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**THE STATE-OWNED ENTERPRISE REFORM
IN CHINA**

**ITS POTENTIAL FOR ECONOMIC TAKE-OFF IN
LESS DEVELOPED LOCALITIES**

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To my parents

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Résumé

Cette thèse, par le biais d'une approche scientifique, propose une solution visant à favoriser le développement économique des localités sous-développées de Chine.

Les mesures institutionnelles prises sous la Réforme vers l'économie de marché (de 1978 à nos jours), n'ont pas permis de réduire les inégalités économiques entre les différentes localités. L'innovation institutionnelle est nécessaire pour permettre le développement économique et engendrer une société harmonieuse.

Bien que davantage d'études théoriques soient encore en cours, mes investigations en Chine en 2004 et 2005 m'ont convaincu que les localités sous-développées de Chine peinent à mettre en place des économies de marché si elles ne bénéficient pas du soutien du gouvernement aussi bien au niveau local que national. Cette découverte contredit le culte actuel du marché et met en évidence la sous-évaluation du rôle à différents niveaux du gouvernement, dans le développement économique local. Grâce aux expériences de développement local en Chine depuis la Réforme, l'intervention de l'Etat a pu adopter une approche 'market-enhancing' et à différents niveaux, le gouvernement a pu coopérer avec des institutions privées pour favoriser le développement économique dans les localités sous-développées. Ainsi, cette thèse tente de redéfinir les relations entre les fonctions économiques du gouvernement, l'économie locale, les agents publics et privés dans le contexte de la Réforme d'économie de marché.

Les entreprises d'état sont le point focal de l'innovation institutionnelle. Pendant la période de Pré-Réforme (1949–1978), elles étaient dirigées par le gouvernement central sous le régime du socialiste et ont remarquablement contribué au développement économique local. Mais la Réforme orientée vers une économie de marché lancée en 1978 les a privatisées ou transformées en corporations avec peu d'objectif sociopolitique et ne visant qu'à maximiser les profits, et donc par conséquent la contribution des entreprises d'état à l'économie locale s'est réduite au paiement des impôts et à la création d'emplois. Les répercussions bénéfiques au niveau local s'avèrent très limitées, notamment pour les localités moins développées ne bénéficiant pas des entreprises d'état réformées.

Inspirée par des pratiques du partenariat public-privée, cette thèse propose un nouveau modèle d'entreprise d'état multifonctionnelle à double objectif sociopolitique et économique. Les caractéristiques possibles de cette entreprise seraient : 1) sa localisation : dans les localités sous-développées ; 2) la coopération publique-privée pouvant adopter différentes formes de organisation avec des droits et obligations bien définis dans le contrat des entreprises; 3) elle encourage les initiatives sociopolitiques contribuant au développement de l'économie locale en combinant les dynamiques de marché.

Mots clés : réforme chinoise, entreprise d'état, intervention d'état, localité sous-développée, réduction de la pauvreté, partenariat public-privée, innovation institutionnelle

Abstract

This PhD dissertation offers a scientifically supported solution to economic development in China's less developed localities (LDLs). The market-oriented Reform (from 1978 onwards) has not produced the institutional arrangement necessary to reduce the spatial economic inequality. Institutional innovation is necessary to achieve economic development and build a harmonious society. My investigations in China during 2004 to 2005 show that the LDLs hardly build up efficient local market economies without the government support from both central and local levels. This finding challenges the current market hype in China and shows the undervaluation of multi-levelled governments' roles in local economic development. Drawing experiences from local economic take-off in China, state intervention can adopt a market-enhancing approach and multi-level governments can cooperate with private forces to develop LDLs. This finding inspires a re-definition of the relationships between the government's economic functions, local economy, public and private forces in the context of the market-oriented Reform. State-owned enterprises (SOE) have proven to be a platform for such cooperation because during the pre-Reform period (1949–1978) they contributed remarkably in their traditional form to local economic development, especially in LDLs. But the SOE reform has gradually privatized traditional SOEs and transformed them into profit-oriented enterprises with hardly any socio-political objectives. The SOEs' contribution to the local economy has been reduced to tax payment and job creation, which both produce very limited benefits to localities, because in LDLs few jobs are created and taxes are collected at higher administrative levels. Recalling and updating the 'old' roles of the SOE, this thesis attempts a redefinition of the relationships between the SOE and the local economy in the context of the market-oriented Reform. A new kind of multi-functional SOE is proposed by drawing upon the traditional and the reformed models. A set of characteristics identify this SOE: 1) it should be located in LDLs; 2) it may adopt various shareholding forms but shareholders have clear duty and right under contract; and 3) it undertakes socio-political objectives, aiming to combine market dynamics with local development potential in order to promote local economic take-off.

Keywords: China's reform, state-owned enterprise, state intervention, less developed locality, poverty reduction, public private partnership, institutional innovation

TABLE OF CONTENTS

LIST OF ABBREVIATIONS..... 12

LIST OF FIGURES 13

LIST OF TABLES 14

LIST OF ANNEXES 15

**CHAPTER 1 GENERAL INTRODUCTION: INTEGRATING THE SOE INTO
THE STUDY ON LESS DEVELOPED LOCALITIES 16**

1.1 BACKGROUND OF THE STUDY: DEVELOPMENT IS THE CENTRAL THEME..... 16

1.2 PROBLEMATIC: LOCAL DEVELOPMENT AND THE SOE REFORM..... 21

1.2.1 LOCALITY 21

1.2.2 LESS DEVELOPED LOCALITY 23

1.2.3 ALLEVIATING SPATIAL INEQUALITY: POVERTY REDUCTION AND ECONOMIC
DEVELOPMENT IN LDLs 25

1.2.4 ECONOMIC DEVELOPMENT IN LDLs: THE ROLE OF PUBLIC-PRIVATE COOPERATION..... 28

1.2.5 STATE-OWNED ENTERPRISE: AN INSTITUTION FOR ECONOMIC TAKE-OFF IN LDLs 32

1.3 METHODOLOGY 36

1.3.1 PART-WHOLE ANALYSIS 37

1.3.2 HISTORICAL ANALYSIS 39

1.3.3 PROCESS ANALYSIS..... 40

1.3.4 THE EMPIRICAL ANALYSIS 41

(a) Interviews with Chinese local government officials..... 43

(b) Case studies in two SOEs 45

(c) Reference cases from Europe..... 45

1.4 STRUCTURE OF THE DISSERTATION 47

CHAPTER 2 THE TRADITIONAL SOE IN CHINA'S PRE-REFORM

ECONOMY	50
INTRODUCTION	50
2.1 CONSTRAINTS ON CHOOSING THE FORM OF THE ECONOMY	52
2.1.1 ECONOMIC LEGACY.....	52
(a) Pre-modern China (before 1840)	52
(b) Modern China (1840 – 1949)	55
2.1.2 INTERNATIONAL RELATIONS	58
SUMMARY.....	62
2.2 A PRESENTATION OF FIVE COMPETING FORMS OF THE ECONOMY	63
2.2.1 PLANNING ECONOMY (1949 – 1978).....	64
2.2.2 <i>GAN CHAO</i> ECONOMY (1949 – 1978).....	67
2.2.3 MILITARY ECONOMY (1949 – 1978).....	70
2.2.4 NEW DEMOCRATIC ECONOMY (1949 – 1953)	74
2.2.5 GREAT LEAP FORWARD (1958 – 1960).....	77
(a) Socialist Human and Mass Line	78
(b) Self-reliance and Egalitarianism.....	79
(c) ‘Walking on the two legs’	80
SUMMARY.....	84
2.3 THE TRADITIONAL SOE	86
2.3.1 STATE OWNERSHIP AND STATE-PARTY-SOE RELATIONS	86
(a) Multitasks.....	88
(b) State’s Infinite Liability for SOEs	89
(c) Supervision System.....	89
2.3.2 MANAGEMENT SYSTEM INSIDE SOE.....	91
(a) ‘One-man management system’ vs. ‘Party-command-system’	91
(b) Ideological Re-education of Workers and Mass Supervision.....	94
2.3.3 INCENTIVES.....	96
(a) Material Incentives.....	96
(b) Non-material Incentives.....	98
2.3.4 THE SOE’S CONTRIBUTION TO THE LOCAL DEVELOPMENT.....	100
(a) Industrialization-Pushed Urbanization.....	100
(b) The nationwide inter-SOE support programme.....	102
SUMMARY.....	103
CONCLUSION: ALL IN ONE GAME	104

CHAPTER 3 CHINA IN TRANSITION: THE REFORM AND THE SOE

- REFORM..... 109**

- INTRODUCTION 109**
- 3.1 OVERVIEW OF THE REFORM..... 112**
 - 3.1.1 LOGIC OF THE REFORM..... 112
 - (a) Why reform? 112
 - (b) Why reform then? 113
 - (c) What to reform? 115
 - 3.1.2 FIVE CHARACTERISTICS OF THE REFORM..... 117
 - (a) Theoretical hesitation and ideological emancipation 117
 - (b) State-led and Grassroots-promoted reform 119
 - (c) Gradualist approach 120
 - (d) From reforming outside-the-Planning to reforming the Planning 122
 - (e) Experiment-Example approach..... 124
- SUMMARY..... 125
- 3.2 THE SOE IN THE REFORM..... 127**
 - 3.2.1 INCENTIVE SCHOOL 129
 - (a) Decentralization of decision-making power 130
 - (b) Profit sharing systems 132
 - (c) Incentives for employees 132
 - (d) Outcome of the incentive reform 138
 - 3.2.2 MARKETIZATION SCHOOL 139
 - (a) Marketization of financial capital 142
 - (b) Marketization of human capital 145
 - (c) SOE’s exit from (competitive) markets 147
 - 3.2.3 OWNERSHIP SCHOOL 149
 - (a) Enterprise ownership 150
 - (b) Shareholding system and stock market..... 150
 - (c) Corporatization 153
 - (d) State assets management system 156
 - (e) Criticisms on the ownership school 158
- SUMMARY..... 163
- CONCLUSION: REDEFINING THE SOE IN A MODERN ENTERPRISE SYSTEM 166**

CHAPTER 4 RETHINKING THE SOE REFORM FOR LOCAL DEVELOPMENT	170
INTRODUCTION	170
4.1 TRANSITION IN SPATIAL DEVELOPMENT STRATEGIES AND LOCAL DEVELOPMENT STYLES	172
4.1.1 THE PRE-REFORM COORDINATED REGIONAL DEVELOPMENT STRATEGY	172
4.1.2 THE UNEVEN DEVELOPMENT STRATEGY SINCE THE REFORM.....	173
(a) The Pearl River style.....	175
(b) The Wenzhou style	177
(c) The Sunan style.....	180
4.1.3 NEW SPATIAL DEVELOPMENT STRATEGIES IN THE 21 ST CENTURY	183
SUMMARY.....	188
4.2 WHY THE LDLs ARE STILL LESS DEVELOPED? AN EMPIRICAL ANALYSIS	189
4.2.1 PRESENT ENDEAVOURS TO DEVELOP THE LDLs	190
(a) Central government's roles in poverty reduction.....	191
(b) Non-governmental aids.....	194
(c) Academic studies	195
(d) Indigenous efforts in LDLs.....	196
4.2.2 BLOCKS TO ECONOMIC TAKE-OFF: INVESTIGATION IN CHINESE LOCALITIES	197
(a) Geographical conditions and transportation networks	198
(b) Natural resources and locally specific industries.....	200
(c) Human capital	205
(d) Financial capital.....	209
(e) Institutional constraints.....	212
SUMMARY.....	218
4.3 THE RATIONALE OF THE SOE FOR PUBLIC-PRIVATE COOPERATION	219
4.3.1 SPECIAL FUNCTIONS OF THE NEW SOE.....	220
(a) Implementing poverty reduction projects	221
(b) Stimulating private investment	222
(c) Increasing human capital	223
4.3.2 THE MULTI-FUNCTIONAL SOE'S SURVIVAL WITHIN MARKET COMPETITION	224
(a) Hard budget control	225
(b) Governing conflicts among interests	226
(c) Scope and scale	227
4.3.3 ANTI-POVERTY GROWTH LEGISLATION.....	229
SUMMARY.....	232

**CONCLUSION: MULTI-FUNCTIONAL SOES AS A PLATFORM FOR PUBLIC-PRIVATE COOPERATION
IN CHINESE LDLs..... 233**

**CHAPTER 5 GENERAL CONCLUSION: FURTHERING THE SOE REFORM
FOR LOCAL DEVELOPMENT IN CHINA 240**

5.1 ADDRESSING THE PROBLEMATIC AND SUB-PROBLEMATICS 241

5.2 CONTRIBUTION OF THE METHODOLOGY 248

5.3 PROSPECTS FOR FURTHER STUDIES 253

LIST OF ABBREVIATIONS

ADB	----	Asian Development Bank
CPC	----	Communist Party of China
EU	----	European Union
FYP	----	Five-Year-Plan
GDP	----	Gross Domestic Product
HGS	----	Headquarters of the General Staff of the People's Liberation Army
IMF	----	International Monetary Fund
LDL	----	less developed locality
LGPR	----	Leading Group of Poverty Reduction
MBO	----	Management-Buy-Out
NGO	----	Non-Government Organisation
NPC	----	National poor county
OECD	----	Organisation for Economic Co-operation and Development
OLGPR	----	Office of the Leading Group of Poverty Reduction
PPC	----	Provincial poor county
PPP	----	Public-private partnership
PRC	----	People's Republic of China
RMB	----	Renminbi (Chinese currency. <i>yuan</i> is its unit used for foreign change. Since 2007, the Euro/yuan exchange rate has been varying between 10 and 11)
SAMS	----	state assets management system
SAOO	----	state assets operation organisation
SASAC	----	State Assets Supervision and Administration Commission
SASMO	----	state assets supervision and management organisation
SOE	----	state-owned enterprise
TVE	----	Township and Village Enterprise
UK	----	United Kingdom
UNDP	----	United Nations Development Programme
US(A)	----	United States (of America)

LIST OF FIGURES

Figure 1: Discussion about the social embeddedness of the economy 39

Figure 2: Structure of the dissertation 49

Figure 3: China’s imports and exports 1950-76 (unit: million US dollar, in constant price) .. 61

Figure 4: Logic of the Military Economy 71

Figure 5: The traditional SOE: organization and functions 104

Figure 6: Five blocks to LDL’s economic take-off and the proposed SOE as a solution
to remove the institutional block.....236

LIST OF TABLES

Table 1-1: China's administrative division	23
Table 1-2: A comparison among market-friendly, market-substituting and market-enhancing approaches	29
Table 2-1: The pre-Reform Economic System in the PRC	69
Table 2-2: Walking on two legs during the GLF	81
Table 2-3: A comparison of the five forms of the economy	85
Table 2-4: Distribution of control rights over China's traditional SOEs	90
Table 2-5: Three basic characteristics of resource-based cities in the pre-Reform China (1949-1978).....	101
Table 3-1: Logic of the Reform.....	126
Table 3-2: Five characteristics of the Reform.....	126
Table 3-3: An outlook of the three competitive schools of thought of the SOE reform in changing the traditional SOE	165
Table 4-1: Three styles of local development: Pearl River, Wenzhou and Sunan.....	182
Table 4-2: Differences between the traditional SOE, the reformed SOE and the multi-functional SOE.....	237
Table 5-1: Methodology's contribution	252

LIST OF ANNEXES

Annex 1: The three regions in China	283
Annex 2: The categories of economic activities in China.....	285
Annex 3: The SOE reform: objectives, measures and effects by stages (from 1978 to 1997).....	286
Annex 4: An overview of Chinese SOEs from the perspective of scale.....	290
Annex 5: A time axe for the analysis of SOE and local development in China	292
Annex 6: The Questionnaire for on-site investigation in China.....	293
Annex 7: Chinese NGOs and Their Poverty Reduction Activities	295
Annex 8: Main International Organizations Contributing to Poverty Reduction in China.....	296

CHAPTER 1

GENERAL INTRODUCTION:

INTEGRATING THE SOE INTO THE STUDY ON LESS DEVELOPED LOCALITIES

1.1 Background of the Study: Development is the Central Theme

Over the last 50 years, China has attracted the world's attention by its strong and fast growing economy. For example, the most frequently cited achievement is that in fixed prices, China's GDP has risen from 1952's 67.9 billion yuan RMB to 1998's 7939.6 billion yuan as the average annual growth rate reached 7.7%; in the year 1997, China ranked as the seventh largest economy in the world (Liu and Shi, 2001: p.466, at current prices)¹. Chinese people are proud of the "China Miracle"². Many of them believe that China is likely to become the largest economy in the world in the 21st century (Lin *et al.* 2002: Abstract). A basic but disputable assumption of this optimistic prospect is that China's economic growth is sustainable from ecological, social and political viewpoints.

However, as the current Prime Minister, Wen Jiabao, stated in 2004, "China has achieved the well-off or all-around prosperous (*xiao kang*) society (*according to GDP per capita*), but this well-off is still at a low level (*in terms of income and welfare*), incomplete and unevenly developed (*i.e. from the spatial perspective*)"³ (translated by Zhu Kai, emphases added). The rapid growth of China's economy has had many weaknesses. Economists commonly criticize China's economic growth since 1949 as an *extensive* growth based on low returns to high energy consumption and high environmental pollution (see Yin Weiguo, 2004; Hong

¹ A complete introduction to Chinese economic achievement can be found in the "Series of the analytical reports of the 50 years' New China" published in the official site of NBSC (<http://www.stats.gov.cn>). Gao Shangquang (1996: Chapter 2) focuses on the economic achievement since the Reform beginning in 1978.

² The term 'China's Miracle' is brought about by Lin *et al.* (2002) in analogy to the 'East-Asian Miracle' which is a label of the rapid economic growth in the East-Asian economies, such as the Four Dragons (South Korea, Taiwan, Hong Kong and Singapore).

³ Wen Jiabao made the remarks at a high-level seminar on the new concept of development held at the Party School of the Central Committee of the Communist Party of China (CPC) for provincial and ministerial level officials on February 21, 2004 (www.xinhuanet.com).

Yinxing, 2001: p.25). The high rate of economic growth cannot conceal or improve the low quality of growth. Especially since 1993, when ‘giving [economic] efficiency (*meaning the economic growth*) the priority with due consideration to fairness’⁴ began to dominate Chinese national strategy, the uneven distribution of the benefits from economic growth among the population and among regions/localities has also become an increasingly serious problem (see Liu Guoguang, 2003; He Qinglian, 1998). Furthermore, the over-emphasis on economic growth rate by the Chinese government⁵ inevitably obliged government officials to pay particular high attention to the Gross Domestic Product (GDP) indicator (at both national and local levels) and its growth rate. Even worse, the growth rate of local GDP has become a key indicator to evaluate a local government’s performance (no matter growing in which way)⁶.

As Hong Zhaohui (2004) summarises, crises have accumulated in eight domains: the financial system (ex. the high rate of Non-Performing-Capital in state-owned banks), economic inequality (income polarization), corruption, unemployment, ‘*san nong*’ (the development of agriculture, rural economy and farmers’ prosperity), population, (natural) resource reserve and ecological environment, along with the rapid economic growth. These crises more and more severely hinder the further success of China’s economy and challenge the political stability of the socialist regime in China.

The pace of economic growth has its limits; the quality of the growth needs to be emphasised. The term ‘development’ now receives great attention in China’s socio-economic strategy and policy making. More socio-economic indicators are taken into account. But, the ambiguous definitions of concepts like economic growth, economic development and development still confuse policy-makers to design proper policies.

4 The definition of the term ‘fairness’, like of others such as equity, equality and social justice, heavily depends on social traditions, values and virtues. In this dissertation, these terms are confined to the issue of economic (re)distribution in the Chinese context, meaning “all the population shares the output of economic growth” (Yin Mengbo, 2002: p3).

5 The government is a state apparatus. It is the administrative-bureaucratic system from central – the top level – to provincial, and finally to local - the bottom level. In the Chinese context, the Communist Party of China (CPC) has delegations at each level of government and these Party delegations have strong influence on the government decision making. Hence, the term ‘government’ used in this dissertation comprises the Party delegations.

6 In many counties that I investigated during 2004 to 2005, local governments set the annual Gross Local Product (GLP) growth rate above 10% and make it mandatory to reach this target, while other social-economic indicators are intentionally ignored or given up as the expense of GLP growth; falsifying statistical data are also common (see Zhang Jianhua, 2004).

Studies on the definitions of the terminologies can be tracked back to Schumpeter (1934). According to him, “economic growth consists of a gradual process of expansion of production – producing more of the same, and using the same methods in order to do so ... [economic development] consists of the carrying out of ‘new combinations of productive means’, such that either the conditions of production of existing goods are transformed, and/or new goods are introduced, or new sources of supply or new markets are opened up, or an industry is reorganised” (see Hunt, 1989: pp.23-24). Thus, the Schumpeterian ‘economic development’ is ‘productive revolutions’, with both economic growth in quantitative terms and structural *change* in qualitative terms. The structural change can involve industrialization, modernization and technological innovation.

Many scholars are not satisfied with ‘economic development’ and pay more attention to ‘development’. Some of them emphasise the environmental problems. Meadows *et al* (1972) asserted the ‘limits to growth’ from five dimensions – population, capital, food, non-recyclable resources and pollution and take the environmental/ecological issue into account of development. The sustainability of economic growth has become a hot topic in economic research since then. Other scholars pay more attention to the (re)distribution system and social justice. Dudley Seers in his “The meaning of development” (1969) defined development as “the reduction and elimination of poverty, inequality and unemployment within a growing economy”. This definition has had much influence on development economics. Another scholar, Sen, pays great attention to human lives in his studies of inequality and poverty. He proposes a ‘development as freedom’ thesis which emphasises the expansion of the ‘capabilities’ of persons to lead the kind of lives they value – and have reason to value (Sen, 1999). Scholars have also made progress in the measurement of development by including non-economic indicators. In May 1990, the United Nations Development Programme (UNDP) proposed in the “Human Development Report 1990” a Human Development Index (HDI), a composite index of three indicators that reflect three major dimensions of human development – longevity, knowledge and access to resources, to measure human development levels.

Drawing upon the debate on the term development, the Chinese government promoted a new concept of “scientific development” at the 16th Congress of the Communist Party of China in 2004⁷. This concept calls for considerations on: (Fewsmith, 2004)

- conforming to reality, further improving the socialist market economic structure;
- combining intensified efforts to readjust the economic structure with promoting rural development;
- combining efforts to promote the role of science and technology with efforts to take the advantages of human resources;
- combining the development of the economy with the protection of resources and the environment;
- combining opening up to the outside world with opening up to other parts of the country; and
- striving to take a civilized development path characterized by the development of production, a wealthy life, and a good ecological environment.

The new concept of scientific development aims to build a *harmonious society*, which is people-centred, comprehensive, coordinated and sustainable, pursuing an overall harmonic development of economy, society and human beings⁸, in contrast with the past blind crusade for high economic growth and the overemphasis on the GDP indicator.

The concept calls for more attention to ‘fairness’ (equity or social justice) which was secondarily considered by the previous growth-oriented and efficiency-first development concept (which is so-called *not scientific*). However, the all-encompassing concept of development proposed by the Chinese government has not provoked enrichment of the theory of development. There is no concrete measure in practice to challenge the central place of economic growth (in the Schumpeterian term) in policy making. According to the guidance of the Chinese government, economic development is always the primary objective because China is still a ‘Low and Middle Income Economy’ according to the World Bank

⁷ The first use of the ‘scientific development concept’ dates back to 2003 by Hu Jintao, the current General Secretary of the CPC. The process of the promotion of the concept is narrated in Fewsmith (2004).

⁸ On 18 May, 2005, the Chinese (Hainan) Reform and Development Institute gathered some Chinese economists, sociologists, political scientists and legal scientists in Beijing to study the concept of the ‘harmonious society’. A brief summary of the outcome was reported by China Economic Times.

classification⁹. The Chinese government believes that only if economy develops and more material wealth is created, can human and social development be achieved. The failure of the Maoist egalitarian and utopian efforts from the 1950s to the 1970s in order to rapidly develop China (see Chapter 2) have taught the current Chinese that ‘enriching together could only result in impoverishing together’, while the only feasible approach for development is the ‘uneven development’ strategy¹⁰. The latter embodies Deng Xiaoping’s view of development which has dominated Chinese economic strategy and policy making from the 1980s onwards (see Chapter 3). The scientific (all-encompassing) development is very difficult to implement in the present China because it may weaken the economic growth and economic development. Hence, it seems that the scientific development is more of ‘a little compromise’ with the increasing social pressure – calling for ‘fairness’ – in order to maintain the political stability than of a complete re-orientation of the national development strategy.

In this light, it is the lack of effective means that troubles the achievement of scientific development in China. A scientific development *with rapid* economic growth is the goal. My research is focused on economic inequality in the present China and how to achieve the goal¹¹. My DEA (Master) dissertation has analysed the situation and formation of Chinese economic inequality from three dimensions: urban-rural divide, regional disparities and inter-personal income gap. As a further study, I endeavour to find out solutions to reduce the Chinese spatial inequality through developing the economy in less developed localities (LDLs). My study is focused on the triangle relationship between enterprise, local economy and government. A part of the results are presented in this PhD dissertation.

9 As the World Bank explains, “For operational and analytical purposes, the World Bank’s main criterion for classifying economies is gross national income (GNI) per capita. In previous editions of our publications, this term was referred to as gross national product, or GNP. (More about this change in terminology). Based on its GNI per capita, every economy is classified as low income, middle income (subdivided into lower middle and upper middle), or high income. Other analytical groups based on geographic regions are also used.” (<http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20420458~menuPK:64133156~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html>) A country classification table can be downloaded from the same webpage.

10 The ‘uneven development’ here means development with inequality, and the inequality is understood from the sectoral, spatial and inter-personal perspectives.

11 The ecological and environmental development is not the central theme in this dissertation, but it does not mean that it is not important.

1.2 Problematic: Local Development and the SOE Reform

Various economic theories and models have studied the issue of convergence and divergence in terms of income level and growth rates¹². For the developing and least developed countries (e.g. the Global South), the convergence often fails due to the increasing returns to scale, unevenness in initial levels of capital, technologies (including human resources), and saving rates, etc., even though foreign trade of raw materials and low-skilled manufacturing products, as well as spill over effects can contribute to reducing the income gap and growth rates. The issue of convergence can also be applied to localities inside a country. In the China case, where the economy is becoming market-oriented, the increasing economic inequality across localities shows that market forces alone have been so far have not managed to achieve the convergence. Economic take-off in LDLs needs cooperation between multi-level government and private entrepreneurs in the market. An institutional innovation is necessary which would offer a platform for such cooperation. I propose a new kind of state-owned enterprise (SOE) to undertake this innovation. The problematic of the dissertation is: Can SOEs be innovated to be platform for such public-private cooperation in the context of China's market economy? The logic of the problematic is explained in this section, and some terms, such as locality, LDLs, SOE, etc. are specifically defined in the Chinese context.

1.2.1 Locality

“A locality is a space within the country borders, such as city, county, village or town considering the administrative criterion and geographical position ... [but] there is a profusion of adjectives which distinguish different types of spaces - social space, economic space, personal space, geographic space, topological space, physical space, perceptual space, absolute space, relational space, and relative space.” (Gore, 1984) The size of a locality varies for different types of spaces. In the present China, spatial economic competition mainly concerns administrative localities (and regions)¹³. Hence, the boundary of an administrative locality coincides with that of an economic one. To improve the use of official statistical information and references that are offered by governments at different levels, the term ‘locality’ (and ‘region’) used in this dissertation is confined to the units within the administrative division of space.

¹² See a survey of theoretical and empirical literature on convergence in Capolupo, 1998.

¹³ Lin Yimin (2004) focuses on the competition among local governments.

China's administrative division has four sub-national levels. They are province (*sheng*), prefecture (*di*), county (*xian*), village (*xiang*). Each level consists of several categories of administrative units:

- At the province level there are
 - Provinces
 - Autonomous Regions (*zi zhi qu*)
 - Municipalities (*zhi xia shi*) – cities directly controlled by the central government
 - Special Administrative Zones (*te bie xing zheng qu*) – Hong Kong and Macao
- At the prefecture level there are
 - cities directly controlled by the State Council (*dan lie shi*)
 - prefecture-level cities – cities directly controlled by the Provincial government
 - autonomous prefectures
 - leagues (*meng*) – particularly in the Inner Mongol Autonomous Region
 - prefecture-level districts (*qu*)
- At the county level there are
 - county-level cities
 - counties
 - autonomous counties
 - Banners (*qi*) – particularly in the Inner Mongol Autonomous Region
 - autonomous Banners
 - districts controlled by the prefecture-level city (*shi xia qu*)
- At the village level there are
 - villages,
 - townships (*zhen*),
 - towns (*cun*)

(See www.xzqh.org.cn; Mao Shoulong, 1995)

Table 1-1 presents China's administrative division. Each category of administrative unit has a government. The governments at the four levels compose China's government system along the hierarchy, from top to bottom. The term 'local' used in this study contains the prefecture, county and village levels; 'regional' means the province level. It is to be noted that the prefecture-level is particular. Although the prefecture-level localities have administrative sovereignty on the county-level localities, their 'geographical territory' is not composed by the latter. The area of the prefecture-level localities is only about 31,000 km² of the 9,600,000 km² as the total area of China (the surface of Chinese territorial waters is not taken into account); the county-level localities share the rest area. More than 85% of the Chinese population is registered in the county-level localities (Economic Daily, 9 November, 2003: p.3). Generally, the prefecture economy is an urban economy, while the county economy is a rural one.

Table 1-1: China's administrative division

Nation-level	Central government				
Province-level	4 Municipalities	5 Autonomous Regions		23 Provinces	2 Special Administrative Zones
Prefecture-level	14 cities directly controlled by the State Council	261 prefecture-level cities		30 Autonomous Prefectures	22 Leagues
County-level	1478 county level cities	116 counties	49 Banners	3 autonomous Banners	830 districts controlled by the city
Village-level	25557 villages		19184 townships		737429 towns

Note: The data of village, township and town is for 1999 (NBSC, 2001); the other data is for 2002 (HGS, 2003). Source: Hudson, 1997: p.318; Mao Shoulong, 1995; NBSC, online databank; HGS, 2003.

Many China studies concentrate on the regional economy and emphasise the (economic) disparities among regions as problematic for their studies on China's spatial inequality (see Zhao Xi, 1999; Wei Houkai, 1999; Liao Yuanhe, 2000; He Liancheng, 2000; Li Siming, 2000). The Chinese government also makes great efforts to promote spatial development at the regional level. For example, in 1999 the central government initiated a Western Development Strategy which substantially increased government investment in the West to improve the local ecological environment and infrastructure quality, so as to encourage private investment to 'Go West' (see Lin and Liu, 2003¹⁴). But such regional studies do not well consider the large disparities within each region, i.e. across localities in the same region. The aid to the less developed region alleviates the regional disparities; in the meanwhile it may also produce more inequality among localities within the region due to the 'uneven development strategy'. Therefore, this dissertation takes into account both the regional and local economy, but it concentrates on the local one. Since the village-level economy is severely limited in scale with regard to capacity of industrial production, and the somewhat complete economic system and government functions only exist in localities at the county-level and higher spatial levels, this study focuses on the county-level locality.

1.2.2 Less developed locality

According to the definition of economic development introduced above, the level of economic development can be measured (and compared) by a series of indicators including the level of industrialization, the level of urbanization, the economic structure (i.e. the proportion of agricultural, industrial and tertiary industries), the level of people's income (measured by

¹⁴ See also information published by State Council Western Development Leading Group (<http://www.cei.gov.cn>).

GDP per capita), living quality (e.g. HDI), and so on¹⁵. China's provinces can be grouped into three geographical regions – East, Middle, and West – according to these indicators (see Liu Shiqing, 2003; see also Annex 1-A). However, if locality, rather than province, is considered, the complex set of indicators makes it difficult to distribute localities into less developed or developed clusters. There are still 88 million poor¹⁶ people according to the threshold of US\$1/day defined by the World Bank's income measure (The World Bank, 2004: p.3) and these poverty-stricken people are geographically concentrated in a few hundreds of counties. True, the complex indicators are not easily applied to classify localities into less developed or developed groups¹⁷. But in the present China where economy is market-oriented, and in these localities where poverty-stricken people are concentrated, the income indicator is significantly consistent with other development indicators. Hence, these counties are agreed to be less or the least developed although only the (local) GDP per capita are considered (to simplify the statistical work). Furthermore, illegal income and the income which is not counted in official statistical reports are not taken into account to measure the development level of a locality.

