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**Development Strategies, Welfare Regime  
and Poverty Reduction in China**

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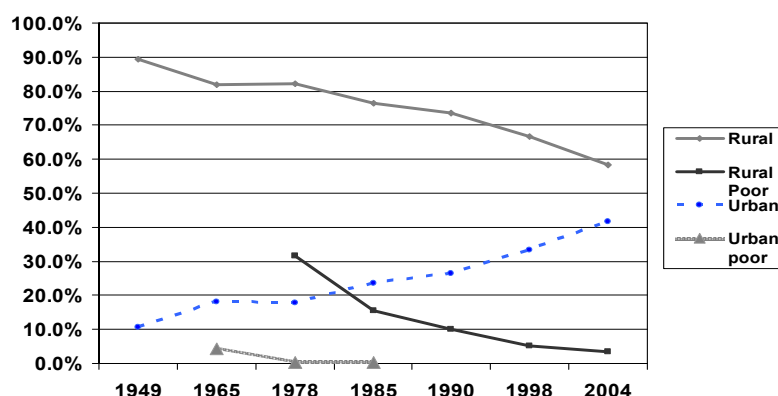
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## 1. Introduction

China achieved historic highs in reducing poverty in the 1980s with Deng Xiaoping's reforms. While there is disagreement about the precise number of people lifted out of poverty,<sup>1</sup> everyone agrees that growth in incomes and GDP have been phenomenal, especially during the early 1980s when the numbers in poverty were cut in half (Naughton 2007). At minimum, more than 200 million people were lifted out of poverty as per capita grain availability reached levels comparable to those in developed countries (Rozelle, Huang and Zhang 2002; Naughton 2007: 212-214; and Zhang 1993).

Most of the poverty in China, both during the Mao period and after reforms, exists in the rural areas. In this respect China differs from most developing countries, where poverty is an urban phenomenon (Naughton 2007). Changes in rural output and incomes were spectacular in China's countryside in the late 1970s into the 1980s. Official Chinese statistics indicate a 15 percent per year increase in per capita rural household income from 1978-1985.<sup>2</sup> As a result, since the mid 1980s "...the number of rural residents officially classified as poor has fallen significantly, from 113 million in 1986 to 65 million in 1995 to 40 million in 1999" (Park, Wang and Wu 2002). In the nearly three decades since the start of the reforms, the rural poverty incidence (based on China's official poverty line) fell from 31.6 percent in 1978 to 2.5 percent in 2005 (NBSC 2006). In 2006 it fell further to 2.3 percent in 2006 (LPOPAD 2007; Huang, Zhang and Rozelle 2007; also see Naughton 2007). As the following figure 1 shows,<sup>3</sup> China has made significant gains in reducing poverty, especially in the rural areas.<sup>3</sup>

Figure 1: Populations and Poor in China



\*Poverty percentages are the percentage of urban or rural residents who fall under the government's poverty line.

Source: Zheng, Yan and Jin (2005).

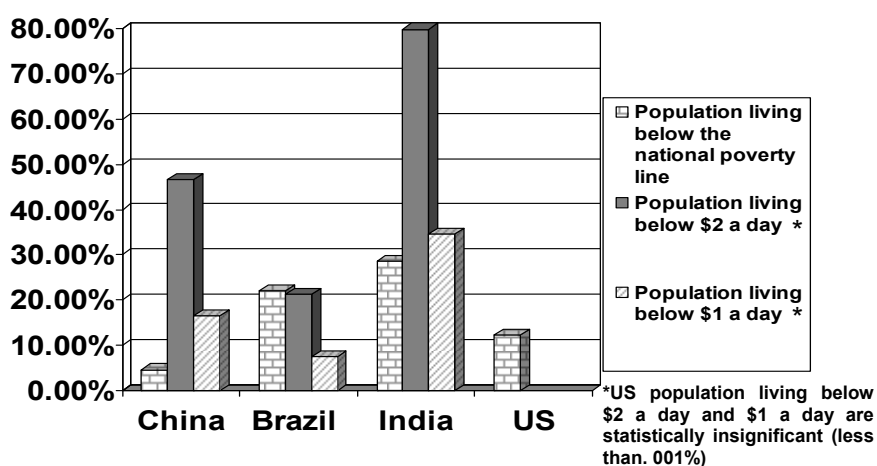
<sup>1</sup> The source of the disagreement is what one determines to be the poverty line. Official Chinese statistics are based on a much lower poverty line than the one used by organizations like the World Bank. Naughton (2007) indicates that the Chinese use 627 RMB per person per year in 2002. The World Bank's is "...equal to the in-country equivalent of one U.S. dollar per day, evaluated at PPP...". Also see Zhang (1993) and UNDP (2007).

<sup>2</sup> Again, Western economists are now questioning the validity of the precise numbers, but there seems little question that the growth was substantial (Naughton 2007).

<sup>3</sup> I thank Bill Hyde for his research assistance on gathering information on poverty in China.

The magnitude of China's achievement in poverty reduction is even more impressive when its performance is compared to other developing countries (see figure 2). We included the US to show the long way these countries still have to go, keeping in mind of course that pockets of poverty exist even in developed countries. Figure 2 starkly and clearly shows that China is well ahead of India in terms of reducing poverty.

Figure 2: China's Comparative Development-2006



Sources: Watkins (2006); DeNavas-Walt, Proctor and Smith (2007). Zhang, Huang and Rozelle (2003).

As impressive as these increases are, China is still far from solving its poverty problem. Some have yet to be lifted out of poverty. Moreover, as suggested above, the number of actual poor is an issue of debate.<sup>4</sup> Some, such as Naughton, suggest that much of the gains may have been due to the coming together of one-time factors, such as the increase in state procurement prices and other incentives introduced at the beginning of the reforms. The speed at which poverty decreased slowed after the mid-1980s, increasing for a few years between 1993 and 1996, but then again decreasing (Naughton 2007). Some of the poor have fallen into difficult economic straits as a result of the reforms. Income inequalities stemming from the reforms have created new tensions in society. These points of tension are considered so serious that the leadership has sought out new social policies in an effort to bring balance and create a “harmonious society” in the wake of three decades of blistering growth. Economists are now arguing that this new poverty, as well as other stubborn pockets of long term poverty, will require new and sustained efforts by the state. Specifically, initiatives aimed at poverty relief through new growth policies which target these remaining poor segments of the population (see Huang, Zhang and Rozelle 2007).

A crucial question is how much of China's success was due to poverty relief programmes and how much to the effects of economic development more generally. While important, it is beyond the scope of this paper to measure the role of poverty relief policies versus general development—that is a task best left to economists.<sup>5</sup> I

<sup>4</sup> For specialized studies devoted to trying to figure out the true levels of poverty in China. See, for example, Park, Wang and Wu (2002).

<sup>5</sup> For an excellent discussion of this complex issue, see, Park and Wang (2001); also Zhang (1993).

begin this paper with a brief overview of China's efforts over time to relieve poverty through assistance to the poor to give a sense of the specific poverty alleviation efforts undertaken during the Mao period and during the early years of reform. Such policies are obviously necessary, no matter how successful a country's economy. However, to understand how China managed to reduce poverty so quickly, one must examine those policies that promoted broad based economic growth and raised peasant incomes more generally.<sup>6</sup> If the goal is to draw some lessons about successful development strategies that may serve other countries in their efforts to reduce poverty, one needs to understand how China could grow its economy so quickly and raise incomes, especially in the rural areas, where the bulk of China's poverty exists. That is the task of this paper. As will be evident, a key part of that answer will centre on the particular nature of China's policy regime.

## **2. A Brief Overview of China's Poverty Alleviation Efforts**

During the Mao period, China had policies to provide special assistance to peasants in the event of a catastrophic, high profile disaster. However, the process for getting relief after a disaster that did *not* attract national attention was cumbersome and rarely achieved (Oi 1989: chapter 2). Such problems are common to any country. Approvals needed to be secured through the bureaucratic hierarchy. The Ministry of Civil Affairs was charged with the responsibility of relief efforts. There was the equivalent of a poverty line but instead of income, it was based on a minimum allocation of grain rations per person per month.<sup>7</sup> Because peasants were members of production teams under the commune system, relief was given to the team as a collective. The team then distributed the relief to individual households. If on average a team's rations fell below the set minimum, they were exempt from paying taxes and received state subsidized grain rations (*fanxiao liang*). The minimum distribution that qualified a team for this grain varied greatly by locality and was set locally. What set Maoist China apart is that in addition to the bureaucratic problems of receiving relief, political problems further stymied the process. Local cadres were hesitant to ask for relief from the upper levels because it reflected badly on their leadership abilities (see Oi 1989). In fact, the opposite sometimes occurred when local officials wanting to impress their superiors would allow grain to be extracted from villages when there was nothing left for the peasants. The massive famine during the Great Leap Forward can be partially attributed to this political phenomenon (see Bernstein 1984; and Oi 1989).

### **2.1 Organization of Poverty Reduction Efforts under Reform**

Soon after the de-collectivization of agriculture, central authorities started to build a substantial bureaucratic apparatus to address the poverty problem. First, some authority was devolved to the localities. In March 1985, the Ministry of Civil Affairs decentralized welfare policies and programmes that had previously been administered by the central government to each province. In 1986, a specialized inter-ministerial body, the Leading Group for the Economic Development of Poor Areas (LGEDPA),

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<sup>6</sup> Because the majority of poverty does exist in China's countryside, the focus will be on the rural areas, with only limited reference made to relief policies for urban areas.

<sup>7</sup> This was officially set at approximately 26 *jin* of grain rations per month per peasant. For more details see Oi (1989: chapter 2).

was established to oversee national poverty alleviation programmes.<sup>8</sup> In 1993, the central authorities instituted the 8-7 Poverty Reduction Programme and set a goal of lifting the 80-100 million remaining poor out of poverty by the year 2000.<sup>9</sup> The 8-7 Programme reaffirmed and expanded the role of the “...LGEDPA as the coordinating body responsible for poverty measurement and research, project planning and monitoring, and management of both domestic and international funding for poverty reduction” (Zhang 1993: 10).

Since the mid-1980s China has developed an extensive bureaucracy devoted to poverty alleviation as the following figure 3 shows. The State Council authorized the LGEDPA as the top anti-poverty executive body leading to coordinate anti-poverty programs at ministerial levels. Under the LGEDPA is the State Council Leading Group for Poverty Alleviation and Development (LGP), which “...has the responsibility to organize, research, draft policies and programs, coordinate and monitor efforts to solve the major issues in development-oriented poverty reduction among various relevant government ministries.”<sup>10</sup> But as the ADB report also states, the LGP usually meets only three to four times a year. The permanent administrative support agency for the LGP is the State Council Leading Group Office of Poverty Alleviation and Development (LGOP).<sup>11</sup> The national LGP and LGOP structure is mirrored at the provincial and county levels.

