exploration two statistical programs, SHAZAM and STATA, are chosen. Some diagnostic tests are done using the former, while regression analyses are conducted in the latter. The reason is that SHAZAM does not have versatile cross-sectional time-series regression tools. The POOL command in SHAZAM, a popular econometric programs, can only accomplish these tasks all at once only when the number of cross sections (provinces in my case) is smaller

the case when the number of cross sections ( $N$ ) exceeds the length of time frame, or when the number of time periods ( $T$ ) is relatively small, for example, less than 59. Since my panel data consist of most of the subject in the samples (the provinces), fixed rather than random effect models are a natural option for analysis. When  $N > T$ , as in the case of my panel data, however, the results of the estimates of all the parameters in fixed-effect models are unreliable, for the number of parameters is much larger than the number of data points (Balestra 1992, 27).

In these unusual circumstances for econometric analysis yet typical for political analysis, OLS regression produces more reliable or efficient estimates of the standard errors. Beck, Katz and others (Beck et al 1993, 5) point out: "The Monte Carlo study shows that FGLS is more efficient than OLS only when there is a high level of contemporaneous correlation of the errors. But even in the worst case for OLS, it is 80% as efficient as FGLS. For moderately correlated errors, OLS is just as efficient as FGLS, and OLS is more efficient than FGLS when the errors show little contemporary correlation." Beck and Katz suggest a tool called panel-corrected standard error (PCSE). OLS regression presumes homoscedasticity of the error variance. Therefore, typical OLS regression is satisfactory but not perfect, given the findings of research by Beck and others (Beck et al 1993).

In light of the above problems, the ideal analytical tool for this task should be able to handle heteroscedasticity, autocorrelation, and panel numbers greater than the number

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than the number of time periods (years in my case). The data in this project do not meet this criterion.

of time periods. Fortunately, STATA is an analytical tool that incorporates OLS with PCSE, while correcting for heteroscedasticity. It also takes into account autocorrelation by estimating a common first-order autocorrelation coefficient (AR1). It is therefore adopted in my tests of the explanation. The second best tool would be cross-sectional time-series OLS regression.

*Multicollinearity* I take two measures to test for possible multicollinearity between the independent variables. First, the statistical package (STATA) used in this research will drop any independent variables highly correlated with the others. No independent variables are dropped in regression. Second, I run principal-component (PC) tests, a typical diagnosis of multicollinearity, on the pooled data of independent variables. PC tests, along with the above STATA procedure, indicate no serious multicollinearity.

Regression using three other methods and the same set of data on the four provincial reform policies generates results similar to those reported above. The first method is OLS regression that pools the data on the provinces. The regression will treat all cases as independent. The second method is time-series cross-sectional random-effects regression. The random-effects model is more reliable given that the number of time periods is too small to estimate the fixed effects of the provinces. The third is regression with robust and cluster options (in STATA program), which treats cases as independent across provinces but not necessarily independent for the same province in different years. In all the analyses, the ownership-based interest group model is the only model that helps to considerably account for all of the four provincial policies, and this model clearly outperforms the others.

## **Chapter Four: Dynamics and Cycles of National Reforms**

### **1. Advantages of Case Studies**

Strengths of hypothesis testing are obvious when the number of cases is relatively large. Sound statistical analyses can reap the benefits of rigorous theoretical reasoning, a large set of data, and unbiased case selection. The tests in the previous chapter help pinpoint the factors from the main political-economic models that are able to explain differences in reform policies in the twenty-eight provinces between 1978 and 1994. Typical case studies, which focus on a handful of cases, would have been ill-fit for this purpose.

Hypothesis tests also have their Achilles heel, namely, lack of information on the empirical process of the observed events. Without any case studies, researchers, as Leamer puts it, may run a high risk of arriving at a conclusion strictly through assumptions, beliefs, and data exploration, without even a careful look at the empirical process (1983, 38-9). A hypothesis usually supplies a multi-stepped story about why given factors cause observed events. A hypothetical example is that an unusually high level of sunspots causes people to lose their temper and go to war. When a hypothesis test unfolds a correlation between a responsible factor and the event to be explained (between levels of sunspots and war frequencies), this hypothesized causation process is then accepted. Two risks emerge, however. The first risk is that the responsible factor helped produce the event in a vastly



different manner.<sup>1</sup> For example, sunspots might cause declines in agricultural outputs and economic crises. Crises tempted nations to go to war. The second risk is that unnoticed factors might have caused the observed event. Economic crises *unrelated* to sunspots might cause war. In both cases, the hypothesized chain of causation broke down. Careful empirical studies can address unanswered questions about the empirical process (whether sunspots trigger human anger and war).

## 2. Outline of the Chapter

The statistical analysis in Chapter 3 suggests that national reform policies toward the provinces over the period of 1978-94 was driven primarily by the preoccupation of the national leaders for support from consumers. This analysis can be better complemented by two empirical studies, one on the change of national reform policies over years, and the other on provincial policies. This and the following chapters constitute these two studies. This chapter examines the dynamics of national elite's conflict over policies

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<sup>1</sup> A hypothetical example helps to illustrate this point. Suppose that the following puzzle exists: The percentage of the peasants in peasant unions in several large countries was much lower than that in a dozen of small countries. Also suppose that an investigator has proposed the following arguments: After a certain level of membership, unions face increasing costs in recruiting new members, thus each union would have a similar number of members across the countries of varying size. Also supposed that she finds in a statistical test that the percentage of peasants in the unions in 20 countries is negatively correlated with the size of peasant population. Thus the test thus supports her plausible hypothesis. The test does not, however, demonstrate that the union recruitment process is subject to the resource constraint as she describes. To make her explanation utterly persuasive, the researcher could present evidence for the empirical process of her story, such as data or description indicating that after a certain level of membership unions would have to spend more in recruiting each new member and that this spending outgrew the union revenue.

between 1978 and 1996. This study can help to assess the validity of the finding in Chapter 3 that national reform arose from the center's efforts to court popular support.

In this chapter, I trace the rise of pro-reform leadership, the subsequent division among the leaders between orthodox and moderate reformists and between reformists and conservatives, and the consequential political business cycles. My main finding is that the reformists and conservative factions strove to meet respectively popular demands for fast growth and that for low inflation and consequently triggered political business cycles. Therefore, my empirical study of the evolution of national policies confirms the finding in Chapter 3 that national leaders heeded popular concerns in introducing reform policies.

I also suggest that China's reforms can be divided into several periods. For this reason, in Chapter 3, I select data in the mid year of each period, instead of randomly selecting years from these periods. I later discuss five periods of reform. This chapter consists of the following parts: 1) literature review, and unanswered questions; 2) an institutional framework of cycles, revealed in factional conflict and preferences; 3) the dynamics of cycles, as revealed in simple statistical analyses; 4) periods of cycles, including the reduced cycle after 1994 with the rise of centrist leaders; 5) conclusion.

### **3. Political Business Cycles and Periods of National Reforms**

#### *Studies on Cycles in Post-Mao China*

China scholars first identified cycles in agricultural politics (Eckstein 1968). Another study (Skinner and Winckler 1969) drew on the organizational theory and

identified eight cycles in campaigns in Communist China during 1949 and 1968. Each cycle had six phases, namely, normalcy, mobilization, high tide, deterioration, retrenchment, and demobilization.

Chinese economists examined the dynamics and sources of economic cycles in China (Li and Liang 1988; Liu 1989; Bi and Liu 1990; Chen 1992; Li et al 1993; Hu 1994; Wang 1998). In one of the most comprehensive studies, Hu argued that cycles exist in ten economic aspects, including production, investment, consumption, wages, money, credits, prices, fiscal income, commerce and stockpile of goods, and foreign trade. The party's congresses, Hu suggested, tended to unleash expansionary policies and higher growth rates (Hu 1994: 2-3, 12-13).

A number of English studies revealed that a cyclical pattern of politics also existed in Deng's China (Tsou 1986: 219-58; Harding 1987: Chapter 4; Hamrin 1990: 4-7; Shirk 1990a and 1990b; Howell 1993; Ruan 1994; Schell 1994, 428-36; Lieberthal 1995: 137-44; Dittmer and Wu 1995; Baum 1996, 5, 7-9). The core of this body of literature on cycles (Lieberthal *ibid*; Shirk *ibid*; Dittmer and Wu 1995; Ruan 1994; Schell *ibid*; Baum *ibid*) pointed to the following features of the cycles.

1. Conflict between liberal and conservative policy packages helped to intensify economic swings between boom and bust.
2. Reformist leaders encouraged economic liberalization, growth, and political relaxation. Economic liberalization tended to lead to destabilizing outcomes.

3. In the face of macroeconomic and political instability, conservative policies would be introduced. As a result, political control would be tightened, and reform and growth would slow down (Lieberthal *ibid*; Shirk *ibid*; Dittmer and Wu 1995; Ruan 1994; Baum 1996, 5, 7-9).

On the other hand, these scholars held different views regarding the subtle interaction of politics and economics, specifically, over the following three issues: Origins of political oscillations, those of economic swings, and the ties between political and economic forces.

1. Regarding the sources of political oscillation. Lieberthal (*ibid*) and Dittmer and Wu (1995) believed a dichotomy of the political position of the reformist leaders versus that of the conservative leaders and their respective attempts to implement their policies were the key sources of political oscillation. Reformists favored ideological relaxation, whereas conservatives believed in ideological orthodox. Such a conflict resulted in liberal political atmospheres during some years, and a stern political environment in others. On the other hand, Shirk (*ibid*) and Ruan (1994) believed that Deng, a widely-believed reformist, leaned toward political liberalism in certain years, and toward political conservatism in others in order to appease the rising conservative pressure within the state.
2. Regarding the sources of economic swings, Lieberthal (*ibid*) and Dittmer and Wu (*ibid*) attributed the alternation of boom and bust to the reformist preference

for rapid growth and the opposing conservative insistence on stable and minimal growth. In addition, these authors tended to stress different direct causes of boom and bust. Lieberthal (1995, 137) argued that devolution of economic control from Beijing allowed local officials to pursue local growth and, in turn, propel economic prosperity. As a result, recentralized economic control could dramatically decelerate the economy. Dittmer and Wu (1995, 487-88), on the other hand, suggested that national expansionist policies, including heavy investment and high wage increases, triggered economic expansion and that national austere fiscal and monetary policies could suffice to cool off the overheating economy. Shirk (ibid), on the other hand, traced the rise and fall in growth rates to China's partially planned and partially marketized economy.

3. Interaction of political and business cycles. Dittmer and Wu (ibid) and Shirk (ibid) argued that both cycles are synchronized after 1980 since political cycles go hand in hand with business cycles. The reformists, Dittmer and Wu suggested, tended to pursue rapid reform and high growth, resulting in an overheating economy, macroeconomic instability, and occasional public protests and calls for substantial changes in the political regime. Conservatives then forced reformists to introduce austere policies to reduce economic imbalances, and ideological control to suppression political liberalism. Conservative policies often slowed the growth rate, allowing reformists to renounce the strict program and push for high growth. Baum (1996, 7) countered that these cycles, when viewed together, are irregular, rather than synchronized. Shirk

emphasized the effect of the business cycle on the political cycle, while Dittmer and Wu argued the opposite.

An examination of the above three issues will help us to better understand the dynamics of political business cycles in China. In the following section, I attempt to investigate a logical and sensible sequence of cycles and arrive at a simplified conclusion. Statistical tests on a few key political and economic indexes aid my verification of the above conflicting arguments. I will begin by discussing the cleavages between moderate and orthodox reformist leaders, which a number of the above authors had neglected. I will then examine the differences between conservative and reformist leaders in their policy preferences. As I shall elaborate in the paragraphs on the periods of cycles and the change after 1994, *the division between reformists, coupled with that between reformists and conservatives, served to aggravate economic and political swings between 1980 and 1994*. These factions, as I shall discuss later, molded ideological environment and fiscal policies, impacted economic growth and inflation, and triggered protests or complaints against the policies. These events would then allow another faction to drastically change the policy direction.

#### *An Institutional Framework of Cycles*

Factions are informal and flexible networks of personal relations that exchange support for resources (Dittmer 1990; Baum 1996, 9). Factions usually consist of a leader

and a group of followers. Members of a faction share policy preferences that differ from those of other factions. Differing preferences often cause conflict between factions.<sup>2</sup>

The existing literature, as summarized, held the conflict between reformist and conservative policies responsible for the cycles. Two versions on factional conflict, however, existed. One view suggested that Deng, standing on the side of the reformist camp, fought against the conservative camp. Another view suggested that Deng oscillated between these two camps over the years. Both views make sense, yet are not accurate in and of themselves. Deng was an orthodox reformist, liberal on economic issues, yet conservative on political ones. *Along with the moderate reformists, including Hu Yaobang and Zhao Ziyang, Deng fought against conservatives for economic reform and the opening up of China. Meanwhile, he also joined hands with conservatives in suppressing the political liberalism advanced by radical intellectuals and tolerated by Hu and Zhao.* To illustrate this point, I shall review the major factions, their differing positions, and the effect of their conflict on politics and economics between 1978- 1994.

**Whateverists versus pragmatists.** Between 1976 and 1978 the Chinese leadership consisted of “whateverists” (orthodox Maoists) represented by Mao’s hand-selected successor Hua Guofeng, and pragmatists, represented by party veterans such as Chen Yun, and later Deng Xiaoping. Pragmatists rejected Mao’s radical politics in favor of an orthodox party ideology and realistic and performance-driven growth path. Deng, relying

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<sup>2</sup> Factional members might maneuver against each other when competing for the same post (Baum, *ibid*). For a thorough discussion on factions, refer to the articles on “the Nature of Chinese Politics” in *The China Journal*, July 1995, 1- 208.

on an extensive power base that he cultivated during his impressive career, carefully coordinated attacks on Hua. In late 1978 Hua succumbed and lost his political influence. In 1980 Hua handed over his positions of the Party General Secretary and the Premier to Deng's protégés, to Hu Yaobang and Zhao Ziyang respectively.

The Third Plenum of the Eleventh Central Committee of the Communist Party (CCCP) in December 1978 marked the start of the reforms. The Plenum declared the party shift its focus away from Maoist ideological campaigns and toward “socialist modernization”. The Plenum also decided to raise procurement prices of agricultural goods, lower prices of agricultural inputs, and delegate power to the localities. The first two measures were to win over the support of peasants, and the third measure was to generate growth (Tang 1998, 98-99, 88-89) as well as the support for reform from provinces (Shirk 1993).

After late 1978, pragmatists occupied the political stage. Disputes over the pace and contents of reforms started to divide the pragmatist camp into two opposing factions, namely the reformists led by Deng versus the conservatives led by Chen.

**Orthodox and moderate reformists.** In the economic arena, both orthodox and moderate reformists supported progressive liberalization. They were open to economic reform experiments, and were willing to adopt ones that were successful. Meanwhile, they preferred a progressive, rather than shock-therapy approach to reform.

*Orthodox* reformists, such as Deng, firmly upheld the dictatorship of the Chinese Communist Party (CCP). *Moderate* reformists, on the other hand, formally accepted yet



occasionally downplayed the CCP's monopoly of power.<sup>3</sup> At the critical points they might even abandon it. Their representatives were Deng's protégés, i.e., Hu Yaobang during 1980-86 and Zhao Ziyang in 1989.

Deng's post-Tiananmen-movement comments regarding the dismissals of Hu and Zhao from their post of the General Party Secretary illustrate the divergence between moderate and orthodox reformists (Tang 1998, 365):

We did not make a mistake in selecting them as the General Party Secretary. However, they later made a mistake and fell on a fundamental issue, namely, that of four cardinal principles. The core of the four cardinal principles is the (Communist) Party leadership and socialism. The opposite of the four cardinal principles is bourgeois liberalization. For several times in each of these years, I have talked about upholding the four cardinal principles and opposing bourgeois liberalization. However, neither of them implemented what I said.

**Conservatives.** Economically, conservatives adhered to the central role of economic planning, and acceded to market forces a secondary position. They also wanted to limit the extent of China's opening to world economy (Lieberthal 1995, 137). Thus conservatives were at odds with reformists over economics.

Conservatives, on the other hand, agreed with *orthodox* reformists regarding the CCP monopoly of power. In addition, conservatives such as Chen Yun emphasized party discipline and honesty, and were constantly on guard against cadre corruption and

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<sup>3</sup> The term "moderate reformists" is used to distinguish this group from *liberal* or *radical* reformists in Eastern Europe in the 1990s and Chinese liberal intellectuals, who embraced both democratization and rapid economic reform.

decadent lifestyles (Bachman 1985, 85). Other leading conservatives included Li Xiannian, Wang Zhen, Peng Zhen, and Li Peng (prior to 1992).<sup>4</sup>

The elders, especially Deng Xiaoping and Chen Yun, wielded enormous power over economic policies prior to 1994. They could initiate a policy and secure its approval at the Politburo, the Central Committee and the Congress of the Communist Party, the State Council, and the People's Congress. But usually the elders were preoccupied with fundamental economic and political decisions and major appointments at or above the ministerial or provincial level. As the most senior and the ultimate leader of the military, Deng was "the first among the equals" in the senior leadership. His profile and seniority in the party and the administration surpassed the other party elders, with the exception of Chen Yun. Deng, on the other hand, had built a tremendous influence and following within the military, popularity among the people, and international recognition, which Chen did not achieve. The latter gave him an edge over Chen.

### *The Dynamics of Cycles: Empirical Verification*

The reformists, especially Deng, were obsessed with high growth (Dittmer and Wu 1995). Lieberthal observed that the Chinese leaders guided economic reform with a growth-oriented strategy in order to keep up with the rapid expansion of its East Asian

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<sup>4</sup> Conservatives might be further divided into moderates and the orthodox. *Moderates* such as Chen Yun believed that a softer approach toward dissidents in the form of admonitions or party disciplines would protect both the party's image and legitimacy. On the other hand,

neighbors and create jobs for a growing population (1995, 244-45). Deng's speeches reveal that he desired fast growth exactly for another reason: By quadrupling the per capita GNP between 1980 and 2000, China could potentially lift itself out of poverty, and the Chinese communism could prove its economic vibrancy (Deng 1993, 10-11; 63-64; 77). Similarly, Deng tried to use rapid growth to garner popular backing for the CCP, as expressed in his talk with national leaders during the 1990 post-Tiananmen retrenchment:

Some countries run into problems. A fundamental reason is that their economies cannot grow, that their living standards decline, and that their people have to live a thrifty life. Why do the people support us now? It is because development has occurred in the past decade and because development is noticeable. Suppose the economy grows at four or five percent, or even two to three percent, what kind of consequence it will lead to? The consequence will not only be economic, but also essentially political (Tang 1998, 417).

The conservatives, on the other hand, were more concerned with macro-economic stability (Dittmer and Wu 1995), the quality of growth, and inflation. Chen, the leading conservative and a top Chinese expert in planned economy, emphasized growth that balanced agriculture and heavy and light industries, and stressed on low inflation. Chen's views reflect both his analysis of the economy and much of the bureaucracy and party apparatus in charge of economic affairs and planning, where he spent most of his career. In addition, Mao's desire to create rash growth and the consequential economic chaos

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*orthodox* conservatives such as Deng Liqun and Wang Zhen, along with *orthodox* reformists, valued law and order and urged harsh suppression of dissidents, such as imprisonment.

also reinforced Chen's view on balanced growth.<sup>5</sup> Chen also stressed on low inflation and macro stability. This view probably originated from his view on balanced growth as well as his experience as a mastermind of taming the hyperinflation that resulted from the Nationalist government. Chen acutely realized that public outrage over rampant inflation helped to weaken the National government and that the Chinese Communist government should caution not to fall into a similar inflation trap.

Deng's reformist faction and Chen's conservative platoon thus emphasized different sets of policies. Hence the first observation (in italics) on cycles follows:

*Proposition 1: Reformists preferred fast growth and pursued a high growth rate, whereas conservatives cherished stable growth and tried to maintain low inflation.*

The above studies reveal a consensus among most of the above-discussed Sinologists. The sources of business cycles thus lie in the fundamentally different policy preferences of reformist and conservative leaders. As we shall see, both factions would mobilize resources to bring about the economic state they each favored.

Both factions initially fought in the ideological sphere for a number of reasons. First, as Lucian Pye (1981, ch. 1) cogently argued, real power in China was often displayed subtly. Leaders who were in ultimate control often exercised their influence through informal institutional channels and challenged their adversaries indirectly. This is particularly true in post-Mao China (Ruan 1994). Hence Baum (1996, 12-3) argued factional conflict was often waged in political discourse and was characterized by subtle

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<sup>5</sup> For a discussion on Chen's view on balanced growth, see Bachman (1985) and Lardy and Lieberthal (1983).

differences in political terms. In the uncertain and high-stake game of politics, ideology signalled to leaders at national and local levels the relative strengths of either faction in a given point of time. Second, and a well-known reason, ideology played a crucial role in political control in communist countries. Post-Mao politics is no exception. As Baum (ibid) insightfully noted, Chen Yun emphasized ideological purity, in addition to economic construction that Deng often stressed. Therefore, each faction tried to take over the areas of propaganda before launching their policies.

After they secured their control of the propaganda instruments, reformists (or, pro-reform centrists after 1989) introduced a relaxed ideological environment. The ease in ideological control, as it related to economic initiatives such as the expansion of non-state sector, encouraged local officials to push forward with economic reform and liberalization initiatives without worrying about possible setbacks on their careers. Such an environment, along with the center's adoption or tolerance of expansionary fiscal policy, encouraged local efforts to bring about local economic boom. In contrast, conservatives, once they began to regain control of policy, first attempted to tighten the ideological bridle. A stern ideological atmosphere naturally dampened enthusiasm for bold economic reform efforts. Under the conservative leadership, the central government promoted austere fiscal policy, discouraging an increase in local investment and facilitating the arrival of local bust and lower inflation. Table 4.1 provides a snapshot of the ideological environment and coding in China. The following proposition thus arises.

*Proposition 2: Reformists tended to ease ideological restrictions over economic reform issues and encouraged a large increase in investment; conservatives were*

Table 4.1: Coding of Ideological Control and Fiscal Policies in China: 1978-1999  
(Coding: 0: conservative; 1: liberal)

Year	Coding of Ideological Control	Events Shaping Ideological Environment in China	Coding of Fiscal Policies
1978	1	3th Plenum of 11th Party Congress (PC); Democracy Wall Movement	1
1979	0	Petitioners' protest in Beijing in January. Deng's four cardinal principles and his suppressing of the Democracy Wall Movement	0
1980	1	Official calls for political reforms; local elections of People's Deputies; college students' election campaigns in Beijing and Changsha	0
1981	0	Official campaign to oppose bourgeois liberalization	0
1982	1	12th PC; debate over alienation and socialist humanism	1
1983	0	Official campaign to combat humanism and spiritual pollution	0
1984	1	The party's embrace of planned commodity economy; opening up of 14 coastal cities	1
1985	0	Campaign against bourgeois liberalism (from the end of 1984 to the early summer); student demonstrations in Beijing and Nanjin between September and December.	1
1986	1	Discussion of political reforms; mass student protests in Hefei, Shanghai, Nanjin, Tianjin, and Beijing in December	0
1987	0	Removal of Hu in January; 13th PC, the theory of primary stage of socialism, and calls for an economic trinity of state, market, and enterprises	0
1988	1	Price reform; criticism on conservative Chinese culture on a TV series ( <i>River Elegy</i> )	1
1989	0	Tiananmen democracy movement and military crackdown	0
1990	0	Tight ideological control; economic austerity and stress on the state sector	0
1991	0	Tight ideological control; economic austerity and stress on the state sector	0
1992	1	Deng's Southern Tour; 14th PC, the party program to build socialist market economy	1
1993	1	The party's call for building socialist market	1
1994	0	Attempts to strengthen the party; anti-official-corruption campaign	0
1995	0	Stable reform stressed; arrests and harsh sentencing of political activists	0
1996	0	PLA fired missiles around Taiwan. A long party document called for a fight against western values	0
1997	1	15th PC, economic liberalism; discussion of political reforms; calls for rule of law	1
1998	1	Political openness around Clinton's visit to China	1
1999	0	Suppression of Falun Buddhist cult movement; protests and surge of conservatism against the NATO bombing of the Chinese embassy in Belgrade	1

Note: The ideological coding for the period of 1978-95 is based on Ruan 1994, Baum 1996, and Lieberthal 1995. Events are from Baum 1996, Ruan 1994, Tang 1998, and news on China from Lexis-Nexis. Coding of fiscal policies of 1978-1991 is from Huang 1996, 158- 66. Coding for other years is based on annual growth rates of state investment in fixed assets (SSB 1993-99).