From 1986 to the end of 2000, the Chinese government pursued a geographically-targeted approach to poverty reduction – the “8-7 Plan” (National Plan for Poverty Reduction). This Plan aspires to lift the majority of the remaining poor above the [Chinese] government's poverty line (annually modified but always lower than the US\$1/day income measure) during the seven-year period 1994-2000. In sum, 592 counties were eligible recipients of state financial and technical assistance and preferential policies¹⁸. These counties were called the

15 Many measurements evaluate the level of local development in China. For example, the ‘China Modernization Strategy Study Program’ puts forward an evaluation system to measure the level of modernization of a county or a locality. This system adopts a panel of indicators taking into account both economic and social development. Since 2001, China's provinces are annually given marks for their levels of modernization. A province with a relatively low mark is ‘less modernised’ or ‘less developed’ (see China Modernization Report 2001). Economists have also worked out an index to evaluate the level of marketization of a country, region or locality (see Zhang Xiaojing, 2004). In a market economy, the level of marketization is highly related to the level of economic development. As China is developing a socialist market economy, a locality at relative low level of marketization can be classified as less developed. Moreover, some Chinese public institutions organise annually the appraisals of the cities’ and counties’ competitiveness. The competitiveness indexes they use include complex indicators are also instructive to evaluate the level of development (see Economic Daily, 18 January, 2002; Ni Pengfei, 2004; Shandong Province Statistic Bureau online information, 2001).

16 The terms ‘poor’ and ‘poverty’ used in this dissertation are both measured by income.

17 For example, it is possible that a locality has higher GDP but lower HDI and another locality has higher HDI but lower GDP. So it is hard to say which one is more developed.

18 The Chinese government worked out a criterion for the ‘national poor county’ in 1986: the county whose income per capita in 1985 was less than 150 yuan, or 200 yuan for the county of ethnic minority. In 1994, the criterion was modified to cover all the counties with income per capita below 400 yuan in 1992's price (700 yuan income at that time was calculated to be the threshold of having enough necessities to survive). In the 592 counties, 54% of the country's poor population (whose personal income was less than 625 yuan in 1992 price) was

‘National Poor Counties’ and renamed in 2001 as ‘key counties for national poverty reduction and development work’ under a new Plan – “Outline for Poverty Reduction and Development of China’s Rural Areas (2001-2010)” (WB, 2004: p.5; p.11, emphasis added). There were at least 200 million people living in these NPCs whose average income was below US\$1/day in 1997 (OLGPR *et al*, 2000). These NPCs are the mainbody of LDLs in the following study.

Other than the national-level evaluation of the poverty, all provinces have their own criteria to select ‘provincial poor counties’ and aid them in various ways. The situation of the PPCs are various according to the provincial criteria. Some PPCs in the East can be classified into the ‘developed’ group in the Middle or the West. Hence, the PPCs are not consisted in LDLs.

1.2.3 Alleviating spatial inequality: poverty reduction and economic development in LDLs

Alleviating spatial inequality does not only mean to promote social cohesion and political stability at the expense of economic growth, or to develop the LDLs by weakening the competitiveness of developed localities. In fact, promoting economic development in the LDLs can alleviate spatial inequality together with improving national economic efficiency¹⁹.

Economic development in a locality is not isolated from that in other localities, even in other countries. For the present, market and market-based divisions of labour connect economies in different locations (localization) and reunite them at a higher spatial scale (national, global). The intergrowth among localities/regions is becoming increasingly significant in China. The intergrowth phenomenon is particularly remarkable in the newly emerging ‘economic belts’ – Yangtze River Delta and the Pearl River Delta (both are based in the East). However, the existence of LDLs holds up the intergrowth among localities for two reasons. *First*, the low quality of infrastructure and the lack of human resources in the LDLs increase the cost of exploiting local resources for both local and external investors, thus weakening the national economic efficiency (e.g. productivity). *Second*, residents in LDLs are prudent to consume and prefer saving because of their low income and increasingly expensive welfare services caused by the Reform. This considerably restrains the domestic demand’s capacity to absorb

covered. More complete information can be found in Rozelle *et al* (2000), Wang Sangui *et al* (2004), ADB (2004), and on official website of Chinese poverty reduction: <http://www.cpad.gov.cn> and <http://www.cfpa.org.cn>.

¹⁹ This is consistent with the thesis that fairness (or social justice) is helpful to achieve the market efficiency (CERRF and CSGCEIR, 2004: p.169).

the overproduction in the East (Yang Mei, 2003). Therefore, alleviating spatial inequality, meaning *economic development* in the LDLs in particular, will not only benefit the local population, but also support the economic development in other localities and help China to achieve *development*.

Several approaches have been developed to alleviate spatial inequality. A basic one is poverty reduction. A simple approach to reduce poverty is ‘relief-dependent poverty reduction’ through the redistribution of wealth (or fiscal transfer), which directly and immediately improves the payment capability of aid-receivers such as individuals, households, but also localities or regions. But this approach will not necessarily turn the ‘capacity to consume’ into ‘development capacity’. When the payment capability runs out, the aid-receivers are very likely to fall back into the previous situation and wait for a next redistribution²⁰. Because sustainability of poverty reduction is not guaranteed, donor’s reluctance is inevitable.

An effective approach to reduce poverty is the *developmental* approach, which aims at long-term economic development, rather than immediate income growth by fiscal redistribution. If the relief-dependent approach is called ‘blood-transfer’ (*shu xue*), the development approach is called ‘blood-generation’ (*zao xue*). The objective of the ‘blood-generation’ approach is to use scarce public funds to promote local (private) entrepreneurial activities so as to improve LDLs’ self-developing capability. There are two means to ‘blood-generation’.

One is microfinance, i.e. subsidising (low interests or discount) loans directly to the poor people or households. Subsidised people are expected to promote their own ‘family programmes’ to increase their income in a sustainable way. This approach was adopted in China during the last half of the 1980s. But the outcome was not very optimal. “There was a general perception that much of the assistance was not spurring growth but was being used to support consumption directly [according to the studies from China’s State Council]. As is typical for formal subsidized loan programmes, loan repayment rates were low [from 30-65% according to other studies]... The main problem, as described in an important policy document, was that the long term development of ‘social productive forces’ in poor areas was being neglected.” (Rozelle *et al*, 2000: p.8) This approach did not efficiently generate blood due to the inefficient supervision of loan’s performance. Hence, the Chinese government

²⁰ According to my investigation in China, many officials of County Poverty Reduction Office prove this thesis.

shifted its interest to the other approach which targets local economic development, e.g. through directing loans at economic entities – enterprises or scaled programmes (ibid: p.9; see also OLGPR *et al*, 2000).

Economic development is the second means. Theoretically, poverty of individuals can be alleviated by economic development of their locality. But in practice, economic-entity-targeted loans are easily used by local governments for growth-oriented objectives which usually pursue short-term interests. Poverty-stricken individuals may not benefit from the outcome of these objectives (due to the limited spill-over effect) or may not be capable to participate in these entities (due to the lack of education and skill). Therefore, development of local economy does not always lead to poverty reduction for individuals.

Poverty reduction is not well integrated with economic development in the LDLs. This informs us about the deficiency of the existing institutional arrangements²¹. To identify possible solutions, the successful implementation of two World Bank supported multi-sectoral and comprehensive programmes – SWPRP and QBPRP – in China during the 1990s provides precious experiences. But some problems remain to be addressed. For example, *first*, the complexity of the large-scale programmes requires high efficiency of organization and implementation, and slows down the spread of experiences. *Second*, various forces in the *public* sector (central, provincial and county governments), *private* sector (e.g. local entrepreneurs and external investors), and *NGOs* – non-governmental organizations (e.g. the WB, the United Nations Development Programme and the Asian Development Bank at the supranational level and various charity organizations at the national level) meet at the local level, and need cooperation to achieve their different objectives. Current institutional arrangements in China need to be innovated to allow for cooperation that would integrate poverty reduction with economic development.

21 North (1990: p.4-5) states: “Institutions include any form of constraint that human beings devise to shape human interaction, both in formal constraint - such as rules that human beings devise - and in informal constraints - such as conventions and codes of behaviour; affect the performance of the economy by their effect on the costs of exchange and production”. Furthermore, according to the holistic definition, institutions are “contexts of development and development action ...the building blocks of a governance system, institutions in their various meanings of habitus, legal and administrative systems, formal and informal behavioural rules.” (Moulaert and Nussbaumer, 2005: p.2073) In this dissertation, the term ‘institution’ is used with the holistic definition.

Although the cooperation of players from multi-sectors is acceptable as a temporary way of implementing a few poverty reduction programmes, can it become a common and sustainable means to develop the economy in Chinese LDLs? A worry is that, during China's economic marketization, public forces (mainly through government intervention) will damage the market efficiency as they did in the pre-Reform period. According to the free market economics, public-private cooperation is not more efficient than market mechanisms and the result of such cooperation may be troublesome. Is public-private cooperation necessary to economic development in Chinese LDLs and feasible in the market economy?

1.2.4 Economic development in LDLs: the role of public-private cooperation

It is widely acknowledged or believed that the market is an effective institution for resource allocation in modern society (although it is still imperfect in reality). This belief led to the transition of socialist economies into market-oriented economies. But there are at least two constraints on market efficiency (for economic development). *First*, the efficiency of the market (as of any other institution) depends on the ensemble of institutions which form an institutional environment. When constrained by the institutional environment, making a perfect market as depicted by the neoclassical theory is impossible due to the never-zero transaction costs (see Coase, 1937; 1960). Market failures²², such as caused by monopolistic tendencies, externalities, public goods, imperfect information, and rent-seeking behaviour (Ingham, 1995: p.138) are hard to overcome.

Second, the market is a multi-scalar institution – international, national, and sub-national level. At each level, the market is geographically fragmented as it unevenly develops. The individual markets at different levels and in each level may be in severe conflict over their own efficiency. In the case of a country, if integrating its economy into an efficient global market economy cannot promote its own economic development, the country itself will be the victim however efficient is the global market economy. The policy of 'infant industry protection'²³ and the centre-periphery, dependency and underdevelopment theses (see

22 "Market failure is defined as a situation in which the market system produces an allocation of resources which is not Pareto-efficient – it is possible to find ways of changing resource allocation so as to make some consumer(s) better off and not worse off. Hence individual self-seeking behaviour by consumers and firms will not achieve the highest level of welfare for society as a whole insofar as market failure is prevalent. It is predicted to occur in the presence of monopoly and oligopoly, externalities, public goods, and common property resources, in each of which individualistic behaviour leads to suboptimal results." (Wade, 1990: pp.11-12, note 6)

23 "Legitimising limited, time-bound protection for certain industries by countries in the early stages of industrialization" (Zedillo Report,

Prebisch, 1962; Frank, 1966) illustrate this worry. Developing countries (including the less and least developed, or undeveloped, countries) know very well that the market cannot single-handedly improve their national economic development, as “the market was the source of underdevelopment, not its solution” (Lundahl and Ndulu, 1996: p.253). This problem is also observable in local economies within a country.

If market itself is not the ‘solution’, economists inevitably consider other institutions. State intervention²⁴ is used to correct market failures and ensure the market efficiency. Different sources of dissatisfaction with the market economy introduce various approaches of state intervention. Crudely, they can be divided into three groups: market-friendly, market-substituting and market-enhancing²⁵ (see Table 1-2). The market-friendly state tries to maximise market efficiency through maintaining a market-favoured institutional environment; the market-substituting state supports the substitution of the market by government intervention at certain scopes; while the market-enhancing state argues for a government-market integration in order to develop the market and make it function better. These approaches of state intervention may be mixed for specific objectives.

Table 1-2: A comparison among market-friendly, market-substituting and market-enhancing approaches

	Arguments
Market-friendly approach	“The role of government is limited to providing a legal infrastructure for market transactions and providing goods subject to market failure.” (Aoki <i>et al</i> , 1998: p1) But government is not justified to intervene in the micro-economy for such behaviour only leads to inefficiency of market economy. Hence, government is a means to improve or complement market economy. For example, the Keynesian state uses fiscal and financial policies to promote demand at a macro level, to fight high unemployment and deflation (see Keynes, 1936); the Welfare state accepts responsibility for the provision of comprehensive and universal welfare for its citizens in order to maximise the social welfare that market cannot achieve (see Barr, 1992; Atkinson, A. B., 1999; Lindbeck, 2001).
Market-substituting approach	As Lundahl and Ndulu state (1996: p.253), “substituting planning and administrative control for market mechanisms seemed to be the rational way to develop ... It was assumed that the state had to take on great responsibilities for initiating the process of industrialization”. Hence, government is more efficient than a free market for resource allocation and promoting the national economy, while the superior government is in general limited in certain economic sectors and time-periods. In these sectors, government and

2000: p.41). “At least in theory, protection gives ‘infant industries’ the opportunity to prepare for freer trade by becoming more productive through ‘learning by doing’, facilitating local supplier networks, investing in physical capital, and undertaking research and development.” (Slaughter, 2004: p.iii) See also Shafaeddin (1998) for case studies of the infant industry protection in the UK and in the USA.

24 State intervention is often interchangeably used with government intervention in economic studies (see for example, Aoki *et al*, 1998; Wade, 1990), because economic functions of the state is mainly executed by governments.

25 The variety of approaches of state intervention is inspired by the classification of three forms of interventionist state (Aoki *et al*, 1998).

market respectively function so as to contribute to the national economy. There is also an extreme of the market-substituting approach – the Soviet Planning Economy. For such an economy, government regulation is believed to be more efficient than market in resource allocation and the whole national economy is under the government regulation (see Jossa and Cuomo, 1997).

Market-
enhancing
approach

“Not viewing government and the market as the only alternatives, [but] as mutually exclusive substitutes”, some Japanese economists propose to “examine the role of government policy to facilitate or complement private-sector coordination. [They] start from the premise that private-sector institutions have important comparative advantages vis-à-vis government, in particular in their ability to provide appropriate incentives and to process locally available information. [They] also recognise that private-sector institutions do not solve all important market imperfections and that this is particularly true for economies in a state of low development. The market-enhancing view thus stresses those mechanisms whereby government policy is directed at improving the ability of the private sector to solve coordination problems and overcome other market imperfections.” (Aoki *et al*, 1997: pp.1-2) This approach does not regard market as a static institution (as market-friendly approach does), but an evolving one. In a market at an early stage of formation, government can help and has the responsibility to help the market development. The great economic development in East Asia awards the market-enhancing approach²⁶ (see Wade, 1990).

Source: Various references with author’s design.

In China’s case, reformers have successfully developed the economy through the market-enhancing approach in place of the pre-Reform market-substituting approach since 1978 (see Chapter 3). But the market was not evenly developed across localities. Reasons can be found on both market and government sides. *First*, Chinese localities generally vary from one to another in economic situation (e.g. local GDP, productivity, population, resource endowment, and physical infrastructure) and in business culture (e.g. entrepreneurship). Their capabilities and ‘opportunities’ to develop local markets and to integrate them into the national as well as global markets considerably differ. *Second*, the Chinese government adopted an uneven development strategy to enhance market-building and allocated scarce resources to those sectors and locations with (potential) advantages in market competition.

Local governments’ attitudes to market were also partly responsible for economic inequality. Some local governments, especially in coastal localities, tried every effort to promote private forces and led local economies into the global market (see Yang Ruilong, 2000; Jiang Debo, 2004). The great contribution of township and village enterprises (TVEs) to the Chinese economic development is attributed to the collaboration between local government and private entrepreneurs in order to take advantage of the market (Walder, 1995; Chen Hongyi,

²⁶ The success of East Asian economies is accredited not only to market-enhancing approach, but also to the market-substituting approach, e.g. the successful implementation of industry protection policies.

1997; Chen and Qian, 1998; Qian and Weingast, 1998; Oi and Walder, 1999; Li Xiaoyi et al, 2000). Meanwhile, many other localities hesitated to develop their local markets so that the private economy grew very slowly. As a consequence, local markets developed following various paths and have reached different stages of development in the present day (see Chapter 4).

Learning from developed localities, the efficient public-private cooperation, e.g. cooperation among private entrepreneurs, local governments and the central government, is more important than each of the sectors (public, private) works individually (see Chapter 4). However, if now the market-friendly approach is applied in the whole country, the cooperation will not be easy to achieve in LDLs. Due to the market-friendly approach, local government has to concentrate on offering civil services and improving institutional environment to fully develop the market²⁷ (see Wang Shanmai, 2002). That means that the various experiences from the developed localities about their local governments' intervention in local economic take-off are no longer instructive. In addition, preferential policies from the central government are less available now in order to reduce the policy bias and maintain the fair competition in the national market. Hence, in this topic, only private forces and market regulation are possible for local development²⁸. The problem is that both of them will not autonomously favour LDLs in their competition with the developed localities which have better physical infrastructure, a market friendly institutional environment, and large reserves of human resources (including those coming from the LDLs). Improving the competitiveness of LDLs through infrastructure construction needs a large amount of investment (both financial and human resources) which is beyond the fiscal capability of local governments (see Chapter 4).

27 Willy Wo-Lap Lam, a CNN Senior China Analyst, reported ("China's WTO membership – now the hard part begins", 13 November, 2001) that:

"The leaders of coastal cities have come out with unequivocal statements about the new goal of 'small government, big society' or 'small government, big service'. Shanghai's dynamic mayor Xu Kuangdi said last week: "What we must do immediately is to change the functions of the government." Xu played up the importance of rendering institutions and systems more compatible with global standards. Likewise, Executive Vice-mayor of Shenzhen Li Decheng said governmental structures and behaviour would be transformed in three to five years. "A government based on law and regulations will replace one based on power", Li said. "A service-oriented government will replace a command-type government."

28 An exception is the poverty reduction programs.

Therefore, for economic take-off in LDLs, the market-enhancing approach is still helpful. It needs rethinking the roles of public and private forces in local contexts. Efficient government intervention which facilitates public-private cooperation will help LDLs more than an institutional arrangement which combines a market-friendly government with a less developed local market. There is an institution which provides a platform for public-private cooperation, i.e. the SOE. In the pre-Reform period, the SOE had contributed much to the LDLs for industrialization as well as urbanization under the leadership of the totalitarian government. But at that time, private forces were absent in the SOE. Since the 1978's Reform, the SOE has reduced its role in local economic development into very *limited* contribution by tax-payment and job-creation. LDLs now hardly benefit from the local SOEs. Why did the SOE change and could it be useful to the economic development in the LDLs?

1.2.5 State-owned enterprise: an institution for economic take-off in LDLs

Economists are familiar with the state-owned enterprise (SOE). But its definition varies according to the initiatives in different countries and in different periods. Confronted with the economic crisis in the 1930s, the European states created SOEs to manage aggregate domestic demand in order to reduce negative effects of economic cycles (Zhang Huiming, 2000: p.3). Then, not long after the World War II, "in Western Europe, socialist Governments in the UK, France, Italy and elsewhere embarked on nationalization programmes focusing primarily on energy, transport, and other utilities, but also extending into some of the tradable, heavy industry sectors as well as finance. In a period when conventional (*i.e. mainstream*) wisdom emphasised the importance of economies of scale, these Governments focused on the consolidation of privately owned companies in sectors such as steel and chemicals under the control of large state-owned enterprises." (Iskander, 1995: p.25, emphasis added) These SOEs could no longer be explained by the Keynesian theories, but were in fact deeply impacted by the Soviet socialist ideology. According to the latter, SOEs were created and developed during wartime in pursuit of high allocation efficiency to mobilise national resources, which could not be attained by market or private enterprises on markets.

The Soviet Union established its own SOE institution through the nationalization of private enterprises (transforming them into SOEs) which was completed in the 1920s. The SOE was reinforced as a cornerstone institution for the national economy during the Stalin period. The Soviet-style SOE aimed at overcoming the 'chaotic' and 'wasteful' capitalist production

(based on market and price systems) in order to improve the forces and relations of production. It was a means to the communist/socialist ends. The SOE was more of a state apparatus or government agency than of a normal firm as studied by the ‘theory of the firm’²⁹.

The Chinese SOE was created as an institutional arrangement under both internal and external constraints (Zhang Huiming, 2000: p.3). It has three origins:

- the enterprises that were operated by the Communist Party of China (CPC) as the production units for its war economy in the Revolution Bases;
- the enterprises that were expropriated by the CPC from the Kuomintang (Nationalist Party) bureaucratic capitalism and foreign imperialism before the foundation of the People’s republic state in 1949; and
- the enterprises that were created by the Soviet aid for industrial programmes concentrating on the heavy industry³⁰ in the 1950s.

The Chinese SOE is hard to define because of its fundamental changes in enterprise orientation, tasks, incentive and welfare systems, ownership structure, micro-level management, macro-level supervision (by the state), and business behaviours since the 1978’s Reform. As the SOE still goes on reforming, no conclusion on ‘what is the SOE’ can be easily made. To understand the Chinese SOE needs reviewing its evolutionary path in the historical and national context. In this dissertation, the SOE in the pre-Reform period is called traditional SOE to differentiate it from the SOE in the Reform period.

For Chinese state, the traditional SOE was an institution to control the allocation of national resources (including natural, financial, and human resources) in pursuit of specific goals, such as accelerating industrialization by focusing on the heavy industry. Many SOEs were built near natural resource³¹ bases. Around the large-scale SOEs, numerous small- and middle-scale SOEs were built to complete industrial chains. New cities were shaped on the basis of these SOEs. Hence, the SOE became the cornerstone of the Chinese early industrialization

29 The terms ‘firm’ and ‘enterprise’ are interchangeably used in this dissertation.

30 See Annex 2 for the categories of economic activities.

31 Natural resources are defined here according to Hackett (2001: p.76): “An element of nature is a natural resource when it is directly useful to people, or when human technology can utilize it to form something valuable.” For example, petrol, gas, arable land, agricultural products, mines, etc. are all natural resources. Furthermore, climate, precipitation, geographical and topographical conditions and other natural factors that directly influence natural resources are also taken into account for the analysis of natural resources.

and urbanization during the three decades after 1949. In addition, the state invested a lot of resources in the less developed inner land, especially in the West, according to the coordinated spatial development strategy and the defence-centred regional development strategy (e.g. the ‘Three-Front Programme’ in the 1960s). Through a nation-wide inter-SOE support programme, the SOEs in industrialised localities, e.g. Shanghai and Northeast, sent their employees to the inner land areas and provided technologies, equipment, and experiences for building SOEs there. This programme significantly improved the local physical infrastructure and societal progress. The localities that were then supported accomplished a rapid urbanization and *are* still socio-economic centres in the West (the traditional SOE will be studied in Chapter 2). This experience inspires this study to focus on the SOE for contemporary and future economic development (including poverty reduction) in the LDLs.

The traditional SOEs have undergone transformations since the 1978’s Reform. With the development of market and the market economy, the SOE reform has gradually become a key issue of the overall Reform³². The current SOE reform concentrates on transforming SOEs into modern corporations with the public-private shareholding system, guided by the neo-institutional economics (e.g. theories of transaction costs, property rights, and principal-agents). Improving efficiency in market competition is the major objective of current SOEs. The micro-level organization inside SOEs, e.g. the incentive system, the management system, and the ownership structure, has changed to achieve this objective. The macro-level organization of the SOE institution has also fundamentally changed in order to relieve social and political tasks from SOEs. As a result, the SOEs’ contributions to the economy are reduced to tax payment and job creation.

Since 1993, a 16-word-guidance was put into effect to corporatize SOEs, i.e. ‘clearly defined property rights, clearly defined rights and duties, separation between the government and the enterprise, and scientific management’. Under this guidance, a strategy named ‘seizing the large and letting go the small’ (*zhua da fang xiao* in Chinese) was implemented in the mid-1990s. Most SOEs were privatised, corporatized or went bankrupt, while less than 200 large-scale SOEs (in fact, they are SOE groups)³³ remain with the ‘state-dominating ownership’

32 Annex 3 lists the SOE reform measures with their effects in chronicle order.

33 The criteria of the scales of SOEs are given in Annex 4.

structure during the corporatization as they operate in oligarchic or monopoly markets. Now there is little difference between a remaining SOE and a private corporation with the exception of the state shares in the ownership structure (the SOE reform will be studied in Chapter 3).

From a corporate perspective, the SOE reform has been well designed by the 16-word-guidance and the future effort is to fully implement the guidance and make the corporations profitable on markets. The SOE reform has successfully improved economic performance by transforming traditional SOEs into profitable corporations, as the Chinese government reports (see Li Rongrong, 2007). Meanwhile, corporatized SOEs lost almost all ‘traditional functions’, e.g. fulfilling the political and social tasks, resulting in the reduction of people’s welfare. It is hard to say that the profit-making corporatized SOEs improve national economic efficiency.

The SOE, or precisely say, the state-owned asset/capital (as the definition of the SOE may confuse corporative economists), should differ in nature from the private capital. Its existence should help to maximise the people’s welfare, rather than to maximise return to capital (Ping Xinqiao, 2005). As public-private cooperation is critical to develop LDLs, in the same way that traditional SOEs historically contributed to LDLs’ development, the problematic is hence raised: Can SOEs be innovated to improve public-private cooperation in China’s market economy?

To address the problematic, the economic functions of the government, the firm, local economy, public and private forces should be considered together. The problematic is divided into three sub-problematics (SP) to be covered in the following analysis:

SP1: What are the functions of the traditional SOEs?

How did the SOE reform transform the traditional SOEs into profit-oriented corporations?

What are the deficiencies of the corporations from the local perspective?

SP2: What are the blocks to economic take-off of Chinese LDLs in the actual market economy?

Is the public-private cooperation in the market-enhancing intervention approach

necessary to remove the blocks?

SP3: How to combine the traditional and corporatized SOEs to help LDLs' economic take-off?

The methodology used to address the (sub-)problematic(s) is explained in the following section.

1.3 Methodology

Although there have been numerous studies on the Chinese SOE since the 1978's Reform, the linkage between the SOE and local development has not been paid enough attention to. The mainstream economic theories (in particular from neo-institutional economics), which have dominated both theoretical guidance and policy making during the Reform period, must be held responsible for this shortcoming. As far as the SOE reform is concerned, the major effort of these theories is to *redefine* the SOE objectives, functions, and organizations at both micro- and macro-levels, in order to transform the traditional SOE into a profitable form of enterprise in a market economy, free of political objectives. This re-definition of the SOE is built in an essentialist way, which "uses abstract categories only, claiming generality from a variety of specific situations (i.e. historical epochs, territorial dynamics, and institutional contexts) ... [Essentialist definitions are] context-alienated and therefore detached from real situations, with a tendency to impose path-independent norms" (Moulaert and Nussbaumer, 2005: pp.2072-2073). From this perspective, it is not surprising to see that the current SOE theories manage to generalise the SOE with no regard to the various situations across localities which are in different stages of economic development (e.g. industrialization, urbanization, marketization, etc.) and institutional transformation. The SOE reform alienates the SOE from its historical, spatial/territorial and institutional contexts.

This dissertation focuses on the linkage between the SOE and local development. Three themes of economic research – the theory of the firm, local economy, and economic functions of the government – are integrated, rather than analysed separately for a context-alienated, normative outcome. The essentialist approach is misleading and I privilege the holistic one (which is connected to the American Pragmatist school, the German historical school, and the

old American institutionalism)³⁴ to drive this study. Three analytical modes, all of them empirically grounded, support this holistic approach. They are the part-whole, the historical and the process analyses. To apply them, I consider the empirical analysis (mainly the field study) as a fourth analytical mode. This is in line with the American Pragmatist tradition (see Ramstad, 1986). The four analytical modes are interpreted as follows.

1.3.1 Part-whole analysis

According to Ramstad (1986: p.1071), holists believe that “Reality is conceptualized as an integrated whole, a unity, not as a set of logically separable structures and processes ... entities or activities are assumed to be truly comprehensible only in their interrelationships with other entities or activities.” The criterion to measure the rationality of a part’s action is subordinated to that of the whole. Furthermore, each part has its end, but this end is only the means to attain the end of the whole (Lange, 1967).

From 1978 on, when China began transforming its economy to a market-based one, economic interests were emphasised and the market logic gradually dominated the policy-making. But the market logic is mainly interpreted by mainstream economics, which isolates economy from society that embedded it. Social norms, trust, morality, and value judgement are oversimplified in mainstream economics. Based on the market logic, China’s pre-Reform economy is criticized by economists for inefficiency because of not market-based and too much political interference. In order to improve economic efficiency, Chinese reformers insist on perfecting market regulation and constraining government intervention in the economy. The overemphasis on economic growth and isolating the SOEs from their local economies as well as from its real context are outcomes of the Reform. But the reform measures hardly achieve the effects promised by mainstream theories, while many ‘unexpected’ or ‘unimagined’ results are brought about³⁵, because of the social embeddedness of the market.

34 According to Moulaert and Nussbaumer, “...both types of definitions (essentialist and holistic) as ‘mutually exclusive’ but as complementary, each having its specific analytical role. The essentialist definition provides a guideline for contextual analysis, whose result (the holistic definition) is intended in its turn to reshape the former, while offering a richer source for comparative analysis of typical cases.” (2005: p.2073)

35 China’s Reform went through some bad experiences due to the abuse of the ‘normative’ proposal. For example, recently China’s medical reform has been publicly criticized as “basically not successful” and “the marketization of the medical system is totally wrong” (Journal of Chinese Youth, 28 July, 2005). The up-roaring tuition caused by the educational (in particular university tuition) reform is also under severe criticism by the public because the expense for child’s education occupies a large share in a household’s income. The international experience is also available for the adoption of mainstream proposals. For example, the Russian economic transition in the end

In recent years, many criticisms have come from heterodox theories, such as institutional economics³⁶, social economics³⁷, and economic sociology³⁸, which emphasise the social embeddedness of economy (see Figure 1). According to these arguments, the economy is a subsystem of society, and the social embeddedness of the economy results in a significant ‘economic’ sphere of ‘social relations’, including formal institutions and informal ones which exert influences on the effectiveness of its functioning, such as production, distribution, exchange, and consumption of social goods. On the basis of such understanding:

- economic development is a means for an overall development which is targeted at building a harmonized society and cannot be achieved by a market economic approach only;
- the SOE does not only exist for its own profit-making – economic interests – on markets, but also to contribute to the efficiency of the national economy and society; and;
- the economic functions of the government must be evaluated as it should serve both economic and social interests.

of the 20th century shows severe inconvenience (or failure) of the ‘shock therapy’ reform guided by the mainstream theories, which intended to liberalize prices, cut subsidies and stabilise the country's budget without respecting the institutional arrangement and social constraints. More comment on the Russian reform can be found in Desai (1996) and Marangos (2002).

³⁶ See Commons (1934) for the discussion of institutional economics.

³⁷ Max Weber has described social economics as “the study of (a) economic phenomena, (b) economically relevant phenomena and (c) economically conditioned phenomena. The first of these categories covers economic phenomena in a strict sense, such as economic events and economic institutions; and Weber has little to say about this category except that it includes phenomena the economic aspects of which constitute their primary cultural significance for us” (Swedberg, 1998: p.19).

³⁸ “Economic sociology can be defined briefly as the application of the sociological tradition to economic phenomena in an attempt to explain these” (Swedberg, 2003: Preface Xi). The researchers in this school are generally classified as sociologists, but as their studies “share most of the concerns and goals of economics” (ibid), why are they not economists? “By the mid-1980s economists had started to redraw the traditional boundary between economics and sociology” (ibid: p32). The difference between the ‘old economic sociology’ and the ‘new economic sociology’ proposed by Granovetter and Swedberg is not discussed here, but can be found in Swedberg (2003: Chapter 2)..