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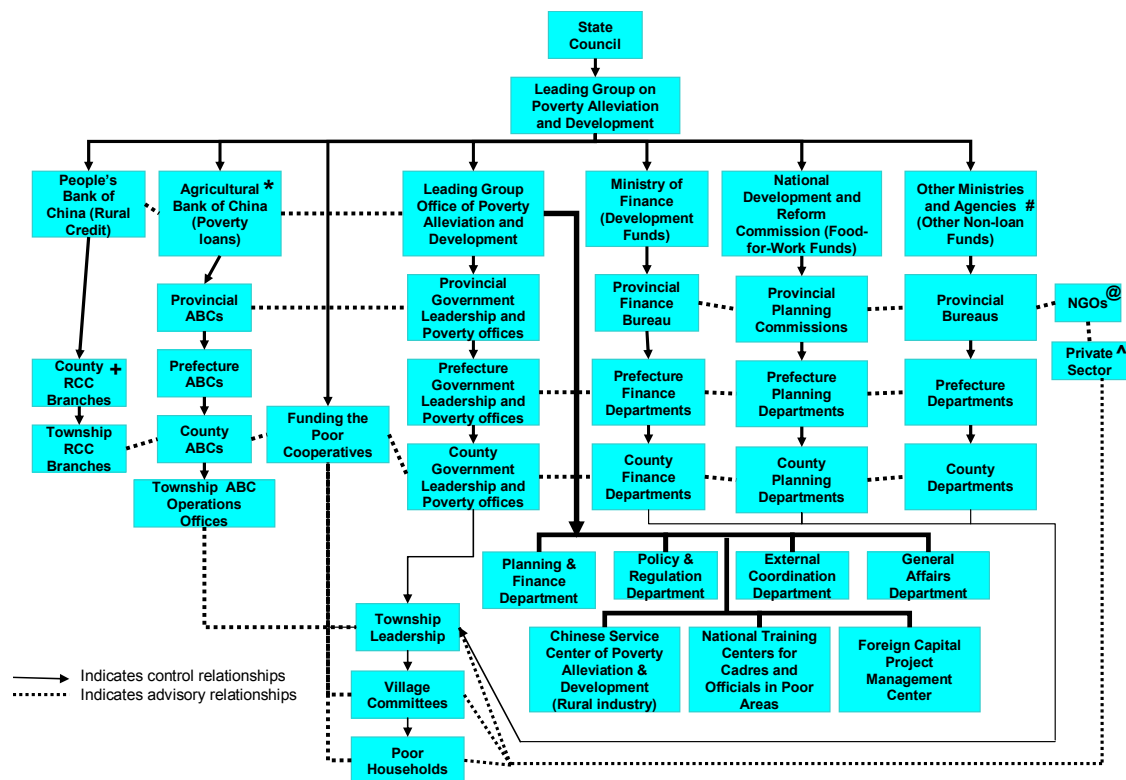
<sup>8</sup> The central government was already subsidizing poor areas, both through direct budgetary transfers (Park *et al.* 1996) and through subsidized grain sales and other assistance to peasants in need (Park *et al.* 1994).

<sup>9</sup> The 8 represents 80 million people and the 7 for the 7 years till the year 2000 (counting from 1994 when the programme was established).

<sup>10</sup> According to the ADB report, “The LGOP is headed by a Director General who directly reports to the LGP chairperson, who is a Vice Premier, and thus the State council, on programming and strategy issues. There are six associated or deputy chairpersons. There are 23 other members comprising vice ministers from a range of ministries, presidents of national government bureaus and commissions, and directors of agencies and Government Organized NGOs (GONGOs). In 2001 Staffing at the national level was around 120 personnel.” Asian Development Bank (2004: 50-52).

<sup>11</sup> One can see this in the functions of the LGOP: “... the day-to-day workload; policy research on development-oriented poverty alleviation; planning and organizing implementation; coordinating poverty reduction efforts from all segments of society...; coordinating and organizing government and Party Central Committee departments to reduce poverty in designated areas; determining the support criteria for the rural poor and State- targeted counties; deliberating on categorization and graduation of targeted counties; organizing and guiding statistical monitoring of poverty reduction; coordinating planning efforts to allocate central government poverty reduction funds; checking and supervising the application of these funds; guiding priorities for anti-poverty projects that cut across provinces; promoting public awareness of poverty reduction; interaction and cooperation with international donors assisting with poverty reduction; hosting the training of cadres from the PRC’s poor areas in the implementation of development-oriented poverty reduction; and handling and other matters referred to it by the LGP.” Asian Development Bank (2004: 50-52).

Figure 3: Institutional Framework for Poverty Reduction Policy-Making and Program Implementation



Notes:

\* For microfinance schemes only

# Particularly Ministry of Commerce, National Forestry Bureau, Ministry of Water Resources, Ministry of Science and Technology, Ministry of Education, Ministry of Public Health, Ministry of Communications, Ministry of Railways, Ministry of Information Industry, Minimum Living Standard Scheme, Ministry of Civil Affairs, and State Family Planning Commission.

@ Such as All-China Women's Federation, All China Communist Youth League, China Foundation for Poverty Alleviation, and Youth and Juvenile Development Fund.

^ Such as the Glorious Scheme.

Source: Asian Development Bank (2004: 51)

Provinces, prefectures and counties have all established Leading Groups and PADOs reflecting the LGP/LGOP structure at the national level. Many townships have one or two staff as the "designated person" to handle anti-poverty work. Provincial PADOs work with the Provincial Planning Commissions and the Bureaux of Finance. County PADOs prepare and approve project applications for central government poverty reduction funds (Asian Development Bank 2004: 52).

Aside from LGEDPAs and PADOs, the State Council also funds four other anti-poverty units that are under the sphere of the Leading Group: the China Development Foundation for Poor Areas, the Cadre Training Centre, the Training Centre Office, and the Economic Development Service Centre.<sup>12</sup> Among the Ministries and Commissions, the most important for poverty relief and reduction are: the Ministry of

<sup>12</sup>For the many other state institutions play an active role in poverty alleviation in China see Asian Development Bank (2004: 54).

Civil Affairs; Ministry of Finance; State Development and Planning Commission; and the Agricultural Bank of China.<sup>13</sup> The existence of so many agencies raises the question of whether there is an adverse effect of overlap and thus ineffective implementation of policies or a waste of resources.

As with many things in China, even in post-Mao China, it is only once a directive is given that a policy or project should be undertaken that everyone then mobilizes their resources. This includes poverty relief. Discussions with scholars, for example, who were previously at places like the Chinese Academy of Social Sciences (CASS) recall when they were sent to implement poverty reduction programmes in poor areas. Individuals or small teams would be sent out to poor areas to try to find ways to increase incomes and get residents to be more economically active. Probing into why some of these efforts are successful, one finds the situation reminiscent of upper level work teams being sent into poor communes during the Mao period. It was not just the leadership and new ideas that made such efforts successful in turning around a poor area. Often, it was that the work teams had the ability to appeal to higher level authorities and obtain additional resources (see Oi 1989). Similarly, an economist from CASS managed to turn around the economic situation for a poor county in Shaanxi by convincing central level authorities to route a new tunnel and national highway through the county, thereby greatly increasing access to the area and cutting the travel time to markets.<sup>14</sup>

Sending new talent and ideas to poor areas, allowing for the poor to learn from the rich is central to these policies. This can take a couple of forms. First, poor areas are taken under the wing of individual officials in more developed areas or other richer administrative areas help poorer administrative regions. For example, county level officials are sometimes designated to help a poor township or village to develop economically. They advise the village and give them tips on how to take advantage of economic opportunities. But most importantly, they may also be able to steer assistance and opportunities to these localities. A similar strategy is used on the provincial level—rich provinces are teamed with poorer provinces.<sup>15</sup> Beijing helps Inner Mongolia, Tianjin helps Gansu, Shanghai helps Yunnan, Guangdong helps Guangxi, Jiangsu helps Shaanxi, Zhejiang helps Sichuan, Shandong helps Xinjiang, Liaoning helps Qinghai, Fujian helps Ningxia, Shenzhen, Qingdao, Dalian and Ningbo help Guizhou (Zhang 1993: 11).<sup>16</sup>

Unlike the Mao period, where poverty status was a complicated process that had to be proven in each instance that aid was needed, in the reform period China designated poor areas as “poverty counties” that were nationally recognized as poor and thus

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<sup>13</sup> Zhang says that according to the “...1994 statistics the number of Central Party agencies, Central Government agencies and enterprises and institutions directly under the central government who participate in the partnership effort increased from 81 in 1993 to 120 in 1994. At the same time, 2457 provincial party agencies, provincial state agencies and enterprises, institutions and mass organizations directly under provincial government also conducted similar activities in 660 poor counties defined by the central government and provincial governments.” Zhang (1993: 10).

<sup>14</sup> Instead of having to travel days to go around the mountains in this county, the new highway and section of tunnel cut directly through the mountain.

<sup>15</sup> This is one of the major measures instituted in the 8-7 Programme.

<sup>16</sup> Recent research in Shandong, for example, suggests that this partnering has had some effect. Some industrialized counties in Shandong, for example, have set up a number of factories in Xinjiang. Author interviews.



deserving of receipt of regular subsidies. This status, while not permanent, is something that can be maintained until development and average income rise above the poverty line. However, it seems that once a county obtains poverty status, it is difficult to take it away, even if they no longer meet the eligibility requirements. This explains why the number of officially designated counties has expanded over time. There are 592 such counties or 28 percent of all county-level administrative districts in China (Park, Wang and Wu 2002: 123-153). Some officially designated “poverty” areas engage in all sorts of strategies to keep their “poverty status”. These efforts include purposely under reporting their development efforts (see, for example, Guo 1999).

In addition to the official nationally designated “poverty counties,” provincial prefecture, county, and township governments have complemented national government efforts by developing and funding separate poverty reduction programmes. They have established their own criteria to determine and give poverty status to counties, townships, villages and individuals other than those designated as national poverty counties (Asian Development Bank 2004).

## ***2.2 Early Poverty Reduction Policies and Their Problems***

Poverty reduction policies have changed over time. Policies during the period 1986–88 clearly dictated that funds be used for direct poverty alleviation, mainly by channelling loans to households for use in agricultural production and other basic needs (State Council 1989; World Bank 1992). In the 1990s, however, lending preferences changed to favour investment in village and township level economic projects. Since 2000, the emphasis has shifted to even longer term goals that help the low-income groups improve their development capabilities in addition to solving more immediate subsistence problems.

The three major poverty programmes are: 1) the subsidized loan programme (*tixiedaikuan*), administered by the LGEDPA and the Agricultural Development Bank; 2) the public works programme, Food for Work Programme (hereafter FFW) (*yigong daizhen*), run by the State Planning Commission; and 3) the Development Grant Programme (*fazhan jijin*), managed by the Ministry of Finance.<sup>17</sup> In addition, in the mid-1990s China began experimenting with microfinance. Pilot projects were spearheaded by NGOs using versions of the Grameen Bank model. Implementation was initially without policy or financial involvement from the government. By the end of 1996, total capital investment in microfinance projects in China had reached almost ¥90 million.

The operation and effectiveness of these programmes are plagued by implementation problems. Regardless of how well intentioned policies may be, because funds are disbursed and used at the grass roots level often far from the policy makers, local officials have the ability to use and abuse these programmes to serve local interests. China is a one party, authoritarian system, but the centre’s ability to regulate its agents

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<sup>17</sup> One of the most comprehensive studies is by the Asian Development Bank (2004); also see Park, Wang and Wu (2002).

at the lower levels of the state is limited. This was true during the Mao period and it holds true now. Local governments will pursue local interests whenever they can.<sup>18</sup>

The subsidized loan programmes received the most poverty relief funding, but these funds may also have been the most fungible. During the 1980s, these types of earmarked funds were diverted for local investment, especially to develop local enterprises. Local officials were able to misappropriate the use of earmarked funds, especially during the late 1980s, when there was a retrenchment that cut credit to Township and Village Enterprises (TVEs) (see below and in Oi 1999). It is not surprising that local officials would try to maximize the return on funds that flowed into their hands. Not until the mid-1990s, when rural industry was on the decline, did policy mandate that subsidized loans be used for poverty reduction. New rules required that the bulk (70 percent) of the loans go to poor households. Moreover, these rules further required that 70 percent of these funds be invested in agriculture (Asian Development Bank 2004: 56-58).

The FFW programmes had different problems, but again they revolve around problems of implementation and how localities made use of the funds. The State Planning Commission established FFW in 1984 to use surplus grain and cotton stocks to fund infrastructure construction in poor areas. The idea was to pay peasants for work on the farm during the off season to build roads, irrigation systems, etc. By 1996 peasants were paid in cash for this type of work by central and local governments (Asian Development Bank 2004). An ADB report notes that a significant number of infrastructural projects were completed.<sup>19</sup> However, it should also be noted that there are questions of whether these were the projects that most benefited local peasants. Regardless of the intentions and the success of projects, there were clearly implementation problems. For example, the well intentioned FFW programme, designed for poverty alleviation, may have actually created new burdens for peasants.