Tabulation 4.1: Data Analyses on the Dynamics of Sequences (Standard errors in the most parentheses; significant level in the parentheses next to  $R^2$ )

**Finding 1: Relaxed ideological control encouraged increasing investment, whereas ideological restrictions dampened investment.**

Test 1: State investment in fixed assets ( $I_t$ ) (in billion 1978 yuan) on that of last year ( $I_{t-1}$ ) and the dummies of ideological environment (IDEO, 1 = relaxed, 0 = strict), 1978-1997

$$I_t = -4.05 + 1.053 I_{t-1} + 23.22 \text{ IDEO}, \quad \text{adjusted } R^2 = 0.951 (2.77 \times 10^{-12})$$

(11.3)      (0.055)      (9.93)

Test 2: Correlation coefficient of indexes of ideological environment and fiscal policy during 1978-1999 = 0.633

(ideological index: 1 = relaxed, 0 = strict; index for fiscal policy: 1 = expansionary; 0 = austere)

**Finding 2: An increase in state investment induced higher growth**

Test 3: Regression of per capita GDP growth rate ( $Y_t$ ) on growth rate of state investment in fixed assets ( $I_t$ ), 1978-1997

$$Y_t = -0.069 + 0.150 I_t, \quad \text{adjusted } R^2 = 0.450 (0.0007)$$

(0.0066)      (0.037)

**Finding 3: Higher growth drove up inflation, whereas slower growth lowered inflation in the following year**

Test 4: Regression of inflation rate ( $P_t$ ) between 1978 and 1997 on per capita GDP growth rate ( $Y_{t-1}$ ) of the previous year

$$P_t = -0.027 + 1.172 Y_{t-1}, \quad \text{adjusted } R^2 = 0.302 (0.007)$$

(0.035)      (0.386)

**Finding 4: Inflation caused public protests**

Test 5: Correlation coefficient between the frequency of social protests and inflation rate, 1980-1993 = 0.728 (Source: Dittmer and Wu 1995, footnote 25)

**Finding 5: Ideological control was tightened and investment was stagnated in the year following high inflation. Ideological control was eased, and investment increased in the year following low inflation.**

**Test 6: Probit Regression of ideological environment of 1980-1998 on inflation of the previous year**

$$\text{IDEO}_t = 0.837 \quad - \quad 13.736 P_{t-1}, \quad \text{pseudo } R^2 = 0.216 \text{ (Prob } > \text{ chi}^2 = 0.017)$$

(0.508)                      (7.094)

**Test 7: Regression of growth rate in state investment in fixed assets ( $I_t$ ) of 1978-97 on that of inflation of the previous year ( $P_{t-1}$ ) (1977-96)**

$$I_t = 0.201 \quad - \quad 1.31 P_{t-1}, \quad \text{adjusted } R^2 = 0.290 \text{ (0.008)}$$

(0.042)                      (0.443)

*Sources:* SSB 1990b, 32; 1998, 57, 301; Baum 1996.

#### Figure 4.1: Dynamics of Cycles

**Reformist ideological relaxation + moderate reformists' tolerance of liberalism >> expansionary policies >> surge in investment >> high growth >> inflation >> political liberalism + protests**

**>> Conservative ideological control >> economic austerity and purging of moderate reformists after large-scale protests >> cut in investment >> slower growth >> low inflation >> malaise >> reformists regained control over policy**

*inclined to enforce the ideological boundary, promote austere fiscal policy, and encourage a moderate growth in investment.*

**Finding 1 of Tests 1 and 2 summarized in Tabulation 4.1 lends support for Proposition 2: Liberal ideological atmosphere tended to stimulate growth in investment, whereas a conservative environment tended to induce a decline.**

**As will be detailed in the later section of the paper, moderate reformists diverged from orthodox reformists on ideological liberalization. The former, represented by Hu**



and Zhao, not only endeavoured to propagandize economic liberalism, but also tolerated at times calls for political reforms and retirement of the senile leaders. On the contrary, orthodox reformists were merely interested in media promotion of economic reforms, and abhorred liberal political calls.

Heavy investment encouraged by reformist policies usually induced rapid growth. Growth generated demands for a large variety of production inputs, including raw materials, investment in fixed assets, and labor. Between 1978 and the early 1990s, China's economy still bore certain characteristics of the command economy (Shirk 1990a and b). Shortage in raw material supplies was one of them (Wong 1986), fueling the increase in prices. As demand for labor increased during the boom period, wage bills also increased, driving up the demand for food and consumers' goods. As a result, prices for these items increased. Premature price reforms aiming at removing the state's control over these staple items, such as grain, meat, edible oil, and clothes would further aid the escalation in these prices in the short run (Hu 1994, 249; 264-70).

As the reformists mismanaged the economy and triggered soaring inflation in their pursuit of high growth, conservatives gained an upper hand, stepping in and to calm the volatile economy. Conservatives thus tended to pursue austere fiscal programs and cut down investment in an attempt to combat inflation, cooling the overheating economy. The following hypothesis thus follows:

*Proposition 3: Reformist encouragement of heavy investment did succeed at producing faster economic growth, yet also triggered soaring inflation. Conversely, conservative control of investment helped to slow down economic growth and inflation.*

Findings 2-3 in Tabulation 4.1 confirm this proposition. Tests 3 and 4 suggest that an increase in investment led to faster growth in per capita gross domestic product (GDP) in the same year, and that a higher per capita GDP growth rate also prompted higher inflation in the following year.

Inflation increased the production and living expenses. Increased prices in agricultural inputs hurt the peasants; increased prices in basic staples hurt urban residents. Inflation thus induced protests. Political dissidents took advantage of these opportunities, as well as moderate reformists' tolerance, voiced their politically liberal opinions, and demanded changes in ideological control and increased supervision of state officials. Public discontent with the regime's policy made the population more sympathetic for these political demands. A proposition thus follows:

*Proposition 4: High inflation resulted in more public protests.*

Finding 4 of Test 5 in Tabulation 4.1 (reported in Dittmer and Wu 1995, footnote 25) provides statistical evidence for this proposition. The correlation coefficient between inflation and the frequencies of public protests during 1980-1993 reaches 0.728, well above the 0.5 level, indicating a strong correlation.

As discussed, between 1978 and 1994 moderate reformists tolerated discussion on political reform, emboldening the liberal intellectuals to be vocal. Relaxed political control and economic complaints, such as high inflation, combined to produce explosive protests. The regime's legitimacy and control of power were consequently challenged. In response, orthodox reformists and conservatives blamed moderate reformists for having been too lenient on dissidents and protesters. Conservatives attacked reformist policies,

silenced reformists, and took over policy making. Conservative leaders tightened the party's ideological leash on the officials, cut investment, decelerated the economy, and restrained inflation. Nevertheless, as inflation decreased to a low level, macroeconomic stability allowed for room for renewed growth. Reformists would then use sluggish growth and the people's stagnant living standard to refute the conservative policy, relaxed ideological restrictions, encouraged investment, and promoted growth. Another round of cycles was initiated. The following proposition seems to capture this aspect of the cycles:

*Proposition 5: The state reasserted ideological control and cut investment in the year following high inflation. The state relaxed ideological control, and encouraged investment and growth in the year following low inflation.*

Finding 5 of Tests 6 and 7 in Tabulation 4.1 supports this proposition. The leaders tightened ideological control and cut investment in the year following high inflation, yet eased ideological control and increased investment in the year following low inflation.

Each cycle typically goes through the following process. When reformists dominated policy making, they loosened the party's grip on ideology and encouraged bold economic initiatives. They pursued and tolerated expansionary fiscal policy, and oversaw a surge in investment. Extensive capital input produced high growth, igniting inflation and creating macroeconomic instability. Rising costs of living, declining income, and moderate reformists' tolerance consequently invited public protests. Conservatives then criticized the moderate reformists' political tolerance of dissidents and orthodox and moderate reformists' reform programs, and usually succeeded in gaining an upper hand in policy making. Conservatives exercised ideological surveillance over society, cut

investment and spending, decreased economic growth, and controlled inflation and public protests. As economic growth slowed to a crawl, the populace's living standard stagnated. Reformist leaders then launched a political comeback, and criticized the conservative program. They relaxed ideological indoctrination, called for reforms and growth, boosted investment, and championed growth. High growth inevitably increased inflation, macroeconomic instability, and public grievance, therefore inviting a conservative resurgence. A flow chart (Figure 4.1) sums up this process, with >> representing the direction of causation.

The above analyses help to clarify the ongoing controversies and misunderstandings on cycles. First, political business cycles are rooted in the deep disagreements between the reformist and conservative policy preferences, namely, pro-growth versus pro-low-inflation, and pro-ideological-relaxation versus pro-ideological-control. The cycles also originate from the division among orthodox and moderate reformists. Cyclical changes in politics precede those in economics, and the latter only reinforce the former. Second, ideological relaxation or control plays an important role in the cycles, usually marking the start of a cycle. Emphasis on different political phrases, such as "reforms and opening up" versus "oppose bourgeois liberalism", signaled to local leaders which faction was in control of policy and which program was to be implemented. Third, lag effects existed in the cycles. Confirming Baum's remark, political and business cycles may not synchronize. High growth tended to drive up inflation in the following year, *not* in the same year as suggested in several major studies on cycles by Dittmer and Wu and by Shirk. Similarly, ideological and investment controls would be tightened *a year after*

(instead of simultaneous with) high inflation. Fourth, the legacies of the command economy and the strong state also enabled the Chinese leaders to exercise extensive and direct influence over investment and monetary policies. As the finding of Test 3 indicates, national leaders could use state investment to boost or decrease the growth rate of national economy.

### *Periods of Cycles*

Given the above findings, I employ the curves of the growth rates and of the retail price index to illustrate and identify cycles of national policies. The cycles are depicted in Figure 4.2, where several major points on the curves are marked and explained. Table 4.2 summarizes the basic economic features of each period of the cycles. Among these periods, reform expansions are characterized by high growth rates and high inflation, and periods of retraction are marked by low growth rates and low inflation (Table 4.2).<sup>6</sup>

As indicated in Table 4.2 and Figure 4.1, *an expansion period of reforms, with the possible exception of the first period of 1978-80, usually started with a year after low inflation and accelerating growth, and ended with relatively lower growth and unusually*

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<sup>6</sup> The inflation rates during 1978-80 and 1989-91 might be regarded as two minor exceptions. During 1978-80, Chen Yun orchestrated the reform initiatives in order to rectify Hua's over-ambitious growth. Chen Yun tamed inflation during the first two years. Nevertheless, the averaged 2.9 per cent was still unusually high by the Chinese standard at that time, for inflation during 1963-76 ranged between -5.9% to 0.6% (SSB 1990b, 32). Although inflation in the second and third years of the retreat of 1989-90 remained low at 2.1% and 2.9% respectively, unusually high inflation at 17.8% in 1989, however, skewed averaged inflation of this period upward to 7.6%. The impact of the ill-fated price reform of 1988, coupled with

*high inflation.* For example, the expansion of reform during 1984-88 was preceded by modest inflation of 1.5% and moderately high growth of 9.3% in 1983. It started with an impressive 13.7% growth rate in 1984, and ended after runaway inflation of 18.5% and a moderately lower 9.5% economic growth in 1988 (Table 4.2).

In contrast, *a contraction of reforms was precipitated by spiraling inflation and a significant yet decelerating growth rate in the previous years, and ended after years of low inflation.* The economic retreat of 1989-91 followed usually high inflation in 1988, and witnessed a dramatic slippage in the retail price level in 1990 and 1991. A brief description of these periods suffices to illustrate the cyclical change between the periods.

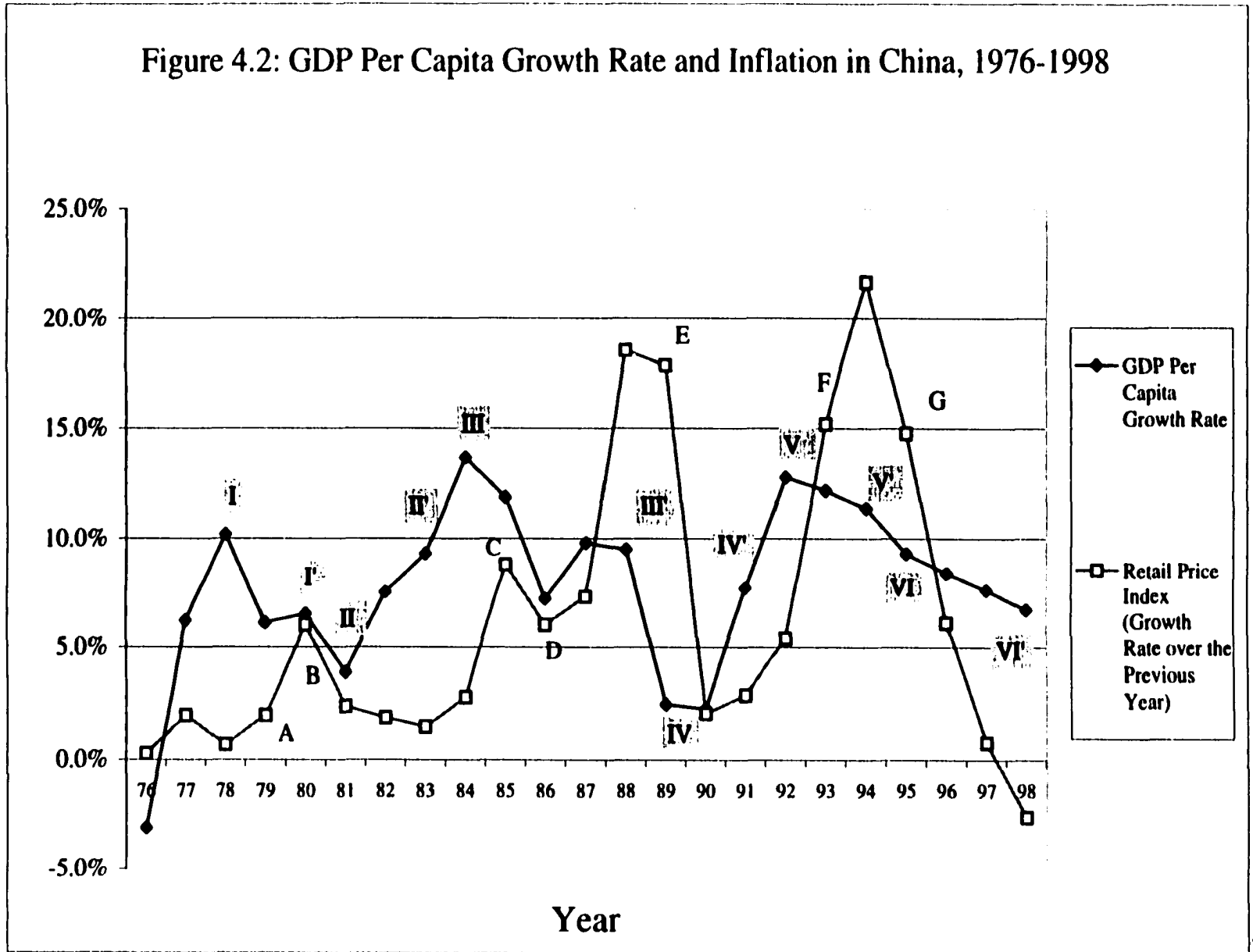
*Expansion of 1978-80* Mao's successor Hua Guofeng's over-ambitious economic drive raised inflation from 0.3% in 1976 to 2% in 1977 (SSB 1990b, 6), and was also threatened by severe under-supplies of raw materials (Naughton 1996, 67-74). The pragmatist leaders initiated economic reforms and retrenchment in 1978 (this is the only period during which retrenchment correlated with reforms). Family farming was introduced to the countryside, and rural and private enterprises grew.

Rising inflation (from 0.7% in 1978 to 2% in 1979) in the wake of fast growth, however, invited liberals at the Democracy Wall Movement in Beijing to criticize the party during the winter of 1978-79 (Point A on Figure 4.2). Protests against abuse of power by local officials also broke out in Beijing. Under pressure from the conservatives, Deng arrested the leading liberals (Baum 1996, 77-82). In 1980, Deng renewed the reform drive

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leaders' inability to take effective measures to reduce inflation due to the Tiananmen turbulence in 1989, enabled high inflation to persist in 1989.

Figure 4.2: GDP Per Capita Growth Rate and Inflation in China, 1976-1998



Notes for Figure 4.2:

Marked points on the inflation curve:

- A. 1979. Crackdown on Democracy Wall and arrests of liberal activists
- B. 1980. A campaign to oppose bourgeois liberalization
- C. 1985. Five student protests; the party's efforts to clean up bourgeois liberalism
- D. 1986. Student protests in Hefei, Shanghai, and Beijing. Hu Yaobang, an open-minded Party General Secretary, was forced to resign in January 1987.
- E. The Tiananmen Movement that demanded greater political opening and crackdown on official corruption
- F. 1993. Start of anti-corruption campaign
- G. 1995. Prosecution of at least two top provincial leaders and three provincial-level leaders for their corruption. Detention of political activists after the largest wave of calls for democracy by dissidents and intellectuals since 1989

Letters on the GNP growth rate curve:

I- I': 1978-80, expansion of reforms; II- II': 1981-83, contraction of reforms; III- III': 1984-88, expansion of reforms; IV- IV': 1989-91, contraction of reforms; V- V': 1992-94, expansion of reforms; VI- VI': 1995- (1998 in the figure), reduced fluctuation. I, II, III, IV, V, and VI stand for the starting point of a period, and I', II', III', IV', V', and VI' the ending point of the period.

Sources: The same as Table 4.1.

Table 4.2: Growth Rates and Inflation of Five Periods (%)

Periods of Reform	Average GNP Growth	Average Inflation	Growth Rate (by Each Year)	Inflation (by Each Year)
1978-80 Expansion	9.2	2.9	10.2, 6.1, 6.5	0.7, 2.0, 6.0
1981-83 Retraction	7.9	1.9	3.9, 7.5, 9.3	2.4, 1.9, 1.5
1984-88 Expansion	11.6	8.7	13.7, 11.9, 7.2, 9.8, 9.5	2.8, 8.8, 6.0, 7.3, 18.5
1989-91 Retraction	5.3	7.6	2.5, 2.3, 7.7	17.8, 2.1, 2.9
1992-94 Expansion	13.1	14.1	12.8, 12.2, 11.4	5.4, 15.2, 21.7
1995-98 Reduced fluctuation	8.0	4.8	9.3, 8.4, 7.6, 6.7	14.8, 6.1, 0.8, -2.6

Sources: The same as Table 4.1.



**Tabulation 4.2. Did Low Inflation Trigger Higher Growth in the Following Year?**  
(Standard errors in the most parentheses; significant level in the parentheses next to R<sup>2</sup>)

Formula 1: Regression of the growth rate of per capita GDP of 1978-93 (Y<sub>t</sub>) on that of retail prices of the previous year (1977-92) (P<sub>t-1</sub>)

$$Y_t = 0.106 - 0.413 P_{t-1}, \quad \text{adjusted } R^2 = 0.369 \text{ (0.007)}$$

(0.010)                      (0.132)

Formula 2: Regression of growth rates of per capita GDP of 1978-96 on the inflation of the previous year

$$Y_t = 0.098 - 0.177 P_{t-1}, \quad \text{adjusted } R^2 = 0.081 \text{ (0.126)}$$

(0.011)                      (0.110)

by approving four special economic zones (SEZs)(Tang ibid, 227-32). Lively elections of the county-level legislators were held (Baum 1996, 97-100).

*Contraction of Reforms of 1981-83.* Fast growth again boosted inflation to 6% in 1980. Subsequent outcries by liberals and Maoists broke out, causing Deng to acquiesce in December 1980 to the conservative proposal of combating “bourgeois (political) liberalization” and reclaiming fiscal and administrative power from the provinces (Point B) (Baum 1996, 102-04; 110-13). Hu Yaobang, Zhao Ziyang, and Wan Li resisted the campaign. The only noticeable reform measure was to promote urban collective and private sectors, as unemployment in the cities soared due to retrenchment. In 1983, the conservatives started to assault SEZs and other reform initiatives and violated Deng’s core economic premise, i.e., reforms, prompting Deng to stop them.

*The Reform Drive of 1984-88.* Deng’s change of heart and lowered inflation during retrenchment favored a number of new reform measures: Active promotion of rural enterprises, opening of the primary economic zones in the coastal region to the world

economy, protection of private business, moderate reforms of state enterprises, and state control of prices. Again, rising inflation in the course of accelerated growth triggered student protests in 1985 and the turn between 1985 and 1986 (Points C and D). In the aftermath, the party's conservative and orthodox reformists joined force in tightening ideological controls, and were angry over Hu's protection of liberal intellectuals who played an active role in the protests. Deng, the leading orthodox reformists, was also upset over Hu's consent to liberal party members' calls for ending the personal cult of Deng and for Deng's retirement (Ruan 1994, 162-68). In the end, Zhao Ziyang replaced Hu Yaobang as the General Party Secretary (Baum 1996, 190-203).

The Thirteen Party Congress of 1987 passed a liberal party platform, and rejuvenated the reforms, especially regarding foreign investment, urban collective sectors, private business, state enterprises, and prices. A premature rush toward price reform in 1988, however, caused a buying picnic and the inflation thus skyrocketed to 18.5% in 1988.

*The Retreat of 1989-91.* Rising inflation triggered the largest pro-democracy protests in the post-Mao era during the summer of 1989. Zhao, who tried to calm the protests by following a conciliatory approach to the protesters, lost Deng's support. Deng called in the troops to crush the protests. He picked Jiang Zemin, a centrist, to replace Zhao as the General Secretary of the party. The conservatives dominated the policy making by tightening the ideological clamp, ferreting dissidents, slowing growth, and protecting state enterprises at the expense of non-state business. The state deregulated prices of major food staples and industrial inputs (Tang *ibid*, 405-08; Gao et al 1993, 1708). Inflation was lowered to 2.9% in 1991.

*Deng's Last Reform Drive of 1992-94.* Retrenchment caused the economy to attain an annual growth rate of 2.1-2.9%. Deng hoped the 1992 Party Congress, the last one in his lifetime, would inherit his reformism. Deng toured the South and called for bolder reforms. In response, the state actively promoted rural, private, and foreign enterprises, embraced market economy, and opened up inland provinces for foreign investment. The Fourteenth Party Congress of 1992 accepted Deng's policies as the party platform.

As the economy grew rapidly, inflation soared to 11.4% in 1994, resulting in increasing public grievances. In addition, local officials channeled funds into investment and financial speculation, and failed to pay peasants for their quota grains. During 1993-94, over 1,300 rural riots broke out, involving 850,000 peasants, and causing over 20 billion yuan in property losses (Baum 1996, 378). The top leaders reacted on two fronts.

Economically: In June 1993, Zhu Rongji, the de facto premier, recentralized financial control, and stepped up tax collections and payments for agricultural procurements (Tang 1998, 478, 488; Gao and He 1998, 370-413). Politically: Jiang launched an anti-corruption campaign in August 1993, and arrested a number of high profile officials on corruption charges (Tang 1998, 467).

*Reduced Fluctuation Since 1994.* Economic reform continued to progress, yet the tolerance for calls for thorough political reforms in the 1980s disappeared. Economic reforms continued to proceed toward a more efficient, open, and equitable economy under sufficient central supervision. In 1994, the currency was devalued to be in line with market exchange rate, the tariff level was slashed by 7.3%, and a uniform national tax system and a central-provincial tax-sharing system were both implemented. Since 1994, the state has

introduced a set of measures to develop market mechanisms. The party has also made efforts to overhaul state enterprises. The party endeavors to develop the interior regions. In late 1999, China reached a landmark agreement with the U.S. regarding China's entry to the World Trade Organization by promising to drastically open up China's market.

The centrist leaders introduced conservative politics during 1994-96 in response to political strains triggered by economic problems. As inflation hovered respectively to 21.7% and 14.8% in 1994 and 1995, a number of liberal activists and prominent intellectuals petitioned National People's Congress in the spring of 1995 for political opening. Jiang suppressed the largest protests since the Tiananmen Movement of 1989, and also arrested the Mayor of Beijing on corruption charges to ease public outrage over corruption. In 1996, Jiang approved the firing of missiles over Taiwan to warn against its leaders' pro-independence rhetoric, and issued a long party document warning against western political influence.

The political atmosphere relaxed in 1997, with inflation dropping to an unusually low 0.8%, and with the Fifteenth Party Congress announcing further reform measures. Discussion on political reforms also surfaced. In 1998, liberal euphoria grew during Clinton's visit. In 1999, however, as unemployment increased (official urban statistics hit 3%, up noticeably from 2.6% in 1993) due to growing difficulties in state enterprises, Jiang hardened his fist of control. He outlawed the Falun Buddhist cult organization, and chilled the expectation for political reforms.

The dynamics of political business cycle described above seemed to weaken during this period. Between 1978 and 1993, low inflation seemed to induce the leaders to pursue

fast growth in the following year, and high inflation would encourage them to decelerate growth. This is confirmed by Formula 1 in Tabulation 4.2. Such a relationship, however, falters into statistical insignificance after the data of 1994-96 is included (Formula 2).

Political-business fluctuation has been reduced after 1994 because the post-1989 second-generation leaders, especially Jiang, urged economic liberalization while suppressing efforts at democratization. They embraced this centralist platform for two reasons. First, their key patrons, i.e., orthodox reformists and conservatives would converge on it. Second, and more importantly, they feared that failure to do so would invite vocal demands against the Party's monopoly of power, consequential backlash from the conservatives, and their losses of power. Their predecessors, namely Hu and Zhao, failed to abide by this centrist mix by tolerating calls for political reforms, and thus lost their posts after large student protests.