Figure 1: Discussion about the social embeddedness of the economy

1. Karl Polanyi, in his “The great transformation”, demonstrates the efficiency of various economic mechanisms, rather than the market, in the pre-capitalist societies, and he criticizes the view that the market economy implies a self-regulating system of markets, which is “capable of organizing the whole economic life without outside help or interference would certainly deserve to be called self-regulating.” (Polanyi, 1944: p.45)
2. Max Weber makes a classification of the types of market and economic-social systems and he asserts “only rational capitalism is centred on the modern type of market...rational capitalism...has emerged only in the West” (Swedberg, 2003: p.16-17).
3. Hodgson (1988: p.174) points out that “there is a neglect of the customary, legal, political and other social arrangements which are central to all market systems”. He defines the market as “a set of social institutions in which a large number of commodity exchanges of a specific type regularly take place and to some extent are facilitated and structured by those institutions.” (ibid)
4. Richard Swedberg (2003, Chapter 6) shows us a historical evolution of the market in the socio-economic context and the different degrees of integration of the market into the economy.
5. Granovetter criticizes the mainstream economics “starts with an atomised individual with purely pecuniary motives and places him or her in a problem situation where the problems of society and polity, of social structure and social relations, on economic activities (that is, on production, distribution and consumption) are assumed away ... Individuals, in the hands of [mainstream] economists, are typically under-socialised, isolated creatures, unaffected by society or polity.” He argues that “economic institutions do not emerge automatically in response to economic needs. Rather, they are constructed by individuals whose action is both facilitated and constrained by the structure and resources available in social networks in which they are embedded.” (1992: p.7)

1.3.2 Historical analysis

Historical analysis is often overlooked or misused by mainstream economists. This is also the case in the China studies. Many economists do review the history of an economic institution but judge it only in normative terms of what the economic model should be like; the historical context is not really considered as explanation for its logic of existence (contrast with the mainstream economic rationality). For example, when criticising the inefficiency of the Chinese economy in the pre-Reform period (1949-1978), mainstream economists often compare it with the perfect market economy, while the then international relations and domestic social-economic-political limited resources to develop a highly-efficient market economy in China are hardly mentioned. The SOE is also unjustly assessed by comparing it to contemporary mainstream (or ‘*perfect*’) models of the profit-maximising, shareholding corporation in a market economy, which are supposed to provide theoretical foundations for the SOE reform. In addition, the SOE’s value within its historical context is not sufficiently emphasised in the mainstream literature, where readers can only find shortcomings of the SOE. Without understanding the SOE within its historical context, mainstream economists find easy reasons to criticize the SOE as inefficient, useless and deemed to be eliminated.

In fact, as mentioned in the previous section, the establishment of a market economy is not a natural or spontaneous process, and its efficiency is determined by the institutional and historical contexts. That the market economy did not develop in China can find an explanation in the long Chinese history. Chinese leaders in the pre-Reform period did not develop a market economy because the then international relations and domestic situation – ideological and economic – were severe constraints on developing a market economy. Various forms of economy were tried out for national development and the SOE was established as an institution, helping industrialization and urbanization for the purpose of the social-economic-political interests as a whole (see Chapter 2). Therefore, to establish its logic of existence, an economic institution should be judged in its own historical context rather than according to an ‘abstract or currently universal economic rationality’. As a consequence, in addition to the part-whole analysis, the historical perspective is adopted in this study, to analyse transformations of the forms of economy, the economic function of the government and the SOE. A time axe for this study is given in Annex 5.

1.3.3 Process analysis

A reason for the ‘unavailability’ of a general, normative, or perfect economic model built on the essentialist methodology is due to the difficulty of applying it in various concrete situations. Although the part-whole analysis emphasises the inter-dependence among parts and between parts and the whole, each part has its specific characteristics and development paths which distinguish it from others. Hence, each part is experiencing an individual process, this being of course connected to encompassing wider processes. In the study of local development, process matters. Accounting for the spatial/territorial context makes it necessary to identify causal relations and solutions to problems in specific processes.

However, the criteria of the process analysis are not fully respected by many China researchers and policy-makers. For example, after the Reform began, Jiangsu Province rapidly developed by its TVE-led local development model. According to the theory of property rights, the TVE is troublesome with the unclear arrangement of property rights and exaggerated intervention from local government. Hence, since the late 1990s, these TVEs have been transformed into private firms with clearly defined property rights. This transformation led some government officials and economists to assert that the TVE is obsolete and not useful to transfer to other local development contexts. But they forget the

irreplaceable role of the TVE in the process of specific local development programmes and actions (the Sunan Style will be discussed in Section 4.1). Many government officials and economists assert that the TVE model is obsolete and should not be applied in other localities because the private enterprise is superior to the TVE from the property rights perspective. They do not carefully think of the applicability and feasibility of the TVE in concrete local contexts. Another example is the recent debate of the transforming public services (e.g. physical infrastructure construction, social housing, public health care, public media, regulations/laws, law enforcement, policy and planning, etc.). The advocates argue that the government functions must be transformed in such market-friendly approach so as to better develop the market economy. But they overlook the necessity of the market-enhancing local governments to local economic development, while deny the potentials of such government intervention for the current LDLs. A third example comes from the SOE reform, which tries to transform SOEs across China into generic shareholding corporations in all localities, without taking into account specific local needs. Thus the special functions of SOEs for their concrete localities are abstracted away. The reform of localized SOEs did not certainly improve enterprises' performance or local economic situation.

Therefore, the process analysis is in particular critical to this study:

- *First*, the experiences from the (past) processes of developed local economies may be or not be instructive for the LDLs; it depends on the concrete local contexts;
- *Second*, the SOE reform must be considered in local contexts and the proposed SOEs must develop their functions according to local specificities.

To compare one process to another, both statistical analysis (for large sample observation) and case study analysis (for small-N comparison) are helpful methods (see Hall, 2003). “As Campbell (1975) noted some years ago, because they allow for more careful measurement and the tracing of causal processes, which statistical methods cannot normally accommodate, single case studies can be superior to aggregate analysis for testing some theories” (ibid, p.396). Hence, I adopt case study analysis for the empirical analysis.

1.3.4 The empirical analysis

The ‘hypothesis-deduction’ approach is not favoured in this study for its lack of relevance to concrete institutional, historical and spatial/territorial contexts. This deficiency is particularly

fatal to this study whose objective is to solve problems in real life. Observing and disclosing the practical actions as well as thoughts of agents and interrelationships in-between institutions are essential to finding and solving problems. An empirical analysis is integrated in this study.

The SOE's evolution, local development styles and the economic functions of local governments are at the core of the empirical analysis, for which various sources provide useful references. The Economic Research Journal (from 1950 onwards) and the Economic Daily (during 2000 to 2003) are both Chinese top-grade journals in economic study and have been selected as credible sources. The World Bank (WB) provides a rich source of case studies where the WB participated or led Poverty Reduction Programmes in Chinese localities. The Chinese official institutions, such as the Office of the Leading Group of Poverty Reduction (OLGPR), also provide useful descriptive information on the situation, efforts and outcome-analysis of Chinese poverty reduction initiatives, in official reports prepared for international conferences and the central government of China for example. However, these sources do not concern roles of the SOE in poverty reduction and for economic development in the LDLs³⁹. Therefore, a personal field study was needed to specifically refer to the problematic and hypothesis of this study.

The field study was effectuated in 2004 and 2005, including two trips in China and both covering 10 months of work. It can be divided into three parts:

- interviews with Chinese local government officials;
- case studies of two Chinese SOEs, one of which has transformed into a corporation and the other which is in the beginning stage of a long-term transformation; and
- reference cases from Europe
 - a 7-day investigation in SEMMASSY in France;
 - report of research programme “Local Development Strategies in Economically Disintegrated Areas: a Proactive Strategy against Poverty in the European Community” for the European Commission (EC) DG V – Poverty III, managed by ‘GEIE Animation et Recherche’ covered in Moulart *et al.* (2000); and

³⁹ There are studies on the SOE reform in the LDLs, but they mainly seek ways to reform local SOEs within the framework of the SOE reform, i.e. transforming SOEs in the modern corporation system. Hence, these studies are not interesting references for this dissertation.

- report of research programme “Social Innovation and/in Governance in (Local) Communities” (SINGOCOM), Framework Programme 5 project of the EC.

(a) Interviews with Chinese local government officials

The national poor counties (NPCs) are the emphasis of my field study. In addition, some provincial poor counties (PPCs), ‘not-poor’ counties (according to either national or provincial criteria for poverty) and cities are included in my investigation for comparative analysis. I targeted a very restrained number of localities, compared to the thousands of localities qualified for my investigation in China. To eliminate provincially specific problems, the NPCs which I selected are divided over the Northeast, North, Northwest, and Southwest regions. After telephonic communication with candidate interviewees (two months before investigation), 20 NPCs were set as targets. Since many NPCs locate in remote areas where transport means and topographical characteristics restrain the access to the ‘outside’ market, while other important economic restraints may be neglected, the selected NPCs are ‘near’ railway stations – within 200 km distance. This distance allows for a round trip between the railway station and the downtown area in a day time; thus the cost of exporting local goods is largely reduced and local residents can easily take part in transactions with the outside world. Due to temporary changes (weather conditions, the absence of interviewees, etc.), finally 15 NPCs, 2 PPCs (one lies in East China and the other in North China), 1 not-poor county (in Northwest China), and 4 cities (3 in North and 1 in Southwest) were investigated (a few of them were newly added into the list of destinations). The geographical locations of these localities are pointed out on the map below (see also Annex 1-B).



Note: China’s three big regions – East, Middle and West – are shown in different colours. The light spots symbolise the localities where I did investigation.

The interviewees are government officials in County Poverty Reduction Offices, County Development and Planning Commission, County Policy Analysis Offices, or local Economy and Trade Commissions. These officials are familiar with local economic conditions and practical problems. Many interviewees participate in local policy making and implementation. Locally, they are key figures for economic development. Their thoughts directly reflect and influence local governments' economic functions.

A general questionnaire was prepared and improved during the 2004's investigation in China. It was applied in 2005's investigation which targeted at NPCs (see Annex 6). It included three parts: local economic situation; local government behaviour; and local culture and residents' ideology. As time for each interview is limited to less than one hour, the questions are not designed to disclose every detail but emphasise several subjects. The part of the local economic situation aims to know the quality of local infrastructure, locally specific products and industrial scale. The part of local government behaviour intends to show local government's policies and regulations in economy on the one side, thoughts and activities of local government officials in economic decision-making and shaping interpersonal relationships with local entrepreneurs on the other side. The third part stresses local culture and residents' ideology because both impose critical influences on local government behaviour (especially policy making) and economic performance (as experiences from three local development styles in the Reform period, see Section 4.1).

All interviews proceeded in manner of off-the-record and open-ended dialogue. It is the best way that I find to communicate with the government officials in order to become acknowledged with their real thinking and the real local situation (statistical data is not always confidential). Constrained by their working experiences, interviewees were unable to answer some questions at times but exceeded the questionnaire's expectation in other answers. The result of interviews helps me to identify the blocks to local economic take-off, which are concluded in five observations – geographical conditions and transportation networks, natural resources and locally specific industries, human capital, financial capital and institutional arrangements. These observations address the sub-problematic of **SP2**.

(b) Case studies in two SOEs

Numerous studies concerning the Chinese SOE and its reform have been made by economists both at home and abroad. But my personal living experience inspires me to rethink the current SOE reform from an ‘empirical’ perspective. I was born in a family attached to a large-scale SOE (in a city with more than 6 million residents) and my parents have worked there for more than thirty years. This SOE is painfully transforming into a corporation and is at risk of going bankrupt. The first twenty years in my life were tightly linked to this SOE and I followed the path of its evolution. Many practical problems and the real life of SOE employees that previous studies do not pay enough attention to are thus available to complement the understanding of the Chinese SOE. To avoid one-sided comment, a ‘successfully transformed’ SOE in a neighbouring city is investigated by interviewing one of its chief directors. The sharp contrast between the two SOEs proves the importance of the ‘contexts’ for various SOEs to reform.

The names of the investigated enterprises and localities do not appear in the dissertation, so as to avoid any adverse consequences to the informants because a large part of the information derived from my interviews is politically very sensitive. In addition, some dialogues that I made with local residents and university professors are not mentioned above. They were randomly made without systematic preparation. This kind of field observation is often used by anthropologists and sociologists. But since the information they provide was informal and one-sided, so *less reliable* than the formal interviews, this method is not favoured by the orthodox economic methodology. As some information that I collected was very interesting, e.g. the stories of the economic take-off of localities, the thoughts and actions from grassroots in developing local economy and innovating local governance, they are prudently referred to in this dissertation.

(c) Reference cases from Europe

In November 2003, I interviewed an ex-mayor of the city of Massy-Palaisau (France), who introduced briefly some great events in the past four decades and emphasised the role of the central government in supporting the economic development of the county, the city and the local large-scale enterprises. Then I spent five days in a local mixed ownership (public-private) enterprise – SEMMASSY – to understand its daily operation through participatory investigation. The multi-level government (EU, national and municipal) participated and the

SEM (société d'économie mixte) network experience is also relevant to my research focus. This experience provides me with a living example for multi-level public-private cooperation in a market economy (in France).

In addition, this dissertation sheds light on two research works, which were accomplished under the coordination of Professor Moulaert, dealing with theoretical reflections on local development and holistic methodology for empirical analysis. The *first* one was a research programme on “Local Development Strategies in Economically Disintegrated Areas: a Proactive Strategy against Poverty in the European Community” for the European Commission (EC) DG V – Poverty III and managed by ‘GEIE Animation et Recherche’. The product was given in its final report (Moulaert *et al*, 1994) which addressed the meaning of poverty and deprivation, social exclusion and integration through economic initiative within developing local communities. The *second* one was named “Social Innovation and/in Governance in (Local) Communities” (SINGOCOM), the Framework 5 project of the EC. It was “a socioeconomic research project dealing with ‘social innovation in governance for local communities’”; the researchers based on their extensive experience as researchers and activists in civil society and local government provided a comparative overview of high quality and innovative community development initiatives in European cities with a new synthesis of theoretical foundations (Moulaert *et al*, 2005: p.1070). SINGOCOM has undertaken an empirical analysis of 32 cases of social innovation, historical or contemporary, followed by an in-depth study of 16 cases; it has developed an ‘alternative model(s) for local innovation’ (ALMOLIN) in order theoretically to orient and methodologically to structure the case study work in the project. Detailed information about SINGOCOM is given in its final report (see Moulaert *et al*, 2005) and a large part of the research results are available on the official website <http://users.skynet.be/frank.moulaert/singocom>. Both of these research projects integrated empirical analysis with theory building for models of local development, and combined economic development with social innovation. Some difficulties of local development disclosed in the case studies of SINGOCOM are also familiar with Chinese LDLs. The local development models analyzed by use of ALMOLIN are instructive for my China study. However, this study is not a simple replication of the ‘Europe-targeted’ work with Chinese case studies. It aims to develop a new perspective to study local development by incorporating the study of the SOE – the institution with Chinese characteristics.

1.4 Structure of the Dissertation

This dissertation is divided into five chapters as depicted in Figure 2. Chapter 1, i.e. this chapter, is dedicated to a general introduction. It is placed high up in the figure and consists of four sections – background, problematic and its logic, methodology and structure. Following the first chapter, Chapter 2 and 3 are placed in both sides of the figure. They try to cover the sub-problematic **SP1**.

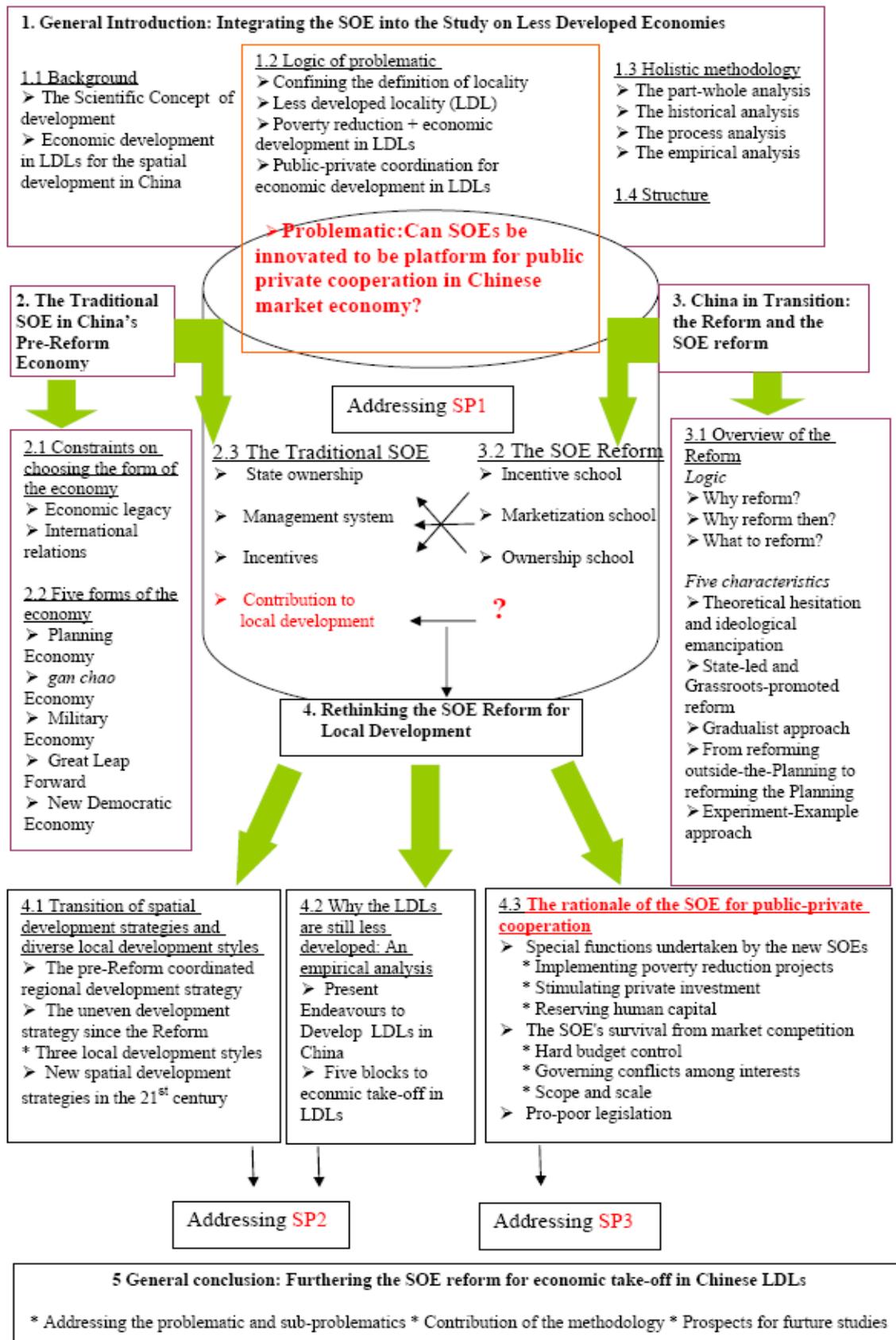
At the left side, Chapter 2 introduces the socialist practice in the pre-Reform China (1949-1978) and covers it in three sections. Section 2.1 explains why the market economy did not emerge in China before 1949 and why it was not adopted after 1949 until the Reform in 1978. Domestic economic, political, social constraints as well as international relations are taken into account. In Section 2.2, five forms of the economy – Planning Economy, *gan chao* Economy, Military Economy, New Democratic Economy and Great-Leap-Forward – are synthesized to illustrate the specificity of the then complex Chinese economic-socio-political system. These two sections explain the historical and institutional background for the traditional SOE which is analyzed in Section 2.3 according to four dimensions: state ownership and state-Party-SOE relationship, management system inside SOE, working incentives and SOE's contribution to the less developed localities.

Chapter 3, at the right side of the figure, introduces the features of the Reform and the evolution of the SOE since 1978 in two sections respectively. Section 3.1 presents an overview of the Reform through analyzing its logic and characteristics. The logic of the Reform is explained by answering three questions: Why Reform? Why Reform then? What to reform? Then five characteristics are summarized as: 'late-coming' theory and ideological emancipation; state-led and grassroots-promoted reform; Gradualist approach; from reforming outside-the-Planning system to reforming the Planning system; and Experiment-Example approach. This section introduces the background for the SOE's evolution and is in contrast with Section 2.1 and 2.2. Section 3.2 studies the SOE reform through a brief survey of three schools of thought – incentive, marketization and ownership, combining with reform measures led by them. A contrast between Section 3.2 and Section 2.3 helps to understand how the traditional SOE has been transformed and stand out the missing consideration of the specific functions for local development. To make the contrast clear, Section 2.3 and 3.2 are put in a box in the middle of the figure and below the problematic.

Chapter 4 is situated at the lower side of the box. It tries to establish a link between the SOE reform and local development and addresses the sub-problematics of SP2 and SP3. Section 4.1 reviews Chinese spatial development strategies since 1949 and briefly analyzes three remarkable styles of local economic development since the Reform. This review explains from the macro-level the evolution of spatial (regional and local) inequality in economic development. The experiences from the styles disclose the critical role of public-private cooperation in local economic take-off. Section 4.2 covers the other part of the **SP2** – why the LDLs are still less developed. *First*, it introduces the present efforts to develop LDLs. *Next*, it makes a synthesis of five observations – results of my on-site investigations – in order to identify the blocks to local economic take-off in the current LDLs. A conclusion is that to remove the institutional block is a key to economic take-off in LDLs and promoting public-private cooperation should be at the heart of institutional innovation. Then, Section 4.3 proposes a new type of SOE meant to achieve the public-private cooperation. Combining the traditional SOE's contribution to local development with the market dynamics for profit-making, such SOEs could undertake certain socio-political objectives through cooperation among the central government, local governments and private investors. Special functions, survival within market competition, and Anti-Poverty legislation are discussed respectively to cover the **SP3**, while further study is still needed.

A general conclusion is given in Chapter 5, placed at the bottom of the figure. *First*, it summarises the entire dissertation and addresses the three groups of sub-problematics. *Second*, the specific significance of the methodology adopted in this study is stressed.

Figure 2: Structure of the dissertation



Note: numbers correspond with chapters/sections in this dissertation; symbolises links between sections and chapters; and symbolises relationships between topics;

CHAPTER 2

THE TRADITIONAL SOE IN CHINA'S PRE-REFORM ECONOMY

Introduction

China's economic system in the pre-Reform period formed a 'whole' generally named 'central planning' or 'central command', which is highly different from the capitalist economy (such as European and American economies). This form of the national economy was symbolised by abandoning the market institution, and even suppressed the visible market place to nearly replace it by a rationing system (for both production and consumption). But if the market economy is so efficient as modern mainstream economists believe, why did it not develop itself in China, or why did the newly founded People's Republic state and its leaders not make efforts to build up a market economy, but instead explored some unprecedented ways (even not completely copied the Soviet form) to develop the national economy? To give an answer to these questions is the first task of this chapter.

Under the Maoist ideology in the pre-Reform era, governing a country was like 'playing a chess game' (which was called in Chinese "*quan guo yi pan qi*")⁴⁰. According to this holistic idea, locality (e.g. provinces, cities, counties, villages) and economic sectors (e.g. agricultural and industrial production, development planning, resource allocation and redistribution) had to harmonise each other to serve the national economy as a whole; collective interest, superior to individual interest, was the base for economic pursuit. The Stalinist ideology, the tradition of Chinese political sovereignty, and the actual international relations all determined the Chinese way of development.

Although China's pre-Reform economic practice is severely criticized by current mainstream economists, especially for the replacement of the market with the central planning in

⁴⁰ This idea was put forward by Chen Yun, one of the former top leaders of the CPC. But it is a problem to find its original source. The earliest one that I can find is the Commentary of the People's Daily, 24 February, 1959.

regulating economy, the economic achievement in that era should not be disregarded and the ‘economic miracle’ should not be totally attributed to the Reform as some reformers propagate⁴¹. The failures of China’s pre-Reform economy could be due to factors such as utopian efforts that went against the laws of the economy (e.g. the radical implementation of the Great Leap Forward and ‘producing the socialist human’); destructive political movements that provoked social unrest (e.g. the most ‘famous’ one is the Cultural Revolution); and the scarce human resources that constrained the fulfilment of the development plans. Natural catastrophes and tense international relations should also be paid attention to. Nevertheless, an objective appraisal of the pre-Reform economy is still necessary, and we have much to learn from the past for the further economic development of socialist China.

In China’s pre-Reform economy, besides the central planning, state-owned enterprise (SOE) as a strong state instrument penetrating the micro economy from the industrial perspective also symbolised state intervention. The analysis of the SOE can provide rich knowledge to understand its critical role in implementing the state plans. It can also provide understanding of the Party-society relationship and the (urban) residents’ dependency on SOEs for working and living, so as to finally understand the ‘(chess) game’. The contribution of the SOEs to local development in the pre-Reform period is a good illustration of the SOE’s social and political tasks and its role in shaping the so-called socialist society from its spatial perspective. This role is the very characteristic that distinguishes the then SOE from the capitalist firm, and from the reformed SOE (since 1978’s Reform). It is also the very factor that can explain both the SOE’s contribution to the pre-Reform national economy and the SOE’s difficulties in the Reform.

This chapter focuses on the traditional SOE and its context - China’s pre-Reform economy. It consists of three sections. The first section explains the constraints on China’s choice and design of the national economic system. A historical analysis is made to explain why the market did not emerge spontaneously in the ancient China, or why it was not chosen to

41 As Han Deqiang (2000) criticizes, in many people’s eyes, the first thirty years after the foundation of the PRC is the ‘pool of ridiculous events’, such as the anti-rightist movement in 1957, the Great Leap Forward in 1958 and the catastrophe in the following three years, as well as the Cultural Revolution since 1966. Economic stagnation, scarce living materials, political persecution, dull cultural life, etc. fills in people’s memory; while the public media is only interested in the achievement during the Reform period, twenty years following the thirty years.

regulate the economy of the newly founded socialist China – the PRC. The analysis of the international relations is helpful to answer the latter. The second section briefly surveys five forms of the economy that were adopted in Chinese economic practices in that era. These forms illustrate China's economy by different logics. The third section analyses the SOE with respect to external supervision (mainly by the State), internal management, working incentive and its contribution to the local development.

2.1 Constraints on Choosing the Form of the Economy

This section explains the constraints on China's economic development from two perspectives: economic legacy and international relations. Other kinds of constraints could also be incorporated into such analysis, for instance, the geographical conditions and resources endowment. But as the aim is to give a background for the discussion of the choices and innovations of economic institutions, which are criticized for their low efficiency in resource allocation and failure in developing the national economy by actual mainstream economists, more emphasis is given to social and institutional dimensions, rather than natural environment. So these two aspects are chosen for their importance to the formation of 'Chinese characteristics' that distinguish China's economy and society from those in other countries.

2.1.1 Economic Legacy

A long-term historical approach is adopted here to introduce the economic legacy of the People's Republic of China (PRC). It focuses on explaining: (1) why did not the industrial revolution and capitalist economy emerge in the pre-modern⁴² China; (2) the damages to China's economy by fighting invaders and the civil war between the Communist Party and the Nationalist Party from the mid of the nineteenth century until 1949.

(a) Pre-modern China (before 1840)

By 300 B.C., Chinese society had developed into a form that had many characteristics of a market economy, with most land privately owned, a high degree of social division of labour, fairly free movement of labour, and well-functioning factor and product markets (Chao Kang, 1986). China's pre-modern achievements in science and technology were even more

⁴² According to Chinese historians, the Chinese history is divided into three periods: ancient China, or pre-modern China, before 1840; modern China, from 1840 to 1949; and contemporary China, after 1949.

remarkable and thus Chinese manufacturing crafts were highly developed⁴³. In retrospect, China had a brilliant start and remained creative for two thousand years of pre-modern history. Many historians agree that by the fourteenth century China had achieved a burst of technological and economic progress, and that it had reached the threshold level of a fully-fledged scientific and industrial revolution (Lin Yifu, 1995: pp.270-271). However, in the mid 19th century, despite its achievements in science, technology and culture, China's evolution stagnated in the feudal agricultural society. Since then, China has lagged far behind the European countries which experienced the Industrial Revolution - the great technological (e.g. Watt's steam machine, railway technology) and institutional (e.g. the patent protection in the UK) innovations, and stepped into capitalist society in the 19th century.

Why did capitalism not emerge in China? According to the thesis that it was the industrial revolution that led the UK and other European countries to capitalist societies, the question can be changed to: Why did the Industrial Revolution not emerge in ancient China? This is the famous 'Needham Puzzle'⁴⁴. Many scholars have given explanations, such as inadequate capital, restricted markets, political hazards, and lack of entrepreneurship in the ancient China. Among them, Elvin (1973) focuses on the rising human-to-land ratio to explain the stagnation of China's technical innovation. The rising human-to-land ratio implies that labour became increasingly cheap and resources and capital increasingly expensive. Therefore, the demand for labour-saving technology also declined and the inventive creativity became insufficient. Lin Yifu (1995), however, gives another reasonable explanation lying in the different ways in which new technology is discovered or invented in China and in Europe. He explains that, "in pre-modern times, technological invention basically stems from experience, whereas in modern times, it mainly results from experiment cum science ... During the period of experience-based technological invention, Europe was at a comparative disadvantage due to its smaller population - a smaller population means a smaller number of trials. However, this disadvantage was countered by the shift to experiment-based technological invention and the closer integration of science and technology arising from the scientific revolution in the seventeenth century." He also agrees with other scholars that "China's failure to make the transition from pre-modern science to modern science probably had something to do with

43 Up to the late 11th century, the total output of iron was estimated to have reached 150, 000 tons.

44 Needham's research started in 1937 as a result of his befriending some Chinese students in Cambridge who had profound knowledge of the history of Chinese science. His systematic research on the same subject started in 1948, and the first volume of "Science and Civilization in China" was published in 1954 by Cambridge University Press (Lin Yifu, 1995: note 6).

China's socio-political system", but he disagrees that the system prohibited intellectual creativity. "The incentive structure of the system diverted the intelligentsia away from scientific endeavours, especially from the mathematization of hypotheses about nature and controlled experimentation." (Lin Yifu, 1995: pp.276-281) Therefore, the industrial revolution based on a series of scientific achievements could not emerge in the pre-modern China.

However, Xu and Chen (2003) and Xu Pingzhong (2003) argue that the driving force of Capitalism is not technological breakthrough, but the development of the market (economy); and that technological breakthrough is produced by the market demand. They attempted to answer the question: Why did the market economy not emerge in China? They give an explanation in terms of the geographical and transportation constraints on the development of the market. The natural conditions in Europe were very diverse and have resulted in a wide spectrum of produced goods in Europe. The differences made the comparative advantage possible and stimulated the boom of local markets. Furthermore, the natural conditions in Europe were favourable to cheap transportation, in particular the inland water and inshore transport, which made the realization of the market exchange based on comparative advantage possible. Market demand caused profit, and profit stimulated technological progress that was translated into great innovations in forces and relations of production. But Chinese natural conditions were different. Chinese civilization mainly developed around the big rivers (e.g. the Yellow River and the Yangtze River), which go from West to East. Climate and soil produce similar agricultural products and no exchange interest arises. The North-to-South differences were great, but there are no significant rivers going along this direction (except the Jing-Hang Canal constructed during three periods from 456 B.C. to A.D.1293 1794 km long⁴⁵). Land transportation was the major means to connect the northern and southern markets. But the cost of land transportation was 30 times that of inland river transportation, including the risk of robbery. The delay for transport also limited the categories of tradable goods. Therefore, even though local markets were dynamic in pre-modern China, they were in fact constrained to small-scale spaces without much connection with each other. Self-sufficient production was the only rational choice for the residents⁴⁶. Although productivity and prosperity attained a relevant high level and surpassed the threshold needed for capitalist

45 More information about the Jing-Hang Canal is given online, e.g. <http://www.huaxia.com/ly/shls.he.dyh.html>.

46 The large cities were an extension of local agglomerations; they were also restrained by the transport conditions, which was a setback for developing the national connected 'market economy'.

production, neither the large-scale market economy nor large-scale production came into being in ancient China.

(b) Modern China (1840 – 1949)

The economy of the Modern China was hardly developed and pushed to collapse in the eve of the foundation of the PRC. The main reasons were the capitalist countries' invasion (during the period 1840 to 1949) and the civil wars among Chinese warlords (during the first decades of the 20th century) and between the Communist Party of China (CPC) and Nationalist Party (*Kuomintang*) (since the 1920s until 1949). Although the capitalist economy was introduced in China when the capitalist invaders opened China's door in 1840 and has sprouted in the modern China since then⁴⁷, its development was severely limited due to the chaotic domestic political and social environment.