The FFW program may have allowed localities to force peasants to work more than was intended under the programme. The problem called for the implementing unit to be local government, in this case, county governments. There is some question regarding whether peasants in the programme were properly paid for all of their work. As a result, local authorities may have used this programme to force workers to contribute free labour towards road building or similar projects rather than to give the poor a special benefit.

There was a distinction made between centrally funded projects that would have fallen under the FFW program and local projects. There is evidence that the two were merged with the result that peasants only received money from the FFW programme but they were nonetheless required to do the locally directed projects as well. Often these were done with little or no pay. Research on the Mao and post-Mao period suggest that *corvée* labour (*yiwu gong*) was a widespread problem (Oi 1999). *Corvée*

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<sup>18</sup> This perspective is developed in Oi (1989) which covers the Mao period, and in Oi (1999), which covers the reform period.

<sup>19</sup> According to the Asian Development Bank (2004: 64). "In the 15 years between 1984 and 1998 FFW projects totaled 300,000 kms of new or improved roads, 63 million people and 54 million heads of livestock gained access to safe drinking water, 55 million mu of farmland had been developed, 83 million mu of farmland had been terraced, 42,000km<sup>2</sup> of land degraded by soil erosion had been brought under control, and more than 46 million mu of timber and orchards planted."

labour was mobilized for precisely the same type of infrastructural work that was defined as the scope of FFW. FFW policy specified that FFW funds should be matched by counterpart funding from both provincial and county levels. However, due to the already impoverished nature of local financial bureaus, especially in poor localities, counterpart funding was rarely provided. Instead, what commonly happened was that central funds covered the capital equipment and material costs of construction, while the voluntary labour of villagers was used to offset the shortage in local counterpart funding.<sup>20</sup> It was only after 2000 that such levies were completely abolished.

From these problems alone it is quite obvious that China's poverty relief efforts could not possibly be the major driver of increased incomes and overall well-being. To understand how China's peasants managed to improve their income and overall livelihood, let us now turn to the major question of this paper—how was China able to generate such rapid turnaround in its rural areas and raise the incomes of the majority of peasants within a relatively short time period.

### **3. Institutional Change and Economic Development to Increase Incomes**

A key lesson of China's economic reforms, especially in the rural areas, where the reforms were first instituted, is that institutional change can promote economic development, regardless of regime type, if the necessary incentives are provided and resources can be mobilized. It suggests that the rational actor model, which says that incentives play a key role in determining the behaviour of economic and political actors, central to determining economic growth, can be extended to political actors in communist, as well as democratic systems. There is no need to accept the notion that communist officials would obstruct or fail to respond to incentives, simply because they are in a one-party, Leninist system. In the case of rural China during the 1980s, we can understand what prompted rapid economic development by examining those factors that affected the behaviour of peasants and the local officials who oversaw development when China began its reforms. What caused them to change their previous patterns of behaviour? How did they mobilize the necessary resources? By examining key institutional changes we can gain some insights into the development process that contributed to the dramatic rise in rural incomes in China.

A feature of China's reform experience worth noting is that large parts of its centrally planned economy were dismantled without local officials necessarily losing power (Oi 1992, 1999). This point is important as it demonstrates one of the reasons why reforms were not obstructed but promoted by local officials. Unlike the situation in Russia or Eastern Europe where there was a revolution and adherence to the "big bang" approach to reform, China purposively used many of the existing personnel and kept its core institutions even as reforms were also being put in place—this was part of the "growing out of the plan" or "groping for stones to cross the river" model of change. The key to China's reforms was not so much what was dismantled, but what was left of the old system, and how the new institutions were crafted. Contrary to

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<sup>20</sup> The Asian Development Bank (2004) states that this type of corvee labor may have provided as much as 40 percent of FFW labour.

earlier theories about how communist officials would react to reform,<sup>21</sup> China's peasants and officials responded to incentives because they were crafted in such a way as to benefit their economic and political well-being.<sup>22</sup>

The institutional changes that China instituted beginning in the late 1970s are well known. They include the de-collectivization of agriculture and the return to household farming, under the household responsibility system, the opening of free markets and the rise in procurement prices of farm output. Along with changes in agricultural production one also sees the dramatic rise in rural industry.

Below, let us examine the changes in turn to highlight the unique aspect of these policies and how they contributed to China's rapid economic development. A key goal of this discussion is to examine how the policy regime and character of the institutions might explain the rapid economic rise in China that brought increased rural incomes. This discussion will be divided into two parts. The first part considers what caused peasants to dramatically increase grain production, beginning in the late 1970s. This would tell us something about what drives peasant behaviour. The second considers how rural industry (which contributed the most to increased peasant incomes after the reforms began) took place, who spearheaded its development, and how resources were secured to achieve such rapid growth.

### ***3.1 Changing Incentives to Increase Peasant Enthusiasm for Production***

Among the changes instituted after the third Plenum in 1978, the de-collectivization of agriculture and the return to household farming represents one of the most significant departures from the Mao period. Some might argue that these reforms were central in spurring the change in peasant behaviour, the reason being that each peasant household gained the right to farm a piece of land and enjoy the right to any surplus from that land. The collective no longer stood between the peasant producer and the harvest.<sup>23</sup> Decollectivization was in many ways akin to a second land reform—the re-division of land in an equitable fashion to each household. Like the original land reform in the early years of the People's Republic of China (PRC) right after 1949, this was a terribly contentious process that sometimes took months, with many charges of cadre corruption. Sometimes disputes could only be settled by drawing straws to determine who should get what piece of land. At stake was, of course, the quality and character of the primary means of production for peasant families. How rich was the land? How far was it from the family house? How far from sources of water for irrigation?

Having equal land distribution, obviously, would give each family the resources to think that they too could benefit from Deng Xiaoping's dictum, that it was acceptable for some to "get rich first". This provided the basis for hope, something that should not be underestimated. However, a case has been made that the household responsibility system, while important, would not have been enough by itself. First, it needs to be pointed out, that this was not privatization. The ownership of the land remained in collective hands. Individual families had the right to the surplus from the

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<sup>21</sup> See, for example, the classic work by Kornai (1992), which argues that Leninist officials would obstruct reform if reforms threatened the planned economy.

<sup>22</sup> I develop this argument in Oi (1999).

<sup>23</sup> See Oi (1989) for a detailed discussion of this process and its impact.

use of the land and the right to manage the land, but did not have the right of alienation—i.e. to sell or transfer the use of the land. Thus, the answer to why peasants started to work harder to grow more grain cannot simply be attributed to a change in property rights.<sup>24</sup> There was a change in property rights, but only a partial change if one accepts Demestz's idea that property rights are actually a bundle of rights (see Demestz 1983). Decollectivization transferred the right of management and the residual from the land to the peasant households, but the right of alienation, the right to sell the land, remained with the collective. Property rights are important, but may not provide the full answer to why peasants would work the land harder to produce more. During the Mao period, the collective owned the land, but that did not mean that production teams worked to maximize output.

Some economists have argued that the dramatic increases in grain production that began in the late 1970s and lasted until the mid-1980s may have occurred even without de-collectivization. Those who make this argument say that a far more important and necessary development than decollectivization accounted for the dramatic increases in procurement prices (see Putterman 1988; McMillan, Whalley and Zhu 1989; Oi 1989). Producers knew that they could keep the surplus after paying the required taxes and making the required sales of grain to the state, but they were even more excited by the knowledge that they would receive up to 50 percent more for the entire amount sold over the basic quota. Even under collective production, assuming that the state also raised the ceiling on the amount that could be distributed; this incentive would have been effective.

Here, as we consider the importance of price increases for agricultural output, let us take a moment to consider the re-opening of the free market as a catalyst for the success of China's rural reforms. Without question, the re-opening of markets was an extremely important component of the reforms—the knowledge that peasants, once they satisfied whatever state obligations they had, could then take their goods to the market. It is also important to know that one could buy much of what one wanted at the market, thus being able to sidestep what had been a state monopoly on the sale and procurement of goods during the Maoist period. However, the market was not the ultimate driving force assumed in the “Washington consensus”. In the case of China, which was a transitional economy, there was both plan and market. This is significant because it led to a situation where the market was *not* always the first choice for either the sale or the procurement of goods if the state offered a better a better price.<sup>25</sup>

It is important to remember that in the late 1970s and early 1980s, when grain production rose to historical highs; the ability of peasants to sell their surplus on the market is not what prompted them to ramp up production. Selling on the market would subject peasants to the vagaries of supply and demand, and changing market prices. The key incentive for peasants to grow so much more grain was that they had a guarantee from the state itself that they would receive a 50 percent bonus for all over-quota sales. It was state procurements that provided peasants a secure market for their output at guaranteed prices, not the free market. Guaranteed state procurements at pre-

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<sup>24</sup> Some have argued the lack of privatization or security reduced the investments in land because of the insecurity of peasants about their future use of the allocated land. See debate between Scott Rozelle and James Kung among others, for example, Brandt, Huang, Li and Rozelle (2002); Kung and Liu (1997); and Kung and Cai (2000).

<sup>25</sup> For details see some early examples in Oi (1986a).

set high prices thus made it exceedingly lucrative for peasants to work harder to grow more and sell more to the state. Thus, one of the most effective institutional changes China made was simply to provide greater incentives through price reforms, little was required in the way of additional knowledge or resources on the part of individual households other than more effort and the willingness to sell to the state (see Naughton 2007).

The effectiveness of grain procurement price increases was so great that the state in the early 1980s faced the unprecedented problem of not being able to handle all the grain that peasants took to state granaries to sell. Granaries were overwhelmed; grain was left out on the road to rot and be eaten by rodents; peasants had to wait days to sell their grain or to bribe local officials to even take their grain.<sup>26</sup> The effectiveness of price incentives is further reflected in the fact that when peasants realized that they would not have a guaranteed state market at guaranteed high prices, i.e. when the state changed its procurement policy and made it less lucrative and secure for peasants to produce more grain, and peasants were forced to go to the open market where prices fluctuated and fell because of excess supply, harvests went down and the state again faced problems in grain production. The point is that peasant productivity responds to price signals and economic incentives, whether these are given by the market or by the state. This is a key lesson to be learned from China's agricultural reforms.

In addition, while probably not as measurable or direct, it should be remembered that there was an accompanying change in what peasants could do with the money they earned. Along with the opening of the free market and price increases, the structure of the economy was modified so that more consumer goods were being produced. Peasant producers had more to buy, whether in state stores or on the free market. Thus, in contrast to the Mao period when everything was rationed and one needed not only money but ration tickets, with these reforms, peasants had new reason to want money to buy the increasing number of goods that were now available in the free market.

### ***3.2 Diversify the Economy and Migration to Expand Options for Increasing Incomes***

The take away message of the early years of China's reform should not be that all a country needs to solve rural poverty is to open markets and promote increased grain production. The more important findings are two fold. First, China found a very effective way at the beginning of the reform process to get peasants to work harder, produce more grain and thus earn more money. Second, it did so without much additional investment from either the state or individual producers. Moreover, through the rise in guaranteed state prices for grain prices during the initial reform period, China provided incentives for all peasants, regardless of how close they were to markets, or their ability to produce other crops, to cash in on the reforms and take advantage of the higher prices for their harvest. Expectedly, as the state phased out price guarantees for all over quota sales, grain production became less attractive. Moreover, the incentives created by price increases were relative to the alternative channels for income creation. Here, the opening up of markets came into play, but the

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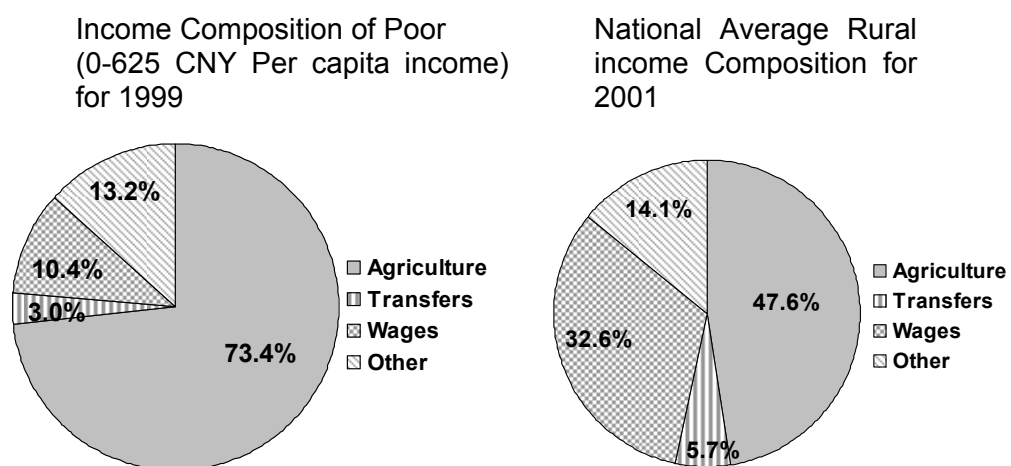
<sup>26</sup>This is detailed in Oi (1986b).

difference is that only some peasants had what it took to take advantage of the opportunities that the reforms offered.