#### **4. Conclusion**

To summarize, national policies between 1978 and 1994 had go through cycles. Each cycle started with a relaxation or a tightening of ideological control, followed by aggressive or conservative investment policy, resulting in initially rising or declining growth rate and inflation, and later, popular protest, or unemployment and a stagnating living standard. As a result, ideological orientation and investment policy shifted, inaugurating another cycle. After 1994, the technocratic and centralist leadership, in an

attempt to avoid wild fluctuation and political setbacks, will not speed up economic growth even when blessed with low inflation. Cycles have thus subsided after 1994.

This chapter indicates that attempts of the powerful leadership factions' to meet popular demands for high growth and low inflation engineered the cyclical change in national reform policies over the period of 1978-96. Three factors helped shape the cycles during the period of 1978-93. The first factor is the institutional arrangement among the national leadership. The balance of power between the reformists and the conservatives conditioned the policy debate and changes. The second factor is the population desires for rapid growth and low inflation, which eventually meant a substantial increase in their living standard. As explained above, Deng's reformist factions opted for fast growth, whereas the conservative factor opted for low inflation. These two popular demands, however, were often inconsistent in a growing economy: Rapid growth tended to induce inflation, whereas low inflation often requires slow growth. The third factor is the state's administrative and political approach to the economy. This approach acted as a powerful accelerator as well as a strong brake for the Chinese economy, exacerbating the rise and fall of the growth rate and inflation.

This empirical study of the change in national reform policies thus supports the statistical findings on national reform policies in Chapter 3. It confirms that national leaders aimed primarily at courting popular support in formulating or modifying national reform policies. This chapter also fills these gaps in the existing literature by settling competing claims and delineating a clear dynamic of political business cycles in China. For an empirical examination of provincial policies, we shall turn to Chapter 5.

## **Chapter Five: The Making of Reform Policies in Two Provinces**

### **1. Introduction**

This chapter compares the evolution of reform policies in Shandong and Jilin Provinces during 1978-1994. Although sharing many similar economic conditions prior to 1978, the two provinces adopted divergent reform policies since the mid-1980s. This chapter finds that the pre-existing regional balance between state and non-state industries largely accounted for different reform efforts in the two provinces. To be specific, Jilin had a much larger state sector than did Shandong. As a result, provincial leaders and a large segment of population in Jilin tended to support a more restrictive policy toward the non-state sectors, and the bureaucracy in Jilin that serviced the state sector remained larger yet less efficient and more hostile to deregulation of non-state sectors. A large unemployed population would also encourage provincial leaders to deregulate the economy and promote non-state sectors. In addition, the national authority also introduced policies that would have facilitated or delayed reforms in these provinces. Among the above factors, the non-state sector and the unemployed constituted key interest groups for reforms, whereas the provincial bureaucracy and the national authority set the institutional settings within which the provincial leaders pushed for or held back bold reform policies.

This chapter will first discuss the strategy for comparative case studies, and review the characteristics of Jilin and Shandong Provinces. It will then compare policies toward rural enterprises, the urban collective sector, private business, and foreign and joint ventures in the two provinces. Finally, it will examine in detail causes of divergent reform policies in the two provinces.

## **2. Methodology for the Comparative Study**

### *The Strategy for Controlled Case Studies*

Although discussed long ago by classical writers, controlled comparison is relatively new in comparative politics. John Stuart Mill examined critically four typical methods in social sciences. *The experimental method* treated social events as outcomes in a natural-science-type social experiment when deriving explanations. *The direct method of differences* attributed different results in two extremely similar countries to a single difference found between them. *The indirect method of differences* regarded different outcomes in partially different countries as a result of the presence or the absence of a single factor found in these countries. *The method of residues* treated the similar part of the observed events in two or more countries as effects of the similarities between these countries, and the remainder of the events as those of the differences between the countries (Mill 1956, 573-78). Mill believed that the latter methods were safer than the previous ones. Although short of using the terms of dependent and independent



variables, Mill implicitly favored selecting cases with different outcomes for comparison and explaining them in terms of their different characteristics.

For a long time, however, comparative political scientists had paid inadequate attention to the differences in the dependent variable (the event to be explained) in their case studies in their case studies. As keen methodologists point out (Geddes 1990, 131; King et al 1993, 119-26), comparativists at times preferred to study cases of a similar dependent variable. For example, scholars of revolution only investigate countries where revolution had broken out, and ignore countries in similar settings yet without dramatic changes. The risk for this selection bias is that, according to the methodologists, these scholars can underestimate the effect of the explanatory variable, or overestimate the significance and generality of the findings (Collier and Mahoney 1996, 88; Geddes 1990; King, Keohane, and Verba 1993, Chapter 4).<sup>1</sup> On the other hand, theoretically-grounded and carefully-executed studies of similar events in one region, as Rogowski (1995) suggests, can shed light on the events that are frequently found in the other parts of the world. These case studies may embody theoretical elegance and insights. Therefore, two

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<sup>1</sup> A hypothetical example can illustrate the second effect. Suppose scholars investigating how policies affected development only studied countries that had experienced rapid development. They concluded, hypothetically, that every two-percent increase in governmental investment could lead to one percent of economic growth (The number of percentages has a rather significant implication, for few countries can grow faster than 6 per cent.) But these researchers did not include countries with *slow economic growth* in their study. Thus two risks arise. First, the study exaggerated the generality of governmental spending in development. It is likely that governments in the countries with slow growth had also attempted to use spending to induce growth, but failed miserably. On the whole, governmental spending may not be effective. Second, the opposite may be true: the study can underestimate the contribution of governmental spending to growth. Suppose ten countries all have increased their investment by one percent, and expand their GDP by two percent. If these countries are not included in the studies because

things are both important for case studies. One is theoretical ground for and deductive implication of the studies, and the other sound research methods such as inclusion of a controlled group, or dissimilar events (Rogowski 1995). For this reason, the case study in this chapter includes a case where the observed event (fast reforms) occurred (cases of occurrence), as well as an instance where the event failed to occur despite several similar conditions (cases of no occurrence) in order to avoid unnecessary problems (Geddes 1990).

### *Selected Provinces for Comparison*

Shandong and Jilin with a number of similar conditions are selected for comparison. Shandong was a populous coastal northern province, south of Beijing and north to Jiangsu and Shanghai. Shandong is known as a dominant state in a period of division of China over two thousand years ago, and as the home place of the best-known Chinese philosophers such as Confucius and Mencius, as well as numerous statesmen, writers, and artists. Jilin was an inland province in the Northeast (Manchuria), immediately north to Liaoning, the only coastal Northeastern province, and bordering with North Korea and Siberia of Russia on the east.

At the very beginning of reforms, both Shandong and Jilin shared similar loan and tax policies toward *the primary non-state industry (NSI)*, namely, rural or urban collective

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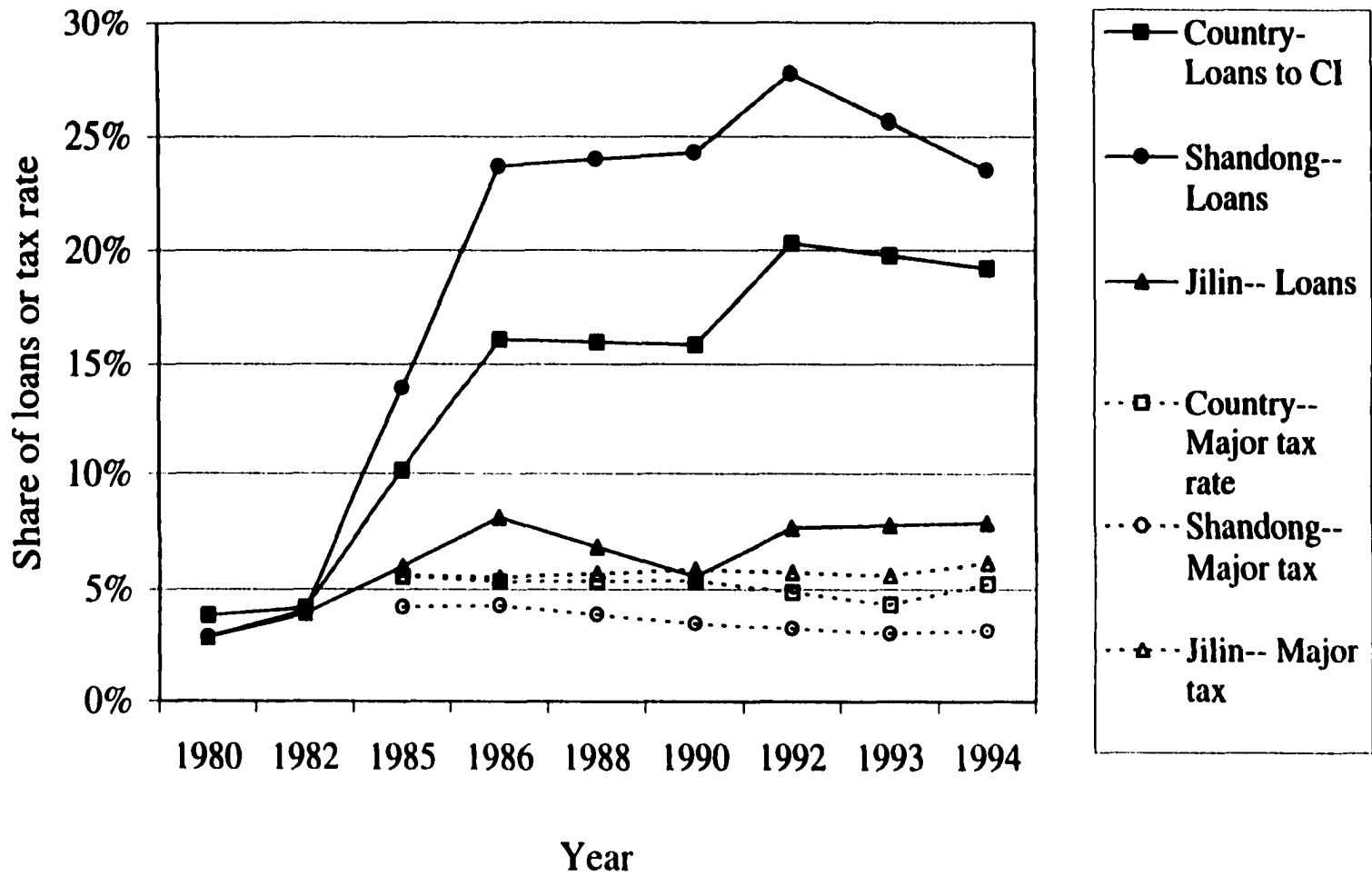
of their slow growth. Should they have been included, the study may find that two percent of governmental investment led to two percent, instead of one percent of GNP growth.

industry. They are reflected in very similar shares of rural enterprises and collective industry in the loans from loans from the Agricultural Banks and Rural Credit Cooperatives during 1980-82 (Figure 5.1), comparable major tax rates (ratio of major taxes to the output) for collective industry during 1985-86 (Figure 5.1), and resembling income tax rate (a secondary tax) on collective sectors between 1980 and 1986 (Figure 5.2). The taxation on collective sectors in the two provinces was not far apart from that than the country, whereas loans to collective enterprises were proportionally lower than the country in the early years.

With the passage of time, especially after the mid-1980s, reform in Shandong started to outpace that in Jilin. The share of collective sectors in the loans in its agricultural banking system in Shandong had risen above that in the country and well above that in Jilin since 1985 (Figure 5.1). Such a discrepancy in the loans to collective sectors between Shandong and Jilin and between Shandong and the country continued through 1994. From the late 1980s onward, Shandong also started to reduce the taxes on the collective sector much further than did Jilin. As a result, Shandong had lower major tax rate and income tax rate on the collective sector than the country and Jilin after 1986, and much lower total tax rate on rural industry than the country and Jilin after 1988, even in 1990 during the post-Tiananmen retrenchment. In contrast, Jilin outdid the national trend in cutting loans to the collective sector, raising major taxes on the collective sector, and increasing total tax rate on rural industry in 1990 (Figures 5.1 and 5.2).

Did Shandong pursue reform initiatives more boldly than Jilin after the mid 1980s because it enjoyed much better economic conditions than Jilin? The answer is no,

Figure 5.1 . Loans to and Major Tax Rates on the Collective Sector in Shandong, Jilin, and the Country



**Figure 5.2: Total Tax Rates regarding Rural Industry and Income Tax Rates regarding the Collective Sectors in Shandong, Jilin, and the Country**

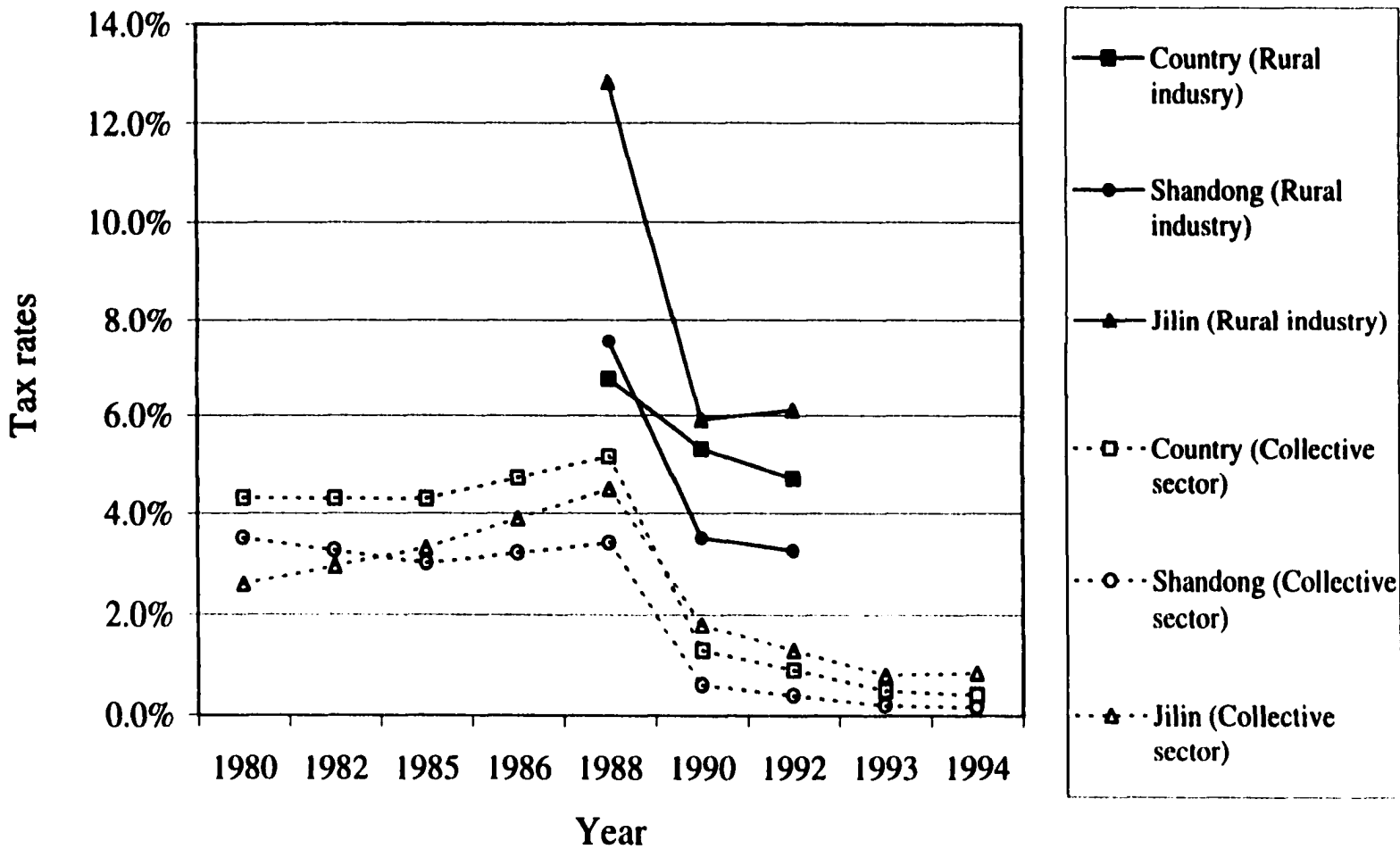


Figure 5.3: Income Tax Rates for the Private and Foreign Sectors in Shandong, Jilin, and the Country

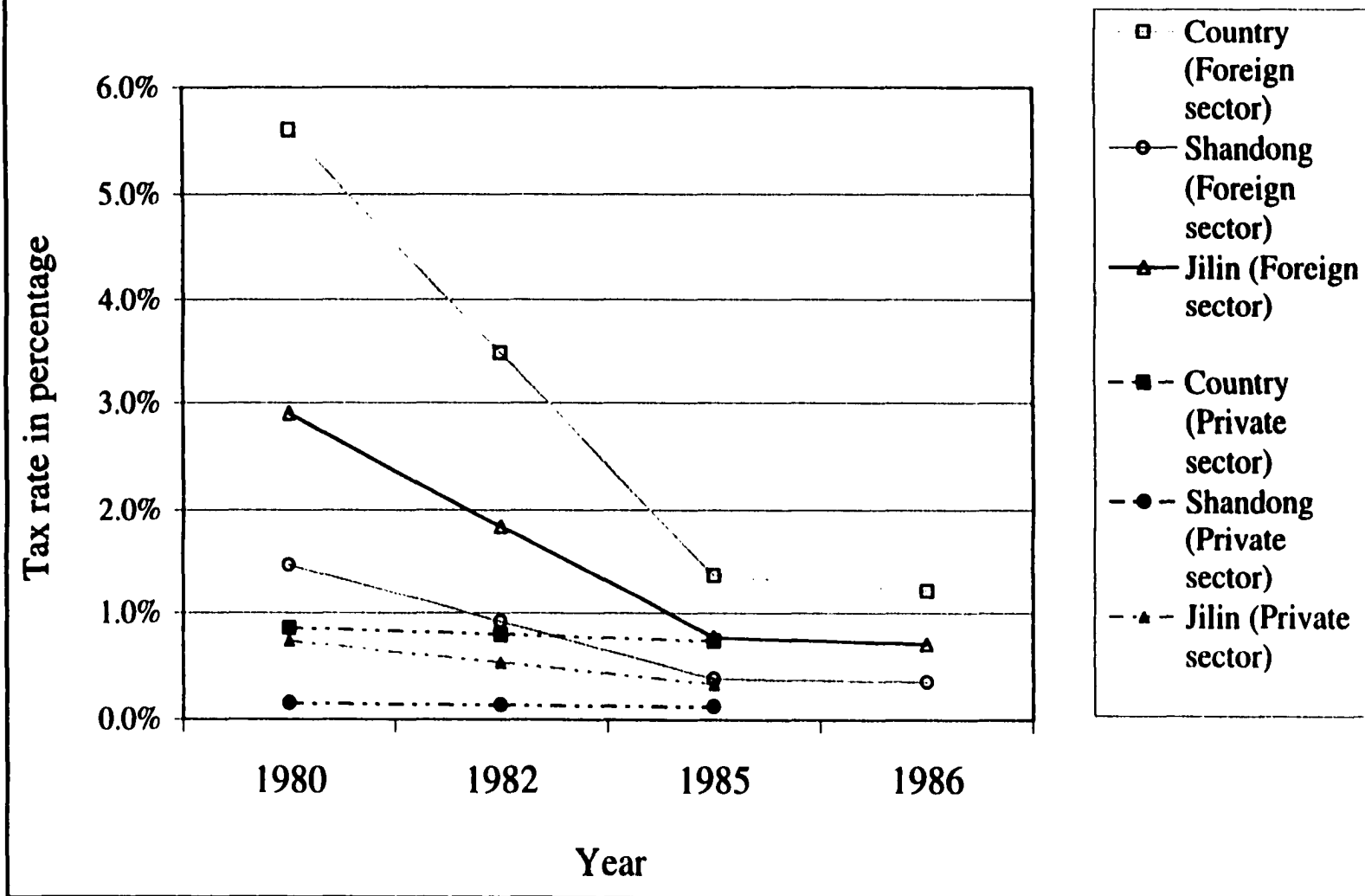
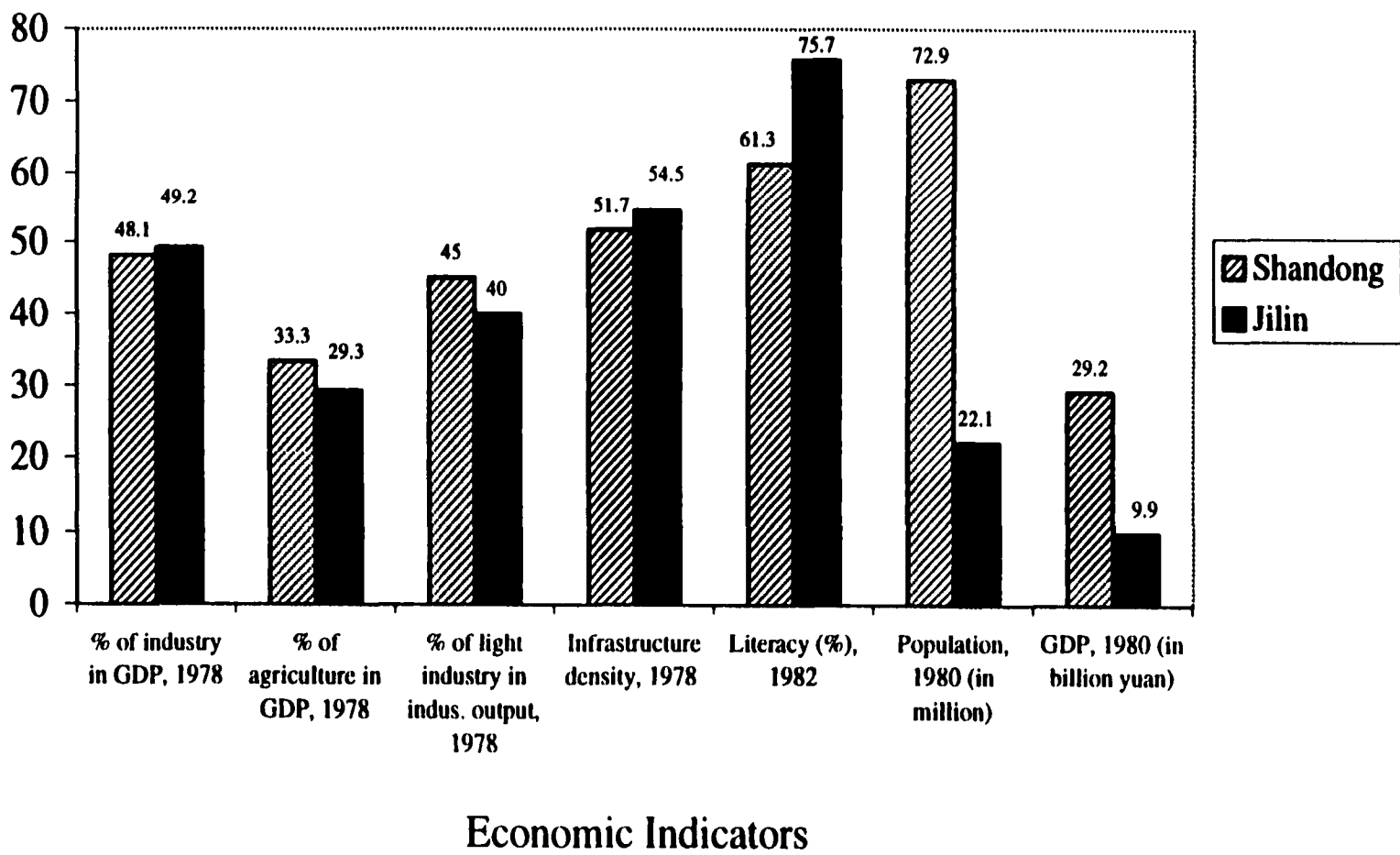
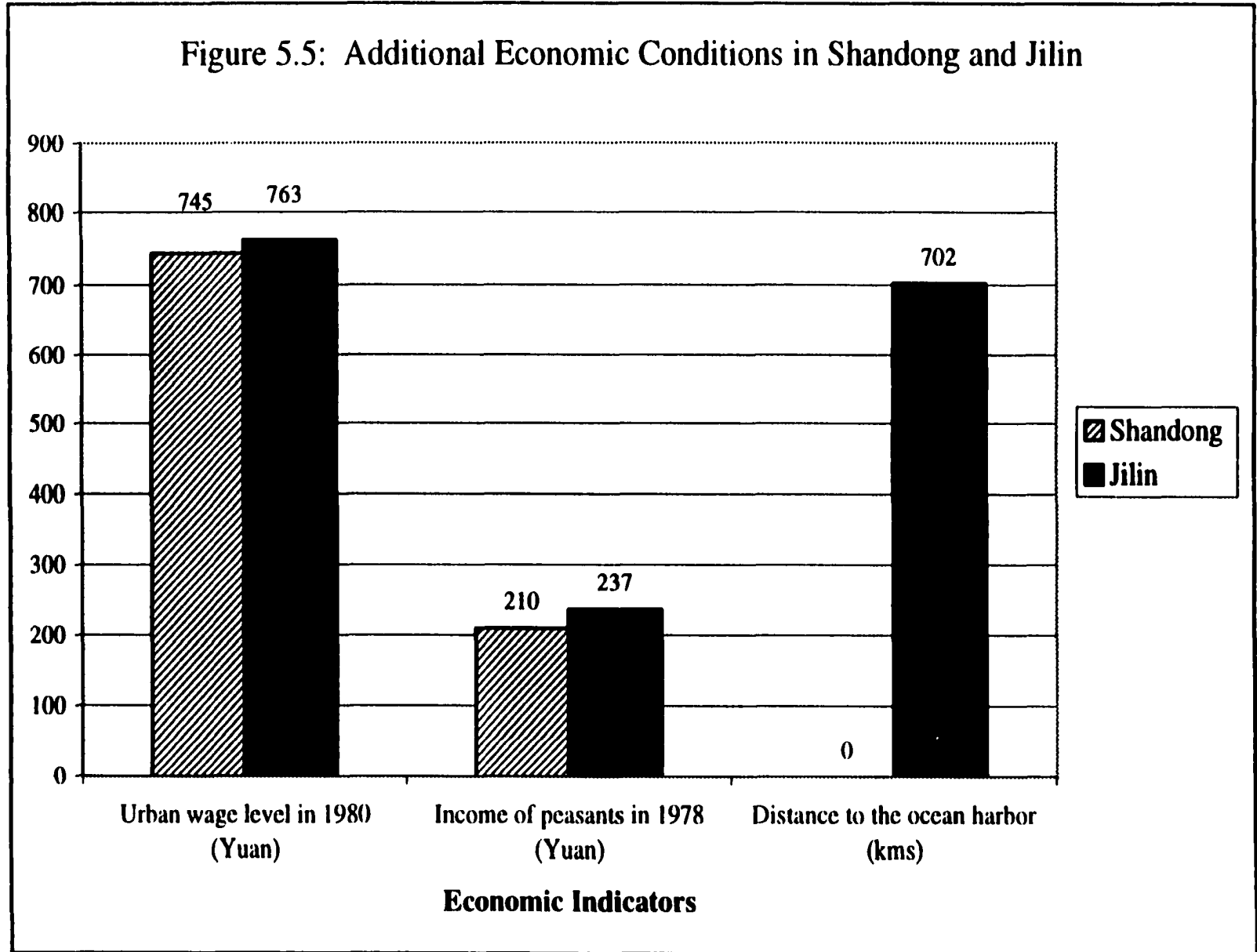


Figure 5.4: Economic Conditions of Shandong and Jilin



Economic Indicators





as major developmental indicators of both provinces in Figures 5.4-5.5 indicate. In the early years of the reforms, Jilin had better economic conditions than Shandong. Jilin possessed a higher level of urbanization, industrialization, and income, a more literate labor force, a better infrastructure, and a smaller population. In addition, Jilin edged over Shandong in endowment of land and agricultural productivity. In 1987, Jilin had the fifth largest arable land per capita and the highest grain yield per capita in China, and Shandong the thirteenth and eighth respectively (Wang 1989, 424-25).