China's gross output (including agricultural and industrial outputs) increased very slowly between 1912 and 1949 without changing income per capita. During the war period from 1937 to 1949, the output per capita and income per capita significantly decreased (Yang Xiaokai, 2001). Some scholars focus on the overall performance of the national economy. For example, the workers in mines and in modern industry accounted for a mere 0.5% of the national population in 1930s. The modern industrial output was only 12.3% of the total agricultural and industrial output in 1933 and decreased to 9.5% in 1935. Comparing China, USSR, US and Japan in 1935, the weight of primary production in total manufacturing output was 5.5%, 58.5%, 42.4% and 48.3% respectively (Dong Fureng, 1999: p.10). In addition, the structure of industrial capital in 1936 was 76% for foreign capital, 8.4% for government-operated capital and 15.6% for domestic private capital (ibid.). The then Chinese secondary industry depended heavily on foreign capital and technologies.

In his study of Chinese industrial productivity during 1933-1946, Wang Jingyu (2004) concluded that, during the Sino-Japan War Chinese industrial productivity declined except for *dongbei* (the Northeast region) which was occupied by Japan; but Chinese main industrial regions had developed their industrial capacities and scales before the retreat of the Japanese, e.g. Shanghai began to display its remarkable industrial capacity, *huabei* (the Middle-northern

⁴⁷ The effort to transform the political institution and build up a market-based society (not only economy) has begun since the end of the 20th century in China (Wang Hui, 2003).

region) had already become a national base for industrial production, and the rear area (mainly the Southwest region) had shown a big potential of industrial development. The productivity increased by 8% from 1933 to 1946. However, the following three-year civil war gravely destroyed the industrial base. The production of cotton, silk, cigarettes, cement, paper, paint and machinery endured more than half a reduction, and many factories stopped working. In *dongbei* and *huabei*, capital equipment was destroyed and Chinese industrial production nearly collapsed. In that period, the productivity of Chinese labour was only 1/19 of the labour in the US.

The economic performance also varied across the country. The rural-urban duality was so typical that capital (foreign capital, government-operated capital and domestic private capital) concentrated on urban areas. Meanwhile, farmers still used traditional mode of production under the sovereignty of landlords (Wu, Li, 1999: p.47). From 1900 to 1938, Chinese urbanization accelerated and urban population accounted for 5% - 6% of the total national population of 500 million in 1938 (Feuerwerier, 1983: p.85). The coastal large cities were connected with the international market and developed a higher level of division of labour; many new professions and industries appeared in these areas (Sachs *et al*, 2000). In comparison, the broad rural areas and hinterland were still self-sufficient societies and only a small part of products (lightly weighted in national income) were exchanged in about 70000 enclosed and separated local markets. The self-sufficient rural population accounted for 75% of the national population and the agricultural output was 65% of the national aggregate output (Feuerwerier, 1983: p.28, p.33; Skinner, 1964: pp.3-44). There was only limited trade and division of labour among cities and local markets and no national united market has formed (Yang Xiaokai, 2001). On the other side, because of the favourable location for transportation and foreign investment⁴⁸ that coastal region benefited from the colonial economy, while the inner regions hardly or slowly increased their production output. The *dongbei* hosted more than half of the national heavy industry and in 1943, its output of iron, steel, coal, electricity and cement accounted for 82.7%, 93%, 49.5%, 78.2% and 66% respectively of the national total according to the statistic data made by Japanese government. According to a survey made by the Economic Department of the Kuomintang government in 1946, 63% of factories and 61% of workers in Chinese main city factories were located in Shanghai and Tianjin – two major metropolises at that time (Wu Li, 1999: p.47).

⁴⁸ In this dissertation, investment from Hong Kong, Macao and Taiwan is also included in the category of foreign investment.

In 1949, Chinese population was 545.83 million with 1.4444 billion ‘*mu*’ of arable land⁴⁹. The rural population accounted for 75.7% of the national total and the agricultural output per capita was about 200 kg (compared to 311 kg in 1914 and 1915, and 270 kg in 1936). Compared to data of 1936, total production outputs suffered an overall reduction: 21% for agricultural output, 26% for agricultural livestock, 27% for agriculturally used chemical fertilizer, 45.6% for cotton, 30% for coal and 57.2% for cement. In addition, the social situation was also quite alarming. In 1949, there were only 205 universities, with 116.5 thousand students, 629 Master students, 46 thousand teachers (including professors) and staff, and the annually enrolled new students were no more than 30.6 thousand; 5219 middle schools educated 1.27 million students while enrolling 500 thousand new students per year (Wu Li, 1999: pp.46-67)⁵⁰. Among the enormous population, the level of national education was considerably low⁵¹.

Even though the foreign, government-operated, and private capitals had followed the western style of the capitalist economy and managed to promote the capitalist economy in modern China, the poor economic performance showed a very different outcome compared to the western developed capitalist economies during that period. This made the CPC leaders question the feasibility of developing the capitalist economy in the Chinese context. An important point to be noted here is that the Nationalist Party had taken 875 tons of gold (nearly all of Chinese gold reserve at that time) to Taiwan by the end of 1949 when it was defeated by the CPC in the civil war. This aggravated the capital shortage and the difficulty to develop a capital-based economy in the newly founded PRC.

49 1 *mu* = 1/15 hectare, or 10000/15 square metre.

50 More data is provided by economic historicists, such as Yao Kaijian (2003) and other authors mentioned in his bibliography.

51 Many recent studies also pay attention to short-term (less than 10 years) and middle-term (10 years to 100 years) performance of specific economic sectors. Three syntheses of modern China’s economic history were published by Xiao Jia (2001), Yang, Jun (2002) and Gao Chaoqun (2004) respectively. They collect 572 articles from 157 Chinese journals and revues that account for the entire outcome made by Chinese researchers. These articles cover nearly all the (super-provincial level) regions and many localities of China and encompass almost all of the economic sectors, such as agriculture, rural economy, handcraft, industry, transportation, mining, commerce, finance, money, fiscal system, businessmen and entrepreneurs, market investigation, foreign debt, trade and investment, overseas Chinese economy, urbanization, social transition, economic policy and thoughts, modernization, etc. They compose together a very detailed economic as well as social situation and transition of the modern China.

2.1.2 International Relations

During the first two decades after the PRC was founded in 1949, the PRC's socialist regime through its policies provoked and suffered negative or even dangerous international reactions. The international relations of the PRC became a very important constraint on China's development. The PRC's leaders predicted this difficulty, but they did not give up the socialist ideology and kept fighting against Capitalism through a set of economic and socio-political strategies. Therefore, only by understanding these relations, could China's strategies and practices be justified, although they are not rational from the modern mainstream economic view.

The PRC was founded in a harsh, even hostile, international environment. The USSR and the US turned from allies into enemies just after the victory in World War II. Through bilateral and multilateral treaties and agreements, many other countries joined the opposite camps and the world was divided into two blocs - the communist and the capitalist. The 'Cold War' was the very mark of the time. The civil war between the CPC and the Nationalist Party was also explicitly coloured by the Cold War for the former was theoretically guided by the Socialist Party of the USSR, while the latter was financially and militarily supported by the US. Although the CPC won the civil war and founded the socialist China, only 25 countries accepted the legitimacy of the CPC's government in the following months and the US refused to accept it. Therefore, space for PRC's diplomatic activity was very limited. Furthermore, the PRC was sandwiched between the two superpowers – the US and the USSR – because of its socialist nature. The CPC, under the communist ideology and Mao Zedong's strategic planning, adopted the policy of 'leaning to one side' (to the USSR) but in fact had no other choice under the tense international relations during the Cold War⁵². The "Sino-Soviet Treaty of Friendship, Alliance and Mutual Assistance" signified the *de facto* political and military alliance between the PRC and the USSR. China was hence pushed to the front of the Cold War and confronted with the US. The situation became even worse when the PRC sent its

⁵² "The forty years' experience of Sun Zhongshan and the twenty-eight years' experience of the Communist Party have taught us to lean to one side, and we are firmly convinced that in order to win victory and consolidate it we must lean to one side. In the light of the experiences accumulated in these forty years and these twenty-eight years, all Chinese without exception must lean either to the side of imperialism or to the side of socialism. Sitting on the fence will not do, nor is there a third road. We oppose the Jiang Jieshi (also written as Chiang Kai-chek) reactionaries who lean to the side of imperialism, and we also oppose the illusions about a third road." This paragraph is quoted from Mao, Zedong, speech "In Commemoration of the 28th Anniversary of the Communist Party of China, June 30, 1949". The complete article in English version can be found online: <http://www.fordham.edu/halsall/mod/1949mo.html>

army to help North Korea in the Korean War during 1950 to 1953. In addition, the PRC refused to implement the treatments signed between China and invaders since 1840. These factors combined caused the economic embargo, political isolation and military encirclement of the PRC by the Western capitalist (or imperialist) countries led by the US.

Moreover, the US pushed Japan to sign the US-Taiwan Mutual Defence Treaty and the Southeast Asia Treaty of Organization, supported India in the Sino-Indian Border Conflict, and engaged herself in the Vietnam War. All these actions aggravated the ‘bad image’ of the US in the mind of Chinese people as the biggest imperialist country and China’s biggest enemy in the world.

The USSR, in contrast, was the ‘big brother’. The PRC’s economic cooperation with foreign countries was concentrated on the allied countries in the Communist bloc. For instance, “the trade between China and the rest of the Communist world shot from only \$350 million in 1950 to almost \$3 billion in 1959...Trade with the Western economies fell after 1951 and accounted for only 25% of China’s trade in 1955. With the relaxation of Western trade restrictions in the second half of the 1950s, trade with the non-Communist countries rose. However, this trade still represented only about 30% of total PRC trade in 1959” (Batsavage and Davie, 1978: p.708). The USSR gave the PRC great support in the start-up of China’s industrial and technological development. “Trade with the USSR – about one half of China’s trade over the decade – provided the major impetus to China’s industrialization efforts through supplying both capital goods and industrial raw materials such as petroleum and metals. From 1950 to 1959, the Soviets delivered 1.35 billion dollars worth of equipment and completed about 130 projects, including factories for trucks, machine tools, and generating equipment. In addition, the Soviets provided massive technical aid in the form of blueprints and technical information, some 10, 000 Soviet technicians and advisers, and training for 15, 000 Chinese in the USSR. Soviet financial aid helped, although only \$430 million of the \$1.4 billion in Soviet loans was specifically for economic development. More important for *Beijing* (Peking) was the USSR’s—and Eastern Europe’s—willingness to accept large amounts of China’s raw materials and consumer goods in payment for Chinese imports.”⁵³

⁵³ The data varies according to references. In Wu Li (1999: p.349), the USSR supported 156 projects in industry; helped building more than 500 laboratories and opened 150 new Majors in Chinese universities, and delivered about 800 specialists to teach Chinese students; from 1950 to 1956, China sent more than 6300 students and 1200 graduates to the USSR who later became the mainstays of Chinese

(Ibid: p.710) Therefore, the diplomatic strategy of the PRC in the 1950s was to ally with the USSR to fight the US (*lian su kang mei*).

However, the Sino-Soviet ‘honeymoon’ did not last for a long time because of a series of conflicts. For example, the ‘long-wave radio station event’, the creation of a combined fleet, the second Taiwan Golf crisis, the USSR’s refusal to provide samples of the atomic bomb to the PRC, the Sino-Indian border conflict, etc. refer to a variety of conflicts (Shen Zhihua, 2003). The 1960s saw the worsening and break-up of Sino-Soviet cooperation⁵⁴. The rift with the USSR became wider in midyear 1960 when Moscow withdrew its technicians, all the blueprints and technical documents, tore up contracts and stopped supplying equipment to China. Many Soviet projects were abandoned or left in the planning stage and completed projects suffered from the lack of Soviet technical guidance. From 1960 to 1962 China’s exports fell as industrial production declined, and imports were cut back sharply (Batsavage and Davie, 1978). The worsening Sino-Soviet relation obliged Mao Zedong to modify the ‘leaning to one side’ strategy. Mao pointed out in 1963 that, the UK and the US changed their strategies of dealing with socialist countries: no military threat any more, but the ‘peaceful evolution’⁵⁵. This marked a significant change of Mao’s attitude to the US. In 1964, Mao began to seriously consider the military threat from the USSR and proposed the Three Fronts Program⁵⁶. The focus of the national defence was the USSR, which became the biggest threat

technological development. The amount and usage of the Soviet loans to the PRC also causes some debate, as the decisive official data is not available. Shen Zhihua (2002) considers that the loans were amounted to 6.6163 billion old Roubles (at 1961’s value) by 13 times during five years, of which 328.3 million was for the economic usage and the left for the military.

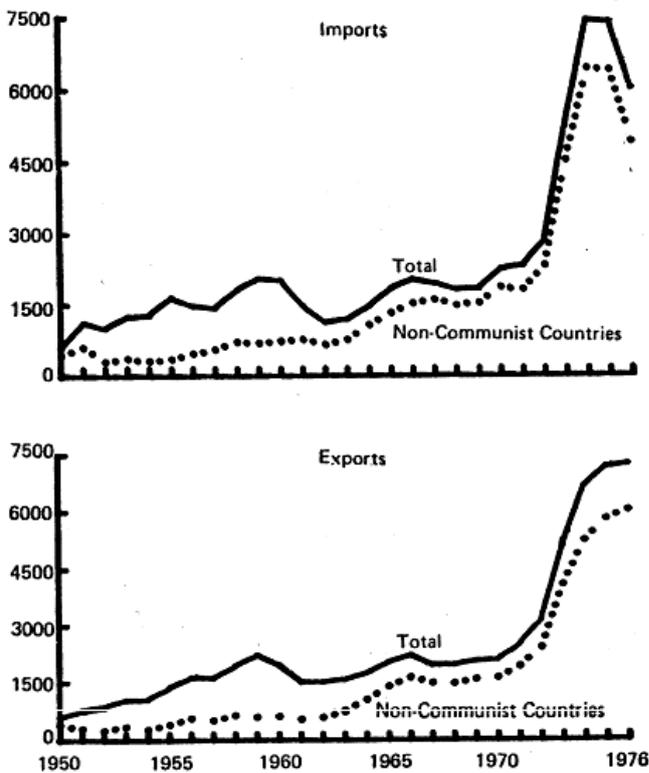
54 Scholars have shown great interest in Sino-Soviet relation and carefully studied its development and break-up. Two problematic are analysed. One is the reason for the break-up and the other is the process. For the former, analyses are made of politics, economy, diplomacy, military, ideology and even the personalities of the leaders. For the latter, the succession or concurrence of factors, situations and events, and their cause-effect relations leading to the end of Sino-Soviet ally are enormously studied.

55 According to Bo Yibo, one of the top leaders of the CPC and the PRC in the last half of the 20th century, “In January 1953, U.S. Secretary of States Dulles emphasized the strategy of ‘peaceful evolution’. He pointed out that ‘the enslaved people’ of socialist countries should be ‘liberated’, and become ‘free people’, and that ‘liberation can be achieved through means other than war’, and ‘the means ought to be and can be peaceful’. He displayed satisfaction with the ‘liberalization-demanding forces’ which had emerged in some socialist countries and placed his hope on the third and fourth generations within socialist countries, contending that if the leader of a socialist regime ‘continues wanting to have children and these children will produce their children, and then the leader’s offspring will obtain freedom’. He also claimed that ‘Chinese communism is in fatal danger’, and ‘represents a fading phenomenon’, and that the obligation of the United States and its allies was ‘to make every effort to facilitate the disappearance of that phenomenon’, and ‘to bring about freedom in all of China by all peaceful means... Mao Zedong paid full attention to these statements by Dulles and watched carefully the changes in strategies and tactics used by imperialists against socialist countries’ (quoted from “Mao Zedong and Dulles’s ‘Peaceful Evolution’ Strategy” in Bo Yibo’s Memoirs).

56 According to Naughton (1988: p.354), the Three Fronts Program aimed at building up three defence fronts on Chinese territory for potential attacks from sea (Pacific Ocean) by Taiwan and US, and from Eurasian Continent by USSR. Most industrial enterprises were

to China (Li Danhui, 2000). The Zhenbao Island (Demansky) conflict in March 1969 showed to the world, in particular to the US that China and the USSR went to the edge of war. After a series of diplomatic efforts during the Vietnam War and based on the common need to resist the USSR, the US and China released the famous Sino-US Joint Communiqué in Shanghai on February 28, 1972. The ‘*lian mei kang su*’ situation (ally with the US to fight against the USSR) was shaped. Due to the improvement of the Sino-US relationship, China withdrew from the frontier of the confrontation between the two superpowers. The international environment became better and better for China. Until the end of 1979, 120 countries established official diplomatic relations and Chinese foreign trade flourished in the 1970s, which is well illustrated in Figure 3⁵⁷.

Figure 3: China’s imports and exports 1950-76 (unit: million US dollar, in constant price)



concentrated in the coastal regions, where would be easy to be attached from sea while would not successfully organise resistance. The relocation of some basic industries and enterprises in the rear-area (i.e. inner land) was therefore necessary. The objective of Third Front was to create an entire industrial system within the naturally remote and strategically secure regions. It was designed as a large-scale industrial network, linking this entire ‘rear area’ through major transport and industrial facilities. A line that demarcates regions above 500 m altitude would approximately enclose the Third Front. Provinces of Sichuan, Yunnan, Guiwhou, Gansu, Qinghai and Ningxia, a portion of Shaanxi (south of the Qinling mountains), and the western, mountainous portions of Henan, Hubei and Hunan were protected by the Front as the ‘big rear area’ of China.

57 The major references drawn upon here are from the personal site of Shen Zhihua and Li Danhui (two Chinese scholars), papers online: <http://shenzhihua.vip.sina.com/mululdh.htm>.

Source: Batsavage and Davie, 1978 (Figure 1).

Summary

This section has reviewed the constraints on the evolution of the Chinese economy into a market-based capitalist one. Two questions – why did the industrial revolution not emerge in China and why did the market economy not emerge in China before the Reform? – have been answered through a brief synthesis of the economic legacy of the PRC, and the international relations in the PRC before the Reform.

To answer the first question, Elvin argues that, in the pre-modern China, the rising human-to-land ratio relaxed the pressure on labour-saving technology and inventive creativity. Lin Yifu emphasises the ancient China's socio-political system, and argues that the incentive structure of the system diverted the intelligentsia away from scientific endeavours, which could lead to the industrial revolution. Xu and Chen (2003) and Xu Pingzhong (2003) give an answer to the second question. They argue that the driving force of Capitalism is not a technological breakthrough, but the development of the market; technological breakthrough is produced by the market demand. Hence, according to their thesis, the geographical conditions and limited transportation technologies constrained the formation of the market economy and capitalist production in the pre-modern China.

In modern China, although the market-based capitalist economy has sprouted when the capitalist invaders entered China in 1840, the market was not developed to become the dominant institution in regulating the national economy. The chaotic political and social environment caused by wars held up any effort to develop a market economy.

The socialist PRC was born and evolved in a tense, even hostile international environment (due to the Cold War) with the economy lagging far behind the capitalist countries. Chinese leaders made the national economic-political independence the main goal. But neither leaning to the USSR nor allying with the US made the PRC feel safe. The common knowledge shared among the leaders was that 'War was unavoidable'⁵⁸. Therefore, strengthening national

⁵⁸ Deng Xiaoping resisted the statement "war was unavoidable" which was overwhelming in the 1950s and 1960s (Deng Xiaoping, 1993: p.127).

defence by military development was the first task for Chinese leaders, rather than the economic development in a peaceful world. The unfavourable economic legacy aggravated the difficulty of the PRC for economic growth and development. Rich natural resources were a good base for boosting the industrial economy, but the low level of technology and the lack of financial and human capital, limited the utility of these resources. These constraints left the PRC's leaders with limited options to design development models. Once engaged, these were not invariable as the environment changed rapidly. In the next section, a presentation of five competing economic development models is made to explain the national economy of the PRC in the pre-Reform era.

2.2 A Presentation of Five Competing Forms of the Economy

The previous section emphasises the historical legacy and international relations to explain why the market economy was not developed in China before the Reform. But what kind of economy was developed in the pre-Reform PRC as a substitute to the market economy? This is a problematic for many economists who try to analyse the Chinese economy and analyse its advantages as well as shortcomings. But the complex economic phenomena and often-modified policies aggravate the difficulty to reach a consensual answer. Five forms⁵⁹ of economy with different logics and analytical angles have been brought about. Planning, *gan chao* (catching up and surpassing) and Military economy are valid for the entire pre-Reform era (1949–1978), while the New-Democratic and Economy the Great-Leap-Forward are only suitable to specific periods (the former for 1949-1953 and the 1970s, and the latter for 1958 – 1960). Although the last two forms are short-lived, they should not be regarded as complementary to any of the first three ones. In fact, they have shown very different logics, strategies and approaches in directing the development of the country. So, here I place the five forms in parallel. As none of them is satisfactory to explain the whole national economy, this section provides a presentation of five competing forms thus explaining the social, political (including ideological) and economic context of the pre-Reform PRC needed for the further analysis of the SOE and the local economy.

59 The form of the economy is interchangeable with the term 'strategic line' in Van Ness and Raichur (1983: p.4): "It is a systematic design which spells out both the ends and the means for purposeful action. Strategic lines, it adopted by a ruling communist party, are implemented by specific development policies; if the policies are thought to be successful and if they are sustained over time, they create a particular social system, a social order and way of life which has its own characteristic division of labour, culture and social values, and form of political rule."

2.2.1 Planning Economy (1949 – 1978)

The Planning Economy has specific meanings in the Chinese context that are different from those in the market economy. The definition given by “China Encyclopaedia” is “taking the socialised production as a premise and based on the public ownership of means of production, the socialist state manages and regulates the national economy through mandatory planning and guidance planning, which are done according to the requirement of the objective laws of economy; it is not only the means and institution to manage the national economy, but also an economic institution, that is one of the basic features of the socialist society.” (translated by Zhu Kai) Hence, the nature of the Chinese Planning Economy is:

- it is a socialist economy;
- state ownership is the base;
- the state directly controls the economic activities of enterprises and people;
- economic sectors should be proportionally developed;
- the market institution is excluded from the national economy;
- all resources are allocated through the central planning; and
- the top-down administrative management is the key means of implementing the central plans.

The Planning Economy originates from the Soviet Union. There were two basic features to the Soviet economic system: state ownership and control, and central planning of production. The economic achievements, in particular the powerful heavy industry, helped the Soviet Union succeed in WWII and become one of the two superpowers in the world. Although many economists criticize the Soviet Planning economy for its fatal defects⁶⁰, the rapid development of the Soviet Union from a less developed country in Europe to a superpower in the world was appealing to the CPC leaders. The initial situation of the national economy of

⁶⁰ Mises (1922) and Hayek (1944) do not believe that the Soviet Planning system could gain sufficient information for the absence of the market, and the cost for planning is too high. Kornai (1980) proposes the soft-budget theory to criticize the distorted allocation of resources and prices for the absence of the private property rights of the factors. Hayek (1988) and Friedman (1962) doubt the possibility of profit maximization in SOEs and believe that the planners have all reasons to keep the excess demand in order to increase their power and all kinds of benefits. Some Chinese economists brought about the ‘virtual ownership’ theory in 1980s that there is no exact person or institution responsible for the state assets under state ownership since the ownership is shared among several power institutions. Zhang Weiying (1999) works out some theorems of impossibility: the entrepreneur is impossible to appear under state ownership; the government is impossible to separate from the enterprise; the budget is impossible to be hard; the bankruptcy of enterprise is impossible to constrain the managers, etc. Shleifer and Vishny explain the general shortage in the socialist economies as a means to gain the monopoly rent for government officials (Yang Xiaokai, 2002).

the USSR was similar to that of the PRC in the end of the 1940s; this also encouraged the PRC leaders to learn from the USSR.

Industrialization, in particular based on heavy industries, was believed to be the prime vehicle for the PRC to be politically (and militarily) independent and economically well-off. In the then world there were two models of industrialization: the model of developed capitalist countries based on the market economy and that of the socialist countries based on the planning economy. The former was represented by the UK. The economic development was a natural and gradual process, from light and textile industry to heavy industry, supported by colonization. The latter was signified by the Soviet Union. The state gave priority to the development of the heavy industry and the basic industries in order to achieve industrialization on the basis of high accumulation and high investment (Wang Jun, 2003). For China, the heavy industry was the key to economic development and national defence. But the traditional capitalist take-off (as developed economies experienced) could not be imitated by the PRC because colonising other countries by military forces was no longer possible since the 1950s, and the economic embargo aggravated the shortage of capital as well as technologies that were necessary for the capitalist economy to take-off. Moreover, the Chinese leaders in the pre-Reform era had no patience to wait a long time for the *natural* industrialization and development (driven by private actors) because the prime experience they had received from the history of the modern China is that “the lagged (countries) get a beating is always a truth”. Hence, only the Soviet Planning model was then available for the PRC and planning under state direction seemed inescapable.

Considering the then socialist ideology, it was believed that the Planning Economy could not be reconciled with the market economy as Socialism could not be mixed with Capitalism. The ambiguity of the market-capitalism relationship misled Chinese leaders to give up the effort to build up the market economy in the PRC. The economic crisis that occurred in the 1930s in the capitalist world had impressed the PRC leaders: the failure of the ‘capitalist economy’ was seen as the failure of the market economy. The Soviet Planning Economy seemed immune to such crisis.

In addition, China has had a long history of centralised state system since the foundation of the Empire Qin (221 B.C.); and the leadership of the CPC in China during the Sino-Japan war

and the civil war both facilitated the establishment of a central planning system. Another factor concerned the Soviet side. The USSR regarded itself as the leader of the Socialist bloc and obliged the other members to follow its forms of the state and the economy. As a result, the Planning Economy was established in the PRC in 1953. During the following three years the Soviet system was almost completely grafted in the PRC owing to the nation-wide 'socialist transformation'. Jiang Hong (1986: pp.59-60) characterizes China's Planning Economy according to six dimensions:

- the economic system was transformed into an administrative system and economic life was politicised;
- a top-down command system was used to manage production and other economic activities;
- enterprises were 'owned by all the people', profits had to be turned over to the centre and no individual economic benefit was permitted to enterprises;
- monopoly of the national resources and products;
- the rigid management of labour and the administrative appointment of state agents were the most reliable methods for administrative management; and
- monopoly of fiscal revenue and expenditure (all investment projects controlled by the central government).

In the Planning Economy, all the resources are allocated and controlled through central planning. Even the micro-operation of enterprises is completely controlled by the Centre. This is the base for state ownership and the 'raison d'être' of establishing state-owned enterprises. However, the Planning Economy in the PRC was different from the Soviet model. The role of the CPC in the Planning economy also made the Chinese economy substantially different from the Soviet system. For example, the technocrat responsibility system in Soviet SOEs was replaced by the party command system in the PRC as the Party power penetrated into the shop floors in SOEs (Ji You, 1998). Granick (1990) commented that the national planning apparatus in China was far less comprehensive than that in the USSR. Perkins *et al* (1977: pp.272-278) also found that although fluctuations in the degree of central control over production and investment decisions date back to the 1950s, broad areas of responsibility were delegated to provinces and localities.

The meaning of ‘Centre’ was also ambiguous for the Chinese. Mao Zedong, in his famous speech “On the ten major relations”⁶¹ observed: “Once a ministry is set up, it wants to have a revolution and so it issues orders. Since the ministries don’t think it proper to issue orders to the Party Committee and people’s councils at the provincial level, they establish direct contact with relevant departments and bureaus in the provinces and municipalities and give them daily orders. These orders are all supposed to come from the central authorities, even though neither the CPC’s Central Committee nor the State Council knows anything about them”. The ministries were not classified as belonging to the ‘Centre’ in Mao’s mind, nor were they classified as part of the local level. Since valid orders were also given by the administrative units below the central government, the ‘Planning Economy’ in the PRC was in fact far more characterised by decentralization than the Soviet economy.

Even though the Planning Economy was not completely implemented in the PRC, it had a deep and long term impact on China’s economy. Many features of the planning institutions can still be found in today’s market-oriented economy. Although the Planning Economy is a valid way to explain many features of the pre-Reform economy in the PRC, as the following discussion shows, it is criticized by some economists, especially considering the logic of choosing the form of the economy.

2.2.2 *gan chao* Economy (1949 – 1978)

Lin *et al* (2002) works out a *gan chao* (catching up and surpassing) Economy model based on a different logic to explain Chinese industrialization and economic form in the pre-Reform period. The heavy industry was the prime vehicle of the PRC’s economic development, as Lin *et al* discuss, the whole economic system was designed to develop the heavy industry. The (central) planning or command system is thus only an institutional arrangement; for the form of the economy, the development strategy is critical. The biggest, if not the only, divergence between *gan chao* and planning form is, according to Lin *et al*: in the *gan chao* form, following the development strategy (e.g. the Heavy-Industry-Oriented-Developed-Strategy), a set of institutional arrangements can be spontaneously established. They compare the economy of the pre-Reform PRC with other socialist, South Asian and Latin American

⁶¹ The speech was made at an enlarged meeting of the Political Bureau of the Central Committee of the CPC in 1956. Mao Zedong summed up China’s experiences, drawing upon the lessons from the Soviet Union, dealt with ten major relations in socialist revolution and socialist construction and set forth the ideas underlying the general line of building socialism with greater, faster, better and more economical results, a line situated to the conditions of China. The English version of the speech is collected in Chai (2000: Vol. 2).

economies, and find a great similarity in the development strategy and the national economic system. So they argue that the PRC's economy was not just a copy from the Soviet model, although the impact of the latter is significant.

The Heavy-Industry-Oriented-Developed-Strategy (HIODS) was not matched by economic conditions in the PRC in the 1950s. Heavy industry is a capital-intensive industry and has three basic features (Lin *et al*, 2002: pp.36-37):

- it requires long-term management, e.g. skilled labour and managers;
- most equipments, at least in the start-up stage, needed to be imported from abroad at that time; and
- it requires a large amount of financial investment for large scale and technologically advanced industrial enterprises.

While accordingly, the PRC's economy had three features (ibid):

- financial capital was scarce; rent and interest for capital were very high;
- products for export were scarce; foreign exchange was in great shortage; the foreign exchange rate was fixed at low level, i.e. the Chinese currency RMB was overvalued, in order to import at a low cost; and
- the economic surplus was very low and the capacity of mobilising the financial capital was seriously low.

As a result, the HIODS was unable to be achieved through market coordination. State intervention to *correct* the market (e.g. the price system) was necessary. Hence, a set of institutional arrangements, featured by the central planning or commands, were established. This form of the economy, i.e. pursuing a development strategy (HIODS), regardless of the constraints of resources, is called *gan chao* Economy by Lin *et al* (ibid: p.38).

Further, Lin *et al* prescribe PRC's traditional economy as a trinity (see Table 2-1): a set of macro economic policies that distort the price system; an over-centralised planning system of resource allocation to ensure the policy implementation and; no autonomy in decision making for actors at the micro-economic level (ibid: pp.38-68).

Table 2-1: The pre-Reform Economic System in the PRC

Institutional arrangement	Measures	Objectives
A set of macro economic policies: four aspects	Low interest rate	Providing capital at low costs for heavy industrial construction
	Low foreign exchange rate of Chinese currency – RMB	Over-valuing the exchange rate of RMB so as to reduce costs of imports
	Low wages and low prices of energy and raw materials	Reducing costs for the enterprises in the heavy industry
	Low prices of agricultural products, living necessities and services	Reducing costs for labour-reproducing and restraining consumption for capital accumulation
Over-centralised resource allocation planning system	Financial management system centred on China People’s Bank (the central bank) and nationalization of Banks	Allocating scarce capital into enterprises and industrial sectors in line with state strategies
	Foreign trade and foreign exchange management system	Regulating the low foreign exchange rate in order to import and export under the state planning with scarce foreign exchange
	Resource allocation system	Ensuring resources for the heavy industry
	Unified purchase and sale system for agricultural products	Compelling farmers to sell their products at low prices to the state by the administrative power
No autonomy in decision making for economic actors at the micro-level	State ownership dominating the national industrial system	As privately owned enterprises were not believed to serve the strategies, state ownership ensures enterprises in the heavy industry to operate in line with the state’s strategies
	Organising agricultural production in commune	Increasing the agricultural outputs at low cost

Source: according to Lin *et al*, 2002: pp.38-54.