Along with decollectivization, the state also opened the door to the diversification of production. No longer did everyone have to grow grain; no longer was production dictated entirely by the plan. The peasants who had the knowledge and the skill required to grow cash crops such as vegetables and fruit could now reap much higher returns than those who stayed only in grain production. In the longer run, grain production has not been the route to increased incomes. In fact, as many existing studies have shown, staying in grain production has left regions behind economically.<sup>27</sup>

While cash cropping brought more income than grain production, we also know that those who stay in agriculture are still at a disadvantage in terms of income. Economists such as Rozelle have shown that the greatest income disparity in rural China can be seen in wages from off-farm income (Rozelle 1994; Naughton 2007). Along with the structural changes in the production of agriculture and new incentives, we also see peasants taking different routes to earning their livelihood. The following figure 4 shows that the poor rely predominantly on agriculture as their major source of income. While the composition of the income of the overall rural population shows agriculture to be about 47 percent, it is more than 73 percent for the rural poor. Conversely, high yielding work in wage labour for the rural poor only make up a little more than 10 percent of their income, while for the rural population as a whole wage labour constitutes more than 32 percent. A 2006 survey shows that low income from agricultural production remains one of the three leading causes of poverty.<sup>28</sup>

Figure 4: Income Composition



Transfers refer to wages remitted to households by members who have left and work elsewhere.

Sources: NBS, 2000. *China's Rural Poverty Monitoring and Evaluation Report*. Beijing and NBS, 2002. *China Statistical Yearbook 2002* cited in Asian Development Bank, 2004: 37, 39.

<sup>27</sup> For a detailed discussion of the problems in agricultural areas see Bernstein and Lu (2003).

<sup>28</sup> Finding reported by Lu Mai, Secretary General, China Development Research Foundation, cited in Stephen Green, 27 Sept. 2007 email.

### 3.3 Migration

Migration to the cities is the most common route taken by rural residents in search of higher incomes. In developing countries, millions of poor who leave their villages end up in dire situations such as the shantytowns of Latin America or the streets of cities like Calcutta. In China, too, the same dreams have taken hold of the young, both male and female. The number of migrants has grown since the reforms began in the late 1970s.<sup>29</sup> The building boom in China has fuelled the growth of that construction industry as a source of higher wages for peasants.

While China has its share of migrants, including beggars, China differs from India or the Latin American countries in its ability to control the influx of rural migrants in search of jobs. This was especially the case during the Mao period when the combination of rationing of basic necessities, most importantly grain, and the household registration system (*hukou*), kept those without urban household registration in the countryside.<sup>30</sup> In China, once the reforms began, migration controls were undermined as free markets were opened and peasants had a way to secure food and housing. More and more peasants found it possible to venture into the cities. However, authorities were capable of, and indeed, periodically engaged in sweeps to clear out the make shift communities that were set up in cities like Beijing.<sup>31</sup>

The attitude and actions of the authorities suggest an inconsistency that reflects their ambivalence about migrants. On the one hand, migrants are needed to fill menial labour positions such as housekeepers and nannies; jobs that urban workers do not want. On the other hand, migrants are the first to be blamed for the rise in crime. In addition to demanding that workers accept lower wages and benefits, the authorities, especially those at the centre, see migration as an important way to raise overall incomes in the rural areas, especially the poorest ones.

Tremendous regional disparities exist in China, especially between the coastal, interior and western provinces. As in any other agrarian society, the hope is that those migrating will bring home new skills and generate growth.<sup>32</sup> It is still unclear how much of this is occurring. What we do know is that remittances from migrants sent back to their hometowns continues to narrow the income gap (Croll 1997). While money sent has improved lives of family members back home, at least in the short run, there are many problems associated with the strategy. First, a high price is paid, not just by those going to the cities to endure harsh conditions, but also for their families, which include the children left behind. Sometimes both parents work in the cities. It has been difficult for migrants to take their children with them because they have not been eligible to receive public services, including the right to attend school. Only recently is this policy changing as China finally attempts to right this situation by allowing those who work in the cities more access to public goods. There is the additional problem of peasants in poor villages foregoing employment, and instead

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<sup>29</sup> The literature on this subject is quite rich. See, for example, Rozelle, Li, Shen, Hughart and Giles (1999); Rozelle, Zhang and Huang (2001). Also see Woon (1999).

<sup>30</sup> For details see Oi (1989).

<sup>31</sup> This has been best documented for “Zhejiang village” in Beijing. See Li (2001).

<sup>32</sup> For an early statement of this hypothesis see Wolf (1969).



living off the relatively lucrative amounts of money remitted by relatives (Croll 1997).

While China does mirror other developing countries in its flow of workers from rural to urban areas, it has not been a blind flow to cities.<sup>33</sup> One of the more interesting things about China's migration is the organization that surrounds much of this movement. Peasants seek industrial jobs, often far from their villages, in different parts of the country. We know that peasants in other developing countries rely on networks to find jobs in cities. However, organization is taken to another level in China. Local officials in poor areas, where there are few off-farm opportunities, often act as labour brokers. Entrepreneurial officials seek out factories, near and far, that need workers. Officials work out contract terms with the firms, sign a contract for a set number of workers, set out the wages and benefits, etc., and then recruit local peasants for these jobs. Often, assuming that a fairly large number go to one factory or locality, buses are sent to bring peasants home for the holidays. In interviews, for example, in a relatively poor county in Henan, officials found jobs for locals in much more developed provinces like Guangdong. Peasants who are fortunate enough to have local officials acting as agents are assured of a job before they leave their home villages. This may explain the relatively low number of homeless and jobless migrants in the cities.

### ***3.4 Wages from Rural Industry***

Migration was not the only way that peasants could find off-farm wages. As part of the diversification of the rural economy, China also began a process of industrialization in the rural areas during the early 1980s. Peasants became workers in factories, however, these were located in the countryside, often in the peasant-workers' home village or in their township. It was this rural industrialization that lifted China's economy out of the doldrums, increased rural incomes, and provided new jobs and wages.<sup>34</sup> The rise of these TVEs<sup>35</sup> was at the heart of China's economic miracle. Some even attribute TVEs as providing the competition that may have forced State-Owned Enterprises (SOEs) to improve their performance.

There had been rural industry during the Mao period, mostly in the form of commune-level enterprises. However, the phenomena that occurred starting in the early to mid-1980s went beyond anything that could be explained by these limited number of commune-level enterprises. Between 1978 and the mid-1990s, according to Naughton, employment in TVEs grew by 9 percent annually, from 28 million in 1978 to a peak of 135 million in 1996. TVE value added went from 6 percent of GDP in 1978 to 26 percent of GDP in 1996. Along with this growth came the creation of new jobs that were essential in explaining how China managed to get so much of its population out of poverty after the de-collectivization of farming. Rural industry

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<sup>33</sup> In fact, migration from one rural area to another has been going on since the reforms were instituted. It is usually to areas where local peasants have already found lucrative non-farm jobs, including migration to big cities, and thus there is a shortage of those willing to work the land. Peasants too busy to farm rent out their land to those from poorer areas who are more than willing to work the land.

<sup>34</sup> This did not mean that some peasants didn't also try to migrate to cities in search jobs—that occurred as well.

<sup>35</sup> This term, TVE, is shorthand for the four types of firms that developed rapidly as a consequent of the reforms: two forms of collectively owned firms—township or village owned enterprises, and two types of privately owned firms—jointly owned firms and individually owned firms.

absorbed a large number of the surplus labour created after the move towards household farming. Townships and villages that had never had industry began setting up factories, producing goods ranging from simple agricultural based items like tofu and soap, to more industrial items like steel piping and chemicals. Both the scale and rapid rise of these firms were impressive, especially at the village level, which saw the growth of the largest number of firms.

#### **4. How to Develop Rural Industry from an Agricultural Base**

The economic history of most countries suggests that industrialization is the route out of rural poverty. Industrialization is usually accompanied by urbanization, where large numbers of those who had previously farmed for a living become workers and move from rural to urban areas. China had long ago gone through industrialization and had major industries in its many large cities. However, a few years after the reforms began, around the time of de-collectivization, a new process of industrialization emerged that was very different from what had occurred earlier in China and for that matter, the rest of the world.

China's rural industrialization, which resulted in new jobs and increased incomes, stands as an attractive model for reform and for reducing poverty in other developing countries. However, as the following sections will show, what occurred in China is not necessarily exportable. China's story of success was a combination of institutional innovation and path dependence. As counter intuitive as it may seem, China's Maoist legacy and particular form of central planning were key and allowed for rapid growth in rural industry (Oi, 1999) .<sup>36</sup> The rise of rural industry is one of the clearest examples of how China's policy regime impacted its development strategy and subsequent outcomes.

The problems of state-led growth are well known. Problems ranging from incompetence to corruption have been the subject of much scholarship in countries including China and those in Africa.<sup>37</sup> The cases of China before reform and the Soviet Union are prime examples of the failures of centrally planned economies. While the centrally planned system of the Mao period can be blamed for the disappointing performance of China's economy, as I have described elsewhere, the legacy of the Maoist system, coupled with changes in the incentives for those overseeing development, became a key variable that allowed rural industry to develop rapidly (Oi 1999). Local officials spearheaded the rapid growth of TVEs. It was a state-led effort, but, more importantly, it was a *local* state-led effort. A new set of powerful incentives made the difference.

##### ***4.1 Local Cadre Incentives for Pursuing Rural Industry***

If any country wants to replicate China's experience, it must give those responsible for overseeing local level development—the local agents of the state—sufficient incentives to support reform and pursue development. The underlying premise is that

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<sup>36</sup> We now know that there were differences in the way central planning worked in different Leninist systems. It is unclear that Russia would have had similar success if it had followed similar policies. For a discussion of some key differences see Goldstein (1996: 143-169).

<sup>37</sup> For citations to this literature see Oi (1999: chapter 1).

when officials are presented with a new set of incentives, they will be enticed to change their behaviour. We hold this to be true in the case of China, despite operating in what is still a communist system. As I have written in other work, China's officials, like those in any political system, "are rational actors who respond to incentives and existing constraints within the limits of their cognitive ability to evaluate alternatives and process information" (Oi 1999: 7). Local level officials, while agents of the central state, will not necessarily always follow the policies of the central state. To understand policy outcomes, especially in China, one needs to disaggregate the "state". Local governments, while under the control of the upper levels, are also distinct entities from the central state and society, with their own agendas. The centre formulates policies, but the policy outcomes, regardless of how well intentioned the policy, depend on how these policies will be received by those at the lower levels, whether there are sufficient incentives, positive and negative, to encourage those at the local levels to implement these policies. Policy formulation and implementation are two entirely different things.<sup>38</sup>

Obviously, incentives alone do not determine policy outcomes. Development is an extremely complex process, there is no magic formula. The effectiveness of incentives will be mediated by the constraints, skills and available resources in a locality to shape economic outcomes.<sup>39</sup> The following sections will examine the incentives that led China's local communist officials to want to develop rural industry in their areas of administration.<sup>40</sup> As the discussion will show, the incentives differed for township and village level officials.