Neither province possessed a noticeable advantage in other aspects. Shandong and Jilin both had considerable natural resources for industrialization. Both were rich in gold and minerals for producing construction materials, such as marble, graphite, talcum, and limestone. Both possessed considerable agricultural resources for light industries either because of developed agriculture (Jilin), or the large size of agriculture (Shandong). Both have access to energy resources. Shandong had the second largest oil field in China and large coal mines. Jilin possessed over half of China's reserve of oil shale, a medium-sized oil field, a developed coal mine, and considerable reserves in natural gas and petroleum. Jilin located also next to Heilongjiang where the largest oil field in China is located (Shi and Hao 1990, 197-267; Wang 1989, 5-14; 46-8).

The relative strengths of both provinces in a set of sectors do not explain the contrast in their reforms either. Jilin's economy was characterized by a productive agriculture, several nationally prominent industrial sectors, such as transportation equipment (automobiles, freight and passenger trains, and tractors), petroleum chemicals, lumber processing, paper-making, coal-mining, grape-wine-making, and food-processing.

Leading industrial products in Shandong, on the other hand, included petroleum chemicals, coal, automobiles, locomotives, tractors, watch, wine, paper, machinery, food processing, and textile (Shi and Hao 1990, 201-67; Wang 1989, 48; 210-17; Fu et al 1992, 31-2; 55-6).

Shandong's obvious advantage was its harbors, especially its large coastal cities Qingdao and Yantai. Jilin would have to use a large harbor in Dalian of Liaoning, which was 702 kilometers by railway from the capital of Jilin. In the early years of reforms, a relatively developed railway system enabled Jilin to overcome this manageable distance.

Therefore, the sources of differing reforms in Jilin and Shandong may lie in elsewhere. The factors found relevant in nationwide statistical analyses, namely, non-state industry, could have shaped reform policies in these provinces. A quick glimpse at Table 5.1 suggests that larger non-state sectors, as well as higher urban and rural unemployment rates might have caused faster reform in Shandong than in Jilin. An empirical study can determine whether these and other factors played a pivotal role.

### *Focus and Data*

The following sections will investigate the evolution of policies in Shandong and Jilin regarding each non-state sector-- rural enterprises, foreign and joint ventures, urban collective enterprises, and private sectors. The discussion will focus on the *provincial* reform policies toward *the first two sectors* for two reasons. First, information on *provincial* reform policies is more accessible than that on *national* policies toward

**Table 5.1. Possible Factors in Shandong's and Jilin's Reform Policies**

	<u>Share of non-state sectors in industrial output</u>			
	1978	1985	1990	1994
Shandong	0.324	0.454	0.586	0.755
Jilin	0.211	0.278	0.296	0.376
Nationwide	0.224	0.369	0.454	0.659
	<u>Surplus rate of rural labor</u>			
	1978	1983	1990	1994
Shandong		2.1	4.8	3.9
Jilin		0.7	2.4	2.3
Nationwide		1.2	4.3	5.1
	<u>Urban unemployment rate</u>			
	1978	1985	1990	1994
Shandong	2.6	3.6	3.2	3.0
Jilin	6.9	2.2	1.9	1.9
Nationwide	5.3	1.8	2.5	2.8

Source: Lai 1998.

these two provinces and on the causes of national policies. Inadequate information makes it difficult to pinpoint the national policies toward Shandong and Jilin and the center's motives behind its policies. Second, limited space does not allow for detailed examination of both provincial and national policies toward each non-state sector. Third, rural enterprises constituted the *largest* non-state sector in China. On the other hand, the rise of foreign and joint ventures signaled China's historical break with its inward-

looking development in the past decades. Foreign enterprises are increasingly important exporters and new sources of investment, technology, and managerial know-how.

Information for the case study comes from the following four sources: my interviews with the officials in Shandong and Jilin who were informed about the reform policies, documents by the provincial governmental agencies, publications on reforms and economy in these provinces written by provincial officials or policy specialists, and official yearbooks. Most of the statistics come from *Statistical Yearbook of China*, *A Collection of Historical Statistics of China's Provinces*, *China's Regional Economy*, and statistical yearbooks of Shandong and Jilin. It is difficult to interview in persons all major individual officials in charge of non-state sectors, especially in the early stage of reform, for many of them had retired, or had been transferred to other departments. Whenever interviews do not supply adequate information on policy making, inferences about the will be drawn from published sources. Although imperfect, they are the best methods available. I reconstruct the empirical process of policy making and the considerations of decision-makers as much as permitted by the data.

### **3. The Evolution of Reform Policies in Shandong and Jilin**

#### *Policies toward Rural Enterprises*

Both Shandong and Jilin conformed to the center's favorable guideline toward rural enterprises during 1978-80. In October, 1979, Jilin Party Committee declared the expansion of rural enterprises an important task (ECLAJP 1992, 3-4). Local governments

in Jilin helped rural enterprises to obtain 80 million yuan for investment, 80% more than the previous year (ibid,191). Shandong went a small step farther than the center's guideline. In March, 1979, Shandong authority declared the growth of rural enterprises an official policy, and exempted new rural enterprises from taxes for three years, except those producing cigarettes, wine, and cotton yarns. During 1978-80, Shandong also exempted small plants that helped produce basic production inputs (iron core mine, power stations, etc) from taxes. In 1978, the People's Bank in Shandong started to lend to rural enterprises on a regular basis (ECLASP 1996, 597-98).

Jilin and Shandong also followed closely the center's order to impose a cap on the growth of the enterprises during 1981-83. State industry and their governmental representatives in Jilin even advanced blatant and fierce charges: "Rural enterprises drew raw materials, energy, and funds away from state enterprises" (Du 1993, 5; interviews). Governmental agencies in Jilin barred rural enterprises from obtaining profitable and urban construction projects, processing agricultural goods, opening business outside the county of origin, and even obtaining a license (Du ibid). Investment funds for rural enterprises shrank or grew modestly at best (ibid). A number of localities even shut down many rural enterprises. In contrast, Shandong imposed moderate restrictions on rural enterprises. Tax exemption was rescinded, high taxes were imposed on the enterprises that produced consumer goods in high demand, and bank lending was tightened (ECLASP 1996, 153-54).

The gap in the reform policies in the two provinces widened after 1984. In the early 1984, the center adopted a relaxed stance toward rural enterprises, calling for a new

phrase in the growth of these enterprises. In response, Jilin Government relaxed its policies, increased moderately bank loans, facilitate personnel inflow, cut taxes on rural enterprises. In 1986, provincial leaders called for a doubling of the output of the enterprises by 1990, and relaxed control over entry and market access of township and village enterprises. Local government stepped up services for the enterprises, such as labor introduction, legal protection, and advice for development (Du *ibid*). Considerable entry barriers still existed, however.

Shandong not only reversed its conservative policies, but also went a large step further. Shandong officials tried to expand rural enterprises through a large variety of means: Generous tax exemptions (up to three years after 1986) and bank lending, promotion of exports and cooperation between enterprises, and substantial governmental services in labor training, information, research and technological upgrading, and developmental planning. As described above, banking lending was much more generous, and taxation was much lower in Shandong than Jilin. In 1986, Shandong leaders rolled out a fundamental shift in their reform policies by declaring expansion of rural enterprises a key strategy in economic development (Wang 1989, 111-17, 185-94, 409; ECLASP 1997, 424-29; SSB 1990b, 1996b; *China Rural Enterprise Yearbook* 1988-95).

These dramatic changes occurred in Shandong due to at least three factors: A larger clout of rural enterprises, a larger population of rural surplus labor, and a new thinking of the leadership in Shandong. First, in 1984, rural enterprises produced nearly 40% of rural gross output and employed 21% of rural labor in Shandong, and respectively 25% and 10% in Jilin. Rural enterprises had therefore assumed a far more significant economic

role in Shandong than in Jilin. Second, a successful agrarian reform produced far more surplus labor in Shandong, a more rural and populous province than Jilin (Wang 1989, 176; Bao and Li 1996, 296). Third, in 1984, Shandong leaders realized that because of their conservative policies during retrenchment of 1981-83, Shandong was losing its advantageous position as an early starter in developing rural industry to other provinces. In 1978, for example, rural enterprises employed respectively 3.25 and 3.23 million peasants, and generated respectively 6.29 and 4.85 billion yuan in 1980 price in Jiangsu, where rural enterprises were the most developed, and Shandong. The ratios of employment and revenue income of rural enterprises in Shandong and Jiangsu in 1978 were respectively 0.994:1 and 0.771:1, indicating that Shandong was not far behind of the national champion. By 1983, the ratio dropped to 0.878:1 and 0.593:1, respectively (Wang 1989, 186-87; unpublished official Jilin statistics; SSB 1990b). Disappointed with the results of their close adherence of the center's retrenchment policies, Shandong leaders concluded that Shandong should keep a step ahead of the country in adopting the center's guideline for reforms.

During the second reform retraction of 1989-91 the reforms in the two provinces were in a sharper contrast. Shandong adopted positive retrenchment only in 1990 by overhauling rapidly-growing rural industry and improving its sectoral composition and management. Shandong leaders used this retrenchment "stone" to "kill two birds": Show its compliance with the center's policies while positioning rural enterprises for further expansion. In 1991 Shandong leaders decisively returned to its previous growth strategy of expanding rural enterprises and improving their property rights. Jilin, in contrast,

under the pressure of state enterprises, pursued positive retrenchment during 1989-90. Hostility toward rural industry even became widespread in 1991, causing deficiency in production inputs for rural firms (Du 1993, 7).

A crucial factor in the divergent reform policies in two provinces again seems to be the greater clout of rural enterprises in Shandong. In 1989, rural enterprises produced 61% of gross output of the countryside and 44% of industrial output in Shandong, and respectively 49% and 18% in Jilin. Not surprisingly, rural enterprises experience less harsh criticisms and restrictions, especially from the state sector and their governmental representatives in Shandong than in Jilin.

As Jilin joined the national reform expansions during 1992-94 by rekindling favorable treatment of rural enterprises, Shandong further liberalized its policies toward the enterprises and helped upgrading their management and technology in order to keep them flourishing and competitive. Table A5.6 (or 5D) in Appendices summarizes the contrasts in Shandong's and Jilin's policies.

### *Policies toward Foreign Direct Investment*

The first joint venture in Jilin was established in 1984. Jilin made two noticeable drives to attract FDI in 1986 and 1988. In 1986, Jilin held trade talks, and sent 78 delegations abroad to initiate trade or gather trade information. In 1988, a new provincial party secretary called for "all-directional opening", resulting in the setting up of five open economic zones. After a brief but sharp downturn in 1989, Jilin leaders reaffirmed their



commitment to introduction of FDI during 1990-91, and set up another developmental zone for FDI in 1991. During the 1992-1994 reform drive, Jilin dramatically modified its guideline for FDI by introducing a series of initiatives. The foreign sector was declared one of the four major forms of ownership. A large area that covered the most important cities was designated as an open region. Jilin leaders stressed improving the official mindset about opening and infrastructure, and called for an innovative plan of cooperation with South Korea, Mongolia, Russia, and North Korea along their common borders. A number of factors obstructed these initiatives of Open Policy in Jilin. They included prevalent and stubborn bureaucraticism, fledgling rural firms that could not play an active role in absorbing FDI and exporting goods, the fact that many state enterprises were indifferent to and unattractive for FDI, and the center's late selection of open cities in Jilin in 1992.

Shandong did benefit more from the center's early selection of open cities in the provinces. In 1984, the center granted two harbor cities in Shandong the status of "coastal open cities". In late 1987, the State Council was reported to make Shandong the primary province to handle non-governmental and economic contact with South Korea (Chung 1998, 272). Similar to Jilin, Shandong authority started to make systemic efforts to introduce FDI since 1986. Shandong Government promulgated an impressive set of favorable regulations toward FDI in 1986 and 1988. In 1987 and 1988 Shandong leaders called for further opening and use of more FDI with a sense of urgency (*Shandong Yearbook* 1988, 322; 1989, 383; Chung 1998, 266).

In each year between 1989 and 1994, Shandong continued to announce favorable policies toward foreign investors, improved infrastructure, and held trade fairs or trade talks. Shandong differed substantially from Jilin in several major aspects, especially after 1988. First, Shandong was more consistent in its policies. Unlike Jilin, Shandong did not retract from its embrace of foreign capital, even during 1989 and 1990. Second, Shandong took earlier and more effective measures to combat bureaucratism, liberalize official mentality, and implement its favorable treatment of foreign enterprises. As early as 1986, Shandong formed a coordinating agency to speed up the approval of FDI projects. In 1990, Jiang Chunyun, the Shandong Party Secretary, ended the infighting between two agencies in charge of foreign enterprises in Shandong. In each year between 1988 and 1994, Shandong leaders emphasized improving the work of the management office of open economic zones. Non-state sectors were much larger in Shandong, accounting for about half of the industrial output in Shandong, but less than 30% in Jilin in 1987. Under the command economy state industry usually required a bureaucracy for economic coordination and planning. Due to its predominant state industry, Jilin's bureaucracy was much larger than that in Shandong, and more assertive in maintaining old-style and redundant procedures and in protecting state enterprises in order to ensure its existence and revenue base. Jilin's officials were also more conservative, and less supportive of simplified procedures for foreign investors. As a result, Shandong was able to put into practice favorable policies and create an enviable environment for foreign investment, whereas Jilin was unable to execute favorable policies and offer efficient governmental services for foreign investors.

### *Policies toward the Urban Collective Sector (UCS)*

The UCS was relatively larger in Jilin than in Shandong. It accounted for 14.9% of total industrial output and 70.4% of collective industrial output in Jilin (*Jilin Yearbook* 1987, 380; SSB 1996b, 375), and respectively 11.6% and 43.8% in Shandong (*Shandong Yearbook* 1989, 482; SSB 1996b, 559). Most of the UCS was in light industry.

During 1978-85, urban collective firms in both provinces had run into stumbling blocks in their development, such as adoption of inefficient management by state enterprises, heavy taxes and fees, and limited access to raw materials and loans (Jin 1985; Cheng et al 1989). The primary obstacle for UCEs in Jilin was short-sighted imitation of management of state enterprises, and the secondary obstacle was conversion of these enterprises from light into heavy industrial production. The largest detriment for the growth of rural enterprises in Shandong was forceful take-over by local government.

As discussed in Chapter Two, the pre-reform system accorded state ownership and heavy industry central economic roles, and provided them with relatively abundant material, human, and financial resources. Employees in state-owned heavy industry had higher income, greater job security, and higher reputation than did those of collective light industrial firms. This was particularly the case in Jilin where state enterprises also had far better equipment and technology than urban collective firms. Employees of collective enterprises felt inferior when compared themselves with those in state enterprises (Jin 1985). The root causes of this inferiority complex are that state firms

prevailed in industry in Jilin and that the population had believed in the advantages of state ownership that were promoted by official ideology.

The state sector was smaller in Shandong. The notion of superiority of state enterprises was also less influential. On the contrary, urban collective light industrial firms were more productive in Shandong than those in Jilin, as an employee generated on average 13144 yuan in Shandong in 1986, and 7875 yuan in Jilin. The firms in Shandong also earned a large amount of hard currency through exports. Disregarding the center's pronounced protection of the firms, local government in Shandong preyed on them in order to extend their revenue basis. Misappropriation by local government set back the urban collective sector in Shandong more than poor imitation of management of state enterprises did to the sector in Jilin during 1978-85.

In the following years, both provinces coped with their respective problems. To enforce property rights, Shandong Government organized a survey of property of UCEs in 1987 and certified the property in the following years. In addition, it helped UCEs to improve management, upgrade products and technology, train employees, and increase exports during 1987-94 (*Shandong Yearbook* 1986, 293-94; 1987, 408). Shandong leaders declared their commitment to liberalization during 1989-91, and boosted the confidence of officials as well as managers and employees of UCEs in expanding the UCS. As a result, the growth of the output of the USC accelerated from 7.1% during 1981-85, to 19.9% during 1986-91, and 21.7% during 1992-94 (*ibid* 1986-95).

Jilin Province took smaller steps in fostering the growth of the UCS. It introduced the contracting system in UCEs in 1986, and promoted other incentive mechanisms in

UCEs in the following years. In 1992, Jilin leaders combined the bureaus that supervised respectively state and collective light industries in order to streamline bureaucracy, reduce redundant production, and increase production scales. Not until 1994 did Jilin undertake a survey of collective property that Shandong adopted in 1987.

While governmental measures were moderate at best, several obstacles were also in the course of the growth of the UCS in Jilin. First, the banks viewed state enterprises as their main client, and refused to lend to collective firms for their apparently outdated equipment and facilities and low profile.<sup>2</sup> Second, managers of UCEs still upheld the pre-reform developmental strategy of producing most accessories at their own firms and disregarded specialization and the economies of scale (*Jilin Yearbook* 1991, 298). Employees in the collective sector still admired the welfare, job security, and status of employees of state enterprises, and hardly attempted to improve the efficiency of the UCEs. Third, Jilin leaders followed in close steps the center's retrenchment during 1989-91, and clamped down on the growth of the UCS. Fourth, after the two bureaus of light industry were combined, efficient UCEs had to live with inefficient state enterprises, dampening their incentive for growth and efficiency (*ibid* 1994, 288). As a result, after improving from 8.4% in light industrial output a year during 1981-89, to below 6% during 1990-91, and 2.5-6.5% during 1992 and 1994.

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<sup>2</sup> Jilin banking officials argued that given the state fully protected state enterprises and served as its sponsor, lending to the state sector was like moving the state bank money from one drawer to another. Since the UCS was not controlled by the state and had no other party for sponsors, lending to it was risky (*interviews*).

## *Policies toward the Private Sector*

*The initial years (1978-83)* In 1978, private business accounted for 0.96% of GDP in Shandong and 0.82% in Jilin (*Shandong Yearbook* 1987, 249; SSB 1996, 546). Thus, despite their negligible economic role, private business was slightly larger in Shandong than in Jilin. Overall, Shandong acted earlier and more consistently than did Jilin in reversing the Maoist prohibition of private business. During 1978-83, surplus labor was a larger factor in Shandong's policies toward the private sector, whereas urban unemployment was a more important factor for Jilin. In 1978, urban unemployment was a modest 2.6 % in Shandong and a high 6.9% in Jilin. In 1983, rural surplus labor constituted 2.1% of rural labor in Shandong, and merely 0.7% in Jilin. Meanwhile, 91% of the population lived in the countryside in Shandong, and 69% in Jilin (Lai 1998).

As the center relaxed its control over the private sector in 1978, serious unemployment (6.9% in 1978 and 5.8% in 1980) battered the cities in Jilin. Concerned governmental agencies in Jilin thus adopted flexible regulations toward the sector in 1980 (ECLAJP 1991, 109; SSB 1996B, 132). When the private sector was winning their competition against state enterprises in 1981, most localities turned against further expansion of individual household enterprises (IHEs), and cut off their supplies of grain, edible oil, and business sites for private business.<sup>3</sup> State commercial enterprises also

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<sup>3</sup> As a legacy of the command economy, urban residents in China continued to buy basic food staples from the state-owned store at prices much lower than those at trade fairs in the early period of reforms. In addition, in the crowded cities private business needed the permission from

reduced their supplies of goods. Only after the center intervened did private business halt its decline (ibid, 109-10).

In 1979, Shandong declared its support for and protection of private enterprises in industry and commerce, and relaxed its restriction on trade in food and small manufactured goods (ROPCCCPS 1988, 103; ibid 1985, 544-48). Since 1980, Shandong also had been constructing urban and rural market places for private business (ibid 1985, 544-48), a measure Jilin did not conscientiously take until 1988 (ECLAJP 1988, 533).

*The following years (1984-88)* In 1985, urban unemployment and rural surplus labor rate reached respectively 2.2% and 1.5% in Jilin, and 3.6% and 4.7% in Shandong. These rates remained higher in Shandong than in Jilin in the following years (Lai 1998). Thus since 1985, Shandong had been under greater pressure to create jobs for its unemployed population.

Not surprisingly, private business encountered greater discrimination in Jilin than in Shandong, though the Bureau of Industrial and Commercial Administration (BICA) in both provinces that regulated enterprises introduced further reforms. Both Jilin and Shandong had further relaxed their restriction over the private sector. Jilin allowed private business to engage in a wide range of sectors, and permitted peasants to set up business in the cities, while Shandong authorized peasants to choose a large variety of private business, and issued license to unregistered yet operating IHEs (ECLAJP 1991, 111-14; *Jilin Yearbook* 1987, 500; 1988, 424-25; *Shandong Yearbook* 1987,257; 1988,

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local government for using space for their operation. Sometimes, they simply needed local government to designate a district for their operation.

420). Many IHEs closed out nevertheless because of heavy fees, inadequate marketplace, removal of business sites by governmental agencies under the name of making city streets orderly, and excessive sanitary requirements. In 1984, even though the BICA of Jilin arranged 20.6 million yuan of loan for IHEs and reduced 2.3 million yuan of taxes and fees on them, and even though 51569 new IHEs opened business, 51313 IHEs went out of business, leaving the net increase in the number of IHEs to 1256 (ECLAJP 1991, 115).

*Retrenchment of 1989-91* People in Jilin and Shandong expressed their disgusts over tax evasion and subtle forms of bribes by private business. There were other causes for public contempt in Jilin. People had a greater respect for state enterprises for their jobs were more secure, and their income and welfare were generous. The population thus had a deep-rooted distrust of private enterprises (interview). In 1989 many officials imposed new restrictions on private enterprises, and twenty governmental agencies charged forty unjustified fees. In Changchun, Jilin's capital, where state enterprises were the most prominent, discrimination against private business was the most severe, resulting in the largest decline in the number and employment of IHEs in the province (*Jilin Yearbook* 1990, 279).

Shandong BICA publicly ensured private business of its favorable attitude in August 1989, eight months earlier than did its counterpart in Jilin. While Jilin also urged and educated private businesspeople to abide by tax laws in order to ease public anger,



Shandong Government declared its readiness to punish any transgressor of their rights (ibid 1991, 229; *Shandong Yearbook* 1991, 376).<sup>4</sup>

*The boom period of 1992-94* Realizing that inconsistent promotion of private business had led to its stagnation during retrenchment, the Jilin Party Secretary called on officials to change their conservative mindset, and boldly promoted the private sector (*Jilin Yearbook* 1993, 1-5). In response, the BICA of Jilin lowered its requirements for registration, seals, and receipts of private enterprises, and reduced taxes and fees on them. It also encouraged peasants to set up private business and rent or purchase small state enterprises (ibid 1995, 195-96). Jilin Government also constructed an unprecedentedly large number of market places for private businesspeople (ibid).