Lin *et al* make a serious criticism of the ‘*gan chao*’ Economy according to two dimensions (ibid: pp.67-68):

- The distorted industrial structure
 - The capital-intensive orientation maintained the advantage of abundant and cheap labour, aggravated the duality in the economy between traditional and modern sectors, which in turn hindered full-employment and urbanization.
 - The economic growth (or the industrial growth) relied on the high rate of capital accumulation, which was achieved through a distorted price, wage and financial system; the population did not benefit from the growth but in fact suffered the low and slowly improving living quality.
 - Foreign trade was not based on, nor was able to develop China’s comparative advantages (cheap and abundant labour) under the state planning.
- The inefficiency of the micro economy:
 - All production factors were allocated by a unified cost accounting.

- All outputs were turned over to the state; no profit was retained in enterprises; an enterprise's expansion in scale and scope and technological upgrading were decided by the state planning, while productivity was not the most determinant factor.
- People's income was not based on their contribution, but was fixed by a nation-wide unified wage system; this severely damaged people's work motivation⁶².

At last, they conclude that, in the pre-Reform period China built up a somewhat complete industrial system at the expense of a potentially higher rate of economic growth which would be based on China's comparative advantage in the world market⁶³; due to the implementation of the HIODS and the adoption of the *gan chao* Economy, China's economy suffered from high costs - the costs of the whole national economy, rather than those of the state system - and low productivity⁶⁴. However, the argument of Lin *et al* may bring up questions such as why such an inefficient economy did survive for thirty years. The national industrial layout (i.e. location of industrial enterprises) also explains the low efficiency of industrial production but is not given enough attention. It seems that the HIODS and the *gan chao* Economy are culprits for China's economic problems and the economy based on comparative advantage is the best, if not the only, choice to develop China.

2.2.3 Military Economy (1949 – 1978)

Both the Planning Economy and the '*gan chao*' Economy present their scenarios within the framework of a normal economy, but Xu Jianming (2002) brings about a special view that China's economy in the pre-Reform era was a Military Economy, i.e. an economy meant for survival, rather than a normal economy for development. The difference between 'survival' and 'development' in Xu's meaning is that survival is not based on the calculation of costs and benefits as development is. Xu emphasises the particular international environment in that era. He states that, "War threatened China. The country was facing the challenge of 'life and death'. To survive from war, war industries must be given priority. Constrained by the feeble

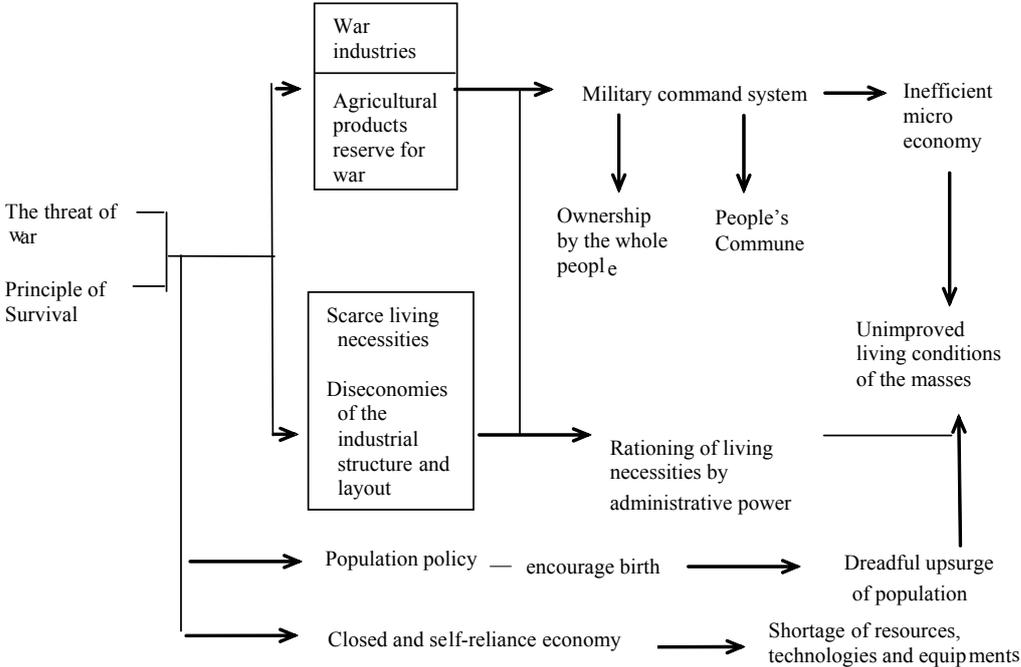
62 The issues of working incentive and wage system will be discussed in detail in Section 2.3 of this chapter.

63 Inferred from this conclusion, Lin *et al* believe that China's Reform succeeds because the comparative advantage has been respected, so the labour-intensive industries have been developed and the distorted industrial structure has been corrected.

64 Here I do not use profitability but productivity, because in the pre-Reform economy, the absence of the market and the distorted price system made it difficult, even impossible to define the profit. Profit was in the then socialist ideology a result of the capital exploitation, so it could not exist in the socialist economy. Hence, even though the state had established nation-wide accounting system for evaluating the outputs of enterprises and individuals, the system emphasised on costs, while the profit was never mentioned then.

national strength, all resources and surplus must be directed to military industries. The state [in particular the government], as an organising authority, must take the duty of a supreme director to prepare for the coming war because only the government, and no one else, could mobilise all kinds of resources and transform the country into a powerful military machine in the most *efficient* way. The military-type organization was implemented top-down and pervaded the shop floors of society. Enterprises functioned as parts of the whole military machine and attached themselves to the government. The population was the source of soldiers and should be trained to heighten the senses of organization, of discipline and of fight. In cities, individuals were attached to ‘*dan wei*’ (working units)⁶⁵ and in rural areas, to People’s Communes. The PRC could not open up to the world [for commercial exchange], so it established a complete self-reliance economic system in order not to land itself in a passive position in the coming war [as the PRC’s leaders believed that “War is inevitable”⁶⁶] ... In the normal economy, war industries are auxiliary to the economic system; while in the Military Economy, the economic system becomes the back office services for war industries” (Xu Jianming, 2000; translated by Zhu Kai). The logic of the Military Economy is shown in the figure below.

Figure 4: Logic of the Military Economy



Source: translated from Xu Jianming, 2000: Figure 6.

65 About the term ‘*dan wei*’, see more discussion in Ji You (1998), and I will talk about it in the following section.

66 Deng Xiaoping has confirmed this worry that “War is unavoidable” was prevailing among the PRC top leaders in the 1950s and the 1960s and they tried best to prepare for the coming war (Deng Xiaoping, 1993).

As Chinese industries were very feeble and technology poor (as explained in section 2.1), most of the agricultural and industrial surplus was directed at war industries. War industries have the particularity of not generating mass consumption and mass industrial production⁶⁷, and the surplus was consumed outside the productive circulation – such consumption cannot reinvest in production for more consumption and development. Consumption of surplus aggravated the shortage of capital and technological innovation and industrial up-grading were further set back. The consumption of energy and resources was tremendously higher than in normal economies for the same amount of output because of the diseconomies of the industrial structure and location. The productivity was therefore significantly increased but people's living conditions improved little⁶⁸ (Xu Jianming, 2000).

Xu argues that the Planning Economy, the *gan chao* Economy and the Market Economy are three forms of the normal economy. Every form aims to optimise resource allocation so as to maximise the material wealth and improve people's living conditions, whatever means they adopt. The Military Economy, however, aims to survive external aggression by developing war industries at the expense of the benefits in other sectors. In peaceful times, war industries are complementary and subordinated to development-oriented economic industries; in wartime, war industries are given priority for resource allocation while other industries are set in a subordinate position i.e. the Military Economy. The 'threatening' international relations in the 1950s obliged the PRC to adopt the wartime economic system. This is similar to the Soviet War Communism or Military Communism⁶⁹ which means the harsh economic policy

67 To be noted that, there are also some products from war industries for civil use. This can be a particular function of war industries in the peaceful time.

68 Chinese scientists have made great progress in many scientific fields, but most of them were related to war industries, e.g. the success of manufacturing of atom bomb, Hydrogen bomb and launching satellite (*liang dan yi xing*).

69 The definition is given by an encyclopaedia online: <http://www.nationmaster.com/encyclopedia/War-communism>. From the same source, War Communism consists of the following policies:

- All large factories to be controlled by the government
- Production planned and organised by the government
- Discipline for workers was strict, and strikers could be shot
- Obligatory labour duty was imposed onto "non-working classes"
- Requisition of agricultural surpluses from farmers in excess of absolute minimum for centralized distribution among the remaining population
- Food and most commodities were rationed and distributed in a centralized way
- Private enterprise became illegal
- Military-like control of railroads was introduced

adopted by Bolsheviks during the Russian Civil War. In fact, the CPC had got much experience in War Communism from the construction of military bases during the wartime (during about 30 years before 1949). The military organization was successfully implemented into daily life, administrative work, battles, and economic as well as societal construction. Mao himself said at many occasions that “we had twenty years’ life of military communism, no wage system, rationing for living necessities; however, Party cadres, soldiers, and masses were unified into a whole... we should keep the revolutionary motivation, zest and spirit, so as to complete the revolution.” (Cheng Lin, 2001, translated by Zhu Kai) This experience was inherited as a good tradition of revolution in the hard times 1950-1970.

The Military Economy regime can explain some basic features of the pre-Reform economy of the PRC:

- The HIODS was adopted because many heavy industries are upstream-for-war industries in the industrial chain and some heavy industries themselves are war industries, e.g. manufacturing of planes, tanks, etc. However, the goal of the HIODS was not ‘catching up and surpassing’ the developed countries, but survival.
- The industrial layout was conformed to the principle of the ‘back office service’ for war, rather than to the location principles in economics. The location of industrial enterprises during the Three Fronts construction is such an example. Since most basic industries and industrial enterprises were located in the coastal regions, they must be the first spaces to be invaded once war is erupted. Hence, industries should be moved to the rear-area in order to gain enough time to prepare for the military defence and counterattack. In this way appeared the Three Fronts Program. Many enterprises were dispersedly located in the mountain and remote areas without good physical infrastructures and resource supply, and some factories even worked in deep caves. Costs were significantly high, so, normal principles of economics were not applicable to such behaviour.
- All agricultural and industrial production was controlled by the state to prepare for war. Production quotas were used for production and a rationing system was adopted for daily consumption. Paper currency lost its function as exchange media and was partially replaced by some kinds of certificates (*zheng*) and coupons (*piao*). A centralised, top-down, hierarchical administrative system was formed on the basis of the military command system.

- The state encouraged child birth. Although China was already the most populated country in the world, a prediction of high death rate in wartime urged such measures in order to increase the human resources (in quantitative sense) to be mobilised for war (at worst for the survival of the race).

The assessment of the Military Economy by a theoretical inference leads to obvious results. There is no surprise to find criticisms from economists on low efficiency and high costs for China's pre-Reform economy, because the economic principles and market laws were not obeyed or adopted then. If the normal economy, not the Military Economy, had been adopted for the 'development', no one could guarantee to avoid the 'predicted war'. Whether the uncountable loss of potential economic development for avoiding the war is worthwhile or not is impossible to judge clearly. The fact that no war broke out may be the excuse for the criticism, but may also support that adopting the Military Economy was the right thing to do.

2.2.4 New Democratic Economy (1949 – 1953)

When the PRC was founded in 1949, its leaders recognized that it would take a long time to enter Socialism. The New Democratic Society was put forward as a transitory societal form. Accordingly, the New Democratic Economy (NDE) was designed and written into the "Common Principle" (the predecessor of the Constitution) declared on the 1st October 1949, and became the basic economic institution (Wu and Dong, 2001). Mao declared the main tasks and orientation of development as "after the success of the revolution, quickly recover and develop production, fight against the Imperialist countries, progressively transform China from an agricultural country into an industrial country, and build China into a great socialist country." (Yao Kaijian, 2003: p.19)

In line with this declaration, the initiative of the NDE was to "actively establish an economic management institution, adjust the economic structure and recover the national economy" (Wu and Dong, 2001). Although it was defined as a transitory (or temporary) form of the economy, the NDE was deliberately prepared to function for a long time because difficulties were obvious and hard to resolve. The NDE was composed of a series of systematic and pragmatic guiding lines, theories and measures. Its core ideas were translated into "developing production, flourishing economy, considering both public and private interest, and benefiting both labourers and capital owners; three Guiding Lines to build the economic

system were translated into “Expropriating bureaucratic capital (legacy of the National Party), abolishing feudal land institution, and protecting national industries and business” (ibid).

A remarkable feature of the NDE was that economic actors of five statuses coexisted during 1949 to 1953, which distinguished the NDE from the first three forms of the economy. These economic actors were classified as:

- state-run economy (socialist status);
- cooperative economy (semi-socialist status);
- private capitalist economy;
- individual economy; and
- state capitalist economy co-operated by the state sector and the private sector.

However, these five kinds of actors were not equal, nor did they live in harmony. In fact there were conflicts and struggles between the socialist and capitalist actors (Liu Shaoqi, 1949). The socialist-state-run economy was the leading power and regulator in the national economy. It was believed that only in this way the socialist society could be built in China (Xie Zhonghou, 1999).

Wang Dong (1999) illustrates the features of the NDE as follows:

- by nature a new market economy managed by a new democratic state power;
- a union of new market economy, new democratic politics and new science and culture;
- the coexistence of economic actors of five statuses;
- the market regulation at the micro economic level with the state planning at the macro economic level;
- the ‘si mian ba fang’ policy – considering both public and private interests, benefiting both labours and capital owners, mutual aid between urban and rural areas, exchanging internal and external resources, in order to regulate internal controversies, avoid social and economic polarization and enrich all the people;
- flexible and diversified forms of state capitalism, to regulate private capitalist economy by “developing-utilising-restraining-transforming”; and
- developing the voluntary and progressive mutual aid and cooperation in agricultural production in order to fully stimulate all peasants to develop private and collective economy.

Owing to the appropriate economic institutions and policies⁷⁰, China's national economy recovered from the wartime destruction. During 1949-1952, the national gross output increased by 82.2%; national income increased by 64.5%; national income per capita increased by 54.5% and national fiscal revenue by 181.7% from 1950 to 1952. The production of main industrial and agricultural products hit historical records⁷¹. The speed of recovery after the war was much faster than that of other countries, considering also the hard conditions faced by the PRC.

However, many chief PRC's leaders were misled by the remarkable economic achievement and the blind optimism on the transition to socialism. In addition, the coexistence of multi-ownerships and the '*si mian ba fang*' policy created an irreconcilable conflict with the policy prioritising heavy industries. The USSR did not allow China to adopt a societal and economic institution that was not conforming to Soviet socialist theory and societal institution; the CPC could not break through the Soviet socialist model (Wu Li, 1999). Since 1953, the three socialist transformations (i.e. transformation of agriculture, handicraft industry and capitalist industries and business) had been implemented and the transition to Socialism was accelerated. The three transformations were accomplished in 1956. But then, the domination of the central planning system and the declining market institution stopped further exploration of the NDE. Furthermore, the success of the first FYP aggravated the blind optimism and raised the main leaders' self satisfaction, which could be a reason for the implementation of the GLF in order to accelerate the entrance into Socialism.

After the GLF ended in 1960, the PRC's leaders worked out a set of policies in order to readjust China's economy. The central government declared that it would make efforts to promote the economic growth. Private economy was revitalised to some extent, especially in rural areas and in agricultural production. But the then socialist ideology held by some PRC's leaders refused to recover the market institution. Instead, a nation-wide political movement – the Great Cultural Revolution (GCR) – was launched by Mao in 1966 to realise his socialism

⁷⁰ For more details about the policies of the NDE implemented during the four years (1949-1952), e.g. policies on reducing inflation, financial speculation, unemployment, fiscal deficit, on improving SOE's performance, on private economy, on business and foreign trade, on industries and agricultural production, and so on, see Wu and Dong (2001).

⁷¹ More data for China's economic achievement during 1949 to 1952 is given by Yao Kaijian (2003: Chapter 1) and Liu and Shi (2001: Chapter 10).

and caused a severe political and social disaster. By the end of 1969 when the Sino-USSR relation broke down, the Three Fronts construction was accelerated. Therefore, national resources continued to be allocated by the central government and the private economy was not yet liberalized, nor did the market institution recover. Only after 1972 when the GCR was near the end and the Sino-US relation defrosted, a series of new policies were put forward to regenerate the economy. Some measures of the NDE were adopted again, but the NDE as a whole was never returned to a dominant place in regulating China's economy.

The NDE was designed "to develop socialism by taking advantage of capitalism under the concrete conditions in the current China" through "bypass[ing] the capitalist society with bourgeois dictatorship, avoid[ing] the dreadful failures of capitalism and draw[ing] upon all achievements and positive experiences of capitalism" (Hu Sheng, 1999). The implementation of the NDE effectively consolidated the union of all positive actors, developed advantages of every factor, and contributed to the remarkable economic achievements between 1949 and 1952. Its thoughts and measures also did contribute to the economic readjustment in the 1970s. Even in the early years of the Reform, we can find many features of the NDE.

2.2.5 Great Leap Forward (1958 – 1960)

The defects of the Soviet Planning Economy exposed during the first Five-Year-Plan received serious criticism and revision by Mao Zedong, who was satisfied with "the immense development of heavy industry" and "high rates of economic growth", but unsatisfied with the large "differences between mental and manual labour, city and countryside, and worker and peasant" (Van Ness and Raichur, 1983: p.10). Mao and his fellow radicals believed that more could be achieved in the second FYP (1958-1962) if people could be ideologically aroused and if domestic resources could be utilised more efficiently for the simultaneous development of industry and agriculture⁷². Consistent with his experience of the successful mass-participation process in wartime, "building socialism for Mao was a dynamic, mass-participant process, not simply the imposition of a centralised social system which gave directions to the populace". (ibid: p.10) The Soviet industrialization, by concentrating onto heavy industry and the Planning system, should not be the only way of building socialism. Thus, China's Socialism must be designed for China's context (ibid: p.10).

⁷² This sentence is cited from <http://www-chaos.umd.edu/history/prc2.html#greatleap>.

After his speech “On the ten major relations” in 1956, Mao pointed out the defects and put forward the new General Line with a new development model to build such Chinese socialism (Wang Jun, 2002):

- Socialist industrialization should be accompanied with socialist transformation of capitalist components – economy, polity and society.
- Industrialization should be paralleled with modernization of agriculture.
- Enforcing scientific research and technological progress.
- Industrialization in the inner land.
- Drawing upon the experiences of the foreign economies (especially the Western developed capitalist economies) and integrating them into Chinese reality.
- Reforming economic institutions in order to delegate more autonomy in management to local authorities and enterprises.

In February 1958, the National People's Congress announced the "Great Leap Forward" Movement that called for massive increases in steel production and electrical and coal output. The goal was to surpass British industrial output by 1972.

The GLF had four basic features: developing economy by socialist ideology; self-reliance; ‘walking on the two legs’; and People’s Communes. These features can fully explain the logic of the GLF.

(a) Socialist Human and Mass Line

The Socialist Human had to be responsible not only for his/her life, but for other people's lives as well. His/her job was to monitor the actions and thoughts of the people around him/her, and correct any improprieties or counter-revolutionary thoughts or actions. The Socialist Human was required to put the state before himself/herself or his family, and was supposed to be able to face others with self-criticism and confessions of wrongdoing. He/she was to be animated by five Loves: Love China, Love people, Love work, Love science, and Love common property⁷³. The Socialist Human was not ready yet, nor would he/she be the natural outcome of the socialist construction. “People must liberate themselves, Mao insisted, they must transform themselves...and the creation of the ‘new human’ in China was in a

⁷³ The definition of the Socialist Human is cited from: <http://www.wsu.edu:8001/~dee/MODCHINA/COMM2.HTM>

sense both the means and the ends of this model [for the socialist construction].” (Van Ness and Raichur, 1983: p.11)

How to transform the people into Socialist Humans? Mao assumed that the key to success was a motivated population. Party-led efforts to mobilise and to sustain support should be designed to tap the basic enthusiasm of the people through the implementation of the ‘Mass Line’. Mao believed that the two objectives of social transformation (continuing fundamental change in the relations of production) and economic modernization (the rapid growth of productive forces) were congruent objectives, both of which could be rapidly achieved through social mobilization. “Serve the people also serve themselves, as the collective effort moves forward both relations of production and forces of production at an unprecedented rate.”⁷⁴ (ibid)

The mass organizations of Maoist China were in reality semi-government bodies or very big semi-government bodies. These mass organizations include the All-China Federation of Democratic Youth, the All-China Federation of Trade Unions, and the Young Pioneers, composed entirely of children. These mass organizations became instruments of mass indoctrination and provided a massive and organized set of groups for demonstrations. The mass organization would be the principal means by which political action was effected in China from 1950 to 1980. When Mao advocated rural development and peasant revolution, he based his theory entirely on the importance of a unified and universal mass movement. At the micro level, the People’s Commune was ‘invented’; for Mao, it was the basic social unit of socialist transformation⁷⁵. Therefore, Mao’s argument that “a thoroughgoing socialist revolution must advance along the three fronts of politics, economics, and ideology” (Mao Zedong, 1977: p.72) was clear in theory and was well implemented in practice.

(b) Self-reliance and Egalitarianism

⁷⁴ To be noted that, this collectivist ideology is just on the contrary to the individualist ideology that was one of the cornerstones of the modern economics. For example, in Adam Smith’s statement in 1776, “(everyone) generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it ... By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it”.

⁷⁵ Cited from <http://www.wsu.edu:8001/~dee/MODCHINA/COMM2.HTM>

National and local self-reliance was at the centre of Mao's ideology and one of the principles of the CPC's revolution and construction during the wartime and pre-Reform period. The purposes of the 'self-reliance' were:

- to make China completely independent of foreign influence and resources in the potential war with the USSR or the US; and
- to fully take advantage of local resources (e.g. scattered or low-grade mineral deposits, small streams – for generating hydroelectricity, and leftover bits and pieces of industrial materials in large plants – but still valuable to the backyard industries) for local economic growth, so as to release the financial burden on the central government and promote local development.

Even though the local economic endowment and capacity for development were different across the country, the then (socialist) ideology did not allow the existence of 'inequality' and egalitarianism was adopted to reduce the local disparities. "The central government's fiscal relationship with the provinces has been shown to be a highly redistributive one. The most developed provinces (and province-level municipalities) such as Shanghai, Liaoning and Jiangsu remit to the central government 70-90% of their provincial revenues, while the poorer provinces keep their entire revenues and receive central subsidies as well." (Riskin, 1978: p.1308) To be noted that the 'egalitarian' campaign was not truly an effort to make things egalitarian, but rather to combat significant discrepancies in the population. In the context of self-reliance and egalitarianism, (local) collective ownership boomed in People's Communes (in rural areas), which became the major social institution (or organization) during the GLF till the Reform.

(c) 'Walking on the two legs'

The Soviet Planning Economy and its overemphasis on heavy industries were criticized by Mao as walking on one leg, unsustainable, and unable to mobilise the masses. Mao also worried that the PRC's heavy dependence on the Soviet technological aid⁷⁶ would be unsustainable because of the worsening Sino-USSR relation. But developing the heavy industries was no doubt the key means to Chinese industrialization and national defence. So, a 'walking on the two legs' strategy was put forward during the GLF (see the table below).

⁷⁶ The first Five Year Plan (FYP), which was proposed in 1951 and implemented during 1953-1957, was based on the 156 Soviet aided items.

Table 2-2: Walking on two legs during the GLF

Decentralization

In Mao's view, the centre controlled too much and autonomy had to be returned to the localities, so the power to allocate resources had to be redistributed among *administrative* levels. It is the so-called decentralization.

The decentralization was in fact to change the former planning system of 'unified balance' and 'commands transmitted top-down level by level' controlled by the Central Planning Commissions, into a planning system of 'combining specialised sectors and regions based on regional overall balance'. The objective of decentralization was in fact to give local governments more authority in five aspects (Wu Jinglian, 2004):

- A part of decision-making power in managing local SOEs
- Allocation of a part of the former planned resources and goods by local officials for local interests outside the central plan
- Examination and approval authority, and investment and credit authority on items of basic construction
- Fiscal budget and tax revenue
- Labour management

Technological dualism – a sectoral approach

- The modern sector

Internationally up-to-date technologies, and capital- and skill-intensiveness were applied to a relatively small number of large-scale industrial projects and SOEs, especially those obtained Soviet assistance continued from the first FYP (Ishikawa, 1972: pp.167-168).

- The traditional sector

Intermediate or appropriate technologies were applied to a great number of small- and medium-scaled and locally-based projects and production units as a rational choice for using labour and saving capital so as to support the modern sector and to support local self-sufficiency (or self-reliance) (ibid: p.168).

Urban-rural dualism – a spatial approach

Since Modern China, the modern sector has been concentrated in cities (normally large ones) and the traditional sector has scattered in rural areas. The spatially dual economy disobeyed the principle of socialist egalitarianism. Hence, the "focus on improving the productivity of all Chinese workers, whether in the rural or urban enterprises, by investing in human development and labour-intensive technology, even at the cost of slowing down the pace of investment in heavy industry" (Gabriel, 1998) was important to:

- reduce the urban-rural divide;
- relieve the employment pressure and fully utilise labour – the most abundant resource;
- develop rural industries as complementary, rather than substitute, to urban economy; and
- promote the urban-rural industrial combination.

Source: Author's design.

Urban areas had been organised by SOEs which implemented the central production plans and provided nearly all of social welfare services by resources allocated by the central government. Each SOE (especially the large-scale SOEs) functioned as a mini-society. The Great Leap Forward centred on a new socioeconomic and political system created in the countryside and in a few urban areas – the People's Communes. But it was more radical than SOE in providing the social functions and organising collective production.

Urban areas had been organised by SOEs which implemented the central production plans and provided nearly all of social welfare services using resources allocated by the central government. Each SOE (especially the large-scale SOEs) functioned as a mini-society. However, it was too costly for the central government to cover the entire rural areas by the SOE-dominating system. The Great Leap Forward style designed a new socioeconomic and political system created in the countryside and in a few urban areas – the People's Communes.

The commune was planned as a self-supporting community for agriculture, small-scale local industry, schooling, marketing, administration, and local security (maintained by militia organizations). Organized along paramilitary and labour saving lines, the commune had communal kitchens, mess halls, and nurseries. In a way, the people's communes constituted a fundamental attack on the institution of the family, especially in a few exemplary areas where radical experiments in communal living – e.g. large dormitories in place of the traditional nuclear family housing – occurred. That these experiments quickly failed was not surprising. The system was also based on the assumption that it would release additional manpower for such major projects as irrigation works and hydroelectric dams, which were seen as integral parts of the plan for the simultaneous development of industry and agriculture (Gabriel, 1998). The GLF also encouraged communes to set up 'backyard' production plants. The most famous were 600,000 backyard furnaces, which produced steel for the communes. When all of these furnaces were working, they added a considerable amount of steel to China's annual total production – 11 million tonnes in the year 1958 (ibid). The Commune system was observed more radical than SOE in providing the social functions and organising collective production.

Unfortunately, three years of natural catastrophes decreased the GLF's enthusiasm. The massive droughts affected every province in China, bringing with it diseases, while the worst typhoons in 50 years flooded twelve provinces (MacFarquhar, 1983: p.322). By the end of May 1960, an undeniable indicator of widespread disaster came when the grain reserves in Beijing, Tianjin, and Shanghai became totally depleted (Becker, 1998: p.80). The subsequent natural disaster caused a huge famine, due to which up to 30 million Chinese died⁷⁷ and devastated agricultural growth for the following six years, finally beginning to recover in 1965 (Clark, 1976: p.244). The impact in some sections of industry was similarly intense, as

⁷⁷ There is no consensus on the number of the death caused by the famine. For more discussion, see Yang Xiaokai, 2002.

100,000 enterprises were closed down between 1960 and 1965 so that over 20 million people could be withdrawn from the urban areas to help salvage something from the agricultural disaster and the stagnation that followed (MacFarquhar, 1983: p.330).

The break-down of the Sino-USSR relation in 1960 and the consequent withdrawal of the Soviet aid further aggravated the difficulty of technological progress and the development of the heavy industry. More agricultural and industrial output was needed to pay off the Soviet loans and support the national economy. Hence, the quotas for the remittance of agricultural and industrial outputs were increased. The burden on the masses, especially rural residents, became heavier than ever before.

The rural industries over-emphasised quantity and neglected quality. Farm machinery quickly produced in factories fell to pieces when used. Many thousands of workers were injured after working long hours and falling asleep at their jobs. Steel produced by the backyard furnaces was frequently too weak to be of any use. Buildings constructed by this substandard steel did not last long. The scattered small-scale production units and local autonomy in developing the economy entitled by decentralization resulted in excessive infrastructure constructions, less specialization and cooperation among localities, and confusion of macro-economic regulation⁷⁸.

The GLF was stopped in 1960 by the PRC's leading group because of its disastrous consequences. However, the explanations for this disaster vary according to their sources. Some scholars direct their satire at the dictatorship of the political leader that allowed carrying out the wrong policies (e.g. Yang Xiaokai, 2002); some ascribe the depression in the rural economy (including agricultural production and rural industries) to the lack of working incentive and effective supervision caused by the 'collective' property rights (e.g. Xu and Huang, 2002; Wu Yi, 1997). The natural catastrophes and the break-down of the Sino-USSR relation also share a part of responsibility. People's blind worship to Mao Zedong and the 'wave of exaggeration' (*fu kua feng*) in many localities⁷⁹ are paid great attention by Kang Jian to explain the failures of the GLF⁸⁰.

⁷⁸ More introduction to the consequences of the GLF can be found in Yao Kaijian (2003: Chapter 2)

⁷⁹ A series of reports of People's Daily in 1958 can illustrate the 'wave of exaggeration': on June 12, 1958, Suiping County (in Henan Province) declared that the local wheat production reached 1765 kg/mu and then on July 23, it reached 3660 kg/mu; the high tide arrived on

One point to be noted here is, although the rural small-scale industries were not successful during the GLF and caused heavy criticism from economists for their inefficiency, they have been the most dynamic force in developing the rural economy since the Reform. The township and village enterprises (TVEs), which derived from the production units established under the GLF, produced great economic achievement⁸¹ and are even praised by some economists as the Chinese way to Socialism. Hence, although the GLF failed, its institutional innovation was not completely a failure. Its usefulness will be demonstrated only when the social context becomes favourable.

Summary

In this section, I made a comparison of five competing forms or visions of the economy which were developed by economists to describe the pre-Reform economy of the PRC. The first three forms – Planning Economy, *gan chao* Economy and Military Economy – try to analyse the national economy during 1949 to 1978 as a whole; while the last two – NDE and GLF– are only valid to specific periods. Although the then national economy is generally called ‘central planning economy’ or ‘central command economy’, the other four forms should not be overlooked because of their own effective explanation of the national economy. As all the five forms are illustrated by different logics and policies, they make different conclusions about the success and failure of the then national economy. The comparison of their logics and appraisals of the national economy is provided in Table 2-3 and a time-axe of the forms is made in Annex 5. None of these forms can fully explain the complex economic phenomenon in the pre-Reform era, but a survey of them is wished to be valuable for this purpose.

September 18, when Hongqi Commune in Huanjiang County (in Guangxi Province) declared that the communal rice production reached 65000 kg/mu. These exaggerated data made many then Chinese people believe “how much people can imagine, how much the land can produce” (please see Yao Kaijian, 2003: p72).

80 In his “The disillusion of glory: admonishing the world by the experience of the People’s Commune”, kang Jian makes a particular explanation of the origin and failure of the GLF in Suiping County, where established the first Chinese People’s Commune, through interviews with local residents who witnessed or participated in that event. He argues: The commune was not created by Mao’s imagination, but at first was spontaneously promoted by peasants; people’s working incentive was not as weak as many economists now assert. While the quota of agricultural outputs surged up due to the wave of exaggeration of the capacity of production; the local governors and peasants curried favour with the GLF and concealed, or over-estimated, their capability of production due to the enthusiasm of revolution, etc. The rapid spread of building commune is supposed to be the main reason for the failure of the People’s Commune because not all localities were compatible with the commune. The personal cult of the masses to Mao may also help understand why the commune could be obliged by Mao to spread over the country without significant resistance. In addition, Qin *et al* (2001) argue that a current chief scientist misled Mao to make wrong decisions by proving that “if the solar energy were fully utilised, the food output could be more than 20000 kg/mu”.