#### *4.1.1 Incentives for township-level officials to develop rural industry*

The reassignment of property rights over increased revenues generated at the local levels prompted local cadres to be entrepreneurial and develop rural industry. The fiscal reforms in 1980 instituted a revenue sharing system. Localities only had to give the upper levels a set portion of the taxes—the quota amount—the residue was theirs to keep and use. Moreover, there was a separate category of taxes that were exempt from revenue sharing. These extra-budgetary revenues belonged entirely to the localities. Under the revenue sharing system, the rights to all over-quota revenues generated at the local level belonged to the locality. The key to why this policy was such a strong incentive centres on how it affected local administrations and individual officials within a locality.

Put simply, increased revenues generated at the local levels not only went into the local coffers for administrative expenses, etc., but these revenues could be used as bonuses to be given to individual cadres at a particular administrative level. Thus, local coffers had more funds to make administration easier, affording officials the ability to provide more public goods or make further investments in the local economy. Equally, if not more, important, cadres who worked hard to generate increased revenues also personally benefited from bigger pay cheques. Interviews reveal that during the boom periods in localities with successful rural industry, bonuses received by local cadres were sometimes more than their basic wage. The

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<sup>38</sup> See Grindle (1980) for excellent studies of the failure of well intentioned policies formulated to help the poor in developing countries.

<sup>39</sup> See Oi (1999) for discussion of these other factors.

<sup>40</sup> It should be noted that not all areas successfully developed rural industry. The effectiveness of incentives is different from the ability of all local officials to be able to capitalize on those incentives and have the necessary skills to make industrialization work.

reassignment of property rights to those who successfully implemented reforms explains why the China case goes against established wisdom that says cadres in Leninist systems will not support reform (Kornai 1992). Unlike the case of Russia where the power of cadres was threatened by reform, there was little reason for most Chinese cadres to oppose reforms like the revenue sharing system and the development of TVEs. The two in tandem allowed cadres to increase their take home pay.

Moreover, it was crucial that when the reforms started, the TVEs that were promoted were collectively owned, i.e. those at the township and the village levels. This is significant, as it meant that these were enterprises that were still under the control of local officials. The number of private firms was much larger than the number of collectively owned ones, but, as I indicated earlier, the private ones were small and remained small because they were not allowed access to the capital needed to develop industry of any scale. Support by local authorities of privately owned firms came much later, only in the 1990s, after the collectively owned ones started having problems.<sup>41</sup> This progression of ownership forms, starting with the collective, helps explain why the China case seems to go against established notions about the response of communist officials to reform. China's reforms did not threaten the power of most incumbent cadres. In contrast to scenarios likely imagined by those who would argue that communist officials would oppose reforms, the development of collectively owned enterprises not only did not threaten cadre power, it enhanced it. Thus, it was relatively easy to get local officials to buy in. Moreover, as the reforms took hold, it became clear that the route to political success and to bureaucratic promotion was to successfully develop one's locality. Thus, officials who wanted to get ahead politically also had an incentive to pursue rural industry and generate increased revenues.

#### *4.1.2 Incentives for Village Level Officials to Develop Rural Industry*

For cadres at the village level the incentives were different. Because it is not considered a level of administration, the revenue sharing policy did not apply. For village cadres, the incentive for developing rural industry boiled down to the need for new sources of *collective* income and the power that came with controlling resources and the de-collectivization of agriculture. When the household became the unit of production after the communes were abolished and the responsibility system put into effect, the rights to agricultural revenue were taken away from the collective and given to the household. Households gained the right to decide the disposition of the surplus after state taxes and sales were made. The collective, instead of giving peasants their share of the harvest, now was dependent on each peasant household to get its only source of revenue, the allowed surcharge, the *tiliu*, which was paid by the household to the collective. But these fees were a small amount tied to a percentage of peasant incomes.<sup>42</sup> Thus, if a village had no other sources of collective revenue, there were little or no funds to provide public goods, sometimes there was not even enough to meet the most basic expenditures. Some village coffers became so poor that village cadres were incapable of governance—some villages became known as “paralyzed villages,” where peasants refused to listen to the cadres and the cadres were void of power because they had little to hold over peasants and were incapable of providing

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<sup>41</sup> There were areas, however, where private firms were dominant from the start such as in Wenzhou and parts of Fujian. See Oi and Walder 1999.

<sup>42</sup> The limit was 5 percent, which included the fees that were to be paid to the townships.

services due to their lack of resources. Ironical as it may be, successful de-collectivization became the root of the “peasant burden” problem that has led to protests and substantial discontent in China’s countryside. Villages devoted primarily to agriculture found themselves in a situation where the only way they could get enough revenues to fund the local coffers was to increasingly demand more surcharges and fees from their peasant households.

However, those villages that were able to successfully mount a village collective enterprise were able to generate and use profits from these collectively owned firms to more than make up for the loss of revenue from the sale of the collective harvest. It is easy to see why village cadres would want to try to do this. With de-collectivization, village cadres lost much of their power. The creation of a village-owned enterprise meant that a village leader mobilized new resources that could become a new power base—this consisted of profits from the firms but also the jobs that were created, which could be doled out to village members. Again, the incentives worked so that promoting development enhanced rather than hurt the power of officials. Some of the most successful village leaders could be promoted to the township level. At minimum these high achieving cadres received accolades, some attained a seat in the local people’s congress and some were named national models. Thus, both economic and political incentives were geared toward promoting growth.

#### ***4.2 The Politics and the Property Rights of TVEs***

Behind China’s reform strategies, particularly in the 1980s and into the 1990s, were political constraints. China’s reform leaders were extremely cognizant of the need to protect certain ideological tenants—to legitimize Deng Xiaoping’s claims that China would still be a socialist system with his reforms. In the case of agriculture, the household responsibility system gave peasant households the right to the surplus from the harvest, but it is important to remember that the ownership of land, i.e. the right of alienation, remained with the collective. The ownership of farm land has never been privatized. Similarly, the reformers were hesitant to change the property rights of its state-owned enterprises, where workers were provided for under the well known “unit system” and benefited from the “iron rice bowl,” regardless of how profitable the factories were (Walder 1986). By the end of the Mao period, it was clear that these factories needed to be radically reformed. Yet, regardless of the need to trim away the fat and let go of excess workers to make operations more efficient, China’s reformers were extremely hesitant to touch what was the core of China’s centrally planned economy. Not until the late 1990s was there any sizeable effort to privatize these firms.<sup>43</sup>

The rise of TVEs is a prime example of China’s overall strategy of reforming around the edges of the still existent centrally planned system—a strategy that has been dubbed as “growing out of the plan” (Naughton 2007). The main idea is that reforms do not immediately dismantle what exists, but proceed relatively slowly, as the policy makers “feel for stones to cross the river”. The idea is that as the reforms take hold, the centrally planned sector will decrease in size and eventually be taken over by market-driven forces. But this strategy also means that China’s reformers were able to adopt different strategies and go at a different pace in different sectors and localities. As

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<sup>43</sup>On patterns of corporate restructuring see Oi (2005).

a result one sees great differences in the degree of change, especially during the 1980s, between sectors like the big state-owned factories and the new TVEs. During the 1980s, when rural industry took off and thrived, these SOEs were still mired in red ink and failed to effectively reform themselves. Some analysts argue that the TVEs became the needed competition that drove SOEs to become more efficient and profitable.

What makes the rise of TVEs in China such a fascinating case is that it goes against many accepted assumptions about development. This development was not due to the rise of private business entrepreneurship. The private sector is now booming in China, but in the 1980s, it was very much still a minor part of the economy. In the mid-1980s when TVEs took off, in terms of numbers, the individually owned private firms dominated. However, these were family operations that were small in scale, in terms of employees and output. Although private business was no longer illegal after the reforms began in 1978, up until 1988, it was illegal for a private business to employ more than seven workers. Thus, in terms of output and employees, it was the collectively owned township and village enterprises that played the principle role in changing the face of China's countryside.<sup>44</sup>

How did village and township enterprises develop and expand so quickly in China's countryside, where there was little in terms of savings and the necessary technical skills and industrial experience? This is where the policy regime and China's Maoist legacy come into play. By the 1980s China was no longer entirely under the plan. The growth in TVEs was neither centrally planned nor directed. In fact, Deng Xiaoping expressed surprise at their success. These factories were collectively owned but they were not under the plan; they were not given planned allocations of low priced inputs; markets had to be found, rather than pre-determined by the state. It should be noted that this was not as it was in Japan or Korea where a central level bureaucracy like MITI or the Economic Planning Board led development. The rise of TVEs was a decentralized, local state-led economic development that occurred at the lowest level of China's formal administrative bureaucracy, townships, and the villages below them.

#### ***4.3 The Business Model: Local State Corporatism***

China's reformers created new institutions that provided incentives for local cadres to support development, but these incentives in themselves were not sufficient. They were complemented by a rather unique set of circumstances created by China's policy regime that allowed rural firms to develop and grow much more quickly than one might expect. This changed the development situation in a number of respects.

First, because these were collective rather than privately owned firms, the correct unit of analysis for understanding development is not the individual firm. One should not ask how individuals raised funds and grew their firms; instead, one should ask how townships and villages, collective entities, developed their local enterprises. In fact, collectively owned township and village enterprises were part of a much larger entity that both acted as the source of inputs and as the bearer of risks and responsibility.

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<sup>44</sup> For further details see Oi (1999: chapter 3).

There was a merger of government and economy, resulting in an institutional development that I have written about extensively elsewhere and labelled *local state corporatism* (Oi 1992, 1999). It refers to the strategy and manner in which local governments ran and developed local industry. Local governments ran their firms as diversified corporations, redistributing profits and risks, thereby allowing the rapid growth of rural industry with limited resources. Local governments took on many characteristics of business corporations, with local officials serving a role equivalent to that of a board of directors (Oi 1999: 12-13). Over time, local governments extended their influence and assistance to encompass private firms.

Under local state corporatism, firms were managed by an individual, who was often contracted to run the firm for a fixed profit, but this manager was not responsible for either the funding or the risks if the firm failed. Thus, the ability to grow these firms was neither dependent on an individual having sufficient savings nor their ability to get loans. It was local officials, state agents in the local bureaucratic agencies who mobilized resources, sought out loans, technical assistance, and bureaucratic approvals for licenses, etc. This is in stark contrast to situations of predatory local officials taking resources out of firms. China's TVEs were created and grew thanks to local official entrepreneurs who mobilized resources to invest in local firms. This is not to say that there was no corruption or abuse of power by local officials. In some villages, these collectively owned firms were essentially assets of local officials (Lin and Chen 1999). Regardless of the inevitable cases of corruption, local officials could routinely and legally benefit in highly developed townships and villages through the receipt of large bonuses without engaging in corruption. Cadre benefits aside, the township and the village as administrative units also benefited from successful development. The richest villages were able to provide their peasants subsidies and paved roads from the profits of these factories. The wages from these factory jobs greatly increased the income of peasant families. Those who successfully developed rural industry catapulted into the ranks of the rich villages in China. Taxes and fees from these village-owned enterprises filled township and county coffers.

#### ***4.4 Adapting the Maoist Legacy to Mobilize Resources***

Accepting that local officials were the real entrepreneurs who spearheaded growth, one still needs to understand how it is that they could mobilize sufficient resources to achieve such high rates of growth. A few examples will illustrate how it was that firms could get started when there was little savings, either in the hands of individuals or in collective coffers.

The essential capital to get firms off the ground could be raised from within the collective by the village party secretary. Using his position as a cadre, he could mobilize individual peasant households within the village to contribute some funds. While the amounts were not large, they often sufficed to start a low tech factory, to produce tofu for example. For the early TVEs, the entry costs were fairly low—the required inputs, technology, etc. were often minimal.