Shandong Government pushed forward its favorable policies pursued in the past years into a comprehensive promotion package. It honored law-abiding private business, streamlined governmental regulations, reduced illegal governmental charges, arranged funds for their investment, provided technological assistance, information services and legal protection, and helped private business to improve their product quality (*Shandong Yearbook* 1993, 358; 1994, 370, 359; 1995, 188-89).

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<sup>4</sup> As discussed in Chapter Two, provincial and local governments in China exercised greater influence over governmental agencies (such as provincial or local BICA) than did the national branch of agencies (such as the State [national] BICA). Thus the measure by the provincial and local BICA would be effective when provincial and local leaders supported them.

#### 4. Causes of Divergence in Reform Policies

As stated, both Shandong and Jilin shared *similar loan and tax policies* toward rural or urban collective industry at the very beginning of reform. Nevertheless, Shandong embraced more favorable policies toward urban collective, private, and foreign sectors, especially since the mid-1980s, even though it was at a moderately higher level of development than was Jilin at the beginning of reform. Influence from non-state sectors, along with other factors, seemed to encourage Shandong to undertake a bolder reform drive than Jilin. Table 5.2 summarizes the effects of these factors on reform policies in both provinces.

Table 5.2. Effects of Major Factors on Policies toward Four Non-State Sectors

	Effects	Rural collective	Urban collective	Private	Foreign
Size of the state sector	--	--	--	--	--
Efficiency of Bureaucracy	++	+	++	++	++
Rural or urban unemployed labor	+	++ (rural employment)	++ (urban unemployment)	+	±
National policies	+	+	+	+	++

Notes: ++ strong positive effect; + moderate positive effect; -- strong negative effect; - moderate negative effect; ± weak positive or negative effect; ̄ weak positive or negative effect.

### *Influence of State Versus Non-State Sectors*

The size and influence of non-state sectors appear to be the main factor that underpinned both sharp and subtle differences in policies toward the four major non-state sectors in Shandong and Jilin. The state sector produced 67.6% of gross industrial output in 1978 in Shandong, and 78.9% in Jilin (Table 5.1). The share of state sectors in industrial output further declined to 41.4% in 1990, and 24.5% in 1994 in Shandong, while it remained 70.4% in 1990 and 62.4% in 1994 in Jilin. Thus compared to Shandong, the state sector in Jilin was significantly larger and carried a greater clout over provincial reform policies. As noted, the opposition from the state sector, or resistance from the governmental agencies associated with the state sector in Jilin stalled reforms at times.

Specifically, during the first national retrenchment of 1981-83, the state sector in Jilin seemed to be more successful in getting governmental agencies to discriminate openly against rural and urban collective and private sectors than did that in Shandong. During this period, governmental agencies representing state sectors and official media in Jilin criticized rural enterprises for their diversion of resources and profits away from large state enterprises. Subsequently, government prohibited rural enterprises from obtaining certain projects, operating outside their county of origin, and even getting a license (Du 1993, 5). In 1981, local government used administrative obstacles, such as sanitary standards and removal of business sites to slow down the growth of private sectors. State commercial sectors refused to supply private business wholesale goods.

The underlying reason for these restrictions is that both local government and state sectors feared that private business was taking profits and consumers away from state enterprises. During the first retrenchment, many urban collective enterprises, due to policy of the government in Jilin, adopted rigid and inefficient management by state enterprises, and suffered from inadequate investment funds as well as lack of access to raw materials and loans (Jin 1985; Cheng et al 1989). The government also converted a number of light industrial enterprises into heavy industrial ones (*Jilin Yearbook* 1987, 380). The retrenchment policies and the lack of support and protection by provincial government interrupted the growth of rural and urban collective and private enterprises during 1989-90.

Shandong Government resembled Jilin in supporting collective and private business in the early period of reforms. It was modestly more tolerant of non-state sectors than was Jilin Government between 1978 and 1980. For example, Shandong adopted moderate and by and large economic restrictions on rural enterprises. As discussed above, Shandong repealed its tax exemption, and imposed high taxes on the enterprises that produced consumer goods in high demand, and tightened bank lending (ECLASP 1996, 153-54). In contrast, as described above, Jilin imposed numerous harsh and administrative restrictions on rural industry, including outright prohibitions of business in certain projects and outside local areas. Another difference is that Shandong officials implemented these measures largely to show their compliance with the national policy of retrenchment and slower growth, whereas many Jilin agencies embraced draconian measures in revenge on behalf of state firms.

Shandong Government, however, proceeded to correct these mistakes in the following years. One of the major changes, namely, active promotion of rural enterprises in 1984, came at a time when rural enterprises were increasing their weight in economy. In that year rural non-state enterprises produced 39.4% of rural economic output and 24.7% of industrial output in Shandong in 1984, a noticeable gain from respective 25.1% and 14% in 1978. In contrast, rural enterprises were responsible for 25.4% of rural output and 9.7% of industrial output in Jilin. Thus it seemed that rural enterprises were poised to become the largest component of rural economy and a significant contributor to industry in Shandong in the coming six years. In contrast, rural enterprises had plenty of mileage to cover before emerging as a key economic player in Jilin.

During the second national retrenchment of 1989-91, Shandong Government acted earlier and more firmly than did Jilin leaders to reassure the non-state investors of no change in reform policies, and strove harder to maintain the growth of rural and urban collective, private, and foreign sectors. It respected more openly the rights of non-state business, and did more to promote efficient management in non-state sectors than did Jilin. Jilin, on the other hand, pursued retrenchment and hindered the growth of collective and private sectors in the cities and countryside and the introduction of international investment for a longer period than did Shandong. Criticisms of non-state sectors were much less frequently voiced in media in Shandong than in Jilin. Again, one underlying reason is that non-state sectors had just grown into the largest component of Shandong's economy (generating 54% of gross industrial output), whereas these sectors

remained a strictly secondary element of Jilin's economy (producing 29% of gross industrial output).

In summary, the state and non-state sectors seemed to affect provincial reform policies in the following five ways. First, it could pressure or encourage the government for favorable treatment. In a province with larger state sector more officials and governmental agencies would be engulfed in the existence and performance of the sector. Provincial and local leaders would thus pay more attention and made more concessions to the sector. The same thing is true for non-state sectors. During 1984-88 relatively larger non-state sectors in Shandong, though less producing than half of the gross industrial output, had greater influences on Shandong leaders than did those in Jilin. Non-state sectors would have more resources to lobby Provincial Government in Shandong. Meanwhile, more governmental agencies and local officials would develop a stake in the well being of these sectors, and would persuade provincial leaders to promote non-state sectors. Furthermore, when non-state sectors were about to replace the non-state sector as the largest economic component, like Shandong before 1988, provincial leaders would facilitate the growth of the non-state sectors in order to find new and expanding constituents.

Second, larger non-state sectors could prompt provincial leaders to be more attentive to local development than the center's directives. This is evident in Shandong. Larger state sector in Jilin, on the contrary, invited Jilin leaders to pay attention both to the state sector and the centers' policies. Non-state enterprises was larger in Shandong was posing to become the dominant ownership in economy after 1986. Failure to attend

to these issues would have meant a loss of golden economic opportunities, a neglect of the need of powerful constituents, and grave economic, social, and political consequences. The reform-minded leaders in Shandong adopted progressive reforms largely to respond to the demands from these sectors. In Jilin state industry played a larger economic role. Leading state firms were state automobile and petrochemical plants, which had close ties with the ministries in Beijing. Therefore, the leaders of Jilin tended to pay more attention to the directives from the center and were cautious in adopting reform measures.

Third, when state sectors loomed large in the economy, elaborate governmental agencies were needed to supervise state enterprises. A large bureaucracy revolving on state enterprises tended to function slowly and maintain cumbersome bureaucratic processes of approving and supervising projects. Such a bureaucracy would dampen the growth of non-state enterprises. This point will be elaborated later.

Fourth, a large state sector tended to breed among the population greater contempt and hostility toward non-state sectors, creating unfavorable public opinion and social environment for non-state sectors. When state sectors overwhelmed the other forms of ownership in the economy, the prevalent ideology, or popular thinking tended to value state sectors and debase non-state enterprises. During the retrenchment of 1989-91, for example, a charge surfaced in the media in Jilin that non-state sectors were undermining state ones and thus the communist economy. In Shandong whose population cared more about economic welfare and stability than orthodox communism, people viewed private business unsympathetically mainly for its active role in student protests of 1989 which

local people viewed as a disruption of their daily lives, and for its tax evasion, false registration status, and kickback in business dealings.<sup>5</sup>

The state sector cultivated a negative image of non-state sectors largely, because it was under intense competition from non-state sectors for resources ranging from raw materials, energy, skilled labor, capital, market, influence within the government, and reputation, and because the transition away from the command economy aggravated the competition. Ever though China started to move away from the command economy in the late 1978, economy could still feel the effect of economic planning, though it was gradually weakened. Under the planned economy, most raw materials, energy supplies, and even capital were arranged by the state, or by the corresponding agencies run by the state. Due to a lack of market signals and low prices set by the state, producers of raw materials and energy had neither the incentives nor the revenue to increase production. Thus these commodities were in constant shortage. At the beginning of reform, rural enterprises would consume these resources and reduce their availability to state industry. State industry, along with governmental agencies associated with it, felt that rural enterprises took away resources from it and endangered its material interests. It lodged this complaint to the government or through news media, and demanded restrictions on rural enterprises. As stated, this was especially the case in Jilin between 1978 and 1984

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<sup>5</sup> Two factors accounted for the Chinese unfavorable view of the student protest of 1989. First, the official media portrayed the protest as malicious attempts to overthrow the government. Second, rapid democratization and marketization in the subsequent years led to political chaos and economic depression in a number of ex-Communist countries in Europe. Many Chinese thus concluded that civil disturbance should have been quelled for smooth economic growth. For the second factor, refer to Pei in *China Briefing* 1997.



(interviews) when economic planning still regulated a sizable portion of economy, and where the state sector was larger than that in Shandong. Thus during the retrenchment of 1981-83 the attacks by state sector on non-state ones were fiercer in Jilin. No locality in Jilin was spared from charges and administrative barriers against rural enterprises (Du 1993, 5).

Fifth, the state sector was less attractive for foreign investors than non-state ones, and therefore tended to be less enthusiastic about Open Policy. When state enterprises had an interest in using foreign capital to revitalize their performance, they often needed matching funds to materialize their projects. Large state sectors in an inland province, such as Jilin, required a larger amount of matching funds, which was not readily available. Thus inland provinces encountered greater difficulties in utilizing international capital. Thus state sectors in these provinces could turn indifferent or even hostile toward foreign business.

#### *Efficiency (Work Style) of the Bureaucracy*

The above differences in the clout of non-state sectors give rise to different institutional setups in Shandong and Jilin. Thanks to the dominance of the state sector in the economy in Jilin in the past decades, the bureaucracy in Jilin was relatively much larger and more hostile toward non-state sectors, the potential competitors of state firms. The government's work style deeply shaped the environment for the operation of non-

state actors, as well as the formulation and implementation of reform policies in the provinces.

The bureaucracy in Jilin was relatively much larger due to the dominance of the state sector in the economy in Jilin in the past decades. Under the command economy, the bureaucracy managed and coordinated economic activities of state firms. A large state sector in Jilin thus gave rise to an excessively large bureaucracy. As late as the end of 1994, 4.1% of the population in Jilin were administrative officials and clerks on the governmental payroll, exceeded the national average by 44.3%. This large bureaucracy was responsible for 1.61 billion yuan of expenses, equivalent to 31.4% of revenue income of Jilin.

A bloated bureaucracy, out of its self interests, tended to be hostile toward non-state sectors and favor lengthy requirements for and heavy fees on non-state business. Since state industry had been the leading sector in Jilin's economy, ministries, bureaus, enterprises, part of the media, and institutions that thrived on state industry would defend the state sector and the state's control of resources, while attacking market forces and non-state economy. Officials in Jilin were also very conscious of their scope of jurisdiction and invested more time and resources to defend it in the course of reform (interviews). They tended to emphasize strict, elaborate, and time-consuming procedures. Non-state enterprises were often required to win the approval of *dozens* of agencies before they could open their business, or accomplish any major task (Bao and Li 1995, 206; SSB 1996 b, 367). Finally, bureaucratic rent seeking also helped to account for slow progress in non-state sectors, especially international investment in Jilin. In order to maintain their

incomes and revenue, governmental officials imposed onerous charges and fees on a variety of non-state enterprises, causing many private sectors to terminate their business and caused these sectors to decline in Jilin in 1989. Not surprisingly, officials and policy analysts whom I interviewed and who published their assessment of the policies in China and the provinces stressed the effect of government's work style on reforms and the well-being of non-state firms.

Among the non-state sectors, foreign or joint enterprises suffered the most from inefficiency of the governmental agencies in Jilin. As noted, the size of bureaucracy in Jilin exceeded the national average by 44%. Once created the governmental agencies were preoccupied with maintaining their authority and generating resources. One telling example is the provincial office that dealt with foreign investment. Jilin Government granted offices of the developmental zones provincial-level jurisdiction over a variety of financial matters, so that they could handle various affairs regarding the zones. Out of the fear of loss of resources and authority, however, departments of the government originally in charge of related affairs, such as tax, banking, environment, and industrial-sectors, refused to allow the office of developmental zones run the business in these areas (interviews; CJ 1996 3; 5; 72). In order to streamline the process of approving FDI projects, Jilin Provincial Government established the Foreign Economic Bureau to coordinate work related to foreign investment in 1992. The bureau coordinated offices in charge of imports of technology, technological cooperation, promotion of international business, the approval of enterprises of international investment and loans (*Jilin Yearbook* 1993, 342). The leaders of the Provincial Party Committee and the Provincial

Government hoped that potential international investment project would need only the approval of this bureau, instead of dozens of agencies (ibid). However, the bureau meant too much a loss of power and resources for the related governmental agencies. The latter still refused to pass their authority to the offices of developmental zones. In 1996, acknowledging that the bureau failed to provide a smooth channel for and coordinate the work on FDI, the provincial leaders were forced to replace the bureau with the Provincial Leading Group of Utilizing Foreign Investment in 1996 (Unpublished document). The Leading Group was stationed in the Economic Planning Commission, the most powerful economic department. Two officials represented each of the eight related governmental departments. These departments still did not budge. They sent poorly-informed officials to the Leading Group. As a result, work on foreign investment still could not proceed smoothly (interviews). In resisting transferal of their authority, these departments often demanded compensations from the Office of Developmental Zones, or favors from foreign business. The continued bureaucratism in Jilin contrasts sharply with the above-discussed story of Shandong: After the merger of two governmental agencies in charge of foreign enterprises and after the personal intervention of Shandong's First Party Secretary, the infighting of these two agencies stopped, and the efficiency of the new agency improved.

The stonewalling by department agencies successfully blocked the implementation of most of the provincial laws and reform policies regarding the developmental zones. In its attempts to attract foreign investors, Jilin Provincial Government announced 34 provincial-level economic authorities and 38 favorable policies in "Regulations regarding

**Several Issues concerning Provincial-Level Economic Developmental Zones" of 1992 and "Several Stipulations Regarding Further Extending Opening Up to the Outside World and Outward-Oriented Development" of 1994. However, around 1996, merely two of the above 72 policies were well in place, three of them were unsatisfactorily implemented, and 67 of them were not adopted at all (CJ 1996, 4). Even provincial officials in charge of developmental zones were conservative and bureaucratic and were reluctant to adopt reforms announced by Provincial Government. As a result, favorable policies regarding developmental zones were fully implemented in merely two out of the sixteen zones, namely, Changchun New and High Technology Industrial Developmental Zone and Huichun Borderline Economic Cooperation Zone (CJ 1996, 71-2).**

**Incompetent provincial officials further delayed the influx of international capital. Quite a number of the staff at the Offices of Developmental Zones was not qualified. In addition, both well-developed laws regarding developmental zones and respect for laws were deficient in Jilin. Illegal procedures or processes occurred frequently in the work at the offices (CJ 1996, 72).**

**In contrast, both the bureaucracy and the leaders in Shandong labored harder for non-state firms. The above-discussed overhaul of governmental agencies in charge of foreign investment in Shandong helps to illustrate the contrast in two provinces. The divergent outcome of the overhaul highlights a sharp contrast in reforms in two provinces. Shandong leaders made numerous efforts to improve the governmental efficiency since the mid 1980s. Jiang Chunyun, the top leader of Shandong, personally intervened to merge two previously independent governmental agencies with similar**

responsibilities over foreign trade and investment. He successfully ended the infighting between these two agencies and the government's efficiency in attracting foreign investment (Chung 1995). Provincial agencies in charge of foreign firms as well as the office of developmental zones laid an emphasis on work efficiency over the ensuing years. Officials in the Yantai Developmental Zone stressed their quick turnarounds in handling the requests from the foreign investors (interview).

### *Rural and Urban Unemployment*

In addition to non-state firms, rural surplus labor and urban unemployment was the other major interest groups that affected provincial reform policies, especially those toward rural, private, and to some extent, foreign enterprises. Temporary and contractual migrant labor in the countryside, a barometer of rural surplus labor, consistently took up a larger share of rural labor in Shandong than in Jilin between 1983 and 1994. For example, in 1983 the share was 2.1% in Shandong, but merely 0.7% in Jilin. The share in Shandong ranged from 2.6% to 4.8% between 1985 and 1994, and that of Jilin ranged from 1.5% to 2.4% (Lai 1998). On the other hand, urban unemployment, judged from the data on unemployment registered at the governmental agencies, tended to be higher in Jilin during 1978-1984, yet higher in Shandong after 1985. Urban unemployment rate in Jilin soared to 6.9% in 1978 and 5.8% in 1980, well above 2.6% and 2.3% in Shandong. Between 1985 and 1994, however, this rate in Jilin fell subsequently to a range of 1.3% to 2.2%, below the range of 2.0% and 4.1% in Shandong.

Rural and urban surplus labor would have exerted greater pressure on leaders of Shandong than those of Jilin to allow rural collective and private enterprises to expand and create jobs and income for surplus labor. It is not coincident that when Shandong Provincial Government adopted a big-push policy toward rural collective and private enterprises between 1984 and 1986, temporary and contractual migrant workers took up a 4.7% of rural labor in 1985. On the other hand, Jilin's policies toward these enterprises swung between encouragement and containment, for merely 1.5% of rural labor was migrant workers respectively in 1985, and for the share declined to 0.94% in 1988.

The official records of the two provinces provide further evidence on the role of rural surplus labor in the formulation of reform policies. The authors of the official *Record of Labor of Shandong* pointed out at beginning of the first chapter that Shandong had a large and fast-growing population, and was thus abundant in labor supplies (ECLASP 1995, 15). On the other hand, a policy analyst for Jilin Government admitted that both rural surplus labor and urban unemployment were relatively small in Jilin even as late as during 1990-95, and that rural surplus labor did not pose any serious threat to jobs in the cities (Bao and Li 1996, 296). It follows that unlike Shandong, leaders in Jilin were not under pressure to pursue consistently liberal policies toward rural collective and private sectors in order to ease severe unemployment between 1978 and 1992.

The officials in Shandong shed light on the factors that induced favorable policies regarding rural enterprises in the province. An official historian of the economy of Shandong suggested that rural enterprises grew as surplus labor moved into non-agricultural sectors (Wang 1989, 176). Official historians of the enterprises declared that

rural enterprises made three contributions in the countryside. First, they employed a large population of rural surplus labor, and reduced massive migration to the cities and consequential disruption. Second, rural enterprises provided considerable funding for rural welfare, and thus reduced the financial burdens on individual peasants. As a result, the party and the peasants developed a closer tie, and social instability was controlled. Third, rural enterprises raised peasants' income (ECLASP 1997).

Most urban and rural unemployed labor were eventually employed at collective and private enterprises. Foreign enterprises or joint ventures employed only a portion of it. The unemployed were probably a secondary factor in the government's policies toward international investors. However, since a fair number of collective and private enterprises exported their products, unemployment might carry some weight in the government's adoption of external-oriented development.

Rural and urban surplus labor could catch the attention from the makers of provincial reform policies also for a subtle reason. Since provincial and municipal governments and large enterprises tended to locate in the cities, potential political costs of unrest in the cities were high. A large unemployed population in the cities were politically destabilizing, for the disgruntled urban unemployed could encircle the provincial and municipal government offices, and block the traffic in the cities, disrupting the work of the government and the operation of large enterprises. A large population of rural surplus labor, on the other hand, could also flood the cities in search for jobs. Rural migrants could take away low-end jobs from urban residents, and create potential criminals who would like to get rich instantly through stealing valuables from homes of



urban residents. These again would trigger outbursts of anger among urban population. The provinces would thus try to control urban unrest by keeping urban unemployment at a low level and by allowing most of rural migrants to work in rural enterprises, rather than flooding the cities. The key for creating jobs is to permit non-state economy to expand.

### *The Center's Policies*

Policies by the national government, especially the center's opening of the provinces and its oscillation between reform expansion and retraction, could have considerably affected on provincial policies. The national government's selection of open areas (areas open for international business) in the provinces furthered the latter's entry into the world market, improved their access to international capital, and enhanced their exposure to international business practice and western economic ideas. As a coastal province, Shandong had major ocean harbors in Qingdao and Yantai, which provided the shortest ocean lanes to South Korea. The national government declared in 1984 three coastal and economically important cities in Shandong, namely, Qingdao, Yantai, and Weihai areas open to international business. In 1988, the center declared another two cities and 24 counties in Shandong "open areas". In contrast, not until 1989 did the center select Changchun as the first open city in Jilin. In 1992, Tumen was also made an open city. In 1986, open cities produced 13.7% of industrial output in Shandong. The share jumped to 55.4% in 1990 and 68.1% in 1994. In 1990, the year following the center's selection of

the first open city in Jilin, the open area produced only 23.3% of industrial output (Lai 1998).

With greater opportunities for the international market and capital, leaders of Shandong were more outward-looking. In their reform initiatives since 1984 they worked harder to boost exports and bring in international investment than did their counterparts in Jilin. The provincial policy statement in 1986 and 1991 explicitly encouraged and granted incentives for exports. Leaders of Jilin did not start to pay attention to exports of rural enterprises until 1989 (ECLASP 1997, 435-36; 443; 447; Jilin Yearbook 1987-1992). As a result, the share of exports in the output of rural enterprises was higher in Shandong, registering 2.3% in 1987 and 7.2% in 1994, compared to 0.54% and 2.2% in Jilin. Even though Jilin had a greater share of international capital in the investment in rural enterprises than Shandong in 1987 (3.8% versus 3.2%), Shandong raised its share to 6.5% in 1994, while the share in Jilin crawled up to merely 4.1%.

This case study confirms the finding in the previous chapter. It finds that the center's selection of cities for comprehensive urban reform in the provinces seemed to have negatively affected provincial policies toward rural enterprises. These cities, as Table A5.3 (or 5A) in Appendices shows, produced over 60% of industrial output in Jilin between 1988 and 1992, and between 34.6% to 38% in Shandong. With this greater authority for urban reform, Jilin adopted more conservative policies toward rural and urban collective, private, and foreign enterprises. It is likely that these cities in Jilin, which were dominated by state industry, exercised newly-extended power to restrain, rather than to promote rural non-state industry. This case study also examines another

policy by the national government, namely, the central-provincial fiscal arrangement in terms of provincial remittance to or subsidies from the center. Jilin received net subsidies from the national government. Shandong was a net fiscal contributor to the center (Table A5.3). Despite its non-existent tax obligation toward the center, Jilin was more conservative and granted fewer tax breaks to non-state sectors. It is possible that a remitting province, such as Shandong possessed more financial revenue than did a subsidized province, such as Jilin. Shandong thus could afford to grant non-state sectors more tax reduction or exemption (interviews).

The center's macroeconomic policies, such as its endorsement of fast reform between 1984 and 1988, its retrenchment program between 1989 and 1991, and harsh treatments of collective sectors between 1981 and 1983 and between 1989 and 1991, could accelerate or decelerate reform policies in the province. During 1978-94, Jilin's and Shandong's leaders were conscious and to varying extent, responsive to the center's policies. These national macroeconomic policies, however, did not dictate the reform course in the provinces. Shandong after 1984 illustrates this point. As noted in the previous discussion of Shandong's policies toward rural enterprises, Shandong gave up its unconditional following of the center after 1984. Instead, it chose its own pace for reform, even when the center sent out opposite signals during 1989-91. On the other hand, Jilin had been a loyal follower of the center and a practitioner of cautious reform initiatives. It paid dearly for its lack of independent stance. Its economy, non-state sectors in particular, was not expanding as rapidly as that in Shandong.