81 Plenty of studies on the TVE can be found, for example, NBSC (1999), Liu, Chen and Deng (2000) and the references given by them.

Table 2-3: A comparison of the five forms of the economy

Form	Starting point of logic	Logic	Appraisal of the national economy
Planning Economy (1949-1978)	Socialist ideology and misunderstanding of the market institution; a comparison of the models for industrialization	Socialism → state ownership → resource allocation by the state → a central planning system → a hierarchical administrative system	The planning and the micro exploration were inefficient
<i>gan chao</i> Economy (1949-1978)	Catching up and surpassing the developed countries in a short time through strong state intervention rather than the market regulation	<i>gan chao</i> → HIODS → a traditional economic system: a set of macro-economic policies that distort the market institution, resources allocation under state planning, industrial nationalization in urban area and People's Communes in rural area	Non-economic rationality of the industrial structure and layout, inefficiency of micro economy
Military Economy (1949-1978)	The economy was aimed at 'survival', not 'development'; it was not the 'normal economy' that pursues wealth-creation or profit-making	To survive the coming war → developing war industries → resources allocated to non-productive consumption (war industries) → military organization in the overall society and self-reliance	Low economic efficiency of the national production system
New Democratic Economy (1949-1953)	Recovering the national economy in order to prepare for entering a socialist society	Socialist ideology → domination of the central planning, complemented by private economy, for optimising the resource allocation	Making dramatic economic restoration, but short-lived (replaced by the <i>gan chao</i> Economy and GLF)
Great-Leap-Forward (1958-1960)	A Chinese way to enter Socialism that is different to the Soviet Planning Economy and HIODS	Ideological innovation → Socialist Man and Mass Line → walking on two legs: central-local authorities; urban-rural dualism; technological dualism; self-reliance and centralised state power → People's Commune in rural areas	Collapse of the People's Commune; blind pursuit of the growth of quantity of production without paying attention to quality; utopianism

Source: Author's design

2.3 The Traditional SOE

In the period 1949-1978, SOEs were principal actors at the micro economic level. They ensured the economic system to operate, whichever form it adopted. Meanwhile, the economic system and institutional arrangements endowed the SOE with many characteristics which distinguished the SOEs from capitalist firms. Many researchers consider the SOEs less an economic than a social and political institution, whether privately or publicly owned, e.g. Walder (1986). The SOE was incorporated into the particular ‘*dan wei*’ (working unit) system, which dominated urban society. Strong political and ideological orientations were two main features of the *dan wei* system (Ji You, 1998: p.3). Hence, the SOE should not be analysed only as an economic instrument, but also as a social institution. The ‘SOE culture’, including intra-SOE relationships, government-SOE relationships, SOE-locality relationships, and personal ties among SOE employees in urban areas, influenced a few generations of Chinese people. Since the Reform, the SOE has also been placed at the centre of the institutional transition because of its critical role in the national economy and in the society. Therefore, a review of the SOE in the pre-Reform era – the traditional SOE – is helpful to understand the reasons that it must be reformed so as to adapt to the newly built socialist market economy. As the SOE in the pre-Reform era was very different from that in the present day, in terms of institutional (external) supervision, organizational (internal) management and working incentive, to make a difference, I called it the ‘traditional SOE’.

The specificity of the traditional SOE is analysed according to four dimensions, thus this section is divided into four parts:

- state ownership and the State-Party-SOE relation;
- the management inside SOE;
- the working incentive of workers and managers; and
- the SOE’s contribution to the local development: the traditional SOE as an institutional instrument for both industrialization and urbanization.

2.3.1 State Ownership and State-Party-SOE Relations

State ownership is the basic characteristic of the SOE and the origin of the other characteristics. Based on Marx’s criticism of the blindness of capitalist production, socialist theorists and practitioners envisaged an economy where all production activities would be organised as if conducted within one enterprise (Ji You, 1998: p.4). All SOEs were components of that ‘big enterprise’ and each SOE functioned like a ‘factory’. They received

guaranteed capital investment and outlets for products through the hierarchal system but had little economic independence or identity⁸². The economy of the 'big enterprise' is "by nature an administrative economy requiring an all-powerful bureaucracy to execute central planning. This has fashioned a unique type of state-enterprise relation. ... The ownership had to be 'pure' because such a big enterprise must have only one owner. The plan had to be detailed enough to ensure strict management procedures. Exchange relations had to be curtailed, as they could cause disorder". Hence, there was no market institution and no market prices were available to direct the SOEs' behaviour⁸³. The SOEs were deprived of the nature of the 'firm' (in the modern economic literature) as seeking profit through market competition. The entrepreneur or entrepreneurship was not necessary for the SOE's operation, as the entrepreneurial function was undertaken by the government sectors only, e.g. the State Planning Commission. The vast economic bureaucracy was founded in the 1950s (accompanying the accomplishment of the first Five-Year-Plan and the socialist transformations).

All SOEs were ranked hierarchically according to criteria such as the amount of state investment they received, the importance of their products and the number of workers they employed. For example, SOE directors were ranked as government officials at administrative levels varying from director of township to director of province, or as an officer in the army at hierarchical levels from battalion commander to army commander (Lu Feng, 1989). "This military-sounding bureaucratization of factories until the late 1970s was meant to facilitate the fulfilment of central plans, as central decrees could be carried out most effectively within an administrative pyramid like that of an army"⁸⁴ (Ji You, 1998: pp.4-5). The hierarchically organised government economic agencies, as the representatives of state ownership, maintained strong bureaucratic control. They wielded the authority to appoint factory directors, allocate products and formulate remuneration and employment policies (Dernberger, 1986)

"Parallel with the economic bureaucracy, the establishment of party cells on shop floors in the 1950s marked the politicising of SOEs." (Ji You, 1998: p.3) "Party cells are instigators of ideological indoctrination and propaganda work. They exercise control over people's thought.

82 The SOEs received eight formal obligatory plan targets: output, quality, variety, and profit, together with delivery contract, material, fuel consumption and the use of working capital (Chai, 1997: p.53).

83 Even in the NDE, where the market was partially functioning under state planning, the SOEs were not players on domestic markets, as they were directly controlled by the state.

84 This military-sounding bureaucratization can be integrated into the discussion of the Military Economy in last section.

Ideological work in China's state factories not only is designed to disseminate propaganda but also is an institution for imposing specific patterns of behaviour. Thought control and organizational control are linked by the party in shop floor politics. For instance, a worker with an allegedly poor work record was commonly regarded in the pre-reform days as hostile to the party and in need of 're-education'." (ibid: p.4) As politicization deepened, the CPC created a monolithic leadership structure in SOEs, and not only the ideological indoctrination and propaganda work, but also the decisions for production, employment, and other enterprise actions were under the control of Party cells. These State-Party-SOE relations have transformed the factory into a unique setting that tied workers closely to the state, a setting that has no real counterpart even in other socialist countries (ibid: p.6).

Three characteristics directly originated from state ownership: the SOEs' multitasks pattern, the supervision system, and the state's infinite liability to SOEs. They are discussed in the following.

(a) Multitasks

Besides the obligatory targets of the state plan, the SOE had to provide a large number of social services for its employees and their families 'from the cradle to the grave': pension system, housing allocation system, health care services, and education for the children of employees (from nursery to middle school), etc. But in market economies, such social functions are normally provided by social institutions rather than enterprises. The 'low wages, low consumption' policy that was carried out in the early 1950s could give an explanation. A centralised, nation-wide unified eight-grade wage system and a rationing system were adopted in the 1950s. But neither the low wages nor the rationing could fully meet workers' living necessities. Instead of creating the corresponding social institutions to provide welfare services like in other countries, Chinese leaders let SOE provide these services without commercial pursuit⁸⁵ because they believed that providing such public services and not profit-making was the state's duty. As a result, the reliance of workers on the SOEs where they worked was deepened; the function of the city was devolved and the 'urban society' became a '*dan wei* dominated society', in which the SOEs shared a large part.

⁸⁵ Other kinds of *danwei* also provided social services to their employees as SOEs did.

(b) State's Infinite Liability for SOEs

The SOEs were like factories where inputs allocated by the state were transformed into outputs required by the state. No profit was retained to SOEs, while no costs or expenses were undertaken by SOEs themselves. To be noted that prices were all decided by the state, rather than by the market. Hence the *profit* of an SOE was also generated under state planning. The state was the only claimer for the gain or loss of SOEs' operation. Moreover, the location of SOEs, the scale and scope of production, the procurement quota of outputs, the equipment and technology, the size and type of labour, and so on, were all planned by the state. It was not necessary to measure the SOE's performance by profitability. The only measure was whether the SOE fulfilled its tasks, rather than whether it made profits or not. Furthermore, the state allocated and distributed resources (including workers) among SOEs without compensation (*wu chang diao bo*) for the resources-losing SOEs, since 'all belonged to the state' and the SOE was not an economic entity. There was no 'suffering' in such transaction because it looked as if money was transferred from the left hand to the right hand.

Bankruptcy, meaning the inability or impairment of ability of an enterprise to pay their creditors, was not applicable to SOEs. Imagine, if an SOE was faced with bankruptcy and at last closed, the state would then have to build up another SOE for the same tasks, in the same location, at the same scale, even employing the same group of workers. There was no need to replace the old SOE with a 'new' one. The closure of an SOE was possible only if the state did not need it in that location or for its production, i.e. when the existence of the SOE had no planning value any more.

The infinite liability resulted in the SOE's 'soft budget constraint' (Kornai, 1979; 1980). As the state had to cover all the deficit of the SOE, SOEs did not really care about their deficit and caused inefficiency in production. So, state supervision on the SOEs' operation became very important to ensure the efficiency of state planning.

(c) Supervision System

Since 1949, the state has established a four-level administrative institution to make production plans, to allocate resources, and to supervise SOEs. At the apex of the hierarchy were the top economic organs, which included the State Planning Commission, the State Economic Commission and the functional bureaus of the State Council. At the level underneath the top economic organs were the ministries, which were in charge of the administration of a branch of industry (for example, Ministry of Agriculture, Ministry of Communication, Ministry of

Machinery, etc.). Each industrial ministry had a subordinate industrial department or bureau, each of which in turn controlled a group of enterprises (Chai, 1997: pp.33-34).

However, it cost the administrative supervisors too much to get enough information to understand the real situation of each of their SOE. Two solutions were put forward. One is the distribution of control rights over SOEs between the central (e.g. ministries) and local authorities. Large and strategic SOEs were subject to the control of the central authorities, with the number of employees fluctuating between 1200 and 10,000. Small and Medium-sized SOEs of local significance were placed under the control of local authorities. There were also some SOEs controlled in cooperation between the central and local authorities (Chai, 1997: p.32). The distribution of control rights between the central and local authorities varied across industrial branches and categories of inputs as shown in the table below.

Table 2-4: Distribution of control rights over China’s traditional SOEs

Industrial branches	Output	Personnel	Working capital	Material	Investment
Metallurgy	L/M	L/M	L/M	M	M
Electric power	M	M	M	M	M
Coal	L/M	L/M	L/M	M	M
Petroleum	L/M	L/M	L/M	M	M
Chemicals	L/M	L/M	L/M	M	M
Machinery	L/M	L/M	L/M	M	M
Light industry	L	L	L	M	M
Textiles	L	L	L	M	M

Note: L and M denote local authority and ministry respectively.
 Source: Chai, 1997: p.33.

The other powerful supervision system – the *nomenklatura* appointment system – was adopted to strengthen the state (or Party) control over SOEs. Through this appointment system, the party selected cadres and made them directly responsible for its policies (Burns, 1988: p.ix-xiii). “The party firmly placed the administration, trade unions, security networks and mass organizations under its control and made them transmission belts through which it penetrated into every corner of the shop floor” (Ji You, 1998: p.4).

This appointment system allowed to directly supervise the SOE directors’ behaviour and was really very powerful in controlling them. But this system caused a serious problem because the directors were mainly ‘loyal’ to their supervisors – upward responsibility, rather than caring about their work and employees at inferior levels of hierarchy – downward responsibility. Especially when the market institution was absent, the evaluation of a SOE director mainly relied on its supervisors’ personal appreciation. This led SOE directors to be careless about the economic performance of the SOE, but to meet the supervisors’ personal

needs. Moreover, the directors were required to be ‘red experts’, i.e. they had to be loyal to the socialist ideology as well as the CPC and at the same time be competent in management. When the political campaigns prevailed, the directors’ political or ideological performance outweighed their economic performance. To be ‘red’ was the most important, if not the mere criterion to select enterprise directors.

Although the supervision system was blamed to cause inefficiency in the economic functioning of SOEs (mostly from the perspective of the market economy), it worked well to ensure the fulfilment of the state planning (Yao Kaijian, 2003). Meeting the planning indicators was in fact a ‘hard task’ to be accomplished. So, in this context, the supervision system played its role well.

2.3.2 Management System inside SOE

The supervision system and the then (both political and social) institutional environment determined to a great extent the organizational system – internal management – of the traditional SOEs. The SOE distinguished itself from modern profit-pursuing firms and even from those in the Soviet SOEs in terms of “who managed” and “how they managed”. This section explains the internal management of the traditional SOE following these two dimensions. Party control and ideological re-education of workers are two main subjects.

(a) ‘One-man management system’ vs. ‘Party-command-system’

Due to the nomenklatura appointment system as well as the Party control over ideology and political orientation, SOEs’ managers were not only production organisers as their counterparts in capitalist economies, but were also responsible for the socialist or communist ideological education for achieving the political targets. Moreover, “party control over shop floor politics has been much tighter in China [the pre-Reform PRC] than in any other socialist state” (Ji You, 1998: p.31). For example, the Soviet-type SOEs adopted the ‘one-man management system’ (or ‘director-responsibility system’), while most of the Soviet industrial Party Cells were not key decision-makers in SOEs. According to the Soviet Party Charter (1986), industrial party committees could exercise some supervisory role over managers in certain areas of work, but on the whole they were mainly caretakers of their internal affairs (Li Mu, 1989: p.46). Stalin believed that industry had to be managed by professional managers without interference from the party (Bo Yibo, 1990: pp.10-11).

In China, between 1950 and 1953, due to the establishment of the NDE, various forms of leadership were exercised in SOEs in different regions of the country. For example, northeast China was heavily influenced by the Stalinist style through the Soviet-aided industrial programs and adopted the one-man management system, while the Party-command system was adopted in other regions. With the conclusion of the three-year economic restoration, the need to standardise the industrial management system across the nation became pressing (Ji You, 1998: p.35). Until the late 1955, when the 'one-man management system' copied from the USSR was abolished, enterprises were supposed to be run as economic entities, even though they took orders from the state. This for some time still allowed managers substantial autonomy in running production systems (Zhang Zhailun, 1985: pp.3-6)

But in many SOEs, the resistance of CPC personnel to the professional managers was obvious. There were heated debates among party cadres and managers over such issues as "whether a manager who was a party member should abide by the party's principle of democratic centralism", and "how far a manager's authority should reach in both production and non-production business. Very often managers were blamed for not seeking advice from the Party and, as a result, their management decrees were blocked in the process of implementation (Du Yaohua, 1987: pp.304-305). A well-known criticism of the one-man management was its effects in undermining Party leadership. In the name of production, professional managers took control over virtually all functions of SOEs leaving the Party to provide moral leadership only.

In 1956, when the country's class struggle highlighted the necessity for stricter party control, and as Mao commented repeatedly that the running of SOEs should follow the long tradition of the CPC, not the practice of the USSR, the 'Party-command system' was formally adopted at the Party's Eighth National Congress (Ji You, 1998: pp.35-37). During the following three decades they constituted the elite of elites and monopolised ultimate policy- and decision-making authority (Barnett, 1967; p.429). Under the Party-command system, however substantial his (her) authority, a manager was only an executive.

The difference between the two management systems is summarised by Schurmann (1968: p. 251) as: "The manager thinks in terms of techniques, both technological and organizational; he prefers rational organization, for he has the confidence that he can manipulate it and use it to achieve his own ends; he likes rules because he knows he can bend them to his will, to enforce compliance from his workers. The cadre, however, is a leader who thinks in terms of

human solidarity. He knows how to ‘solidarize’ people so that goals can be achieved; he knows how to manipulate their thoughts and sentiments; he operates not on ethos but by ideology; he strives for a different kind of mechanical solidarity, namely that of the combat team.” This comparison polarises between ‘the manager’ and ‘the party cadre’ in fulfilling production and political tasks. Although the polarization was not valid for all managers and party cadres, it is still very helpful to understand some general differences between the two roles.

In the pre-Reform PRC, like in other socialist countries in the same era, trade unions had two functions: to protect workers’ interests from being encroached upon by the state; and to organise workers to enhance the proletariat’s and the state’s control. As the CPC has declared that it is the vanguard of the working class and the protector of workers’ interests, the CPC commissions in SOEs in theory undertake the functions of trade unions. In other words, as party commissions have been set up in each SOE, trade unions were in fact attached to these commissions and only dealt with some welfare services for SOE employees (Ji You, 1998: pp.33-35).

“As the power holders, party cadres were asked to keep an eye on production performance. But they were more inclined to and good at following political preferences set by their party superiors. They intended to keep people under a political organization, an official ideology and a special way of life. From the Party’s point of view, the Party-command system was more suitable for its political task and purpose of revolution.” (ibid: pp.38-39) Combined with the supervision system, the Party took a monistic control over SOEs and their managers. A multi-layer hierarchy was established from the top manager to the workers, referred to as military-like bureaucratization. This bureaucratization was indeed very efficient to implement the top-down command, but very inefficient for the bottom-up echo. There were many complaints about the applications for equipment from the bottom-up that were delayed for months and even years without response. The applications were transferred among the bureaus for their opinions and admissions. When the approvals were returned to the appliers, the equipment had already become obsolete⁸⁶. According to the modern science of management, this bureaucratic pattern is unacceptable because of the blockage of information flows from the bottom-up. This was a fatal weakness for the central plan-making and policy

⁸⁶ Gao Shangquan (1996: p.1) tells such stories to criticize the inefficient administrative information procession. Indeed, this weakness is not only the SOE’s problem, but can be found in almost all administrative systems in the world.

adjustment. Unfortunately, no better management pattern was found compatible with the central planning system at that time.

(b) Ideological Re-education of Workers and Mass Supervision

“The management of workers inside SOEs was implemented in a totally different approach from the capitalist economies, which emphasises performance-evaluation or objective-management, and managers have authority to punish mistake-makers by reducing bonus, wages, or even dismissing unqualified employees. In Mao’s idea, however, a factory was a revolutionary school and management was also socialist education.” (Ji You, 1998: p.38) According to the labour policy in the PRC before the Reform, SOEs had little authority to hire or fire employees; a labour quota was assigned from above (Chai, 1997: p.55). So, it was almost impossible to dismiss workers (except for political reasons)⁸⁷; and the management of workers heavily relied on ideological re-education. The wrongdoers could neither be punished by material means because their material gains only maintained their survival, nor be fired because the wrongdoers might continue to do wrong elsewhere and damage the society. The only but also the best solution was correcting the wrong behaviours through re-education.

Furthermore, in order to educate workers against individualism, which was regarded as a feature of capitalist ideology, a collective production pattern under collectivism was adopted as the means of production in SOEs (another example was People’s Communes during the GLF). People were educated that: the state is superior to the collective and the collective is superior to the individual, if there is a conflict of interests among them; one must work for, first the state, second the collective, and at last himself/herself; as one works (and lives) in a collective, the interests of the collective are directly related to one’s own interest and reversely one’s behaviour directly influences the collective. Therefore, everyone in the collective must think of the collective first, and to this purpose he/she is supervised by other members. An SOE is a collective. As managers were not effective in overseeing all mistakes made by workers, collective supervision was introduced to make up for this weakness. In this way everyone was supervised and educated by other members of the collective where he/she worked⁸⁸. But in many cases the collective was still too large to be effective for collective

87 That is why workers in the traditional SOEs had job tenure for life, and the job in such SOEs is often referred to as the ‘iron rice bowl’ (Pyle, 1997: p.90).

88 The collective supervision used here is interpersonal, different from that of the ‘supervision system’, which is administrative and inter-bureaus.

supervision. So, large collectives were subdivided into many small sub-collectives such as working groups, departments, or bureaus.

This collectivism can be successful. Riskin (1975: pp.428-432) analyses the modes of behaviour for the collective work in the traditional SOE by way of a 'game' model. He concludes that it is theoretically possible for team workers that each member in a collective prefers to be hard-working as long as other members also work hard, if all members are persuaded to behave 'socialistically', rather than 'selfishly'. The ideological education and the collective supervision were both effective in forming the social consciousness of hardworking-hardworking cooperation among workers and imposing peaceful coercion on lazy workers to work hard.

In practice, if someone was lazy or shirking, he/she was treated as anti-collectivist, anti-socialist, anti-CPC, and anti-revolutionist. One's attitude towards labour was related to his/her attitude towards political and ideological orientation. During the years of political movements (from the 1950s to the 1970s), the social environment was extremely 'hostile' to the *antis* and the political suppression was very severe. Without enough income, one could still live with the help of his/her collective (except for the famine after the GLF); but without a good political evaluation, it was difficult to survive in the society. The political status was more important to people's life than the material means was. As a positive result, cases of 'lazy behaviour' were only individual and specific. Their bad behaviours were not copied or followed, but condemned by the society. The party cells, if they were informed such behaviour, would organise special groups to deal with the 'problem individuals' by educating socialist principles and Mao Zedong Thought, until the bad behaviours were corrected. The social pressure was considerably big on the wrongdoers⁸⁹.

Management was not the unique instrument to ensure that people would work hard. Stimulation (material and mental) was also important and necessary because one must be motivated rather than merely commanded or punished. In the traditional SOE, a special incentive system was created to 'motivate' workers and also managers. This is the issue to be discussed in the following section.

⁸⁹ Galston (1972) depicts the social pressure in the Commune, and it is also applicable in SOEs.

2.3.3 Incentives

There are generally two types of incentives in enterprises: one for the enterprise as a whole and the other for its employees. However, in China's traditional SOEs, all net income and products were delivered to the state and the expansion of employment as well as the scale of enterprise was decided by the state plan. The incentive for the enterprise was minimised and that for employees (including managers) became the mere concern. Both material and non-material incentives were adopted to motivate people.

(a) Material Incentives

The material incentive was based on wage, rationing, and welfare services. In SOEs, wages conformed to standards set by the state and differentiated by branch of activity. For ordinary workers the usual pattern is an eight-grade system, with the top wage averaging two to three times the bottom one. Each worker was assigned a grade according to his seniority, skill, and function (Hoffman, 1974: Chapter 4). Non-production employees were paid according to a seven-grade system. According to the Labour Chronicle of Guilin⁹⁰ (a city in Guangxi Autonomous Region), in 1952, the wage for workers varied from 1.02 yuan RMB/month for the first grade to 3.69 yuan for the eighth grade; the wage for managers varied from 2.20 yuan to 3.40 yuan and the wage for other non-productive staff varied from 1.10 yuan to 2.30 yuan (at current prices). The gap was really limited. In 8 of the 38 industrial enterprises he visited in 1966, Barry Richman found that workers⁹¹ were the highest-paid among employees. In most of the 38 enterprises, a director's wage was only twice as high as the average enterprise pay, and the ratio never exceeded 3 to 1. The average ratio of the salary of the highest-paid engineer or technician to the average enterprise wage was less than 2.7 to 1 (Richman, 1967: pp.800-805).

A bonus was normally used to stimulate production dynamism, but before the Reform, it was not really related to one's performance. In Guilin's case, it was more like a supplementary wage. The bonus system was not aimed to create big differentials in remuneration among workers, because the big differentials would damage cohesion within and among collectives and were counter to the socialist ideology.

⁹⁰ The Chronicle can be found in the official website of the Guilin's government:

<http://guilin.gov.cn/default.asp?CatalogCode=35219816054784&Task=Show&DocumentID=609&DocPos=5>.

⁹¹ Here the worker is distinguished from non-production employees.

In addition to the centralised, nationally unified wage and bonus system which was monetised, a ration system was adopted to allocate a basket of necessities of everyday life for the urban dweller⁹². The rationing goods contained the living necessities within the limit that the state believed appropriate. For instance, in 1978 the per capita income for each city dweller was 26.3 yuan per month, while the rationed commodities cost 22.74 yuan. These included an average of 15 kg of grain stuff, 0.56 kg of vegetables, 0.51 kg of meat, 0.16 kg of sugar and 0.25 kg of cooking oil (Cheng *et al*, 1987: pp.33-38). Houses were also built by SOEs and allocated to SOE employees according to their function, work performance, years of career, and situation of family. Managers of SOEs were allocated some scarce or high-priced goods as a privilege of the cadre. The percentage of welfare funds in the total wage bill was high, 12 to 13.5, and even to 36% for medical expenses, trade union operations, educational, recreational, cultural, insurance, and social security expenses (Richman, 1969: p.807).

Under the wage, bonus, and ration systems, the ‘low wage, low consumption’ policy was put into practice. Throughout the two decades from 1959 to 1979, about 20% of all urban families received less than 20 yuan per head. People had to work for survival, as Riskin (1975: p.423) introduces: “Workers worked only to avoid starvation, so that the utility attached to increments of income above the subsistence level was zero. In this case, no wage increase, however large, could ever induce more work from a labourer. The more he was paid, the less work he needed to perform to earn his subsistence. The moral, of course, is to pay as little as possible.” The material incentives were just used to cover the necessary living expenses⁹³. It is reasonable for David McClelland to ask, “Could their chief motive be profit (money) if they were expressively denied the possibility of enjoying material benefits?” (Higgins, 1968: pp.299-300)

However, the state could benefit from the low payment mechanism and collect the maximum of financial capital from the masses which was possible because of the high saving rate (more than 30%) to fund heavy and military industries; create more jobs in the urban area to absorb rural labourers. Job security, welfare system that guaranteed ‘everyone’ to live, and the little differential of personal income, ensured the social stability and people’s satisfaction. Moreover, few goods were available to exchange with money due to the shortage of goods

92 The ration system was applied for all the urban population from 1955 to 1993.

93 Riskin (1975: p.450) also argues that the SOE employees “still enjoyed the best working conditions and welfare benefits, had the highest wages outside the small group of very highly paid intellectuals and scientists”.

and the lack of markets. So the utility of money for ordinary people was low. They had to rely on their SOEs for being offered goods and services meeting living necessities. The state could thus fully control the SOE employees so as to maximally mobilise the labour resources.

Such a low material incentive is often criticized by orthodox economists: “The ordinary incentives (as we know them) to work hard and well have been drastically weakened in China. Moreover, this supposed fact is generally held responsible for a record of dismal failure in economic development efforts.” (Riskin, 1975: p.415) The orthodox theories assume that “everyone is in pursuit of shirking in work for work is a ‘negative good’, to which ‘disutility’ is attached. ‘Leisure’ (the desired state among workers) consists of sitting around and doing nothing ... [we see] the exclusive attention of the orthodox school of Pekingologists to external, individual, material incentives as if there were the sole or at least dominant sources of motivation to be considered.” (ibid: pp.423-425) The facts, however, did not support the criticisms. As Riskin cites (1975: p.415): “Visitors to China invariably comment on the energy and zeal of the people they met there. Seymour Topping’s impression is that “the basic needs of the people are being met and the foundation is being laid for a modern industrial country” which he ascribes partly to “the energy exhibited everywhere.” Business economist Barry Richman (1967: pp.73-74) found that Chinese industrial executives had a “high need for achievement” and displayed “considerable zeal, dedication, patriotism...a deep sense of commitment and purpose”. He argues: “The Chinese approach to motivation requires us to broaden our treatment of this concept (of incentive) as well as to understand its links with other variables, such as organization, leadership, and the distribution of political power.” (ibid: p.416) Non-material incentive should be paid more attention to in the study of working incentives in the pre-Reform PRC.

(b) Non-material Incentives

McGregor (1960: p.309) believes that worker behaviour responsive to direct external stimuli “is not a consequence of man’s inherent nature, (but) is a consequence rather of the nature of industrial organizations, or management philosophy, policy and practice”. The Maoist policies were such evidence as they tried to make up for the shortage of the material incentives by non-material incentives, because at that time the material incentives were very limited in amount and in function. If material incentives were the only means to motivate people, the nation-wide unified low payment policy would not be sufficient or sustainable, thus the state could not collect capital that were dispersed in the entire country to implement its capital-intensive industrial projects. Moreover, material incentives would certainly cause

disparities of income among people; this was believed to damage the socialist justice according to Maoist egalitarianism and to cause the capitalist illness, e.g. the mammonism. Hence, non-material incentives were offered to substitute for the material ones. Two types of non-material incentives are discussed here: social reputation and political promotion.

To be an industrial worker in the pre-Reform PRC meant to be in a politically privileged position. The CPC Charter declares that the working class represents the most advanced force of production and the leading force of the societal evolution⁹⁴. As SOEs were main workplaces of the working class, an SOE employee was highly respected by the whole society.

In order to ensure the efficiency of production, labour emulation (*lao dong jing sai*) was adopted to encourage workers to improve their techniques by offering them honour rather than material bonus. The workers, who contributed the most to the collective or the SOE, were elected as the ‘exemplary workers’ for others. They were honoured as heroes in wars, and managers had to pay attention to the opinions of these ‘examples’ when making some important decisions.

Political promotion was also an effective means to motivate people, especially for the SOE managers. Those who had the right political attitude (firmly supporting the CPC), good working performance (fulfilling the state planned obligatory targets) and the appreciation from the superior directors, would be promoted to higher administrative positions. Some SOE directors were also candidates to become Ministers in the relevant industrial sectors, or local government officers. The political promotion was really effective, especially when material incentives for motivation were minimised.

The Pre-Reform incentive system received heavy criticisms from orthodox economists because its weak material incentives are supposed to be useless in motivating people. The market values and norms denied the ‘rationality’ of such system. But these criticisms were not accepted until the Reform, when material incentives became widely used to motivate people. This will be discussed in the next chapter. But in the pre-Reform period, the mixed (material

⁹⁴ This ideology impacted Chinese people so deep that “even in the mushrooming local industries at the country level, industrial workers are even more in the position of pioneers, mastering for the first time scientific and industrial technology, playing the role of “leading factor” in the economic transformation of their localities (Riskin, 1975: p.450).

and non-material) incentive system did function to motivate people to work, for the country and the collective, rather than only for the individual.

2.3.4 The SOE's contribution to the local development

The fourth specificity of the traditional SOE concerns the spatial dimension. Unlike the capitalist firms in the market economies, which contribute to the locality and society mainly through paying taxes and creating jobs, the traditional SOE in the pre-Reform PRC has played a particular role in local development. The formation of this role can be attributed to a series of factors:

- the SOE was the main force of the then industrialization and the then urbanization was mainly industrialization-pushed;
- the traditional SOE shouldered social and political multitasks to serve society;
- SOEs were established for war industries in the remote and often less developed localities (e.g. the Three Fronts construction) so that improved local productivity;
- a nationwide inter-SOE support programme was created to reduce the disparities among localities (with regard to the levels of urbanization, industrialization, and civilization), i.e. the state transferred (physical, human and financial) resources from the cornerstone SOEs in the then 'developed' localities to the SOEs in the less developed localities.

In the following text, I illustrate the SOE's contribution to local development by focusing on industrialization-pushed urbanization and the nationwide inter-SOE support programme.

(a) Industrialization-Pushed Urbanization

In 1949, China had only 132 cities (Municipalities and provincial-level cities). The level of urbanization was only 5.1% according to the percentage of the urban population in the total Chinese population. Until the end of 1957, owing to the first FYP, 44 new cities were built, and a pack of 'old', large and middle cities were restructured and enlarged, and became production bases for the heavy industries (NBSC, 1999). By 1978, the industrial SOEs had become the cornerstone of the urban economy. Hence, the urbanization in the pre-Reform era was industrialization-pushed.