Aside from raising the necessary initial capital, cadres also had the power to take profits from a factory to use for re-development. Over time, the capital was pooled within the collective to maximize development. If the first factory effort was successful, then the profits from that factory could be pooled and used to either fund a

technology upgrade or to expand the operation. In some cases, when a factory was highly profitable the excess funds could be allocated to start a second factory. The key point was that the cadres in China's villages had the power to mobilize whatever resources were available within the community. Cadres could raise funds even in a relatively poor village from small amounts contributed by numerous individual villagers to start a small enterprise that could quickly grow and then help fund new village firms.

One might question whether this type of villager contribution has been entirely voluntary. Local cadres have been criticized for this type of forced "fund raising" from its rural households. While there was no doubt that in some instances peasants would have preferred not to give up their modest savings, one can also see how they could easily be persuaded to contribute to a collective effort that promised to bring new jobs, non-agricultural jobs, and collective revenue.

Moreover, because China did not follow the big bang approach there was a unique situation where both plan and market operated side by side. As a result, local officials became the entrepreneurs who spearheaded rural industry and could capitalize on their bureaucratic position to access state allocated goods, to the extent that they still existed. At a minimum, they would have access to the negotiated priced goods that existed as China transitioned from a planned to a market economy.<sup>45</sup> Most importantly, this included key inputs including credit from the local banks and credit cooperatives. Thus, instead of throwing the old institutions out (what one might expect of a country trying to reform), the Maoist bureaucratic structure provided critical support to the rapid development of China's TVEs. This included a hierarchical banking system and access to information and technology. Officials at the lowest levels had access to the full array of resources at the disposal of China's entire bureaucratic hierarchy, all the way to Beijing. Lower level officials were connected to higher levels by going through bureaucratic channels. Each successive level had access to more and more goods and services. This was the sinew of local state corporatism.

In the context created by local state corporatism, unlike firms in a market setting, no single individual had to bear the risks of starting a company. The risks were borne by the collective. This collective strategy thus overcame two huge barriers to development in poor countries—the lack of individual savings and the fear of failure. Moreover, each collectively owned township and village enterprise was part of the larger corporation. Those at the village level could seek help from the township and the county. The ladder extended all the way up the bureaucracy to Beijing.

## **5. New Problems in Peasant Incomes**

By the 1990s the quick gains of the earlier successes in the rural reforms were gone; problems plagued both agriculture and rural industry. Increases in peasant incomes began to decline. The gap between urban and rural incomes increased.

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<sup>45</sup> These were goods that were less than market price but more than the allocated state price.



### *5.1 Declines in Returns from Agriculture*

Part of the problem was the declining price of grain that peasants could secure. The high prices and guaranteed sales ended in the mid-1980s. When peasants were forced to take their surplus to the market, prices declined with increased supplies. As we indicated earlier, agriculture proved not to be a sustainable source of increased income, especially for those that stayed in grain production. After an initial rise that lasted up to the mid-1980s, increases in agricultural incomes could not be maintained. One cause of this decline was the flattening prices of agricultural goods while the costs of production continued to increase, creating a scissors problem for peasants (Ash 2001). In the mid-1990s when procurement prices again increased and the government provided support, incomes again increased (Naughton 2007: 215).

The decreasing profitability of agriculture has hastened the movement away from farming. One survey shows that over the course of the ten-year period 1985-95, average industrial product value increased by more than 500 percent, yielding a 12 percent increase in average industrial product per capita. At the same time, the data show a dramatic decrease (82.9 percent) in agricultural product value, which, when adjusted for population change, yields an average agricultural product value per capita drop of 42 percent.<sup>46</sup> Economists have shown that grain production in 2001 fell back to 1993 levels. In 2002, there were continuing falls in agricultural, especially grain, prices, as well as in grain output.<sup>47</sup>

The increasing gap between rich and poor regions remains painfully evident in the provision of public goods and services. Education has been of particular concern, as this is one of the costliest items on local government budgets. It is this expense that many townships claim eats up the bulk of their limited monies. Unfunded mandates calling for localities to improve education is a leading cause of debt in townships (Oi and Zhao 2007). Some teachers were on the verge of striking to force the leadership to assume responsibility and pay their salaries.

Moreover, over time, even in the industrialized areas, the initial economic success shows signs of stalling or even being undone. One survey shows that when sampled villages were arranged along an agricultural dependence continuum, there was a decrease in village income per capita in almost one half of the tiers on which there is data, with the greatest declines in villages that were semi-industrial.<sup>48</sup> In the most highly industrialized villages from 1984 to 1995, there is only a 3.7 percent increase in income. The arrow is going the right way, but this rate of growth is less than one might have predicted. Moreover, the bulk of the increase in village collective income per capita (VCIPC) appears in the 1984 to 1988 period. Between 1988 and 1995 there is a 27 percent decrease in incomes.

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<sup>46</sup> Author survey.

<sup>47</sup> See Xiao (2002). Ash (2001) provides an excellent and more detailed discussion of the grain and price situation.

<sup>48</sup> Villages are sorted and grouped into 8 tiers according to their dependence on agriculture. The dependence on agriculture was determined by agricultural production as a percentage of total village production. Villages in the survey were stratified into 8 groups by every half of a standard deviation. See Oi and Shimizu (forthcoming).

## 5.2 Decline of TVEs

The TVEs, as successful as they were, were not without problems, the extent of which is only now being fully understood. During the period between the late 1980s and 1990s, TVEs began to suffer from inefficiencies and soft budget constraints (Kung 1999), in addition to softening markets, increased competition and decreasing profits. Before we examine the problems and their impact on peasant incomes, it should be noted that the take away message from the Chinese model is NOT that collectively owned firms are superior to privately owned ones. “Local state corporatism,” allowed rapid economic growth, but this does not mean that collectively owned enterprises were the most economically efficient.

The point that needs to be remembered about the China case is that collectively owned township and village enterprises were the most economically and politically *feasible* in the context of the beginning of the reforms, when there was both little private savings and deep seated distrust of the private sector with deep ideological roots. If China had at the beginning of the reforms promoted a strategy that promoted the rapid development of a private sector that was capable of challenging local officials, the outcome would likely have been much more like that predicted by Kornai. Communist officials would have either blocked reform or preyed heavily upon private business. Only later, when the collectively owned firms began to be a financial burden and private ones turned into a viable revenue source did officials begin to rethink their options. Perhaps equally important, local officials realized that they could still have power with the rise of private business.

The Chinese case, while offering hope for other developing countries, also serves as a caveat for the costs when these enterprises fail. There is now considerable evidence that more than a few TVEs saw hard times by the 1990s, leaving villages with rusting factories and heavy debt.<sup>49</sup> Rural industry was one of the most common sources of village debt left for villages today (Oi and Zhao 2007). This was even true of those that were seemingly very successful in the 1980s. The financial toll from TVE failures was heavy, both for the individual villages and ultimately for the individual peasant families who had to pay the bill. The rural credit cooperatives, which lent the money for the factories, were mired in red ink. Using survey data to arrange villages along an agricultural dependence continuum, we find that a wide range of villages, including those that had industrialized, faced a situation where debt was going up rapidly while incomes were slowing or decreasing.<sup>50</sup> Although the sources of the debt were different, there are large increases in debt at both ends of the agricultural dependence spectrum. Villages that were highly industrialized and those most dependent on agriculture accrued increasing debt. For example, the survey data show that in the most highly industrialized villages from 1988 to 1995, village debt per capita increased by more than 200 percent. During the same period, in the most agriculturally dependent villages, collective village debt per capita increased by more than 700 percent.

The extent of the problems with collectively owned TVEs is evident in the decision by local officials to switch their support to private firms, which had begun to equal or

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<sup>49</sup>There are early signs of this in studies such as Sargeson and Zhang (1999). Also see Oi (1999).

<sup>50</sup> Author survey.

outpace collective firms in generating increased revenues. Interviews with bankers and local officials said that the major reason was that loans to the private sector were more secure. Collateral was required in loans to private firms and it was clear who was responsible for paying back the loans. This was in sharp contrast to the situation for the collectively owned firms, where no collateral was required. Local governments simply signed as the guarantor for a loan, which meant that there was no single person clearly named as being legally responsible for repayment. When there was a market downturn and TVEs faced problems, the number of bad loans to collectively owned TVEs mounted with no relief in sight. In response to problems with public ownership and heavy debt, many localities engaged in state-sponsored privatization, selling village and township enterprises (Li and Rozelle 2003). By the mid-1990s an increasing number of collectively owned firms were sold as local officials decided that they were too costly and other sources of revenue generation became available, i.e. private firms.

But even in rich areas that have enjoyed growth and still have high incomes, new problems have emerged as consequences of successful industrialization and development. Farming land is requisitioned but some peasants fail to receive adequate compensation. As a related problem, rural industry continues to pollute farm land and water supplies. In some places rural industry has spoiled rivers to the point where water is no longer potable or even suitable for irrigation.<sup>51</sup>

Aside from serving as a cautionary tale, the China case also suggests that too many assumptions have been made about the course of development and industrialization in particular. Development is not a linear process. Villages that started down the road towards industrialization can and did suffer setbacks, even those that seemed to have been initially successful. Some failed attempts were so costly that the village finances could not recover. The negative experience of some villages with rural industrialization brings attention to an interesting possibility. Some villages that never attempted to industrialize actually found themselves in a better economic condition than the ones that attempted to industrialize but failed; accruing heavy debt in the process. Contrary to common assumptions, survey evidence reveal that the financially troubled villages in the 1990s include those that never attempted to industrialize *and* those that attempted to industrialize but failed (Oi and Shimizu forthcoming).

The failure and debt from TVEs reveals the flip side of the successful collective model of development. The Maoist legacy allowed rural industry to develop very rapidly, more rapidly than would probably have been the case if the private entrepreneur model had been followed. However, this also meant that unsustainable firms were established because officials could mobilize the necessary resources, at least in the short run. A national retrenchment in the late 1980s created havoc with credit freezes and resulted in a market shake up. While a market shake up was ultimately necessary, those that were relatively weak and produced lower quality goods found themselves unable to compete. Exports were increasingly an important part of the market, but only firms that employed more highly skilled workers or could upgrade their equipment to produce the higher quality products could compete.

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<sup>51</sup> For pollution problems from TVEs see Warwick (2003).

### 5.3 Local Government Debt and Peasant Burdens

The consequences of the role of the local state in China's rural development are still felt today. Those who successfully stayed on the road of industrialization are among the richest villages in China. For those who tried to industrialize but failed, the problems caused by the decline of TVEs have contributed to lasting fiscal problems for villages and townships, and for individual peasant households who have seen fees and surcharges increase. In the wake of hardening budget constraints under China's revenue sharing policies and various unfunded mandates from the upper levels, the decline of TVEs was another source of debt. Cash-strapped local coffers have affected the provision of public goods and services, and in some localities there are not even sufficient funds to pay administrative staff. A Chinese government publication admits that from 1998 to the first half of 2001, the number of counties and townships, especially in the central and western regions of the county, that were unable to pay their wages rose from 14 percent to 37 percent. In one province, more than 90 percent of county and township governments were in debt, with an average debt of nearly 5 million *yuan* (Xiao 2002).

A recent survey of 20 townships in 15 counties located in 10 provinces found that the problems are fairly widespread.<sup>52</sup> It should be noted, however, that these findings may overstate the problems somewhat as there was a selection bias toward agricultural areas, which would increase the likelihood of finding a prevalence of debt in the sample. Of the 20 townships studied, only four had no debt.<sup>53</sup> Of the remaining 16 townships, ten reported that their debt had a direct impact on their work, with four noting that it was serious. The debt in the 16 townships totalled 56 million *yuan*, which averages out to 2.8 million *yuan* of debt per township, a figure that is very close to the Ministry of Agriculture's estimate above. Comparing this average debt to the income of our townships, we see that in almost half of the townships the debt is larger than their total average annual income. The following table 1 shows the number of townships and their range of debt. More than half of the sample had debt of at least 1 million *yuan*.