Three findings emerge from the statistical study of national reform policies in the previous chapter. First, the center tended to select cities with a large state sector for urban reform. Second, the center was moderately, not primarily concerned with generating high growth from provinces closer to the coast and with better. Third, the center tried to court the support from rural and urban consumers.

A look at the measures of national policies and these major independent variables in Table A5.3 suggests that Shandong and Jilin fit into the first finding. Jilin had much larger state industrial sectors than did Shandong. As a result, the center granted it more authority in urban reform. Both provinces, however, did not fit well into the second findings (on national Open Policy), for Jilin, despite its better infrastructure and more literate population, earned the privileged status of open area much later than did Shandong. Shandong's level of rural consumption lagged behind that of Jilin between 1980 and 1990, and its level of urban consumption also fell behind that of Jilin from 1982 to 1986. Shandong's tele-communication system, measured by the number of telephones per 1000 residents, had been less developed than that of Jilin between 1978 and 1990 (Table A5.3). Shandong's backwardness in these aspects contradicts part of the second finding on national opening of the provinces. On the other hand, Shandong had several ocean harbors, while Jilin's capital was 702 kilometers away from the closest ocean harbor by railway. This is the only piece of evidence that supports the above finding.

A close look at the residuals of urban and rural consumption in the regression of national opening of the provinces suggests that Shandong and Jilin did not conform to the above third finding (Figures A5.6-A5.7 in Appendices). None of the data points for both

provinces is a noticeable outlier. However, the residuals of opening of Shandong, most of which are positive, tend to outweigh those of Jilin, most of which are negative. Thus the model of national opening of provinces seems to over-predict the values for Jilin, while under-predicting those for Shandong. This may have caused the divergence of Shandong and Jilin from the findings of national opening of the provinces.

### *Conclusion*

This case study finds that both interest groups, such as state and non-state sectors, the unemployed population, and institutional factors, such as the efficiency of bureaucracy and national policies, critically shape provincial reform policies and their implementation. Politically, provincial leaders and officials in Shandong and Jilin were rational. They pursued reform policy that would generate favorable reaction from the powerful clients (state versus non-state sectors and the unemployed) or patron (the center) and would yield immediate results yet controllable damage or dislocation. Shandong leaders implemented reforms when key interest groups (such as state and non-state sectors, as well as the urban and rural unemployed) supported them, when bureaucrats favored them, and when the center facilitated them. Jilin leaders pursued slow liberalization since these forces failed to back up a bold reform course. Their choice might be complicated when these entities (interest groups or the center) took opposing positions. In this case, the provincial leaders would try to appease the more powerful and assertive entities.

The provincial leaders attempted to meet the needs of their key constituents in their reform efforts. As elaborated, the size of interest groups, namely, pro-reform non-state sectors and the unemployed, and reform-resistant bureaucracy, varied in Shandong and Jilin. These players emerged as powerful lobby groups in reforms because reform policies would have a disproportionately large impact on them and because these players had relatively ready institutional access or representatives. In terms of access, the state sector relied on the powerful bureaus that represented state firms in a variety of sectors, namely, the Planning Commission, Bureaus of Machinery, Coal, Metallurgical Industry, and Petrochemical Industry, and Office of Science, Technology, and Industry for National Defense; non-state sectors (especially rural industry) relied on local (county) governments, and a few bureaus (Bureaus of Light Industry, Textile Industry, and Agriculture, and to some extent, Commission on Foreign Economic Relations and Trade, Industrial and Commercial Administration, and Labor).

The center fostered differing conditions for the reforms in the two provinces through its policies. The center's earlier and greater opening of Shandong and the lesser freedom it granted for Shandong for "urban reforms" created favorable conditions for liberalization in the province. Conversely, the center's late opening of Jilin and greater freedom it granted to Jilin for "urban reforms" lent Jilin a weaker impetus for reconstruction of its planned economy.

The finding suggests that both institutional conditions and rationality are useful tools for grasping the complexity of empirical political process. Institutional conditions, especially the provincial bureaucracy from below and the national authority from above,

helped define rationality or choice of provincial leaders. Hence, an analytical framework that presumes the actor's rationality and institutional constraints may be a useful tool for interpreting governmental or politicians' behavior. In the conclusion chapter, I will discuss the implication of this finding by placing it in the context of political economy literature on institutions.

## Appendices: Reform Policies, Conditions, and Non-State Sectors in Two Provinces

5A (Table A5.3). National Policies toward Shandong and Jilin and Possible Causes

<u>Nationally-Selected Open Areas (Their shares in provincial industrial output)</u>				
Year	1980	1986	1990	1994
Shandong	0	13.7	55.4	68.1
Jilin	0	0	23.3	32.7
Nationwide	0.5	18.6	30.2	39.4
<u>Cities for Comprehensive Urban Reform (Shares in provincial industrial output)</u>				
Year	1984	1988	1990	1992
Shandong	0	37.9	37.0	34.6
Jilin	0	63.7	62.6	67.3
Nationwide	29.3	51.7	50.9	50.3
<u>National Fiscal Policies (Share of remittance to or subsidies (negative data) from the center in provincial revenue; percentages)</u>				
Year	1982	1985	1990	1992
Shandong	51.1	38.8	2.6	1.5
Jilin	-25.1	-18.3	-2.1	-1.9
Nationwide	-25.5	-14.3	-3.4	-2.2
<u>Rural Consumption Per Capita, 1980 Yuan</u>				
Year	1980	1982	1986	1990
Shandong	183	239	308	295
Jilin	205	243	334	318
<u>Urban Consumption Per Capita</u>				
Year	1980	1982	1986	1990
Shandong	471	480	599	660
Jilin	463	506	632	612
<u>Size of Non-State Industry (Share in provincial industrial output)</u>				
Year	1978	1982	1986	1990
Shandong	0.32	0.33	0.47	0.59
Jilin	0.21	0.29	0.27	0.30
<u>Phones Per 1000 Residents</u>				
Year	1978	1982	1986	1990
Shandong	1.4	1.7	2.4	4.0
Jilin	6.1	7.5	10.5	17.0
<u>Distance from the Ocean Harbor (kms)</u>				
Shandong	0			
Jilin	706			

Source: Lai 1998.



5B (Table A5.4). Economic Changes of Shandong and Jilin Provinces during 1978-1995  
(percentage for data on shares; indices and current yuan for data on GDP and income;  
rank among the provinces in parentheses)

<u>Share Of Light Industry in Industrial Output</u>				
Year	1978	1985	1990	1994
Shandong	45.1	54.6	50.8	46.6
Jilin	39.8	40.1	41.9	27.6
Nationwide	43.1	49.6	49.4	42.8
<u>GDP Per Capita</u>				
Year	1980	1985	1990	1995
Shandong	402 (11)	887 (10)	1815 (9)	5758 (9)
Jilin	445 (11)	868 (11)	1746 (12)	4414 (14)
<u>Indices of GDP Per Capita (1978=100)</u>				
Year	1980	1985	1990	1995
Shandong	117.5 (9)	194.7 (10)	263.3 (8)	556.7 (7)
Jilin	107.9 (23)	172.6 (17)	243.7 (12)	394.2 (15)
<u>Average Annual Wage Per Staff And Worker</u>				
Year	1980	1985	1990	1995
Shandong	745 (18)	1110 (16)	2150 (13)	4430 (25)
Jilin	763 (14)	1081 (19)	1888 (25)	5145 (15)
<u>Average Annual Net Income Per Peasant</u>				
Year	1978	1985	1990	1994
Shandong	210 (10)	408 (10)	680 (13)	1715 (10)
Jilin	237 (6)	414 (9)	804 (7)	1610 (12)

Source: Lai 1998.

5C (Table A5.5). Rural Enterprises in Shandong and Jilin and Two Developed Provinces

Year	<u>Employees (million)</u>				<u>Revenue Income (billion yuan in 1980 price)</u>			
	Shandong	Jiangsu	Zhejiang	Jilin	Shandong	Jiangsu	Zhejiang	Jilin (Output)
1978	3.23	3.25	1.90	0.36	4.85	6.29	2.64	0.71
1980	3.34	3.89	2.35	0.42	5.89	10.95	4.62	1.01
1981	3.51	4.1	2.50	0.43	6.56	12.43	5.93	1.10
1983	4.03	4.59	2.63	0.48	10.00	16.87	8.24	1.61

Year	<u>Annual Growth Rate of Employees</u>				<u>Annual Growth Rate of Revenue</u>			
	Shandong	Jiangsu	Zhejiang	Jilin	Shandong	Jiangsu	Zhejiang	Jilin (Output)
1979-80	0.02	0.09	0.11	0.08	0.10	0.32	0.32	0.19
1981-83	0.06	0.06	0.04	0.05	0.19	0.15	0.21	0.17
1979-83	0.05	0.07	0.07	0.06	0.16	0.22	0.26	0.18

Year	<u>Revenue Per Employee</u>				Period	<u>Annual Growth Rate of Revenue Per Employee</u>			
	Shandong	Jiangsu	Zhejiang	Jilin		Shandong	Jiangsu	Zhejiang	Jilin
1978	1502	1935	1389	1972	1979-80	0.08	0.21	0.19	0.10
1980	1763	2815	1966	2405	1981-83	0.12	0.09	0.17	0.12
1981	1869	3032	2372	2558	1979-83	0.11	0.14	0.18	0.11
1983	2481	3675	3133	3354					

Year	<u>Share of Rural Labor in Rural Enterprises</u>				Year	<u>Share of Rural Enterprise in Rural Economic Output</u>			
	Shandong	Jiangsu	Zhejiang	Jilin		Shandong	Jiangsu	Zhejiang	Jilin
1978	0.129	0.148	0.128	0.111	1978	0.251	0.306	0.235	0.126

Sources: Wang 1989, 186-87; unpublished official statistics on Jilin; SSB 1990b.

5D (Table A5.6). A Summary of Policies toward Rural Enterprises in Shandong and Jilin

Year	Shandong	Jilin
1978-80	Tax reduction and exemption more favorable than the center's; initial stagnation and growth of loans; implementation of the center's relaxed policies	Growth of rural enterprises was declared an important task. Reduction in restrictions and discrimination against rural enterprise. Reduction of taxes for underdeveloped areas. Substantial increase in bank loans
1981-83	Strict tax policies; close-down of thousands of enterprises; adherence to the center's tight control over rural enterprises and prohibition of their entry into a variety of sectors; increase in loans	Harsh criticisms of rural industry by many circles, especially the state sector; severe governmental restrictions on and discrimination against rural enterprises; a temporary decline in funds and the number of rural enterprises
1984	Radical reversal of the conservative policy; minimal restrictions on entry, favorable policies on loans, taxation, labor training, corporate collaboration, and exports; a step much further than the relaxed national policy	Reversals of discrimination against rural enterprise; significant growth in bank loans; a renewal in government's and its agencies' support for rural enterprises; relaxed environment; existence of substantial entry barriers
1986	Declaration of rural enterprises a key strategic in rural and overall economic growth; continuation of the previous favorable policies; numerous tax exemptions (up to three years) to encourage reinvestment and technological upgrading; reform well ahead of national policies	Continued support and relaxed conditions; a call for doubling the output of rural enterprises by 1990; bank lending, and personnel inflow; exemption of income tax on new enterprises for one year; relaxed control over entry and market access (Yearbook 1987, 485; 488)
1989-90	Continued favorable lending and taxing policies; slowdown of growth of the enterprises in 1990, adjustment of the sectoral composition and improvement of the management, product quality, and efficiency of the enterprises; limited compliance with national retrenchment	Positive retrenchment: Deceleration of growth, efforts to improve the management and efficiency of rural enterprises; slow growth in bank loans, and sharp increase in tax and fee burdens; hostility by various agencies and state enterprises toward rural enterprises
1991	Re-affirmation of rural enterprises as a strategic focus of development; promotion of a variety of ownership forms; emphasis on the development, efficiency, and product quality of the enterprises; a breakaway from the conservative national policy	Hostility toward rural plants, shortage in funds, lack of access to raw materials and the market; limited governmental assistance to rural enterprises to continue their operation
1992-	Continued liberal policy to develop and upgrade rural enterprises; the output of rural enterprises topped all the provinces for the first time in 1993	Participation in the national big push toward reform. The government's declaration of rural enterprises as an important economic component; the governmental plan to double their output within three years. Construction of rural industrial districts. A small role of bank loans in the growth of rural enterprises

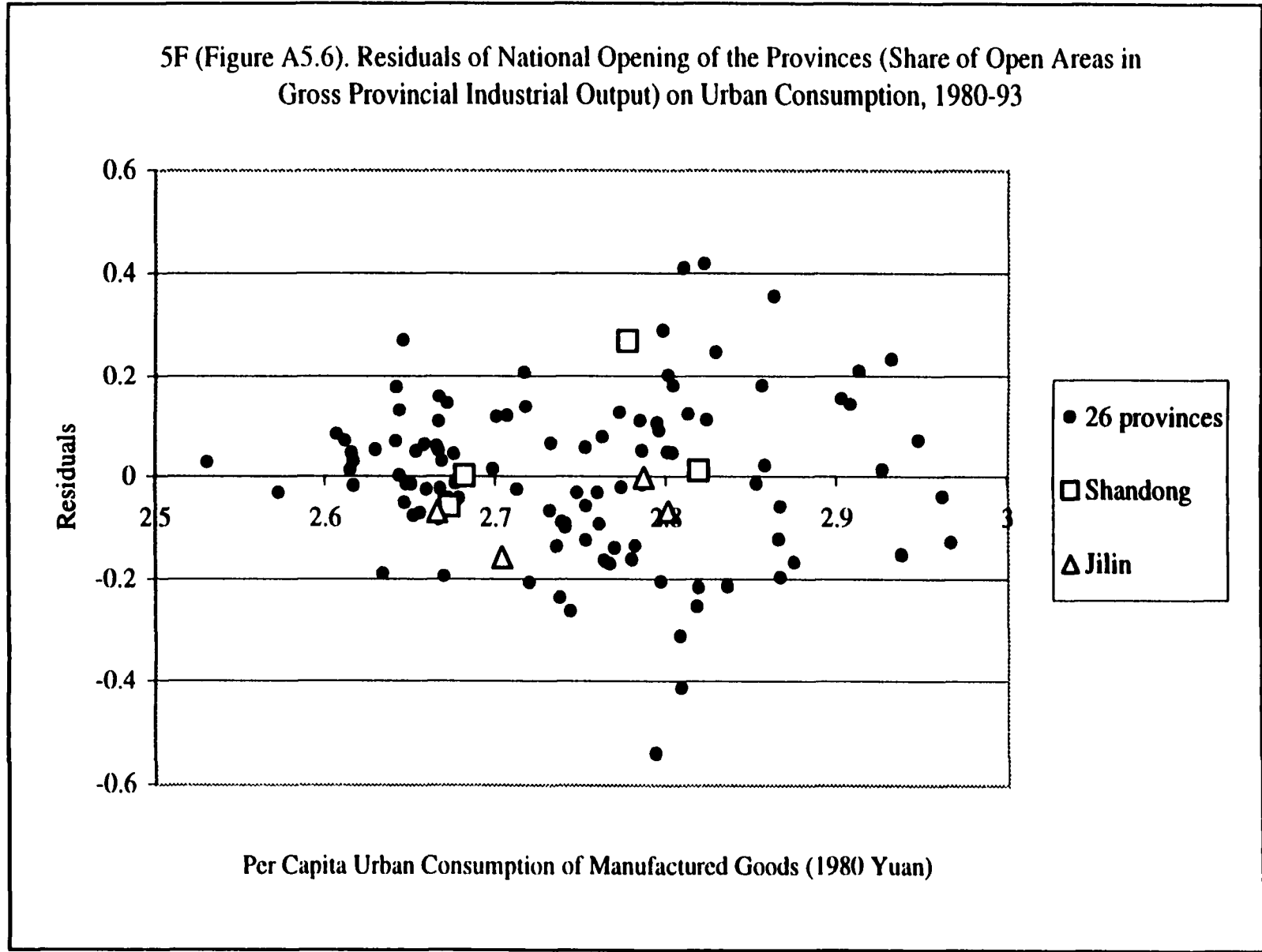
5E (Table A5.7). Economic Indicators on Private Sectors in Jilin and Shandong

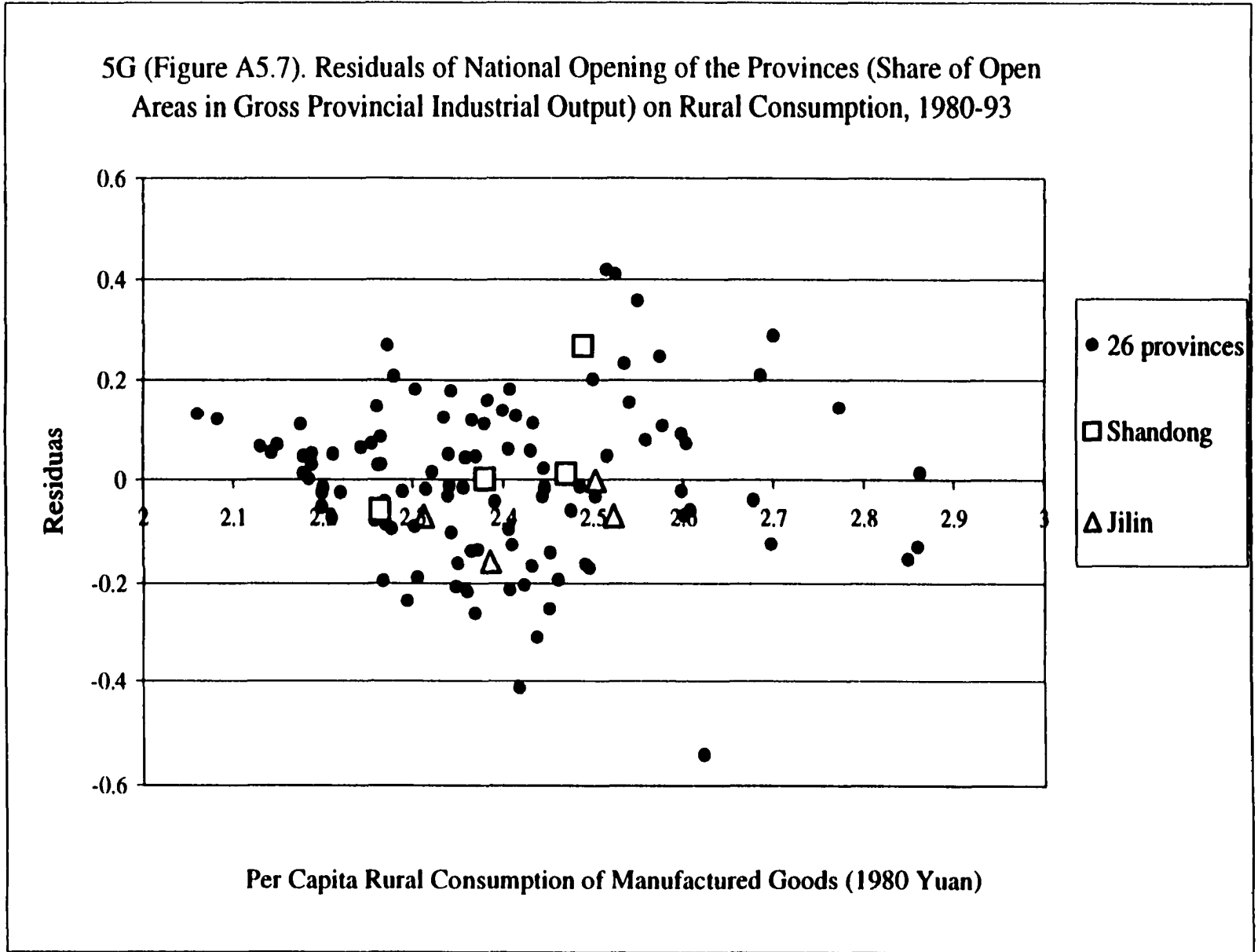
Year	Number of Enterprises		Employees		Registered Liquid Assets (million yuan)		Output and Sales (million yuan)	
	Jilin	Shandong	Jilin	Shandong	Jilin	Shandong	Jilin	Shandong
1980	37,014	90,063	42,938	109,968	8.9	20.6	80.7	279.6
1983	137,297	623,470	169,097	807,550	88.3	322.0	86.2	2,969.9
1988	307,148	1,300,000	457,909	2,300,000	833.8	2,551.3	4831.1	16,600.0
1991	312,861	1,324,000	444,804	2,494,000	1,594.1	3,510.0	7,539.2	23,580.0
1994	415,758	1,507,400	608,822	3,138,000	2,642.7	5,166.0	17,215.6	43,940.0

Annual Growth Rate

1980-83	0.55	0.91	0.58	0.94	1.10	1.47	-0.002	1.18
1984-88	0.11	0.13	0.14	0.19	0.27	0.18	0.29	0.27
1989-91	0.013	0.11	0.005	0.17	0.29	0.11	0.17	0.21
1992-94	0.47	0.22	0.47	0.29	0.50	0.74	0.29	0.37

Sources: *Jilin Yearbook 1987-95; Shandong Yearbook 1987-95; Almanac of China's Industrial and Commercial Administration and Management 1991-94.*





## **Chapter Six: China in Political Economics and Transitional Politics**

### **1. China in Political Economics and Transitional Politics**

#### *Rationality, Institutions, and Economic Policies*

As Chapter One elaborates, scholars have debated over the causes of the reform policies in the transitional economies in general and in China in particular. Few of them, however, have conducted systemic tests to determine their contending claims. This study tests four major political economy explanations in the interprovincial differences in national and provincial reform policies. This study finds that the national authority strove for popular support in promoting reforms in individual provinces. As Wong and Perry (1985, 4) and Lieberthal (1995, 127) suggest, the Chinese state tried to buy off the population through promoting consumerism and delivering the population the “goodies”. The center pursued efficiency and revenue as secondary goals. This test also finds that the provincial governments tried to appease the interest groups with high stakes in adopting reform policies, namely, the state and non-state sectors.

In a sense, this study highlights the relative strengths of the contending political economy models in the case of China’s reforms: Political explanations of reforms appear to carry greater weight than economic explanations. Specifically, the political-support and the ownership-oriented interest groups models perform better than do the efficiency and

revenue arguments in the tests. This study also finds that the clout of light industry contributed to the national opening of the provinces merely marginally. Light industry, however, seemed to hinder provincial reforms regarding foreign business by causing higher taxes on foreign enterprises in the provinces. Thus the sectoral interest-groups model (Shirk 1985) seems to have limited explanatory power.

This study may also tell us something about the strengths of political explanations of economic liberalization. The Chinese economic reforms have been hailed as the most successful in the contemporary world, for it has brought forth impressive economic and social progresses in the most populous country. Many scholars, economists in particular, assume that the government chooses economic reforms in order to overcome severe economic problems and improve efficiency. Ironically, both the Chinese national and provincial governments adopted reform policies primarily not for *economic* reasons, but for *political* reasons. The center primarily sought the support from the population, and the provinces were mostly interested in support from the major interest groups. If a political rather than economic logic drives the successful economic reforms, it is possible that many other governments adopt economic reforms out of political concerns. Therefore, politics remains a key intellectual compass in the studies of economic reforms.

This study, the case study in particular, also affirms that institutions shape the choice of rational actors and thus deserve a great deal of attention in studies of political economy. The interprovincial study reveals that the national-provincial institutional arrangements in China bestowed the national and provincial governments different primary political constituents. As a result, the national and provincial governments paid attention to different



sets of factors in formulating their reform policies, as summarized above. The empirical study of evolution of national reform policies indicates that the predominance of two major factions is responsible for the dash toward and retreat from reforms. The case study of Shandong and Jilin suggests that the institutional settings of the provinces (namely, the bureaucracy, and national policies toward the provinces) shaped the rationality of actors (provincial leaders). These conditions helped to define the policy sphere within which the leaders could maneuver. Sometimes, they operated as either a catalyst or an impediment in the leaders' pursuit of goals in the immediate term, and even in the long term. On the other hand, leaders usually have limited authority for modifying these institutional constraints in the foreseeable future.

This finding confirms the institutionalist political economy several scholars have advocated. Douglass North, a pioneer in the field of public institutions, argues that institutions can help to minimize transition costs in the market activities (1981, 5). Jean-Laurent Rosenthal, in his study of the economic impact of French Revolution, argues that state could define property rights and thus affect individuals' economic incentives (1992, 25) and that different institutional arrangements, on the other hand, could affect the incentives of the bureaucrats for improving the property rights (1992, 31). Robert Bates elucidates the significance of institutions in economic policies well: "[Institutions] play the same role in politics that markets play in economics: for rational actors, they create incentives that lead to characteristic choices. By creating a system of incentives, they help to account for the decisions taken by governments...[Policy is a result of] a struggle among competing interests that takes place within a setting of political institutions rather than

markets” (1989a, 5). It follows that a sensible approach in comparative case studies is to explore how institutional settings shape the preferences and behavior of rational actors.