In his historical materialist analysis of society, Marx concentrates on the production process as the most fundamental (the most irreducible) of all social relationships. His study of capitalism is focused on productive activities because he believed that the value (and profit) comes from the production process rather than the circulation process, and occurs in factories

rather than on markets. This proposition was fully accepted by the PRC leaders in the pre-Reform era as a principle to guide the socialist practice. Market exchange, entertainment of people, etc. were minimised because of their non-productive nature. Thus, urban development strategy was devoted to ‘production first, life [entertainment] second’ so as to increase social wealth. A city’s function was thus confined to (material) production. The economic sectors for consumption lost in status because they were thought to waste resources for production. Moreover, most social functions, e.g. welfare services, were incorporated to the traditional SOE. As most of the urban residents worked in *dan wei* and SOEs were the main workplace, the city became an agglomeration of SOEs. There were some cities, Daqing, Anshan, Baiyin, Panzhihua, and so on, where all urban residents worked in only one large-scale SOE. As a result, the traditional SOE dominated the urban life and industrialization.

The resource-based cities are a typical example of the industrialization-pushed urbanization. Wang Qingyun (2003) has done a detailed study on these cities. He summarises three basic characteristics of such cities, as shown below.

Table 2-5: Three basic characteristics of resource-based cities in the pre-Reform China (1949-1978)

Unitary economic structure	<ul style="list-style-type: none"> ➤ The industrial structure is concentrated on resource exploitation and processing industry; so is the employment structure. ➤ State ownership is dominant in local enterprises and large scale operations prevail. ➤ The enterprises are similar to each other in, for example, organizational structure; level of industrial output, fixed capital (original value), tax and profit; and employment size.
Fast urbanization and scattered location with low population density	<ul style="list-style-type: none"> ➤ The cities are built up in a short period (a few years) owing to a large amount of investment of financial, human and physical capital from the state. ➤ These cities are mostly located near the resource bases, but these bases are scattered in the country and many are located in the remote and undeveloped areas. In addition, the cities have to avoid being built on the surface of the underground resources. Hence the residents must be settled in a dispersed way. Thus, the population density of these cities is very low, compared to the average urban population density of the country.
Dual systems for urban public services	<ul style="list-style-type: none"> ➤ SOEs and local government in a city are managed by the same group of state cadres. Many physical infrastructures are built and managed by SOEs. This one-management-group-for-two-institutions model still remains in some localities up to now.

Source: Wang Qingyun, 2003: pp.21-30.

The urbanization of the resource-based cities was criticized for its high costs of urban infrastructure construction (e.g. water supply, urban housing, urban transportation, education, and other infrastructures for people’s daily life) and business contacts with other production bases (e.g. high transportation costs caused by unreasonable location). Although the top level

managers in SOEs were usually local government officials, very few resources under their control were targeted at urban functions, but rather at the production in SOEs. Hence, little fiscal capacity was under the control of 'local government'. From this angle, these cities are hardly qualified as cities, but more as production sites of the 'large enterprise'. Despite the criticisms, the industrialization-pushed urbanization has greatly promoted and accelerated industrialization and urbanization in some remote areas.

(b) The nationwide inter-SOE support programme

Considering the situation of the less developed localities, the low income per capita was not the only problem. The low levels of industrialization, urbanization and civilization and the lack of human, physical and financial capitals were the main causes of the less development. The fiscal transfer (redistribution) was not sufficient to save the poor population from going broke, especially when the state was in great shortage of financial capital in the first twenty years of the PRC. Hence, the state distributed a large part of industrial programs to the less developed localities in order to improve local capability of acquiring self-reliance and anti-poverty strategies. During the first FYP period (1953-1957), nearly 56% of the state investment in fixed assets went to the inland regions (as they were less developed than the coastal counterparts). But to implement these industrial projects, these regions also needed a good deal of imported resources. So, the state implemented the nationwide inter-SOE support programme to allocate skilled labour and educated persons from the well 'developed' SOEs (often in coastal regions) to those in the less developed localities. These imported labourers could, from the technical angle, train local unskilled labourers at the same time, and improve the local capability for industrialization and development; from the political perspective, educate local people by the SOE's culture and the ideology of the worker class; from the social values, facilitate national cohesion and reinforce the socialist ideology.

Owing to the programme, many SOEs and research institutes were quickly set up in the less developed localities and improved the local situation. For example, Liaoning and Shanghai have been the largest production bases for the heavy industries since the early 20th century. Nationally advanced technologies and skilled labours were concentrated there and many large scaled SOEs were the cornerstones for the then national industry and economy. Owing to the programme, these SOEs sent many technicians, workers, staff, and managers to less developed areas to build up new SOEs and develop local industries. These immigrants have devoted their whole lives there and made a remarkable contribution to social development. Many SOEs and research institutes, physical infrastructures (e.g. railways) are still the main

contributors to the local economies in the present day. Many localities that were supported are now the central cities in the remote regions (Yinchuan – in Ningxia Autonomous Region – is such an example) and drive the regional dynamism in economic and social development (Liu Shiqing, 2003). The programme has laid a good foundation of infrastructure and reduced to a great extent the difficulty of implementing the current ‘Go West’ strategy, which stresses infrastructure construction in the less developed areas in the Western China⁹⁵.

To be noted that, this support programme was under the state planning and no payment from the state to compensate the exporting SOEs for their ‘individual loss’ (because of political and social tasks). Hence, such programme and such contribution of the SOE were only possible in the specific institutional context – the economic system, the socio-political environment and the SOE’s specificities in the pre-Reform PRC. In this context, the traditional SOE was really an *effective* institution (or instrument) to implement the state planning and to realise the CPC’s socialist construction. But when the context experienced a fundamental transition after the Reform, especially from the economic perspective, the material interests were emphasised by the market logic and the market has replaced the planning system little by little, and the contributors to the achievement of the traditional SOE became ‘burdens’ on the SOE as actors in the market-based economy. So, a fundamental adaptation of both institutional and organizational arrangements for the SOE to the new context is necessary. But in practice, such adaptation also degrades the SOE’s contribution to society and its localities. This is the subject for next chapter.

Summary

This section has analysed the traditional SOE as an institution specifically embedded in the pre-Reform China. The traditional SOE was not in pursuit of pure economic targets, but rather aiming at the mandatory goals of state planning, for both political and social reasons. Its specificities manifest themselves according to four dimensions:

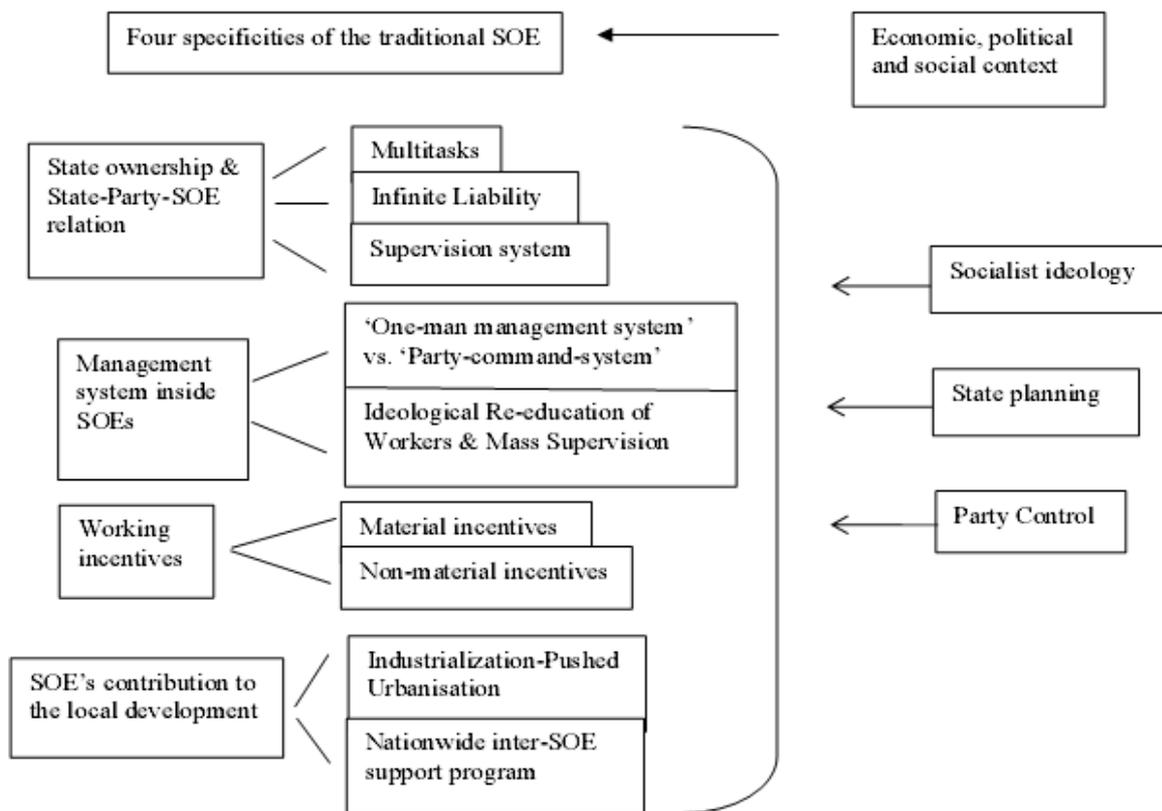
- state ownership and the State-Party-SOE relation, which emphasise the SOE’s institutional context, i.e. multitasks, the state’s infinite liability to SOEs and the supervision system;
- the management system, which is different from the supervision system, emphasising management inside SOEs;

⁹⁵ The ‘Go West’ strategy aims to promote the development of the western regions by preferential policies in financial support (fiscal transfer, tax reduction) and industrial programs from the central government (Lü Wei, 2005).

- incentives, to stimulate SOE employees by non-material incentives when material incentives were insufficient; and
- the role of the SOE in localities, especially in the less developed localities.

Figure 5 is developed to show the traditional SOE's organization and functions according to the four dimensions.

Figure 5: The traditional SOE: organization and functions



Source: Author's design

Conclusion: All in One Game

The pre-Reform PRC's economy pursued more than material interests; it partly followed the normal economic rationality, but also aimed to serve the socialist ideology, i.e. economy as a means to lead the society into socialism. Whichever form of economy the PRC adopted, as surveyed in section 2.2, the then national economy showed many characteristics that are very different from the capitalist economies and even from the other socialist economies. This particular economic system was formed in a pragmatic way, rather than through a theoretical approach. Even though mid 20th century economists have made great efforts to work out a complete socialist economy model, e.g. Lange's theory that the central planning substitutes the market through price simulation; or the Stalinist central planning system, and so on (see

Kornai, 1979; Jossa and Cuomo, 1997). In fact, the Chinese economy was formed under a series of constraints stemming from both the situation of the domestic economy and international relations.

As analysed in section 2.1, the market-based capitalist economy did not emerge in pre-modern China (before 1840). The human-to-land ratio was too high to develop labour-saving technologies and experience-based technological innovation limited the emergence of modern technologies which are experiment-based. Geographical and transportation constraints help to explain why the market-based capitalist economy did not develop in pre-modern China. Although modern technologies and market economy were introduced in modern China (1840-1949) by Western invaders, social and political instability caused by wars, and the colonial economy that dominated in China prevented modern China to develop the market-based capitalism”.

When the CPC won the civil war and founded the PRC in 1949, wars had destroyed the national economy. An urgent task for the state was to recover the economy. However, the world did not provide a peaceful environment for the socialist China. The hostile attitude of the capitalist states blocked communications between the PRC and the Western developed nations. But the USSR – the socialist ‘big brother’ – was not reliable for the PRC to ‘lean to’. The rapidly changing international situation and tense international relations aggravated the difficulty for the PRC to launch its ambitious goal of building up an economically prosperous and politically independent socialist country. The emphasis on national defence, on socialist ideology, and on political movement (continuous revolution) heavily restrained economic growth.

Due to these constraints, but also sometimes because of unrealistic actions of the then PRC leaders, the PRC’s economy in the pre-Reform era (1949-1978) went through five often combined forms, some of which were very strange (or abnormal) to market economists. As encouraged by the achievement of the Soviet socialist construction, and discouraged by the capitalist crisis in the 1930s, and misled by the then socialist ideology that failed to differentiate market economy from capitalism, the PRC leaders gave up the efforts to develop a free market-based economy. Even the market exchange and private economy were strictly under state control. The rapid development of heavy industries was very remarkable, but was seriously challenged by scarce capitals (physical, financial and human). The PRC leaders adopted central planning to mobilise resources from all over the country. A military-like

command system strongly supported the planning institution's top-down planning. Under the direct control of the state the traditional SOE was the backbone of nationalization and industrialization. This form of economy reassembled its Soviet counterpart, and in fact, the Soviet form strongly influenced the Chinese one. But Mao was unsatisfied with the neglect of rural development – because the industrialization was concentrated in the urban areas. So he launched the Great-Leap-Forward to correct the mistakes. “Walking on two legs” is the best representation of the state's strategy during 1958 to 1960. But the failure of the GLF urged the PRC leaders to adjust the economic policies, and give up utopian efforts. Some market mechanisms were permitted to complement the planning institution, but still under the strict control of the state. The political movements, for instance, the Great-Culture-Revolution (1966-1976), dispersed much of the country's attention and energy needed to develop the economy.

In this unstable and rapidly changing socio-political context, the traditional SOE contributed on a regular basis to China's development. Besides its critical role in the industrialization and fulfilling the state production plans, the SOE provided a full set of welfare services to its employees and their families and educated them to the socialist ideology. In addition, SOEs, in particular the middle and large scaled SOEs, undertook many construction projects to improve the local public infrastructure in ‘their’ urban area. Therefore, the urban life in the pre-Reform PRC heavily depended on the SOE. The SOE also contributed to the urbanization and industrialization in the less developed localities. The nationwide inter-SOE support programme greatly improved the local situations in terms of economy and culture. Many supported SOEs are still the main forces in developing the local economy and society, and many of the then supported localities are today the most dynamic actors in their regions.

The function of the traditional SOE was stipulated and ensured by a set of institutional arrangements as presented in section 2.2. The State-Party-Society relation required the SOE to fulfil multitasks for the overall social interests based on the then socialist ideology, while making profit was not a task; required the state to be infinite liable for the SOE. There were no gains or losses for SOEs, but only for the state. Commands were made by the central planning authorities, passed through the administrative system, and implemented by the management system inside SOEs.

The review of the economic institutions in the pre-Reform PRC demonstrates that the state was dominant in governing the country not only in economic but also in political and social

domains. “All in one game” (governing the country like playing a chess game) was a remarkable feature of the governance. The state, or personalised as the state leader (group), was the player. Individuals, enterprises, localities, and institutions in the country were all game roles. The rule was, once the goal of the game was decided, all pieces should be devoted to accomplish the goal, rather than pursue their own interests. This is not like the Pareto improvement – any change that makes someone better off without making anyone else worse off. The game permitted and sometimes needed someone(s) to lose. But this cruel rule is not easy to enforce in democratic societies, where losers are able to protest. So the state must develop a set of means to persuade or compel the losers to obey the rule. Ideological education was really effective in persuading people to wholeheartedly serve the country and the collective, even though in some cases this caused pain to individuals. The central planning and the military-like top-down command system were considered necessary means to allocate the national resources for the state interests. The state was totalitarian. Its infinite and supreme authority also entitled it to infinite responsibility of the whole social life.

This ‘game’ had its shortcomings:

- Its efficient functioning had to be based on a certain ideology. If the ideological education lost its effect, the authority would be damaged. In fact, this ideological education is very difficult to maintain, especially when the situation in reality challenges one’s survival. For example, the collapsed rural agricultural production and the consequent serious famine at the end of the 1950s damaged the collectivist ideology because people had to struggle for their own lives. Since then, individualism returned to the PRC and Riskin’s ‘diligent-diligent’ pattern for the team work became more and more difficult to maintain. The Free-rider problem became increasingly serious and efficiency problematic.
- Its problem-solving mechanism was inefficient. Central planning was state-led social engineering. But successful engineering depends on the measurable and controllable variables. Difficulty is obvious. Information is impossible to be complete as society will never be completely predictable or controllable. Once a plan is made, the problem-solving mechanism will play a critical role for adjusting the plan according to the real context and unpredictable accidents that are determinant to fulfil the plan. However, the top-down command system had no parallel bottom-up channels to efficiently provide in-time information for its adjustment, so in practice problems usually remained unsolved. .
- The state leaders were responsible for the effectiveness of the ‘social engineering’. If they made the right decisions, efficient implementation was supposed to materialise a good outcome. Once a wrong decision was made, efficient implementation could only lead to a

disaster. But how to ensure the decisions were right? When China began its economic recovery and promotion of heavy industry in 1953, the Soviet experience helped to obtain remarkable success; when China attempted new ways to socialism, experience became scarce and the right decisions became hard to predict. The failure of the GLF is an example. In addition, all the game pieces had no formal and direct connections among each other. The inter-enterprise (inter-SOE) business contacts were replaced by enterprise-state-enterprise contacts. Hence, the information about demand and supply in different enterprises (SOEs) was necessarily centralised to the state through the administrative system. That was the meaning of “the market was substituted by the central planning”. But at the micro-economic level, enterprise-state-enterprise information flows could not outdo enterprise-enterprise contact with regard to their quality and speed, because the efficiency of the administrative system restrained the information flows.

- There were no means to reward the roles in the ‘game’, who suffered from the central command. If the game continues until the game player (the state) wins – realise the socialism, compensation would (perhaps) satisfy the suffering roles. But if the game is interrupted or ended while the game player has not won (as socialism is not yet achieved), the suffering roles will lose for no compensation. Furthermore, the victims will also continue to suffer in a new game, as they have no equivalent competence, let alone advantage, to other game pieces. When the game roles get the experience or the capacity to predict that they will suffer or lose for nothing, they will not support the game player any more.

The defects, however, should not lead people to overlook the values of game-like governance. Here, I emphasise the SOE’s contribution to the whole Chinese society, especially its less developed localities (as discussed in section 2.3). Creating SOEs in the less developed localities and the nationwide inter-SOE support programme were favoured by the game. The ideological education was probably the main driving force when the material incentives were absent to encourage people to support the development of the less developed localities for the benefit of national harmonization. In addition, SOEs had no their own interests, as they were branches of the state. Hence, the state could allocate resources through the inter-SOE support programme in pursuit of a better social efficiency, but not necessary to compensate the resources-exported SOEs. This arouses two questions: can the SOE adapt to the new rule and new environment since the Reform in 1978, and can the SOE contribute to the less developed localities for their economic development? This will be answered in the following chapters.

CHAPTER 3

CHINA IN TRANSITION: THE REFORM AND THE SOE REFORM

Introduction

The disastrous outcome of the political campaigns during the three decades after the foundation of the PRC taught China's leaders that political campaigns could not develop the economy and that without economic development, socialism would not be achieved in China. Hence, since the late 1970s, economic development has replaced political struggle to become the prime task for the Chinese socialist practice. Due to the lack of useful theoretical guidance for China's socialist construction, the leaders firstly drew upon the experiences from the five forms of the economy experimented in the first two decades of the PRC. Market, private economy, and local dynamism were little by little released from the state-run economic system. The improved international relations since 1971 offered China a chance to learn from other countries. The economic miracle of the 'Four Asian Dragons' (South Korea, Singapore, Hong Kong, and Taiwan) has convinced the Chinese leaders to further the market economy and take advantage of the international market to develop China's economy. After a reallocation of power among the political leaders, Deng Xiaoping finally had enough power to put his idea of 'Reform and Opening Up' into effect in 1978. Since then, China has entered the period of the Reform.

An essential part of the Reform was the marketization of the national economic system through 'Opening Up' to the global market. The marketization aimed at improving the efficiency of resource allocation through transforming the 'order-obey relation between the government and its economic agents' in the previous planning system into 'free transactions between equal persons in markets'⁹⁶. The Opening Up was expected to break down the 'autarky' economy and take advantage of foreign resources in a global market. Efforts have been made in four ways to accomplish marketization (Ma and Lü, 1994):

- allocating resources basically by markets (not by planning);

⁹⁶ This definition of marketization is translated by Zhu Kai from Sheng Hong (1992).

- building a unified, open, competitive and orderly market system;
- gradually establishing a regulation system and legislative institution that guarantee an efficient market economy and virtuous behaviour of actors on markets (*shi chang zhu ti*); and
- gradually building a clearly defined property rights system, transforming actors in markets into independent accounting units.

Through reforms in incentive, resource allocation as well as redistribution, and developing the economy by market logic and norms, the Chinese economy greatly improved the efficiency of wealth creation which can be quantified by GDP growth (Sheng Hong, 1991). Furthermore, everyone can easily see radical changes during the Reform period in the political regime⁹⁷, social values and ideology, people's life styles, etc., although China has insisted on socialist ideology and the legitimacy that CPC holds the state power. The Reform has gone beyond the economic limit and fundamentally changed the rules of the game in the pre-Reform period.

As we saw, the SOE has been the cornerstone of the pre-Reform economy but also society. Even after nearly thirty years of transformation, the SOE and the state economy are still important players in the Chinese economy. The SOE related reform practices have always had strong influences on the overall Reform and the society. For example, state ownership is the main target of reform to establish a clarified property rights system which favours the market economy, because any change of state ownership inevitably touches the core of the traditional socialist ideology; resource allocation by central planning within the SOE is the biggest obstacle on the way of developing a market economy as resources are monopolised by the state; the reforms in the social security system that was guaranteed by the traditional SOE degrade millions of people to poverty, before the substitute institutions are put into effect, and this is a main cause of social and political instability today.

Since 1978, many studies have been made on the SOE reform by economists and social scientists. For the economic literature, I classify them according to three competitive schools of thought – the Incentive, Marketization and Ownership Schools. After more than twenty years of research and experiments, these schools have finally integrated their analyses and led the SOE reform to establishing a modern enterprise system. In this system, SOEs should be corporatized into profit-oriented and independent accounting units with clarified property

⁹⁷ The criticism on China's unbalanced political-economic reform is always severe; but no one can deny the ongoing political liberation in China (see Bernstein, 1999).

rights operating in markets. The state control on SOEs is now reduced to the control of state-owned assets through a new state assets management system. State intervention and the government's role in the economy are also adjusted to develop the market economy. Although the SOE reform has made state assets profitable, shortcomings are obvious. The millions of unemployed SOE employees, their degrading income and the decline of social security services, as well as the enormous loss of state assets partly misused by power-holders (government officials, SOE managers and private speculators), have caused a serious social and political instability.

Furthermore, the transformation of the state assets management system significantly influences local economies. A review of the SOE reform leads to the conclusion that the linkage between SOEs and localities is missing or is insufficiently emphasised in the framework of the SOE reform. It seems that SOEs maximise profit and that their contribution to localities is limited to the 'automatic' economic benefits – tax payment and job creation. So, 'new' SOEs are no 'better' than private enterprises as to their benefits to localities and there is no need to emphasise, or even mention, the SOE-locality relationship. The SOE's contribution to local development introduced in the previous chapter is thus no longer favoured by the reformers. The breaking of the link between SOE and locality has become a very serious problem for local development, especially for LDLs.

This chapter focuses on the review of the SOE reform. But it is mandatory to understand the overall Reform before addressing the specific reform measures, e.g. those affecting the SOE. The first section provides an overall picture of the Reform. Answers to three questions – why Reform, why Reform then, and what to Reform? – inform us on the Reform's context and initiatives. Furthermore, the Reform is not a blueprint designed once and for all. On the contrary, it is a self-adjusting evolutionary process for the long term. Five characteristics of the overall Reform are summarised to illustrate the evolution: (1) theoretical hesitation and ideological emancipation; (2) state-led and Grassroots-promoted reform; (3) gradualist approach; (4) from reforming outside-the-Planning to reforming the Planning; and (5) Experiment-Example approach. The second section reviews the SOE reform through a synthesis of the three schools of thought, regarding to their theories and practices, achievements and deficiencies. The final section is devoted to my criticisms of the SOE reform in two points: one is the 'interest-allocation' issue and the other is the broken linkage between SOEs and localities. The second point will be the central discussion in the next chapter.

3.1 Overview of the Reform

When talking about the Reform, many wonder ‘Why Reform?’, ‘Why Reform at that time?’, ‘What are Reform’s practices and why?’ and ‘What are Reform’s outcomes and why?’ Numerous studies in the past 20 years have concentrated on answering these questions⁹⁸. This section makes an overview of the Reform by focusing on the logic and characteristics of the Reform.

3.1.1 Logic of the Reform

As introduced in section 2.2, in the pre-Reform period, China tried out five forms of the economy to improve the efficiency of production. However, these forms did not modify state ownership and central planning system. So it is safe to say the five forms were only partial modifications within the system. But the Reform has shown much difference to these forms and modified the whole system. Then a question is: *why reform?*

(a) Why reform?

In the 1970s, China’s international relations, including economic exchange between China and the western (capitalist) countries boomed. At that time, these communications were centred on importing foreign advanced equipments and technologies⁹⁹. This was the second large-scale technology import wave since 1949 (Yao and Chen, 2003: p.142, p.158). This exchange did not only bring foreign goods and technologies to China, but also provided reasons for Chinese leaders to reform the national economy (Lin *et al.*, 1994: pp.138-140):

- The Heavy-Industry-Oriented-Development-Strategy (HIODS) did not help China catch up with the developed countries:
- The gap between China and these countries in aspects of economic growth, industrialization, national wealth and people’s living quality grew; and
- People’s living quality did not improve for a long time; the supply of living necessities was in severe shortage and some hundred thousand peasants starved.

⁹⁸ It is impossible to put all references here as the list must be too long. *Economic Research Journal*, *Furl* and *China Economic Review*, etc. are rich sources for the study of the Reform.

⁹⁹ In 1972, several import programs were brought about by the National Planning Committee and were smoothly approved by the leaders of the central government. In 1973, the National Planning Committee regulated the equipment and technology import and worked out a project that totally required 4.3 billion US dollars (at 1973’s price). So this project was also called ‘four-three project’. Based on this project, a few more programs were added and the sum of required US dollars reached 5.14 billion. These imports were allocated to 26 large-scale industrial enterprises. A list for these import programs is given by Yao and Chen (2003: p159-160)

- The remarkable economic achievement in neighbouring countries, especially in the Asian Newly Industrialised Countries (e.g. South Korea, Singapore, Hong Kong, and Taiwan), made a sharp contrast to China's poverty and put high pressure on China to reform its economy.
- At the micro economic level, for example, in SOEs and People's Communes, low efficiency and low incentives of workers damaged productivity that could only be improved by reforms.
- The ten-year lasting Great Culture Revolution (GCR) caused serious political instability and gravely damaged the national economy which nearly collapsed.
- The modifications within the system (the five economic forms) turned out ineffective for economic development in China, thus proving that a real transformation of the system instead of modifications within the system was needed. When foreign experiences became available, dominating economic theories in China were significantly challenged.

This reform was launched in 1978. Thus, a second question is: *why reform then?*

(b) Why reform then?

It is the result of a historically cumulative process. Four factors have been identified:

- In the 1970s, a series of diplomatic events improved China's international relations. The PRC recovered the official identity in the United Nations on the 25th October, 1971. Nixon, the then president of the US, made an official visit in China and signed the "Sino-US collaboration Communiqué" on the 21st February 1972, which signified the normalization of Sino-US diplomatic relation. This fundamental change of Sino-US relation 'motivated' other western countries to establish normal diplomatic relations with China¹⁰⁰. As international relations improved, the threat of war seemed less and less, so that economy, rather than defence, could be placed at the centre of Chinese socialist agenda. Thus, the external conditions for the Reform were provided.
- Mao Zedong's decease in 1976 provoked a political struggle among Chinese top leaders. Deng Xiaoping's victory in this struggle gave him a chance to accomplish his thoughts, which are, to a large extent, different from Mao's ideology. In disagreement with Mao's emphasis on political struggle and the Utopian Socialist practice, Deng insisted on economy-centred development strategy. When he held the state power, Deng motivated the great ideological emancipation. On the 11th May, 1978, the Guangming Daily (an

¹⁰⁰ It is to be noted that, France is the first western country that established diplomatic relation with the PRC in (1964). But most of other western countries established diplomatic relations with the PRC only after the "Sino-US collaboration Communiqué".

official newspaper of the CPC) published the article “Practice is the sole criterion for testing truth” to resist the leftist “two whatevers” ideology – “whatever policies Chairman Mao devised we will resolutely support, and whatever directives Chairman Mao laid down we will forever observe” (Tong Yanqi, 1997: p.52). The debate on the ‘problem of the truth’ called on people to give up the dogma of the Utopian thoughts¹⁰¹ and turn to think about the practical problems (Yao and Chen, 2003: p.168). Thus the ideological conditions for Chinese economic reform were met.

- During 1967 to 1968, some areas in China suffered long term drought that dramatically affected agricultural production and peasants’ living conditions. In the following decade, People’s Communes and collective production still dominated the agricultural production and peasants’ life. They were institutional factors to the severe problems in the rural areas (Yao and Chen, 2003: p.172). A bottom-up breakthrough was made in 1977. In Anhui province, one of the suffering provinces, peasants and local officials spontaneously put forward a series of measures, such as ‘leasing land to survive the starvation’ (*jie di du huang*), ‘making working groups or households independently responsible for the production’ (*bao chan dao zu and bao chan dao hu*). Similar measures also occurred in Sichuan Province in 1978¹⁰². These measures succeeded in improving local agricultural production and strengthened Deng’s determination to reform.
- In the ‘Third Plenary of the Eleventh Central Committee’ in December 1978, Deng declared a fundamental shift in the emphasis of the Party's work to socialist modernization, with the statement that “the large-scale turbulent class struggles ... have globally come to an end”. This explicitly reversed the basic ideological line of Maoist ideology. It also declared for the first time in CPC’s history that “it was necessary to act firmly in line with economic laws, and attach importance to the role of the law of value” (Tong Yanqi, 1997: p.52). In the meanwhile, the Plenum corrected many mistakes made during the GCR and reinstated many state cadres that were mistakenly disciplined during the GCR.

As all conditions were ready in 1978, reform was the certain output. But *what to be reformed* is a third question.

101 Although it is attributed to Mao’s ideology, the Utopian thoughts are not part of the Mao Zedong Thoughts.

102 These measures are in fact against the collective production, and permit to work for the private interests. So they were officially prohibited between 1962 and 1978. However the practices in Anhui and Sichuan were strongly (but not publicly) supported by the provincial government leaders and Deng Xiaoping, so they were not held up (Yao and Chen, 2003: p171-174).

(c) What to reform?

Although the Reform is now clearly market-oriented, its purpose was not to build a market economy. The preliminary guiding thoughts on reform were based on the urgency of the reality and some basic understandings of the traditional¹⁰³ economic system. The orientation of the Reform was not to replace the traditional system with a market economy (as we would say today), the objectives of the Reform were not clearly determined: in theory, developing the Socialist doctrine improved the understanding of socialism and created more space (in abstract sense) for reform; in practice, it meant recovering some realistic measures by drawing on historical experiences and delegating decision-making power of the central government to government institutions at lower levels (CERRF and CEIRC, 2004: pp.35-36).

From 1978 to 1982 the reform practices were focused on four domains (Yao and Chen, 2003: pp.170-180; CERRF and CEIRC, 2004: pp.1-34):

- supplementing the central planning system by the market (but the former was still dominant in the national economy);
- creating Special Economic Zones – simulating the Export Areas in other countries – as a main measure for the ‘Opening Up’ strategy;
- in the agricultural sector (in rural areas) – implementing the Household Contract System in some rural areas, while maintaining collectivism; and
- in SOEs (in urban areas) – delegating more decision-making power to SOEs from the central planning establishments and linking the employees’ personal income to the enterprise’s economic performance.

However, the key contribution of these practices is the introduction of the market and pursuit of material interests for individuals in the economic system. The early reformers still took the central planning system as the cornerstone of the socialist economy and wanted to improve its dynamism through the market. The co-existence of the central planning institution and the market institution formed the ‘dual track’ economy and aroused a serious institutional conflict. In theory, each of the two institutions damaged the efficiency of the other. But in reality, the contrary became true. The market efficiency attracted the resources that were under control of the planning institution. The market institution grew very fast while the planning institution

103 When we enter the Reform period, the pre-Reform practices are also called traditional.

was further weakened but remained very efficient through its control on the allocation of resources¹⁰⁴.