Table 1: Size of Township Debt

	Less than 1 Million RMB	1-3 Million RMB	3-5 Million RMB	5-7 Million RMB	More than 8 Million RMB
# of Townships	5	3	3	3	2

The solution for many villages and townships is to squeeze what they can from the peasants. As others who have detailed macro changes in the Chinese rural economy

<sup>52</sup> The 10 provinces were Hebei, Shanxi, Shandong, Zhejiang, Anhui, Hunan, Sichuan, Gansu, Ningxia, and Shaanxi. Research in these provinces, counties, and townships was carried out between January and December of 2003. In addition, we also conducted research in a county in Hebei in the summer of 2004. These sites were purposively selected. We knew in advance the likely fiscal situation of each county and township. We selected a few relatively well-off areas but focused on those likely to be having fiscal difficulty so that we could delve into these problems more deeply. We want to thank the Ford Foundation for its generous support for our project. A special thanks to Sarah Cook for her encouragement in overseeing the project.

<sup>53</sup> For more details see Oi and Zhao (2007) from which this section draws heavily.

have argued, peasant burdens constitute the moral economy problem in China's countryside (Ash 2001). Overall, the empirical evidence suggests that the determinants of peasant burdens are embedded in the local political economy, its resource endowments, and the political pressures that circumscribe the behaviour of local authorities. Peasant burdens are linked to village collective income and expenditures; they are also linked to township assessments on villages. Burdens were borne by villages as a collective and by individual peasant households.<sup>54</sup> These problems fuelled the mounting peasant protests.

## 6. Need for Relief Policies

By the time of the sixteenth party congress in 2002, China's leaders had a newfound awareness as to the degree of discontent and problems that had developed over the course of the reforms. Simply promoting economic growth was not sufficient. A concerted effort has been made to address problems of inequality and the excesses including environmental degradation and pollution. Reducing peasant burdens was high on the list. Fortunately, China's booming economy has yielded record revenues that have given the government the option of simply eliminating fees and eventually taxes on peasants. However, these policies, as we will show later in the section, have created a new set of problems as the regime weighs the policy trade-offs.

### 6.1 Tax for Fee Reform and the Abolition of the Agricultural Tax

The tax for fee reform (*feigaishui*) policy, which was announced in the spring of 2001 for nationwide implementation, explicitly acknowledges the arbitrary and increasing burdens that have plagued China's peasantry (Nanjing Xinhua Ribao 2001). This policy marks a major departure by the state in its response to the peasant burden problem. Unlike earlier directives that simply *urged* local officials to keep fees in check, the "tax for fee" reform directly and explicitly *abolished* all of the previous fees and taxes. In their place, there are only two taxes on peasants: a reformulated agricultural tax and a surcharge on the new agricultural tax.<sup>55</sup> Instead of paying a *tiliu* and *tongchou* to the village and township, a land contract fee and various other ad hoc charges; peasant households were only assessed regarding one tax, either the agricultural or a special agricultural products tax, and its associated surcharge. In some provinces, to ensure that cadres cannot manipulate the new system by padding the quotas, each household received a letter explaining the new system. Moreover, each peasant must sign an agreement that states how much his or her household must pay in tax and surcharge. Although it has not been explicitly stated, the working assumption is that these tax amounts will be fixed for some time to come.

There is evidence that the new policy has substantially reduced past peasant burdens. In one village peasant tax burdens were reduced by 38 percent after only one year.<sup>56</sup> In another village, this new policy has resulted in a 40 percent drop compared to the previous year.<sup>57</sup> These findings are in line with a 2002 State Administration of Tax

<sup>54</sup> Further details can be found in Oi (2004)..

<sup>55</sup> For those areas that have special agricultural products, then there is a special agricultural products tax and a surcharge on that tax. Peasant households pay either the agricultural or the special agricultural products tax and its associated surcharge but not both.

<sup>56</sup> Author's China Interviews (hereafter CI) 101202.

<sup>57</sup> CI 101302.

report that indicates a 31 percent reduction in tax burden per capita on average in Anhui, 30 percent in Jiangsu, and over 25 percent in the other pilot areas (cited in Lin, Tao, Liu and Zhang 2002). A State Council research report indicated that after the *feigaishui* policy was expanded to 16 provinces in the beginning of 2002, the per capita spending on taxes and fees nationwide decreased by 3.9 percent from the previous year (Xiao 2002).

The positive impact of these policies on peasant incomes was further heightened by good harvests. A report from China's national bureau of statistics revealed that grain production has steadily increased in the last three years, as have peasant incomes. It is said that "In 2006, the per capita net income of farmers was 3,587 *yuan*, 1,111 *yuan* more than in 2002, an increase of 44 percent. Year-on-year growth in the per capita net income of rural residents rose from 4.8 percent in 2002 to 7.4 percent in 2006, the report said."<sup>58</sup> Not surprisingly, there is a reported decline in the number of poor. "The number of poverty-stricken people is on the decline thanks to the rapid increase in farmers' income... In 2006, there were 21.48 million poor people with an annual income of less than 693 *yuan*, 6.72 million less than 2002."

## **6.2 Negative Impact on Local Government Revenues**

While the tax for fee reform (*feigaishui*) was good for peasant incomes, it also substantially cut revenues of villages and townships. The waves of debt are attributed to the efforts to develop TVEs, unfunded education improvement mandates, and the failure of credit associations, among others. The effort made by the central authorities to reduce peasant burdens through the tax for fee reforms only aggravated the problem and pushed some localities over the fiscal edge into debt.

The new agricultural tax goes to the township; the surcharge on the agricultural tax goes to the village. However, neither amount equals the earlier total of fees that villages or townships collected. The revenue shortfalls created by the *feigaishui* policy were so severe (or feared to be so severe) that the implementation of this policy had to be stopped in 2001 shortly after it was announced for nationwide implementation because of opposition from the localities. Areas were left unable to pay their expenses, including cadre salaries. The problem only adds to the already large debt, which was caused by the earlier institutional disjuncture faced by townships.

Despite the hardships that the new tax system posed for townships and villages, the leadership forged ahead in 2002 and implemented the reforms in approximately 20 provinces. Preliminary research reveals that where the policy is currently being implemented, the revenue declines are substantial. In one township, the new system resulted in a 2 million *yuan* loss of revenue; this means that 6 of its 34 villages will be unable to pay their village cadre salaries; another 5-6 villages will only be able to pay their cadre salaries but have no money left for any other expenditures.<sup>59</sup>

Localities are expected to make up lost revenue through increased economic development. In some areas where there are relatively abundant development possibilities, the decreased revenues seem manageable. Some richer villages never depended on *tiliu*; some villages paid the *tiliu* for the peasants—but those types of

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<sup>58</sup> Clippings from Steven Green and Chartered Bank, 27 September 2007 email.

<sup>59</sup> Author interviews.

villages are in the minority. The difficulty exists in those areas that lack easy development opportunities. It is not hard to imagine that the same syndrome that drove cuts in one levy only to increase in another is going to re-emerge. Anticipating such problems, the regime is restricting additional peasant levies to try to ensure that the new *feigaishui* policy will not be undermined. If a village needs more funds for a project than the surcharge returned to the village can cover, it must convene a village meeting. But even if the village as a whole decides to go forward with a project and raise additional funds, the amount levied on each peasant cannot exceed 15 *yuan* per person per year.

The situation for local coffers was made that much worse when the central state decided in 2005 to go a step further and take an unprecedented move to abolish the remaining agricultural tax.<sup>60</sup> By 2006 peasants were for the first time in China's history free from all taxes and surcharges. This policy move was done three years earlier than originally planned. According to government reports, this "...tax reform helped reduce peasant burdens by 22 billion *yuan* (\$US\$2.7 billion) in 2005, and 23.4 billion *yuan* (\$US\$2.8 billion) during the period from 2001 to 2004..." (Xinhua News Agency 2006a).

This policy to help relieve peasant burdens only increased the fiscal problems for local governments who were now also deprived of the revenue from the agricultural tax. Obviously, this is great for peasants who now once again are enjoying a bout of increased incomes. Local governments at the township level that have few non-agricultural sources of income are essentially devoid of resources. Many, as earlier sections have shown, have large debts.

### **6.3 Fiscal Transfers to fill the Gap**

In a concession to the localities, the centre decided to grant fiscal transfers to facilitate the implementation of *feigaishui*. After the abolition of the agricultural tax this has become the standard way of making up lost revenues. The central state is providing some fiscal safety nets, as it did when it implemented its 1980s fiscal reforms, to stem political opposition from the localities (Oi 1999: chapter 2). These fiscal transfers will compensate the localities for some of the revenue shortfalls and allow localities to meet basic expenditures. The centre allocates funds to provinces that then disburse them to counties and eventually to townships, which will then use the money to help their villages and to supplement their own revenues.

There are questions as to whether the system of fiscal transfers can adequately fund the operations of townships and villages, and the provision of adequate public goods. The jury is not yet completely in on how well this system works. Interviews in selected counties suggest that the localities are still very short of past revenues generated. However, recent surveys suggest that many infrastructural projects have been granted to localities through fiscal transfers. The disbursement of these funds however, does not seem to be even. (CCAP/UC Davis/University of Toronto Research Team 2007). The patterns of the disbursal of fiscal transfers are unclear. The amounts are also complicated to calculate. There are funds sent as replacement

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<sup>60</sup> This was not a large percentage of national revenues, only 60 billion RMB or 2.2 percent of total revenues (Naughton 2007: 440).

for lost taxes and surcharges as well as special earmarked transfers, which are the most difficult to tabulate.

While new research shows that considerable money is flowing into poor areas to provide public goods, there is also evidence from this same research that these grants are not always used in the most efficient manner. In one village every household had benefits from a special earmarked grant—the grant was designated for the construction of new outhouses, one for each family. Unfortunately, peasants did not need these structures—so these new outhouses turned into storage sheds (Rozelle forthcoming). This example illustrates the larger trend that seems to be emerging through the use of fiscal transfers from the upper levels and the centralization that is taking place with regard to village funds (see Oi and Zhao 2007). Aside from the irrational use of funds often found in this type of central allocation, interviews also reveal that intermediate levels have been skimming off some of the funds meant for the lower levels.

Aside from problems of implementation, there is also the long term question of whether this system of fiscal transfers is sustainable. Beijing is currently flush with revenues but what will happen if there is a downturn in central level coffers? There is also the question of how this affects the incentives of local officials. Some local officials complain that the cuts in fiscal and political resources have “hollowed out” township administration, leaving it as nothing more than “fake government”. The various policies implemented by the central state to reduce peasant burdens and improve peasant-state relations have left many townships in a very precarious position.

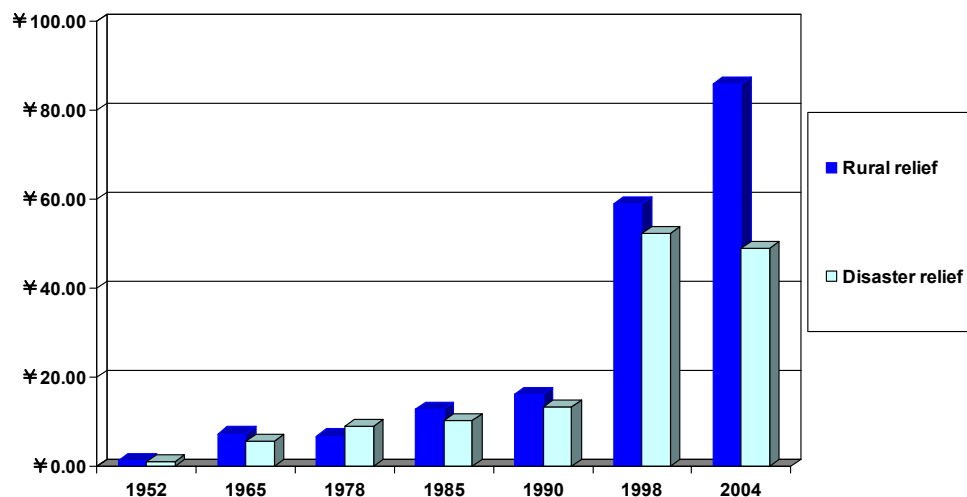
There has been talk of abolishing townships as a level of government. It seems unlikely that this will occur anytime soon, if at all. In the meantime, and certainly if the centre decides to keep the township as a level of government, it must resolve the institutional disjunctures that are the legacy of China’s piecemeal reforms. The centre cannot simply let townships wither away for lack of resources. Township governance must be founded on a stable economic base. Governmental and economic reforms must be brought into balance to have effective township governance. The role and resources of townships must be redefined to fit China’s new political economy. At the village level where there is no source of collective revenue, there is a perceptible sense of malaise among local officials. They have little power because they control no resources and they know it.