### *Regime Types and Improvement of Public Welfare*

Findings in this project also challenge the general perception about responsiveness of authoritarian regimes. A view is gaining currency among a number of scholars on democracy and growth that authoritarian regimes are less susceptible to public opinion and concerns (Friedman 1962; Becker 1983; USAID 1991; Olson 1993; Hellman 1998). This view holds that democratic regimes, because of public election of major offices, are more responsive to popular demands. While this claim has theoretical appeal, a number of statistical studies dispute the generality of this claim among the developing countries (Sirowy and Inkeles 1990; Przeworski and Limongi 1993; Lindenberg and Devarajan 1993; Bates and Krueger 1993, 459).<sup>1</sup> These studies reveal no definite relationship between policy responses and regime types.

The point I try to make is in *certain* (neither *all* nor *most*) circumstances, authoritarian regimes may endeavor to promote public welfare in order to consolidate themselves. Valerie Bunce (1980) demonstrates on the basis of data analyses that the leaders of the Soviet Union, similar to the leaders in the West, tried to consolidate their power by promoting public welfare, especially when they were striving for a victory in a succession struggle. The Chinese regime is based on a highly centralized political structure. The

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<sup>1</sup> An often cited and largely non-quantitative study is Haggard and Kaufman 1995, 151-227.

Chinese Communist Party monopolizes power and controls most political institutions, including the military, the government, the legislature, the judiciary, and the media. Its control even extended to the grass-root level. Even with such an enormous power, the national leaders of the CCP still labored for popular support through introducing and adjusting its reform policies. In this process they engineered the most successful economic reforms in the contemporary world, while achieving their goal of securing popular support. The Vietnamese Communist Party seems to have followed a similar path. Other familiar examples include Franco's Spain, Pinochet's Chile, and Taiwan, Singapore, and South Korea during the 1960s and 1980s. Therefore, authoritarian governments in ex-communist economies may introduce far-reaching economic programs on behalf of the public demands.

Authoritarian leaders paid more attention to popular economic demands when they confronted with either strong rivals (such as Maoist successor in the Chinese case), or the legitimacy of the regime is in doubt (such as the CCP before the reform, and the grand failures of the economic policies of the Vietnamese Communist Party). Playing to the popular demands through economic reforms became a necessary and optimal strategy to enhance the power of the leaders and the regime.

This is not to deny that people under these regimes have either paid high prices of curtailed personal freedom and *political* rights, or have a long way to go before they can gain sufficient access to their political system and policy making. Furthermore, these regimes could have adopted moderate political reforms to improve the performance of the regime, such as granting more freedom for the press and more power for the legislature to

supervise the officials and reduce policy errors and corruption. These governments have been even more reluctant to accede to the demands of more far-reaching political changes.

Democratic regimes in the transitional economies, on the other hand, may not warrant policies that advance economic interests of population. Political liberalization might abolish old methods of political control without producing effective ones. It may fail to produce an effective democratic government in some cases. At least in the light of the development in three most populous ex-communist economies, namely, China, Vietnam, and Russia (where over one-quarter of the world population reside), the view of non-responsive authoritarianism does not hold. This cautions us against indiscriminate application of growth-retarding authoritarianism to the ex-communist economies.<sup>2</sup>

The survey data on the public evaluation of the government's performance in the ex-communist or communist countries buttress the above argument. According to a poll of 2,500 residents in ten Chinese cities in October 1994, two thirds of the respondents said the economic conditions in China were improving. In parallel, 54 percent of the respondents in the same survey said that economic development was more important than democracy. Since the poll was conducted independently by private institutions, the Chinese respondents were under no pressure to hide their opinion. Another poll of 2,000 urban residents in

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<sup>2</sup> The Chinese, on the other hand, under the influence of Confucianism, are more ready to accept that authoritarian regimes would have to take care of public welfare in order to hold on to power. Confucius advocated the idea that a person of merits came to power and sustained his reign through improving the livelihood of the people. Tai Zong of the Tang Dynasty, the emperor of the highest regard in the Chinese history, had summarized his art of governance in an analogy that had been widely recited by the coming rulers: People are like water, and the government is like a ship. Water can carry a ship, and also can overturn it.

November 1995 found that 70 percent viewed positively the government's policy of promoting economic growth and social stability (Pei 1997, 17-18).

On the other hand, as population in several democratized post-communist countries suffers from political instability and economic misery, it is dismayed at the new government. In Russia, the largest former European Communist economy, gross national product declined by 12.6% in 1994, and popular welfare suffered a nosedive. In addition, corruption and mafia activities rose, and public order decayed. As a result, only 8% of the Russian surveyed in 1994 thought positively of democracy. As a matter of fact, data on popular support in transitional countries paints a gloomy picture. Among the nineteen democratized or democratizing countries in the former Soviet Union and Eastern Europe, only one democracy (the Czech Republic) had an approval rate over 40% (45% in the Czech Republic), and merely six countries enjoyed support of 30-36% of their citizens according to the surveys. Most of the remaining garnered a disappointing 14-28% popular approval rating, and three (partly democratic Russia and Armenia and democratic Bulgaria according to Freedom House survey) even registered single-digit percentages of popular satisfaction (Berglund 1998, 233). This lack of popular support for the emerging democracies underscores the inability of these governments to address economic issues.

### *Pocket-Book Politics*

Why would an authoritarian regime make enormous efforts to improve the welfare of its population? As implied in the preceding discussion, the population tends to judge the

performance of the government by the economic situation across countries. A worsening economy would thus make the people disgruntle and more ready to change the government.

By the late 1970s, the legitimacy of the Chinese Communist Party (CCP), as stated in the previous chapters, had suffered from political trauma and economic devastation of Mao's politics. The CCP embarked on the reform course in an effort to regain popular support. Its leaders probably reasoned that reform initiatives would help to deliver food and consumer goods to the poverty-stricken population, and would turn the discontented Chinese into happy consumers and acquiescent supporters of the regime. This strategy seemed to have worked. In a survey conducted by a private survey firm in Beijing, 49% of the Chinese respondents in ten cities expressed their satisfaction with the regime during the 1980s, when the reform tide was riding high. Their approval rating dropped to 33% for 1989-91, right after the Tiananmen crackdown, and improved to 37% for the period of 1992-94, as Deng rejuvenated the reform drive and as the economy prospered again (Pei 1997, 17-9; *Far Eastern Economic Review* 1995: Dec 5: 36).<sup>3</sup> This rating even surpassed those in most of ex-communist countries, including Hungary, Poland, the Baltic States, Albania, and Romania. It only lagged behind Croatia and Czech Republic. Even though the Chinese experienced an improvement in their material life as fast as in the 1980s, the

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<sup>3</sup> This approval rating still seemed relatively low, compared with that fact 54% of the respondents approved of the party's stable policy of "liberalization but not democratization", as mentioned later. One possibility is that the percentage here included only those Chinese who were satisfied with the overall performance of the Communist regime and excluded those who were somewhat satisfied. This survey was conducted among the urban residents in *ten* large cities in China. In contrast, a survey on Beijing residents in 1994 reported over 90% of approval rating of the regime.

approval rating in 1992-94 was still lower than that in 1980s. As a result of the consumer revolution unleashed by the CCP, the population formed an unrealistically high expectation, and consequently, were not satisfied with the pace of improvement in their material lives (*Far Eastern Economic Review* *ibid*). Another evidence of the success of the CCP's reform calculus is that 54% of the respondents in the above privately-conducted survey agreed with the part's oft-iterated theme that the most urgent need for China is economic development, not greater democracy (*ibid*). Therefore, the majority of the Chinese appeared to reject the radical reforms in the former Soviet Union and Eastern Europe.

Economic growth (consequently, rise in income), inflation, unemployment, and democratization may help to account for the level of popular support for the existing- and post-communist regimes. Regression analyses can help to explore factors underneath popular support in Eastern European countries, the CIS states, and China in 1994 and 1995. The test findings (in Tabulation 6.1) reveal a marginally significant correlation of the GNP growth rate with the level of political support in 1994. The tests also find that the growth in GNP and the lack of freedom are highly correlated with the approval rating of the government in 1995.<sup>4</sup> Political reform (that led to greater political freedom), inflation, or unemployment did not appear to contribute to the level of popular support of the government effectively. Economic growth and improvement of personal welfare, not political freedom, seem to account for variation in the level of popular approval of the

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<sup>4</sup> Because of the well-understood lack of poll surveys in the ex-communist countries in the earlier years, poll data are available only in a few years after 1992. Regression for individual years is adopted because data on two years are available. Time-series analyses require that the number of time series exceeds that of the countries, which is not possible for now.

Tabulation 6.1. Analyses of Political Support in the Ex- and Existing Communist Countries

Equation 1: Regression of the government approval rating during 1994 (S) on the GNP growth rate in 1994 (G), political repression rating of 1993-94 (R), and inflation (P) and unemployment in 1994 (J) for Eastern European countries, CIS states, and China (19 cases):

$$S = 0.289 + 0.447 G - 0.0027 R - 0.024 P - 0.272 J$$

$$(0.0009) \quad (0.072) \quad (0.881) \quad (0.177) \quad (0.171)$$

(Data in the above parentheses were significant levels. Adjusted R square = 0.222, F= 2.28)

Equation 2: Regression of the government approval rating during 1995 (S) on the GNP growth rate in 1994 (G), political repression rating of 1994-95 (R), and inflation (P) and unemployment in 1994 (J) for Eastern European countries, CIS states, and China (20 cases):

$$S = 0.0334 + 1.666 G + 0.068 R - 0.044 P + 0.151 J$$

$$(0.727) \quad (0.0067) \quad (0.0084) \quad (0.131) \quad (0.730)$$

(Data in the above parentheses were significant levels. Adjusted R square = 0.574, F= 7.39)

Notes: Government approval ratings for Eastern Europe countries and the CIS states are the proportion of "satisfied" and "fairly satisfied" respondents to the question: "On the whole, are you satisfied, fairly satisfied, not very satisfied or not at all satisfied with the way democracy is developing in our country?". The data are from Berglund et al 1998, 233. The nineteen countries in the first equation included Albania, Armenia, Belarus, Bulgaria, China, the Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Latvia, Lithuania, Macedonia, Poland, Romania, Russia, Slovakia, Slovenia, and Ukraine. The twenty countries in the second equation included these countries plus Croatia. Inflation data undergo natural log transformation to reduce the range of raw data. The approval rating of the Chinese government in 1994 is the proportion of the respondents who were satisfied with communist rule in a survey of 2,500 people in 10 cities. Former CASS pollster Min Qi, who conducted a nationwide survey back in the 1980s, led an independent Beijing Market Research Consultancy to carry out this survey in October 1994. The data is from *Far Eastern Economic Review*, December 7, p. 36. The approval rating of the Chinese government in 1995 was based on an opinion survey of Beijing residents in 1995 conducted by scholars from the U.S. (Chen, Zhong, and Hillard 1997). The repression (freedom) ratings ranged from 1, the most free system, to 7, the least free regime. They come from Freedom House dataset, available at <http://www.freedomhouse.org>.



regime across the communist and democratized ex-communist countries. Sometimes (such as 1995) authoritarianism buttressed, instead of hurting the popularity of the government. The public approval of the post-communist governments resembled strikingly the pocket-book voting in the U.S. The post-Cold War campaign slogan in the U.S. “It is the economy, stupid!” seems to illuminate the politics in the ex-communist economies as well. In many Eastern European and former Soviet countries, as the economy has slipped into deep recessions after shock-therapy-type reforms, population’s respect for the nascent democratic government also plummeted. Unfortunately, radical economic liberalization has thus tarnished rather than polished the popular image of democracy there.

#### *Reforms in China and the Former USSR<sup>5</sup>*

The approaches and outcomes of reforms in the former Soviet Union and China contrast sharply. Since 1978 the Chinese communists have embarked on economic reforms by decentralizing economic power without loosening their political control. Chinese economic reforms propelled China into one of the longest modernization eras in its modern history. On the other hand, the Soviets moved decisively to open its political system and decentralize its political power. They carried out political reforms much faster in order to accelerate economic reforms. In the following years, the USSR broke up, anarchy ensued.

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<sup>5</sup> I express my deep gratitude to Barry Naughton. He asked me a question “Why the reforms in China proceeded differently than did those in Eastern Europe and the former Soviet Union (EEFSU)?” in a conversation, prompting me to apply my dissertation findings to this issue.

Meanwhile, economic reforms resulted in economic depression, and privatization degenerated into official embezzlement. Such a contrast is academically intriguing because both countries were large in size, and had adopted the command economy for decades.

A number of scholars have observed this contrast in their studies of China (Shirk 1993; Huang 1994; Naughton 1995). China's planning system, Huang (1994) suggests, was more rudimentary than the Soviet Union's and more susceptible to macroeconomic instability. Therefore, the Chinese were more willing to search for alternative options through reform. Sachs and Woo (1995), on the other hand, proposed that large state sector in the former USSR and Eastern Europe precluded the smooth and fruitful gradual reforms, for heavily subsidized employees of state enterprises refused to move to more dynamic non-state sectors. They argue that a largely rural population and a smaller state sector contributed to the success of reforms in China. An evaluation of these arguments requires a systemic statistical analysis. This study is far from being a thorough test of these claims. It does, however, yield interesting implications for the above arguments.

While there is a grain of truth in Huang's argument on the national level for the former Soviet Union and China, the thesis by Sachs and Woo (1995) seems to carry greater explanatory power in accounting for provincial variation in the extent of reforms. In the remotely interior provinces, such as Qinghai, Gansu, Ningxia, Inner Mongolia, Guizhou, and Yunnan, the planning system was established later and arguably had been in rather poor shape. Nevertheless, these provinces tended to be cautious, instead of bold in reforms. Economic planning was firstly installed and in a relatively better shape in the Northeastern provinces than other provinces. These provinces (including Jilin), nevertheless, also

pursued slow reforms. The only common denominators among the remotely interior and Northeastern provinces were large state industry, as the findings in this research suggest. Therefore, the size of state sector, a key factor according to Sachs and Woo, seemed to be a more consistent factor in provincial reforms than the quality of the planning system.

The findings of this study indicate that provinces with large non-state sector were more likely to pursue faster reforms. The argument by Sachs and Woo that different size in non-state sectors helped to account for the different Chinese and Soviet reform outcomes seems to carry some explanatory power. My test results also indicate that provinces with larger heavy industry did not necessarily block reforms, and that the center encouraged deeper reforms in provinces with a higher rural consumption level. These pro-reform provinces were usually coastal and more urbanized. These test findings contradict an implied argument in the article by Sachs and Woo that provinces with larger heavy industry and with a smaller rural population preferred slow reforms.

The clue for the Soviet and Chinese reform approaches and outcomes lie in two factors: the size of state sectors in the sub-national units and the level of ethnic diversity. Overall the Chinese provinces, the eastern provinces in particular, had a much smaller state sector than the Soviet republics at the beginning of reforms. Under the pressure from a considerable non-state industrial sector, as described in the previous chapters, the eastern provinces viewed reforms favorably. A popular-support-conscious center was then able to expand reforms in the large country in a moderate fashion. It devolved economic power firstly to the eastern provinces while maintaining political control. With expanded economic freedom, the eastern provinces eagerly adopted reforms and experienced an

economic takeoff. This demonstration effect of the success of these provinces, together with the gradual decline of the state sector and the steady rise of reform-prone non-state sectors, draws the interior provinces into the reform endeavors.

In the former Soviet Union, on the other hand, the state sector took up an overwhelming share of total employment prior to perestroika (88% versus China's 24% of total labor, and 96% versus China's 78% of urban labor force in Table 6.1). The heavily subsidized state sector, the bureaucrats who oversaw the sector, and the employees of state firms who had benefited from generous public welfare would lose income and even their jobs from market-oriented reform. Therefore, local resistance to economic reform would have been much stronger in the former USSR. As scholars have suggested, Gorbachev opened the regime and decentralized political power through *glasnost* in order to overcome opposition against reform (Shirk 1993, 348-49). The two regression formula in Table 6.2 not only support this argument, but also shed light on the Soviet reform process. Formula 1 suggests that the former Soviet republics with a larger state sector pursued faster democratization, and as a result, had a lower rating of political repression. The formula also implies that a 50% gap in the share of the state sector in total labor force could account for a 6.5 difference in the ranking of repression, i.e., almost the total difference between the most and the least oppressive regimes. Formula 2 suggests that the former Soviet republics adopting faster democratization implemented bolder economic reform in the later years. Formula 2 also implies that a 7-point gap in the repression ranking could account for a fourteen-point difference in the ranking of economic reform, i.e., a virtual difference between the most and the least liberal reforms.

Highly diverse ethnicity and loosening of central political control may combine to cause the state to disintegrate. This effect is reflected in the sharp contrast between countries in Group A and Group B in terms of their statehood (Table 6.1). These two groups of nations are the major ex- or current communist countries that have adopted economic reforms. Countries in Group A tended to have a highly homogeneous ethnic makeup, with the largest ethnic group constituting the absolute majority (over 88%) of the population. Some of these countries, such as Poland and Hungary, have democratized rapidly, whereas some others have maintained the authoritarian regime, such as China and Vietnam. Nevertheless, none of these countries has broken up. Even though East Germany has merged with West Germany, it moved toward integration, instead of disintegration. The case of German unification thus demonstrates the political integrating effect of ethnic homogeneity. On the other hand, countries in Group B had a very diverse ethnic profile, with the largest ethnic group accounting for 36.3% to 62.7% of the population. The repression capacity of the state in these countries had declined, as the countries moved toward political decentralization and democratization. All these countries have broken up. An additional and very intriguing aspect of the disintegration of these countries is that the larger the majority ethnic group, the more peaceful the disintegration process. Czechoslovakia, where the ethnic majority made up 62.7% of the population, dissolved into two states peacefully. Yugoslavia, where the ethnic majority constituted merely 36.3% of the population, has witnessed prolonged and massive ethnic warfare ever since the death of the former union.

Table 6.1. Ethnic Diversity and Survival of Ex- or Current Communist Statehood

Country Year of data	Share of the largest ethnic group in the population (%)	1990-91 political repression rating	Current status of past nationhood
Group A			
Albania 1989	98	6.5	Existent
Bulgaria 1981	85.3	3.5	Existent
China 1982	92.2	7	Existent
East Germany 1990	99	1.5	Unified with West Germany
Hungary 1990	98.8	2	Existent
Poland, early 1990s	98	2	Existent
Romania 1989	89	5.5	Existent
Vietnam 1999	87.5*	7	Existent
Group B			
Czechoslovakia 1989	62.7	2	Disintegrated; no conflict
USSR 1991	51	4.5	Disintegrated with localized conflict
Yugoslavia 1981	36.3	4.5	Disintegrated & with massive ethnic violence

Sources: *Eastern Europe and the Commonwealth of Independent States 1992*, London: Europa Publications Limited, 1992; SSB 1990, 2; Fu et al 1992, 2. Data with asterisk comes from CIA, *The World Factbook 1999* (<http://www.odci.gov/cia/publications/factbook/country.html>). Refer to notes under Tabulation 6.1 regarding political repression rating. 7 on the political repression rating of 1990-91 stands for the most repressive regime, and 1 the most free regime.

Table 6.2: Reforms in the USSR

1. Regression of Freedom-House rating of political repression in 1993-94 (REPRESSION) on the share of the state sector in employment in 1988 in former Soviet Republics (STATESECTOR)

$$REPRESSION = 15.07 - 12.97 STATESECTOR \quad (R \text{ square adjusted: } 0.41, \text{significance of } F: 0.02) \\ (3.78) \quad (4.58)$$

2. Regression of economic reform in 1996 (ECONREFORM) on Freedom-House rating of political repression in 1993-94 (REPRESSION) in former Soviet Republics

$$ECONREFORM = 16.23 - 2.05 REPRESSION \quad (R \text{ square adjusted: } 0.60, \text{significance of } F: 0.003) \\ (2.40) \quad (0.51)$$

Notes: Standard errors in the parentheses underneath the equations. Complete data are available only on the following eleven former Soviet republics: Azerbaijan, Byelorussian, Estonia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Russia, Turkmenistan, Ukraine, and Uzbekistan. Sources: IMF et al, 1991; Freedom House.

In the former Soviet Union, the ethnic majority Russians accounted for 51% of the population. As glasnost eroded central political control in the large Soviet nation-state, regional separatism emerged, and the Union broke up in peace. Tension or even conflict intensified in certain regions. The center lost control over local officials and reform, and an economic fiasco ensued. In contrast, economic, rather than political power has been substantially loosened in China. Unified political power helped produce political stability in China, enabling economic liberalism to progress smoothly.

## **2. Changes in China since 1994**

Since 1994, the center has continued to promote collective, private, and foreign sectors, the three primary non-state economies. First, it has retained its categorical claim of 1993 that rural collective enterprises were an important element of public ownership, the orthodox pillar of communist economy. This claim has virtually lifted up the status of rural collective firms to that of state firms. Second, the center has also continued to view the private sector as a legitimate and beneficial supplement of the public sector. Third, the center is still committed to opening up China further for international investors. As a result of these promotions, the share of non-state sectors in gross industrial output in China has grown from 62.7% in 1994, to 74.5% in 1997 (SSB 1998, 431).<sup>6</sup>

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<sup>6</sup> These three policies were summarized in a landmark document by the Central Committee of the CCP regarding the construction of a socialist market economic structure on November 14, 1993 (*China Economic Yearbook* 1994, 2; 8-10). This document served as a policy guideline for China's reforms in the following years.

Meanwhile, as I shall elaborate, the center has introduced the following measures to improve its arrangement for reforms in the provinces for the sake of popular support and efficiency. Therefore, the logic of national policies that is analyzed in Chapter 3 seems to apply to the post-1993 period.

To state briefly, firstly, the center has promoted non-state sectors in the interior region, and has allowed the interior provinces to enjoy the favorable policies that the developed provinces had exclusively enjoyed. The center did so in order to secure the support from the population in the interior region, whose living standard had reached a critical level. The interior provinces, under the pressure of growing non-state industry, also pressed the center for favorable policies. The center's policy could have contributed to the fast growth of non-state sectors in China during these years. Secondly, carrying the momentum of past market-oriented reforms, and trying to stem the snowballing losses accumulated by state firms, the state has started to reform state enterprises, and unified taxes on enterprises to generate revenue for the state, create a level play field and appease state enterprises. Nevertheless, the center has refrained from a dramatic approach of state enterprise reform out of the fear of protests from the layoffs, resistance from managers, weakening of the party's control of the economy, and political instability. Third, the center has taken measures to centralize the fiscal and banking systems in order to reduce provincial authority's distortion of the market and in the case of the fiscal system, capture more revenue. The center has curtailed the provinces' economic power. I will discuss these measures one by one.

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(*China Economic Yearbook* 1994, 2; 8-10). This document served as a policy guideline for China's reforms in the following years.



### ***Promoting Non-State Sectors in the Interior Provinces***

Despite slower growth than the coastal provinces, the consumption level in the interior region also increased considerably during 1978 and 1992. In 1992, per capita rural consumption in the interior provinces in 1992 averaged 286 yuan in 1980 price, equivalent to the rural consumption level *during 1982-1985*. In addition, per capita urban consumption in the interior provinces averaged 689 yuan in 1980 price, equivalent to the averaged level of the coastal provinces around *1986*. As the findings in this research suggest, with a higher level of consumption, the population in the interior region would demand the center to adopt greater reforms in the region. It may not be by coincidence that the center extended open areas from Guangdong and Fujian to eight other coastal provinces in 1984 and 1985, and speeded up urban reforms in the coastal provinces around 1986.

The interior provincial leaders were also changing their attitudes. During the national reform drive of 1992-94, leaders of interior provinces realized that their timid stance toward reforms during 1978-1991 had cost them valuable opportunities for growth. In addition, non-state sectors in the interior provinces had grown into a considerable component of the economy, accounting for roughly one third of the industrial output in the interior provinces. This share was equivalent to that of the coastal provinces between 1982 and 1985, when reforms started to take off in these provinces. Due to these two factors, the leaders of the interior provinces started to view non-state sectors as an engine of growth for local economy

and granted them favorable treatments. They asked the center for more resources and favorable policies.<sup>7</sup>

The center acceded to the demands by the interior population and leaders for deeper reforms in order to command their support, reduce regional disparity, and maintain national unity. Since the early 1990s, the center has been promoting rural enterprises and foreign business, especially those in resources-extraction and labor-intensive industries, in the interior provinces. The center also increased its fiscal support and investment in infrastructure and resources-extraction in these provinces. In addition, it encouraged the developed region to upgrade technology and transfer labor-intensive industries to underdeveloped provinces. Finally, it asked the developed provinces to invest in the interior provinces, and arrange for the employment of the labor from the undeveloped areas in the developed areas (*China Economic Yearbook* 1996, 35-6; 713; 445-48).

Favorable national and provincial policies did yield positive results. In 1996, for example, added industrial value of rural enterprises in the interior region grew by about 38%, well ahead of the 16.3% growth rate in the coastal region (ibid, 685). The number of employees and the amount of registered capital in family-run private enterprises (IHEs) grew by 15% and 27.5% respectively in the central interior provinces, 7% and 18.4% in the western interior provinces, but only 4.2% and 14.3% in the coastal provinces. Inland provinces have managed to expand FDI at roughly the same pace as coastal provinces. The

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<sup>7</sup> Fan (1995) suggests that inter-provincial inequality in China's development has declined during the reform era. I interpret her finding as follows: The center's post-1994 efforts to promote non-state sectors in the interior have more to do with appeasing the demand by consumers in the interior than cutting down inter-provincial inequality.

share of the interior provinces in total FDI in China was 14.5% in 1993, 15.9% in 1994, 15.4% in 1996, and 14.3% in 1997 (ibid 1994, 411; 1995, 611; 1997, 690; 718).

Two political factors help to explain why rural enterprises, not foreign firms grew much faster in the interior provinces than the coastal provinces. First, as the chapter of comparative study demonstrates, inland provinces tended to have a larger state sector and bureaucracy, and recalcitrant officials would maintain cumbersome routines to justify their existence, hence scaring away foreign investors. Second, as the previous analysis of the influence of national on provincial policies suggests, both the center and the provinces tended to treat rural enterprises more favorably than foreign enterprises. Rural enterprises produced more goods for the consumers, and employed more rural surplus labor, and better served the center's need to appease both consumers and the unemployed. Rural enterprises altogether constitute a large sector than foreign firms and have more extensive government agencies to represent them, ranging from local governments to governmental agencies. They could exert greater influence on provincial governments.

### *Reforming State Enterprises*

Prior to 1994, the government introduced in state enterprises measures that were inspired by successful rural land-contracting reforms. State firms contracted out profits and losses, hired labor on a contractual basis, paid the employees piece-rate wage, retained a portion of profits, and remitted the rest to the state in taxes. Failing to clarify ambiguous property rights, these measures accorded limited success.

As the performances of state enterprises in four aspects deteriorated in the 1990s, the center had to take more dramatic measures. The growth rate in the sales of state enterprises declined over years, from 35.6% in 1993, through -2.4% in 1994, to 5.4% in 1997 (ibid 1998, 807). Meanwhile, the share of state enterprises with independent accounts and in red was rising over the years, from a range of 9.7%-16% during 1983-1989, to 27.6% in 1990, and 28.8% in 1993 (Zheng et al, 1998, 33).<sup>8</sup> Some estimates also paint a gloomy picture of state firms: Over one-third of the employees in state enterprises was redundant (ibid, 604); because of their poor performance, state enterprises as a whole could not repay their bank loans in 1995, and as a result, outstanding debts might have accounted for 22%-25% of the banks' assets in the mid 1990s (ibid, 74; Lardy 1996, 340).

From November 1994 onward, the state has experimented with three initiatives in a number of state firms. First, the state attempted to introduce a sound (or "modern") enterprise system by defining and keeping track of the value of enterprise assets, and setting up supervisory agencies to oversee state enterprises (ibid 1997, 682). The state hoped to turn itself into investors, and the enterprises recipients of investment. Second, the state allowed these enterprises to downsize their work force. The state enterprises first trained and then transferred surplus labor to the service sector. They also spun off their social services, such as schools and hospitals (ibid 1996, 708). Third, the government helped the state firms to upgrade their technology by providing a special fund and by rebating 15% of

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<sup>8</sup> In 1994, 34.3% of all state enterprises were registering losses, whereas 22.5% of all the enterprises were in red (*China Economic Yearbook* 1995, 603). The ratio of total losses in loss-making state firms with independent accounts to total profits of profitable state firms has increased from 0.036-0.084 during 1983-1989, to 0.195 in 1989, and 0.356 in 1993 (ibid).

their income tax for their loan financing (*China Economic Yearbook* 1995, 604; 1996, 708-09; 1997, 679-82).

In 1996, the national government introduced a fourth strategy of "grasping the large, and letting go the small" (*jiada fangxiao*). The state would turn 1000 large state enterprises or conglomerates into competitive entities, and allow small state enterprises to undergo dramatic restructuring such as regrouping, merger, take-over, stock-sharing, lease, or contracting-out. A main reason is that these large- and medium-size state firms took up too large a portion of the output of the state sector to let go and that they dominated strategically significant sectors such as resources extraction, energy supplies, and infrastructure (*ibid*, 1996, 708). The official justification is that small state enterprises performed poorly, whereas large- or medium-sized state enterprises were doing well. In 1994, for example, the amount of losses equaled that of profits in small enterprises (*ibid* 1995, 603), while many large- or medium-size state enterprises were competitive (*ibid* 1996, 708). This claim is only partially true for some large- or medium-size state enterprises have started to face financial difficulties in 1997 (*ibid*, 707, 710).

The Fifteen Party Congress in 1997 proposed an ambitious program of solving the problems at most large- and medium-sized state enterprises within roughly three years. The proposed remedies were the above four initiatives and improving management of state firms (*ibid*, 709-10). The party, however, would keep the party secretary in state firms to supervise the management and the use of state investment, and help the firms to build modern management (*ibid*, 710). Provincial and local governments tested the managerial personnel of 130,000 enterprises, and dismissed 14% of it (*ibid*, 708). The change was

timid, for a survey in eight major cities in 1993 revealed that 81.7% of 2,586 state firms surveyed ran in red mainly due to poor management (Zheng et al, 1998, 98).

On the Fourth Plenum of the Fifteen Party Congress in September 1999 officially approved of some of the above reforms, such as checking the property values of state enterprises and overhauling their management. Nevertheless, Jiang Zemin, the Party Secretary, disappointed the liberals in China and abroad by declaring that public ownership was the hallmark of socialism, and that the state would merge and regroup rather than privatize state firms.

In sum, the center has committed itself to these moderate reforms again for *political* reasons. Fearing the political instability by the unemployed, it preferred mergers and regrouping over bankruptcy, and transfer of redundant employees to subsidiary services of the enterprises over an independent service sector. The party cadres continue to supervise enterprise managers in order to maintain the party's economic clout and resources. The party has rejected privatization and dramatic overhauls of the management in order to retain its orthodox ideology, appease ideologues, and ease managers' concerns over a loss of their jobs. This mild approach will help maintain political stability, yet yield moderate economic results. Predictably, the need for deeper reforms will become apparent in the coming years.

### *Equalizing Taxes on Various Types of Ownership*

In 1994, the state equalized the tax rate for enterprises of different types of ownership. In the past, collective firms were taxed at a progressive rate ranging from 10% to 55%, as

were small state enterprises. The tax rate for private enterprises was 35%. Foreign investment enterprises enjoyed the lowest tax rate: 33% in general, and 15% in the SEZs. The tax reform of 1994 unified income tax on state, collective, private, and foreign enterprises at 33% (Tsang and Cheng 1994, 783).

A number of reasons probably caused the change in the tax system. First, as non-state sectors evolved into the largest component of the economy, and as the state sector was shrinking 16 years after reforms, the state felt a greater need to generate more revenue from the non-state sectors. Thus raising the income tax on the non-state sectors seemed to be a natural option. Second, unifying the tax rate simplified the procedures of tax calculation and strengthened the state's capacity to collect taxes. Third, the state tried to appease and help out medium- and large- state enterprises. Prior to 1994, these enterprises faced the highest income tax rate for all sectors, namely, 55% (Gao 1993, 1728-31). In addition, inefficient property rights and overall generous employee welfare caused their productivity to decline. Meanwhile, non-state sectors were expanding quickly and threatening the markets and revenue of state entities (*China Economic Yearbook* 1997, 682). State enterprises had run into increasing difficulties, as described above. They complained loudly that heavy tax burdens had prevented them from competing in a leveled field against non-state firms (ibid). This claim is largely untrue, for, as to be stated, state firms still performed poorly after the tax reform.

Tax hikes on rural and foreign enterprises, coupled with slowdown in the exports to other East Asia economies, seem to have decelerated the expansion of these two sectors in the following years. Annual growth rate in the added value of the output of rural enterprises

declined from 42% during 1990-95 to 33% in 1995, 21% in 1996, and 18% in 1997. The amount of registered foreign direct investment declined by 38.6% in 1996 from the previous year, and by 22.5% in 1997 (ibid 1997, 685, 688; 1998, 805, 712, 717). A unified and lower income tax has not lifted state enterprises out of predicaments either, largely due to poorly-specified property rights of, over regulation of, and a heavy welfare burden on the enterprises. The growth rate in the sales of state enterprises declined over years, from 35.6% in 1993, to 4.1% in 1996 and 5.4% in 1997 (ibid 1998, 807).

### *Central-Local Fiscal Relations*

As suggested in Chapter 2, the provinces and localities had claimed a central role in the provincial and local taxation. Through these leverages, they were able to expand or restrain the non-state sectors. While their intervention in local taxation and banking may have helped the nascent non-state sectors, it can distort market signals and the center's reform initiatives. Since 1993, the center has made attempts to reclaim its control over taxation and banking from the provinces. First, the center split the former provincial tax bureau into the State Tax Bureau and the Local Tax Bureau. The State Tax Bureau that collects the taxes for the center receives its revenue directly from the center and is fiscally independent of provincial governments.

Second, associated with the new tax system was a new central-local fiscal system that tilted toward the center in 1994. Under this tax sharing system (TSS), the center derived its revenue from several large revenue sources, including income tax of central enterprises, tax



on revenues collected by railways, banks, and insurance companies, customs duties, and the consumption tax. Local taxes include revenue remittance of local enterprises, urban land use taxes, personal income taxes, and other miscellaneous taxes such as stamp tax, agricultural taxes, and the title taxes. In addition, the center and provinces shared one of the largest revenue sources, the value-added tax (VAT). The center is entitled to 75% of the VAT revenue, and the provinces 25%. In order to reduce local resistance, the center set the base revenue of each for 1994 equivalent to the retained revenue by the province in 1993. It also promised to return 30% of the increase of the center's revenues from VAT and consumption tax to the provinces (Wong 1997, 33-34; Tsang and Cheng 1994, 779; Zhang 1999, 133-35). After the introduction of the TSS, the center raised its share in total budgetary revenue from 22% in 1993, to 52%- 55.7% during 1994-96 (Zhang *ibid*, 134-35). The center seems to reclaim considerable fiscal control through the TTS.

Third, the state tax agencies have doubled their efforts to collect taxes, especially from non-state enterprises. All the above measures may have increased the center's economic leverage over the provinces. Nevertheless, since their power was largely unchecked, and since the political system was rather opaque, provincial and local officials may still continue to manipulate the tax system, though to a lesser extent. In 1998, an official at a provincial tax bureau told me without hesitation that he would listen to provincial leaders first and national tax officials second (interviews).<sup>9</sup>

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<sup>9</sup> A field study of 1997 revealed that village officials in were able to reduce tax submission by under-reporting the output of local non-state enterprises (Unger and Chan 1999, 56-7).

## *Centralizing the Banking System*

As described in Chapter 2, the provincial leaders were able to dictate local bank lending to state and non-state firms, despite the center's stipulation that provincial banks should only take orders from their national office (Huang 1996, 43). While local control of bank loans has helped produce rapid economic growth, it also entails several risks. First, unbridled local investment might lead to economic overheat and inflation, popular grievances, and political liabilities for the regime (ibid, 10-14). Second, the provinces might treat the center as the lenders' last resort, and invested zealously without careful calculation of costs and benefits, forcing the center to bail out local banks deep in bad debts (ibid, 43).

Sensing these growing risks and learning from the financial meltdown in Southeast Asia, the center announced an initiative to centralize the banking systems in November 1998. Nine interprovincial banks were to be established to oversee the business of major provincial banks (*China Daily*, Nov. 17, 1998).<sup>10</sup> At an administrative rank higher than the provincial leaders, interprovincial banks can prevail over provincial governments and stem the latter's inference in provincial banking. Meanwhile, they can closely monitor their provincial branches that are directly below them. Bank reconstruction should have

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<sup>10</sup> These interprovincial banks and their geographic jurisdiction are as follows: 1. Tianjin branch overseeing provincial branches of Tianjin, Hebei, Shanxi, and Inner Mongolia; 2. Sheyang branch supervising those of Liaoning, Jilin, and Heilongjiang; 3. Shanghai branch in charge of Shanghai, Zhejiang, and Fujian; 4. Nanjing branch in charge of Jiangsu and Anhui; 5. Jinan branch

strengthened the center's control of provincial banking activities to a certain extent. As a tradeoff for the banking reform, however, the center may have handed over to the provinces the control of small banks and credit cooperatives. In the past one to two years, some of these financial institutions terminated their operation due to huge debts they had accumulated.

### **3. China's Strategies, Successes, and Tasks Ahead**

In the past two decades, the Chinese state has wisely incorporated three strategies in its reforms. First, it recognizes that deregulation and non-state ownership can create incentives for individuals to work hard, enable them to earn higher income, and convert them into supporters for the regime. Second, in a similar vein, it realizes that economic decentralization will encourage provinces to experiment with reforms for faster growth. As this study demonstrates, provinces with larger non-state sectors tended to respond more enthusiastically to the center's calls for liberalization. Third, the center senses correctly that swift and sweeping initiatives will erode political and macro-economic stability as well as popular support for reforms. It has thus chosen an incremental course over a radical approach that is preached by neo-classical economists.<sup>11</sup>

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superseeing Shandong and Henan Provinces; 6. Guangzhou branch over Guangdong, Hainan, and Guangxi; 7. Xi'an branch that covers Shaanxi, Gangu, Qinghai, Ningxia, and Xinjiang.

<sup>11</sup> Reflecting on the failure of the radical approach in the former Soviet Union and Eastern Europe, an economist states: Take our words about what the economy should be, but not our proposal about how to make it happen.

Combining these three considerations, the center has allowed non-state enterprises to prop up, and has attempted to reform state firms. It has decentralized economic authority to the provinces and has rewarded provincial leaders for successful reform initiatives. Finally, it tackles major economic problems steps by steps, trials out innovative measures in a few provinces before implementing them nationwide, and adjusts its strategy after trials and errors. The result was an astounding success. Invigorating an over-regulated and backward economy has produced handsome efficiency gains and fast growth.

In particular, national and provincial sanctioning of non-state sectors in the past two decades have vastly transformed autarkic, impoverished, and overwhelmingly rural China. China has become one of the developing countries that attract the largest amounts of foreign investment. It has also become a significant exporter, and its export volume, after a recent stagnation, is again growing. Both the size of the economy and the living standard has nearly tripled (SSB 1996, 133; 144). Furthermore, even though over half of the population still lives in the countryside, many peasants nowadays work either in the cities, or in the manufacturing firms in their own localities (rural enterprises). Thanks to past gradual reforms and decisive restructuring of the banking system during 1993-96, China has avoided the East Asian and Southeast Asian financial debacle in the 1990s. In addition, the center has taken the above-described measures to overcome the inadequacies of the past reforms.

Needlessly to say, more remains to be done in China's reforms. Under an incremental reform scheme, liberalization should proceed continuously so that the economy can move out of the shadow of the administrative economy. In the coming years, painful reforms are

needed to cleanse deeper "blood clogs" in the Chinese economy. Otherwise, high economic growth will slow down over the years because of these structural economic problems, the negative effect of the Asian financial crisis, and the natural slow-down effect due to China's higher level of development. Along the theme of non-state sectors and property rights in this study, China will have to do more to clarify property rights, empower market agents and establish norms, and open its economy to the world market. These three measures would help to move the Chinese economy toward a well-regulated and truly market economy, where governmental intervention would be limited to mainly enforcing business codes or fiscal regulation, and where genuine non-state firms compete with each other or with well-managed and well-supervised state firms.

### *Clarifying Property Rights*

Chinese reform policies of allowing the entry of non-state sectors have produced two efficiency gains. On the one hand, non-state enterprises have expanded and come to dominate industry. On the other hand, they have pressured state enterprises that had been retarded by poorly-delineated property-rights to improve their efficiency.

Rural enterprises have an edge over state enterprises due to their better enforcement of property rights. State enterprises had no effective supervisor. Rural enterprises, on the other hand, have effective owners, including local governments and local groups.<sup>12</sup> In the early

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<sup>12</sup> For an empirical survey of property rights of rural enterprises in China, please refer to Hu and Zheng, 1996, 129-32; 137- 40; 144-45; 151-52; 155-61.

development of rural enterprises, township and village officials offered various assistance to rural enterprises, such as constructing infrastructures, obtained business licenses, bank loans, raw materials, energy supplies, and market outlets, and supplied local land at low costs. When the command economy still lingered in the background, these helps reduced the start-up costs of rural enterprises (ibid, 1998, 803).

Over time, however, some rural collective enterprises start to suffer from excessive intervention by village and township officials in several ways. First, ownership of enterprise property may not be defined clearly, for both local groups and local governments have never delineated their shares of enterprise property. Local governments may claim a large share in enterprise property for their heavy investment for the enterprises. Second, village officials can appoint their managers, and may even influence enterprises as a board director, preventing enterprises from making independent decisions based on the market situation. Sometimes village or township authorities may impose heavy taxes and fees on rural enterprises to generate revenues (ibid, 1998, 802-03). In other cases, in order to provide local employment and showcase their administrative achievements, local officials may pressure local banks into lending to rural enterprises regardless of their profitability, and may grant the enterprises large tax cuts or exemption (Hu and Zheng 1996, 155-61). Contrary to what several optimistic Sinologists claim (Walder 1992; Oi 1997, 128), administrative intervention has led to efficiency losses in some provinces in recent years (Unger and Chan 1999; Sargeson and Zhang 1999). Remedies range from western-type stock shares, through co-ownership with private individuals, and to auction and rental. In Jiangsu Province whose extensive governmental influence over rural enterprises would

have won the praise of the corporatist Sinologists, a number of rural enterprises have gone into financial problems since the mid-1990s. As a result, some localities in Jiangsu allowed private businessmen to take over loss-making rural enterprises through rental or auction sales (Woo, 1997: 169).

As far as state enterprises are concerned, the most severe problem is that *no owners effectively supervise* the enterprises. Managers are often party cadres, or *de facto* bureaucrats. The state hardly polices and seldom disciplines its own core followers. Incompetent managers are often transferred to other state firms, and misappropriation and management blunders are seldom investigated. In addition, life-time tenure and comprehensive welfare package for employees created a large population of redundant labor and pension-recipients, lowering productivity of state enterprises.

The state can create more efficient property-rights by allowing investors and the public to own and exchange firms' stocks and by making book keeping accurately-done and transparent. It also can sell state firms along with their bank debts to mainland Chinese, Hongkongese, Taiwanese, or international investors. This will help to revive the overloaded banking system. Finally, it can withdraw the party secretary from the top management post and put him along with publicly elected legislators on a supervisory board to oversee state firms. Several supplementary changes should also follow. First, the state should de-bureaucratize managers by denying them party posts or bureaucratic ranks, and hold them responsible for their gross management errors or crimes. Second, in order to cut redundant workers, the government should help train and transfer surplus labor in state firms into a non-state service sector and provide it with unemployment benefits.

### *Empowering Market Agents and Establishing Economic Norms*

By devolving economic power to the provinces, the center has motivated first coastal and then interior provinces to embrace the reform course (Shirk 1993), creating a federal economy where provinces compete against each other with their own initiatives for resources and growth opportunities (Montinola, Qian, Weingast 1995; Huang 1996).

Economic decentralization also has drawbacks. In pursuit of their localized interests or political careers, provincial and local officials at times ignore long-run investment returns, or hinder the rise of genuine entrepreneurs (Lieberthal 1995, 262-65). Local governments tended to invest in profitable projects that manufacture consumers' goods, rather than much-needed infrastructure. As a result, some sectors of consumer goods are overcrowded with local enterprises. The bright side is that competing enterprises increase product variety and drive down prices. The dark side is that some local governments may block imports of products by outside competitors, and order the bank to finance the loss-making local enterprises (Lieberthal 1995, 270). As a result, some successful firms have a difficult time in building up their national markets, while inefficient firms dominate local markets and disregard the economy of scale. The economy in certain localities may have grown at the expenses of a well-functioned banking system, efficiency, and a national market (Wang and Hu 1993, 117-19). Statistical tests in Chapter 3 suggest that the national government, rather than provincial authorities, took into account efficiency and growth in formulating reform policies. This finding buttresses the above analysis.



**Devolving power to local officials without granting the local legislature and the media the power to supervise them also leads to corruption and losses of public welfare. With easy access to resources yet meager salaries, officials have a great temptation to enrich themselves.**

**Future reforms should focus on devolving economic power to local market agents, such as entrepreneurs, managers, consumers, and employees. This measure will be effective only when the state takes local governments out of the management and operation of state and rural enterprises. These changes will improve efficiency and reduce corruption.**

**The Chinese government has been slow to empower businessmen, out of the fear that relaxed governmental control will encourage them to commit foul plays, such as selling poisonous fake brand-name wine, or devising sinister financial schemes to lure funds from innocent investors. Frequent public outcries at flagrant practice of "primitive capitalism" on the media suggest that these concerns are valid. Nevertheless, the most effective way to fight illegal business is to formulate and enforce business regulations that protect legitimate business and punish deceitful merchants. Concentration of economic power in the hand of officials will only perpetuate inefficient policy, corruption, and reckless business practice. However, the state should grant national, provincial, and local officials the power to enforce market norms, and allow the legislature and the media to oversee their administrative behavior.**

## *Promoting Exports and Liberalizing Imports*

Open-up of provinces to international between 1978 and 1994 has profoundly transformed regional economy. In the open areas, as revealed in statistical analyses, rural enterprises obtained a large amount of bank loans and enjoyed low taxes. In addition, foreign enterprises supplied international capital, boosted imports and exports (Lardy 1994, 110-16; 73-9), exemplified efficient management, and attracted a pool of talents. State, collective, and private enterprises increased their exports, and imported advanced technology. Two studies (Lee 1994 and Chen 1992) found that exports significantly contributed to the growth in the coastal provinces.<sup>13</sup>

These findings seem to confirm an explanation of the rise and fall of East Asia and Latin America. Lai (1997) proposed that the economies in Latin America and East Asia, whose factor endowments complemented those of the leading economy, will export heavily to the latter and grow faster.<sup>14</sup> China's coastal provinces are densely populated and scarce in minerals and land, much more so than the interior provinces. Since their factor endowments complement those of the land-rich U.S. very well, the coastal provinces have been able to trade heavily with the U.S. and grow faster. Taking into account China's direct exports and indirect exports to the U.S. through Hong Kong, a quarter to thirty

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<sup>13</sup> These two studies are reported in Jin and Chen 1996, 303-04.

<sup>14</sup> He observes that between the late nineteenth century and the early twentieth century the *land*-abundant Americas exported more heavily to *labor*-intensive Great Britain, the leading economic power, than did most of *labor*-abundant East Asia. Thus the Americas grew faster than

percent of China's exports went to the U.S. The majority of these exports originated from the coastal provinces (Naughton 1996, 309-16; 329-30). A rapid increase in exports has extended the output of China's enterprises in the coastal region, and has prompted these enterprises to improve management and technology and upgrade their products. Nevertheless, two sets of variables will condition China's growth through trade. One is property-rights reforms and the construction of market norms, as discussed above. The other is the health of China-U.S. relations, further opening of China's economy, and China's membership to the World Trade Organization (WTO).

A fallout of mainland-Taiwan tensions, as well as unbridled hostilities in both the U.S. and China toward each other can severely set back China's Open Policy. The discussion here, however, will focus on the opening up China's market for international business and China's entry into the World Trade Organization, for the sake of the theme of this research. Trade liberalization will force China's long-protected sectors, such as auto and telecommunication industries, a number of agricultural sectors, and financial industries, to improve their management and efficiency, generating long-term benefits for Chinese economy. In particular, the state can allow international investors to take over state firms, invest in the financial sectors, and set up business in more economic fields. Import liberalization can also enable China to maintain its own access to foreign markets. Trade liberalization, however, will allow foreign competition to drive out inefficient Chinese business, throw tens of millions of people suddenly out of work, and cause tremendous

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most of East Asia. Since WWII, *labor*-abundant East Asia exported more to the *land*-rich U.S. than did *land*-abundant Latin America and thus outgrew Latin America.

economic dislocation and political uncertainties (Lardy 1996, 340). Despite stubborn domestic opposition and temporary setback of the tentative WTO consensus between Premier Zhu Rongji and President Clinton during Zhu's trip to the U.S. of the early 1999, the Chinese and the U.S. delegates eventually reached an agreement on China's entry to WTO in the late 1999. Such a surprising and epic agreement seems to confirm the findings of the tests in Chapter 3: Reform in exchange for the support of happy consumer. The Chinese leaders appear to use China's entry to WTO to attract foreign investors and import well-made western products, force inefficient Chinese firms to improve their performance, and hence deliver better and cheaper goods to most of the population in order to convert them into loyal supporters of the regime. For this likely reason, the Chinese leaders have fended off the resistance by bureaucracies and inefficient domestic firms.

Chinese leaders have proceeded rightly toward deeper reforms in order to create a market economy that could better improve public welfare. State enterprise reform, equalizing reform and developmental progress across provinces, and moving the fiscal and banking systems toward centralized ones are chief examples. Nevertheless, Chinese leaders have yet to summon the consensus and the will for more painful initiatives in these or other directions, without losing political and macroeconomic balances. As this study has demonstrated, Chinese national leaders have tended to place political stability and popular support above efficiency in their reforms of recent two decades. It remains to be seen whether this balance point will change and where this balance art will take China's economy.

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The following data set, based on the data sources listed below, was used for the regression analyses.

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