#### 6.4 New Social Policies and Funding

In addition to relieving peasants of burdens, China has been increasing its earmarked spending on rural welfare, as the following in figure 5 shows.

Figure 5: Rural Welfare Expenditure (in 100 million *Yuan*)



Source: Jingping, Jianhui and Zhaofeng (2005).

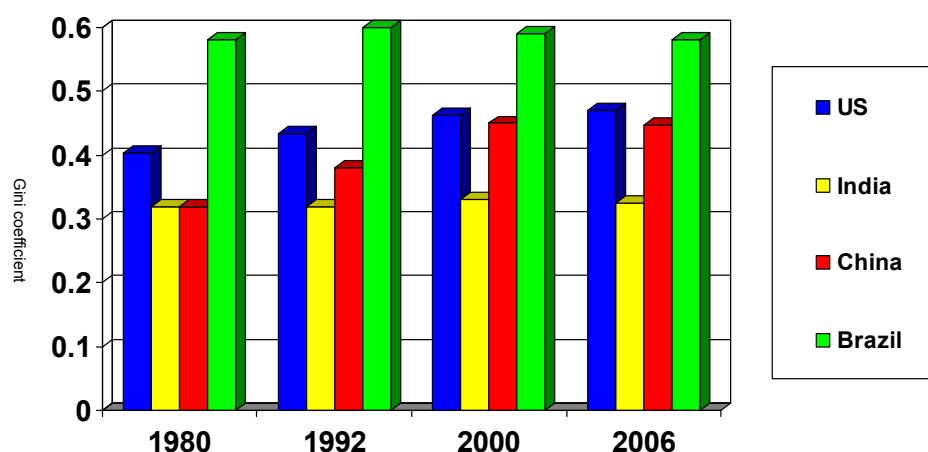
Since 2000, the Development Orientated Poverty Alleviation Programme in Rural China (2001-2010) has been implemented to solve the subsistence problems of the remaining poor and to help the low-income group. The goal is to improve infrastructure, technology, education, public health care and cultural development to achieve all around community development and improved living standards . (Rural Survey Organization of National Bureau of Statistics 2004).

This upward trend in peasant assistance received a further boost when President Hu Jintao declared the need to create a “harmonious society,” which explicitly recognizes the problems that have come with China’s rapid growth.<sup>61</sup> Hu presided over a four day plenary session of China’s leadership in October of 2006 that focused almost exclusively on these problems (Fan 2006). Among these are tensions resulting from the lack of social welfare policies and the increasing income inequalities that have emerged in China. As the following figure 6 shows, China’s level of income inequality, as measured by the Gini coefficient,<sup>62</sup> while not high when compared to developed countries, has risen dramatically since the reforms began in China.

<sup>61</sup> This is most evident in the hesitant pattern of reform seen in its SOEs.

<sup>62</sup> The closer to one the more unequal is the distribution of income.

Figure 6: Comparative Changes in Inequality



Source: Watkins (2006); US Census Bureau (2007); Ahluwalia (2007).

At the recent seventeenth CCP Congress, the themes of relieving tensions and reducing inequalities caused by the reforms were emphasized. Reports were given of progress made and pledges were made to guarantee future key expenditures and accelerate the development of all social programmes. It was reported that 13.7 billion *yuan* in poverty relief funds was used in 2006 from the central budget for “... infrastructural development in poor villages, job training for poor farm laborers looking for urban employment and industrialization.” (Ministry of Finance 2007). The central and western regions received support for the development of a rural medical assistance system. Under the new cooperative health care system, farmers are responsible for just one-third of insurance costs while central and local governments share the remaining two-thirds. A NBS report indicated that “By the end of 2006, 1,451 counties nationwide, or more than half of all counties, had started the program and a total of 410 million farmers, almost half of the rural population.”<sup>63</sup>

The Ministry of Finance Report on the implementation of the 2006 budget revealed the following increased expenditures on efforts to relieve poverty and aid development (Ministry of Finance 2007):

- An additional 24.1 billion *yuan* was spent on the social safety net;
- An additional 37.2 billion *yuan* from a special surcharge on oil sales was spent to subsidize increased expenditures in agriculture, fishery and forestry due to price increases in oil and also to fund major projects in energy development, conservation and environmental protection;

<sup>63</sup> From Green, 27 September 2007 email.

- Another 10 billion *yuan* was spent to increase regular investment in the central budget, which was mainly used to support the building of a new socialist countryside;
- An additional 13.5 billion *yuan* in special expenditures went toward building roads, purchasing oil reserves and providing further aid to residents who were relocated to make way for the construction of large and medium-sized reservoirs; and
- An additional 3.5 billion *yuan* was spent to increase funding for the "three rewards and one subsidy" policy, subsidies for farmers and herdsmen in Tibet and for the fight against smuggling, and transfer payments to ports.

The government acknowledges remaining problems in the fiscal transfer system and has pledged to improve the mechanism for ensuring a stable increase in general transfer payments.<sup>64</sup> Measures were also taken to expand the transfer payments to ethnic minority areas, providing a total of 15.563 billion *yuan* in 2006. Ethnic autonomous counties that are not located in an ethnic autonomous region or prefecture were included in the scope of these payments. Improvements were also noted for the rules regarding transfer payments to financially strapped areas such as old revolutionary areas, border areas and Tibet. Wen Jiabao, in a visit to Shanxi province promised to spend 339.7 billion *yuan* (US\$41.9 billion) for "... farmers, agriculture and rural areas this year—a record high and an increase of 14.2% over last year's funding" (Xinhua New Agency 2006b).

The Ministry of Finance Report also stated that the 2007 budget further increased allocations to address problems in the countryside, including new efforts toward poverty alleviation. A total of 14.4 billion *yuan*, an increase of 700 million *yuan* over the total for 2006, was allocated for poverty relief. Perhaps most important is the extension of a basic living allowance programme, which was introduced in the 1990s for urban areas, to rural residents across the country. The central government will allocate 3 billion *yuan* to fund basic cost of living allowances for rural residents (Ministry of Civil Affairs 2007). However, it will leave localities to determine the scope of the entitled group and the basic allowance amount based on local conditions. The central government will then assist poor areas as needed (Ministry of Finance 2007). An NBS report indicated that "The rural population covered by the rural minimum living allowance regime increased to 15.93 million in 2006, about four times that of 2002."<sup>65</sup>

A very important policy development was the decision to exempt some people from school tuition fees. The same NBS report cited above indicates that starting in 2006 students receiving nine-year compulsory education in the western regions were exempted from paying tuition. Moreover, grants were offered to poverty-stricken families.<sup>66</sup>

The problems related to transfer payments were also addressed. Pledges were made to increase transfer payments to improve the ability of local governments to provide

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<sup>64</sup> The central government allocated 152.7 billion *yuan* in 2006 for general transfer payments to local governments, mainly those in the central and western regions. This represents an increase of 40.7 billion *yuan* over the 2005 figure (Xinhua New Agency 2006b).

<sup>65</sup> From Green, 27 September 2007 email.

<sup>66</sup> From Green, 27 September 2007 email.

basic public services. Regular transfer payments from the central budget to local governments in 2007 were set at 192.4 billion yuan. These will be mainly to the central and western regions. Regular transfer payments to ethnic minority areas were set at 21 billion yuan, an increase of 39.7 billion yuan and 5.4 billion yuan, respectively, over the 2006 figures. In addition, there were more general allocations to ease the financial problems of counties and townships (Ministry of Finance 2007).

China's new social policies suggest that the leadership has come to the decision that broad based growth policies are no longer enough. China made great strides early in its reform efforts, but the ability to quickly increase incomes has diminished. It has been much harder to maintain the high rates of increase since the huge rises in income in the early to mid-1980s. The recent rise in rural incomes suggests that the situation may begin to change for the better, but the state is now enacting policies that will provide a stronger safety net, social security, and increased health care provisions. The new policies suggest that China realizes the need to reinforce its efforts at poverty alleviation in addition to trying to help the poor achieve economic growth in their localities. This assessment is supported by the recent research by western economists who have looked at causes of poverty and income increases and concluded that just following broad based growth policies will no longer be sufficient (Zhang, Huang and Rozelle 2003).

Economists in China are themselves now pushing for a new definition of poverty. A group of 30 economists suggested that the government "raise the poverty line and include basic expenditures on education and medical services in the calculation." They advocate using the minimum standard of approximately 1,100 *yuan* instead of the current 683 *yuan*. Wang Xiaolu, the lead author of *Alleviating Poverty through Development*, a report from the China Development Research Foundation, said that "Using the standards we propose, 80 million Chinese are still in poverty, rather than the official figure of 23 million (using the official standard)."<sup>67</sup>

## 7. Lessons from China's Reforms

China obviously has a long way to go before it solves its many problems, both old and new. Its booming economy bode well for its ability to meet the fiscal challenges the solutions will entail. Clearly the social and welfare policies of the Maoist era, the iron rice bowl and security of the unit system, are mostly memories of the past. It needs to build and fund new welfare institutions and fund social policies suitable to a market economy.

In spite of the incompleteness and problems of China's reforms, the amazing transformation of the economy in the last decades of the twentieth century no doubt serve as an attractive model for poor countries to try to replicate. Dramatic increases in agricultural output were achieved without dramatic investments of resources, other than procurement price increases. Rural industrialization occurred with limited resources and technical know how, and again with limited investment by the central state. Thus, the early stage of China's reforms is the ultimate low-cost development model, requiring little from central coffers.

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<sup>67</sup> Cited in Green, 27 September 2007 email.

Obviously, such a model had problems, as the discussion above has highlighted. The increases in grain production were relatively short lived and very much tied to prices. Local led rural industrialization had its negative consequences. Nonetheless, China's development experience suggests that countries, even those with limited resources have the potential to increase enthusiasm for production and output by providing sufficient incentives for producers and those in charge of overseeing development.

But it is unclear whether there is a Chinese model and whether it can be exported. A key part of the success of China's reforms, especially its rural industrialization is the infrastructural support that was embedded in a strong Maoist state from which the reforms emerged. Local state corporatism with its institutions of support for credit, technology, and technical know how are key in understanding how a backward economy could so quickly mobilize so many resources and organize. The existence of a unified and effective state that runs from the centre to the localities is thus the key element of the Chinese experience. Having a strong central state, however, is not inconsistent with agents at the local level who pursue development to advance their own discreet set of interests. China's reform experience illustrates how the right set of incentives can be deployed to mobilize local officials to push economic reform. Thus, China's reform experience is a clear illustration of the importance of historical context and institutions. This suggests path dependence but it also stresses the ability to spur change by embedding incentives into institutions. There was a specific political economy of reform in China that dictated a particular path of change and development. The model was not one that always stressed economic efficiency. The decision to promote collectively owned enterprises is a good case in point. But, collectively owned rural industry was the one option feasible both economically *and* politically. Ignoring the political constraints would have been disastrous. Instead, only gradually, as the context changed, were private firms promoted. Such examples suggest that there is much to be said for China's more gradual route to development. "Growing out of the plan" or "groping for stone to cross the river" may seem to some only to prolong well known problems of the old regime, but in some cases, it may be the most feasible and ultimately the most successful strategy. In the case of China, one must also remember that there was the overarching political constraint of ideological justification and keeping the Chinese Communist Party in power.

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