The predominance of the Reform principle – “giving [economic] efficiency (*meaning the economic growth*) the priority with due consideration to fairness” – made the expansion of the market inevitable. The market attracted more and more resources and occupied (institutional) space to develop itself. The market efficiency in economic growth urged policy-makers to adjust reform guidelines and policies for developing the market. A series of changes have been made on the specification of the economic system. As the official documents show: in 1979 (a special central government conference) “planning is primary and market is secondary”¹⁰⁵; in 1984 (the 12th Congress of the CPC) the “Commodity Economy” was put forward; in 1987 (the 13th Congress of the CPC) the socialist economy became “the planned commodity economy based on the public ownership” and the statement of “state regulates market, market directs enterprises” made the market-orientation very clear¹⁰⁶; and in 1992 (the 14th Congress of the CPC) China’s economic reform objective was *finally* set to build up the ‘Socialist Market Economy’. The Reform is mainly an institutional change. Along this institutional change, a great transformation in every aspect of the economy and even in the social life is apparent. The interdependent reforms in the economy, concerning price mechanisms, finance, government, enterprise, social security, ownership and property rights system, factor markets, foreign trade ... and the changing development view, political

104 This problem of the dual track economy is very serious. For example, many SOE managers got resources/goods at the ‘planning price’ and sold them at the market price (often much higher than the planning price) to private enterprises. There were also (private) middlemen between SOEs and private enterprises to do business. This rent-seeking behaviour caused a transfer of a great amount of resources from the planning system to the market system via SOEs. The State capability in allocating resources and controlling prices for certain resources/goods was damaged and in the meanwhile, the private business and the market boomed.

105 In 1979, Liu *et al* (1979) pointed out that the market and planning were the two mechanisms that human society had developed to regulate the economy. They argued that the market was the result of a commodity economy, not of capitalism. The market as a regulating mechanism might provide links among production, supply, and distribution; correct imbalances; and promote competition in socialist as well as capitalist systems. They proposed the integration of the market and planning modes by introducing a system of non-compulsory guidance planning, creating a flexible price system, opening markets for the means of production, allowing more job mobility, and having the enterprise assume sole responsibility for its profits and losses (Tong Yanqi, 1997: p76).

106 The political report of the Thirteenth Party Congress held in 1987 presented a new formula: The State regulates the market, and the market guides the enterprise. According to this formula, the State would regulate the relationship between supply and demand through economic, legal, and (if necessary) administrative means and create a favourable economic and social environment to which enterprises would respond and make correct managerial decisions accordingly. The report held that the socialist market system should include not only markets for consumer and capital goods but also markets for other essential factors of production, such as capital, labour, technology, information and real estate. The following paragraph from the report clearly represented the Party’s ideological stand on this issue: “Some of the things we have introduced in the process of reform, such as expanded markets for means of production, funds, technology and labour service and the issuance of stocks and bonds, are phenomena which are not peculiar to capitalism but are bound to appear in the wake of large-scale, socialized production and the development of a commodity economy” (Beijing Review, 9-16 November, 1987: pp. 33-35; Tong Yanqi, 1997: p77-78).

ideology, social value, strategies of local development, and so on, facilitated the fundamental change of the Rules of the Game fixed in the pre-Reform period.

3.1.2 Five Characteristics of the Reform

The evolution of the Reform is not the result of deliberate design. It is more of a *continuous reaction to changes of situation and problem-solving process* (until 1992) than an *objectively-clear, one-ended and all-sides-at-one-pace* transformation. It means that each reform practice was rooted in the social situation (not only economic situation) that developed by earlier practices and corrected or adjusted the earlier practices. I will not give an all-encompassing overview of the Reform in this dissertation¹⁰⁷ but will focus on five of its main characteristics.

(a) Theoretical hesitation and ideological emancipation

When the Reform began in China, there was no theoretical model informing such systematic transition of a socialist economy available. At that time, Chinese economic researchers introduced various theories developed in both Western and other socialist countries (e.g. the East European socialist countries). But in the early years of the Reform, the ideological constraint in China was still very hard to remove. The Marxist economics and the classical political economics were main references for reformers to study some essential theoretical issues such as ‘why produce’, ‘why the commodity production’, ‘return justice to the law of value’, ‘re-establish the private ownership (Sheng Hong, 1996a). A key force pushing the Reform forward came from Deng’s pragmatist slogan ‘no matter white or black, the cat that can seize rats is good – the *cat* theory’, ‘speak less, do more’, etc., which encouraged people to break up the ideological restraints to develop the economy through markets and private interests. The success of the reform practices proved the value of market and urged theorists to adopt more market concepts into the theory of socialist economy.

In the 1980s, the theoretical criticism on the traditional socialist economy by East European economists, e.g. Lange (Poland), Kornai (Hungary), and the theories of the market economy from neoclassical economics were introduced to China. Further measures for marketization were applied to China’s economy. Neoclassical economics and Keynesian macro-regulation became the basic analytical tools to reform the economy. But many social illnesses and ‘capitalist phenomena’ emerged during the marketization. Many scholars (called the conservatives by the then reformers) insisted on the traditional socialist cardinal principles

¹⁰⁷ Writing out such overall review of the more than twenty years’ Reform is beyond my capability. The size of such review is also too big for this dissertation. Some researchers have made such effort, see Gao Shangquan, 1996; CERRF and CEIRC, 2004.

and resisted the market-oriented reform. Debate was provoked in the whole society and was focused on whether to ‘Reform or not’, ‘marketization or not’, and ‘the market: capitalist or socialist’. The theoretical ambiguity slowed the pace of marketization and the economic growth. In 1992, Deng made a tour in South China and ended the debate by ‘setting the nature of the market aside and economic development as primary’. This is highly praised as an ideological emancipation and the Reform was continued¹⁰⁸. In the same year, the CPC decided that the market would be the essential institution regulating China’s economy and part of the socialist principles in China’s Constitution were amended.

Since the 1990s, neo-institutional economics and other schools of economic theory have provided rich sources for Chinese theorists and the process of the Reform has become the focus of Chinese researchers. But the reform practices did not follow and in fact challenged orthodox economic theories. The particular situation in China urged Chinese economists to elaborate a ‘Chinese transition economics’ theorising the transition (Sheng Hong, 1996a). It is not until then that theories become *ex ante* guidance for Reform practices, rather than *ex post* interpretations.

The ‘overdue’ theories had both positive and negative effects on the Reform. As the objective of the Reform was not clear before 1992, pragmatism prevailed in driving the Reform. Most practices were aimed at short-term improvement in wealth creation (or efficiency of production). The Reform was guided by the principle that benefits should surpass costs. However, the ambiguity in theory and the often changed reform practices showed paradoxes. Although we can say in general that the Reform has been progressing in developing the market economy, the concrete practices during the Reform did not all contribute to the progress. Some practices even meant a return to the old¹⁰⁹. The costs of such practices were considerably high. Moreover, although the political slogans (e.g. Deng’s slogans) pushed the Reform forward in the early stage, they soon began to impede the deepening of the Reform or badly influenced the social development¹¹⁰.

108 Ma and Ling (2000) have made a detailed historical review on the debate and its influence on china’s society.

109 The marketization sometimes caused too much costs to cover by short-term benefit. So some due practices were not applied or held up after implementation. Such phenomenon is mentioned by Lin *et al* (1993) as ‘two steps forward, one step backward’. See also Zhang Zhuoyuan (1998).

110 Deng’s ‘cat theory’ boomed the private economy under the dominance of the planning economy, but also aroused some wrong understandings like mammonism and overlooking the role of ideology (because it is useless to distinguish socialism from capitalism to develop the economy), etc.

(b) State-led and Grassroots-promoted reform

The pre-Reform China was strictly controlled by the totalitarian state dominated by the CPC. The central planning economy could not reform itself into a market economy because of opposite logics. There were two ways to start up the Reform. One was grassroots-promoted, i.e. people's spontaneous behaviour at the micro economic level; the other was state-led, i.e. the state reformed the economic system by its supra-economic power.

In some domains and periods, the state did not clearly know what and how to reform. The uncertain outcome of a reform practice made reformers hesitant to make decisions. So, the grassroots moved in front of the state and made small-scale experiments possible and necessary. Such experiments, if succeeded, were then considered as examples by the state and extrapolated to the whole country. For such reform, we can speak of grassroots innovation accompanied by state-led expansion. For example, the agricultural reform in 1978 drew upon the experiences of peasants' spontaneous practices in Anhui and Sichuan Provinces and expanded the Household Contract System to rural areas all over China.

The opposite situation occurred in other domains and period. Grassroots had no idea, force, or willingness to promote the institutional transition because of bounded knowledge (and rationality), but the state has intelligence to bring about measures supporting transition. Foreign experiences (and lessons) and theoretical research both gave guidance to the state-led practice. The state must put forward the initiatives, organise the implementation, and educate people to understand as well as support the reforms, for example, of the SOE, price mechanisms and social security system.

Owing to the common goal – revitalising the economy – the state and the grassroots achieved cooperation in China and gave proof of great effectiveness to reform the economy. But the cooperation was not always smooth. “The main argument is that the Communist Party will never give up its monopoly of economic, social, and political lives. It will not allow, not to mention launch, any changes that will undermine its power ... the Communist Party would never undertake thorough reform measures or would collapse ... To be sure, reform policies were seriously restricted by the ideological and political considerations of the Party elite. But these elites had a range of political views, and they were learning and adjusting. The whole system has been undergoing an evolutionary rather than revolutionary change. ... To achieve the goal of the Reform, the Party had to relax ideological and political controls so that the people could participate and the intellectuals innovate. However, if society was genuinely free

from traditional ideological and political constraints, it might mount a challenge to the fundamental legitimacy of the Communist Party. Committing themselves to reform on the one hand and to the Party leadership on the other, the reformist leaders ... were constantly conducting a two-front struggle: They had to fight the orthodox left to encourage innovation and at the same time to contest the deviations of the right to preserve their power.” (Tong Yanqi, 1997: p.37) Thus, the ‘two steps forward, one step backward’ phenomenon during the Reform is also the result of political dilemma. As the economy became more and more dominant in Chinese social life, economic inefficiency would devalue the CPC’s authority and prestige, and even challenge its legitimacy. Therefore, economic development became the determinant politics of the CPC-led state in the current China.

A serious problem to be noted here is that of ‘compensation’. The Reform is by nature a ‘Non-Pareto Improvement’ (Fan Gang, 1993)¹¹¹. Some groups and areas did not benefit from the Reform and have been suffering from the negative effects of the Reform, e.g. the laid-off SOE workers and the remote or the resource-based localities. In reality, the market has not been perfect and it is far from the situation that each factor gets due returns as the mainstream theories describe. The Chinese state has not corrected this defect but even aggravated the shortage of compensation for ‘losers’ during the Reform by transferring central funds elsewhere to foster economic growth. Hence, many reform practices have faced resistance from the losers and the implementation of such reforms has significantly depended on the state’s coercive power, rather than on the sincere support from all the stakeholders. In this sense, the state-led approach is a key responsible for both the positive and negative effects of the Reform.

(c) Gradualist approach

The proposal for a ‘gradualist reform’ was brought about as an anti-thesis to the ‘radical reform’ or ‘shock therapy’ applied in the USSR and some other socialist economies in the early 1990s. Some economists (usually orthodox economists) have advocated the ‘radical reform’ on the base that: if the transformation to a new institution (or system) starts from the ‘old’ inefficient institution, and adopts the ‘step-by-step’ approach, the institution in each step must be second-best and inefficient; each step will lead the institution farther away from the best or efficient situation; and each step may aggravate the difficulty of the following steps and increase the costs of reform (the reduction of the national wealth). So, this kind of

¹¹¹ The ‘Non-Pareto Improvement’ means that when someone gets better, there are someone gets worse, but the total wealth (or welfare) is improved.

transformation will not achieve the best institutions. By comparison, the ‘one-ended’ approach can break up the old inefficient institutions as fast as possible, building up completely new institutions, which are in theory the best; although there may be social instability in the start-up phase because the starting costs of reform are too high for the society to cover in a short run, it can avoid the long-term inefficient transformation. So the total costs of reform are less than in the ‘step-by-step’ approach (Fan Gang, 1993).

However, the radical reform faces two constraints: one is that the process and all factors of reform are not under strict control by reformers; the other is that the radical reform involves a transformation of all relevant factors. Any factor ignored or uncontrolled will possibly cause the entire failure. The painful result of the ‘shock therapy’ applied in the USSR seems to devalue the rapid, comprehensive and far-reaching reform proposal, while the achievement of China’s economic reform seems to prove the rightness of the gradualist approach, although it is still too early to give a final appraisal. But the gradualist approach could be divided into various styles according to whether the reform is deliberately designed for each step.

China’s Reform follows Deng’s slogan “feeling for the stones to grasp as one crosses the river” rather than ‘placing stones and grasping them to cross the river’. That means: reformers understood well that the Reform could not be achieved by a radical transformation in one step, they agreed that the Reform must be achieved step-by-step; but they did not know in how many steps and what to do in each step to accomplish the Reform. Although a two-step-forward proposal was brought about in the 12th Party Congress in 1982, it only put forward some goals¹¹² without clear measures for each step. Only after deciding to build a socialist market economy in 1992, the objective of the Reform became clear. With the accumulation of experience, more scientific planning was applied to design and guide the Reform.

True, in the theoretical discussion, the gradualist approach, as radical reformers criticize, has many shortcomings and some really occur in real life¹¹³. But in practice, as the best institutions are not achievable due to the social and political constraints both at home and

112 This Congress decided the goal of Chinese economic construction from 1981 to 2000 was to double the gross agricultural and industrial product value, i.e. increasing from 710 billion yuan (RMB) in 1980 to 2800 billion yuan in 2000; limiting the population within 1.2 billion; and increasing income per capita to 800 US dollars. The first ten years (1981-1990) will establish a good base, accumulate strength and creating conditions; the second ten years (1991-2000) will enter a new era for economic regeneration (Yao and Chen, 2003: p.142, p.220).

113 For example, the dual track economy is the output of the gradualist approach (in a radical market-oriented reform, the central planning cannot be maintained to regulate economy as much as the market, so the dual track economy is impossible). In this system, damaging national interests for personal benefit, maintaining the inefficient institutions and impeding the marketization, and so on, were not rare.

abroad, the ‘second-best choice in theory’ may get ‘the best result in practice’. The series of ‘second-best’ choices may also lead the transformation to move closer to the target, although it needs more time. Furthermore, the gradualist approach gives the society and its people time to adapt to the institutional changes and to correct the mistakes made in the past reform practices. Especially in China, where the political and ideological constraints are so difficult to remove, the gradualist approach may achieve the best cost-benefit result for the Reform.

(d) From reforming outside-the-Planning to reforming the Planning

Central planning was the basic institution regulating China’s pre-Reform economy. But it was impossible for the central government to control every economic activity through planning due to limited resources and insufficient knowledge (see section 2.2). Hence, the central planning emphasised the key economic sectors and activities, e.g. the heavy industry and the urban economy, while left a large part of economy outside the planning. For the introduction of market into the economy, reformers had to decide ‘where market would land’: inside or outside the planning system. Because of the theoretical hesitation and the worry about the uncertain outcome of the market, the resistance to the Reform from the planning system was strong. Market had to prove its efficiency of developing the economy so as to reduce the resistance to the Reform. In the early stage of the Reform, Planning kept its dominant role in regulating the economy, and market functioned outside the Planning as a supplementary means to planning.

The light industry (industrial dimension) and the areas less controlled by the Planning system (from the spatial dimension) were first ‘landing points’ for market. Private forces, enjoying the market institution, significantly developed in the light industry, dealt with the production and trade of consumer commodities, while SOEs were still the backbone of the heavy industry and controlled by the Planning system; many localities (e.g. the four Economic Development Zones, counties in Guangdong, Zhejiang and Jiangsu Provinces) that had been excluded from the Planning system then demonstrated great dynamism of industrial development and made great progress in labour productivity, while the Northeast China was still the base of heavy industry and its industrial production was firmly controlled by the planning system. A dual economy was thus formed. The outside-the-Planning economy was regulated by the market and the Reform in that stage was called outside-the-Planning Reform (*ti zhi wai gai ge*).

The outside-the-Planning economy had made great success in developing private forces and the market. This encouraged reformers to deepen the Reform and reforming the Planning system for higher economic efficiency. So, the focus of the Reform was thus shift from the outside-the-Planning economy to the Planning economy. The Planning gave way to the market in more and more sectors and activities. When the market reached to a certain level of impact, the Planning economy was no longer dominant. A market economy, therefore, evolved and became dominant in China.

As the market needs time to develop itself in regulating the economy, all the economic institutions cannot be marketized in a short time as the ‘big bang’ hypothesis asserts. Keeping the old Planning system was necessary to avoid the potential turbulent situation that occurs when the Planning system was abandoned but private forces and the market were not capable to fill the vacancy. Therefore, even though the Planning system was criticized inefficient by the market logic, it made up for the failures of the less developed market. An example is the SOE that absorbed redundant labour and supported the state-funded social security system. As Chinese economists (e.g. Miao Zhuang, 1992; Lin *et al*, 1993; Chang and Gao, 1998) argue, the approach of ‘from reforming outside-the-Planning to reforming the Planning’ is a main contributor to Chinese gradualist Reform. However, this approach has also negative effects on the Reform. The different logics of planning and market were not compatible in many occasions. Resources are scarce; the competition between the planning economy and the outside-the-planning economy for resources was hard as both were aiming efficiency and according to their specific rationale. On one side, to ensure the fulfilment of plans, certain resources must remain inside the planning system; this damaged the market efficiency and held up the development of the market. On the other side, the planning system took many socio-economic responsibilities, while the outside-the-institution had no such burdens to maximise profit and improve productivity; this made the planning system look ‘less efficient’ from the view of mainstream economists. From the spatial perspective, many preferential policies benefited the market-landed localities in order to fully develop the market economy. Resources, especially human resources, flowed to these localities to enjoy the policies; but other localities that were controlled by the planning suffered from the loss of resources. Therefore, it is difficult to argue that the outside-the-Planning economy developed independently of the Planning economy.

(e) Experiment-Example approach

Many Chinese reform measures were initiated as experiments in some appointed localities, enterprises or industries. Experiments with good results were then recognized as good practice and applied to the whole country. The grassroots-promoted reforms were spontaneous experiments but state-led reforms also adopted this approach. The Household Contract System, the coastal Economic Zones, the SOE reform and many other practices were spread through the country through the experiment-example approach.

This approach is also a main contributor to the success of the gradualist Reform. Experimenting a reform initiative with a limited scope can reduce the potential negative results. The market economy was a new institution to China in the beginning of the Reform. People need proof to understand ‘what the market is and what it can do’. The experiments with positive results could educate and convince the sceptics and facilitate the marketization. Furthermore, the market depends on a series of rules, customs and physical infrastructures to function, while these conditions cannot ubiquitously be met in a short time. Marketization can first be launched where the market environment is good.

The deficiencies of this approach are also remarkable. *First*, the experiments are often independent practices and do not serve a complete or well designed goal. This directly causes the uneven distribution of the Reform’s outcome. The lack of supplementary measures may also lead some good ideas to failure. *Second*, the success or failure of an experiment in a specific space – locality or industry – should be considered in a broader space. Some industries, localities, and persons, have benefited from the experiments while others suffered in the meanwhile. Whether a successful experiment in a space can be an example for potential followers is uncertain. For example, an experiment in developing a local economy can be successful due to the agglomeration effect making resources to flow in from neighbouring localities. If such experiment is modelled and becomes an example for the neighbouring localities with out-flowing resources, both the pioneer and following localities will not benefit from the agglomeration effect. This model may fail. In addition, some successful experiments have benefited from the state preferential policies which were not conforming to fair market competition. This certainly devalued the market-orientation and stimulated followers to pursue preferential policies. The abuse of the preferential policies will certainly damage the market economy, so the experiment has a misleading demonstration¹¹⁴. Many references have

¹¹⁴ For example, if the preferential policies implemented in the four Special Economic Zones, including tax holiday, fiscal revenue retain,

studied the effects of the Experiment-Example approach. See Sheng Hong (1996a), Lin *et al* (1993), CERRF and CEIRC (2004), Liu Shiqing (2003), Liu Shijin (1993), etc. for more details.

Summary

This section has focused on the Reform, in particular, on the logic and five characteristics of the Reform, which are summarised in Table 3-1 and 3-2. A main line of the Reform is marketization. But this line is neither short nor straight. The market-orientation was fixed fourteen years after the launch of the Reform. The lack of theories, experiences, and the political and ideological restraints compelled the Reform to choose a gradualist approach, from reforming outside-the-Planning economy to reforming the Planning economy, from partial experiments to a unified model for the whole country. Reform measures were orchestrated by either grassroots initiatives or the state, under a more complex coordination than would be the case in a spontaneous market development. During the Reform, numerous problems occurred, but they cannot all be attributed to the pre-Reform regime. In fact, the complex process of the Reform and the newly established imperfect socialist market economy should be responsible for many of them. The Reform has greatly contributed to China's economic development, but not all interest groups and areas have benefited. Furthermore, as the compensation attributed to the negatively influenced groups by both the state and the market has been far from sufficient, the Reform was not 'silent'; some noises even shook the whole society. This deficiency lowers the quality of the Reform and leads to the question "whom the Reform has served?" The following sections provide an analysis of the reforms of SOE and local development styles to give an answer.

decision-making power on import and export, launching large scale industrial programs, etc. were implemented in all the country, the national fiscal revenue would be severely reduced and the power of the central government in macro economic regulation would be deadly weakened. The overheated creation of 'Developing Zones' in China since 2002 produced a negative outcome so obvious that the central government put forward strict regulations to cancel and control the creation of such Zones in 2004 (<http://www.sina.com.cn>, November 26, 2004).

Table 3-1: Logic of the Reform

Why reform?	HIODS failed to help China ‘catch up’
	The remarkable economic achievement in neighbouring countries
	Micro inefficiency
	GCR caused the national economy nearly collapsed
	Modifications within the system is not enough
	Foreign experiences were available for profound consideration of economic theories and practices
Why reform then?	International relations were improved
	The political change and Deng held the state power
	Experiments were successful
	The Third Plenum of the 11th Central Committee of the CPC
What to reform?	Initial reforms in four ways: <ul style="list-style-type: none"> ➤ using the market to regulating the national economy ➤ opening up the national economy to the global market ➤ implementing the Household Contract System ➤ authorising SOEs more decision-making power
	Following reforms concentrated on the marketization by three stages: <ul style="list-style-type: none"> ➤ building up the Commodity Economy ➤ building up the Market-orientated Economy ➤ building up the Socialist Market Economy

Source: Author’s design

Table 3-2: Five characteristics of the Reform

Characteristics	Positive effects	Negative effects
Theoretical hesitation and ideological emancipation	<ul style="list-style-type: none"> ➤ breaking up the ideological and political restraints; and ➤ educating people by practices 	<ul style="list-style-type: none"> ➤ the ambiguity of the orientation and objectives of the Reform make the Reform costly
State-led and Grassroots-promoted reform	<ul style="list-style-type: none"> ➤ facilitating the institutional transition by dynamism from both the state and the grassroots 	<ul style="list-style-type: none"> ➤ ideological and political consideration of the state and the CPC increases the costs of the Reform
Gradualist approach	<ul style="list-style-type: none"> ➤ reducing the costs of the Reform; and ➤ learning by doing effect 	<ul style="list-style-type: none"> ➤ caused inefficient institutional transition; and ➤ needed more time to reform than the radical approach
From reforming outside-the-Planning to reforming the Planning	<ul style="list-style-type: none"> ➤ facilitating the marketization of the economy; and ➤ developing private forces and the market with socio-political stability 	<ul style="list-style-type: none"> ➤ the market could not allocate all the national resources, so its efficiency was damaged; and ➤ the development of the market damaged the Planning efficiency
Experiment-Example approach	<ul style="list-style-type: none"> ➤ limiting unpredicted negative results in a small scope; and ➤ learning by experiment; ➤ 	<ul style="list-style-type: none"> ➤ uncomplimentary measures for an individual experiment; ➤ experiment-targeted interest groups benefit while others cannot; and ➤ not all successful experiments can become examples for the whole country

Source: Author’s design

3.2 The SOE in the Reform

As analysed in section 2.3, in the pre-Reform period (1949-1978), SOE was the cornerstone of China's economy (especially industry) and Chinese urban residents heavily depended on SOE (*dan wei*). It is not surprising that the SOE reform is highly relevant for Chinese people and has a great impact on the Chinese economy, politics and society. A question one may ask is: *Why reform the SOE?*

The initiative of the SOE reform did not derive from theories, but from practice. No theory, except for the perfect market hypothesis, denies the necessity of the SOE's existence. But the problem of the SOE commonly viewed by economists is their bad economic performance with regard to profit-making and productivity¹¹⁵. Relevant interest groups have different considerations (Fan Gang, 1997: p.39):

- From the government's point of view, SOEs represent part of its power domain and are the main source of its revenues; without reform, the SOE's situation would become worse and the burden on the government would become heavier as well.
- SOE managers want reforms since they are having a hard time surviving.
- The emerging private sector would like to see an SOE reform, for reasons of fair competition.
- SOE's employees want to reform their enterprises because the wages are gradually decreasing compared to non-state firms.

However, although the SOE reform has accompanied the Reform since 1978 up to date, it has not yet ended. *Why has the SOE reform lasted such a long time?*

A simple answer is: because of its particular nature, it is difficult to reform the SOE. Even though the SOE reform has been centred on improving the SOEs' profitability, the characteristics of the Reform and the special functions of SOE required by its nature have made it difficult for the SOE reform to achieve that goal. *First*, compared to private

¹¹⁵ In July, 1991, the editor of Economic Research Journal organized the 'Symposium on the Theory of State-owned Enterprise Reform and managerial mechanism'. The editorial of the Economic Research Journal, Chinese Social Science Academy, Economic Research Institute of the Dongbei Finance and Economy University, and some SOEs in Dalian (China) attended the discussion. In the summary of the Symposium (EERJ, 1991) the low economic efficiency was commonly believed by attendants as a fatal reason for the (Chinese) SOE's problems and hindered the national economic development. Moreover, in Sherley and Walsh (2001) a brief synthesis is made about the comparison between the State and private enterprise in terms of the impacts of ownership and market competition on enterprise's economic performance. The private enterprise is acknowledged as having superior economic performance to the public (state) enterprise.

enterprises, whose owners are openly in pursuit of profit-maximization, the SOE has to undertake some political and social tasks besides the profit-making for its owner – the state (who has to conciliate both market efficiency and social justice). As these tasks are often in conflict with profit-making, the ‘multitasks’ pattern makes harder for the SOE to compete with private enterprise. The measures to relieve these tasks from SOE have helped SOEs get better performance in profit-making, but the lack of the social institutions to substitute the SOE’s social responsibility has significantly increased the costs of welfare provision. Millions of SOE workers and their families suffer from degraded living quality. This has caused a severe political and social instability up to date and been the main force of resistance to the SOE reform.

Second, as the state is ‘impersonal’, the central government – directed by Party cadres – represents the state in the role of SOE owner. To operate the numerous SOEs and supervise their managers was beyond the government’s capability. When SOEs can gain profit on markets and SOE employees can be rewarded according to their contribution, the SOE managers are guided by their personal *material* interest. As SOE managers have no profit or loss responsibility for their enterprises (because they are neither owners nor shareholders), the self-opportunist behaviour is not under the control of the central government. So, the principal-agent problem¹¹⁶ is serious in SOE and the government-SOE relationship is one of the key aspects of it.

According to the logic of agency theory, if the managers become shareholders, their self-opportunist behaviour will be reduced. But this cannot be applied to the SOE unless state ownership is changed. In China, state ownership has been determined by the Constitution as the basic characteristic of the socialist China; hence, state ownership is difficult to revise. This is the third reason. This ideological constraint makes the transformation of SOEs into modern ‘Corporations’¹¹⁷ very delicate. How to keep state ownership and reduce managers’ self-opportunist behaviour in the meanwhile is another key problem.

The marketization in the Reform both provides SOE with the opportunity to make profit and to restrain SOE’s special functions; the SOE reform improves market efficiency and holds up

116 The principal-agent problem is well analysed by the theory of agency; see Ross (1973), Jensen and Mechling (1976), and Eggertsson (1990). The information costs and the free-rider problem are also relevant subjects; see Alchian and Demsetz (1972) for example.

117 The term corporation is in general meaning similar to the shareholding company. Microsoft is a typical corporation. More detailed explanation is given in section 4.3.

the radical marketization (e.g. maintaining state ownership is an obstacle for the property rights reform, which aims at building up an institutional structure of private ownership). Hence, SOE has “double dependence” as Kornai (1985: pp.10-15) describes, namely focusing one eye on the state for subsidised resources and the other on the profitability of the output market. The Reform cannot be accomplished if SOE still damages the market; but the SOE reform cannot be carried out if the Reform does not build up an efficient market for enterprises (including SOE). The SOE reform is tightly connected to the whole Reform; they are living or dying together.

Chinese reformers have also drawn upon foreign theories and practical experiences to resolve the problems in SOEs. Neo-classical and neo-institutional economics dominate reformers’ ideas; SOE reforms in transition economies and public enterprise reform in developed market economies are both important references for Chinese reformers. The objective and the lead ideas of the SOE reform have also experienced a gradualist evolution. Here I introduce the SOE reform according to two perspectives: one is the theoretical debate, which impacted significantly on the reform policy-making; the other is the reform practices, which are either guided by theories or experimented before theories emerge. In this gradualist process, three schools of thoughts – incentive, marketization and property rights school – have mixed together in guiding the SOE reform. The following sections will respectively introduce the three schools and their corresponding policy so as to provide an overview of the SOE reform with Chinese characteristics.

3.2.1 Incentive School

In the traditional SOE (see section 2.3), the ‘iron rice bowl’¹¹⁸ phenomenon was very severe in SOEs and in other public institutions, since employees’ living necessities were allocated by the government rationing system and money lost its value in commodity exchange. There was no direct link between the rewarding of workers as well as managers and their enterprises’ performance. Material incentive was also minimised and non-material incentive was abused with the supposed result that ‘nobody would work more’. This was believed by early reformers and market economists to be the main reason for the SOE’s low efficiency in micro operation. Incentive system was thus the first target of reform and the early reform practices emphasised on strengthening work incentives under the domination of the central planning economy. The central government authorised SOEs to provide services (including products)

¹¹⁸ ‘Iron rice bowl’ phenomenon means that the workers in SOE or other public institutions and enterprises were fired only if they made grave political mistakes.

to meet the market demand after fulfilling the state's tasks, and delegated to SOE managers more power in production organization and revenue distribution. Reformers expected these measures to transform SOEs into profit-makers on markets (not yet profit-oriented). Most efforts to improve the incentive system in SOEs were made from 1978 to 1992. The detailed practices can be classified into three dimensions as decentralization of decision-making power, profit sharing systems and incentives of employees.

(a) Decentralization of decision-making power

Two approaches were implemented in the early years of the Reform to decentralise the over-centralised decision-making power: from the central to local governments along the administrative hierarchy and from the government to SOEs. Owing to the first approach, the old four-level hierarchy (Planning and Economic Commission – ministries – departments – enterprises) was reduced to two levels, namely the Economic Commission and enterprise. It was further envisaged that while a few large-scale and strategic industrial enterprises would continue to be administered directly by the central Economic Commission, most industrial enterprises would be administered directly by the Economic Commissions of the cities where they were located (Chai, 1997: p.40).

Enterprise consolidation was carried out in 1979 and during the 1980s through merging industrial SOEs in both horizontal and vertical senses, in order to minimise the number of SOEs at the bottom of the industrial hierarchy which the top economic organs had to deal with, and to increase the size of production enterprises for the sake of economies of scale (Ma Hong, 1982). However, different from the merger and acquisition behaviour in the market economies, the Chinese approach was marked by the administrative intervention. “Out of the 2300 industrial corporations [i.e. industrial groups] established by the end of 1981, only 236 were [done through] business [process], the rest were administrative ... the administrative industrial corporations had neither an independent accounting system nor independent managerial authority over the planning and management of the component enterprises. Their member enterprises maintained their own economic identity.” (Chai, 1997: p.37) These administratively merged SOEs still exist up to now (according to my investigation).

The second approach – granting SOEs more decision-making power – consisted of a series of measures as follows (ibid: pp.52-63; pp.140-146):

- Relaxation of plan constraints – SOEs gained increased discretion in output decisions as both the number of products and the share of industrial output subject to mandatory

planning went down. The former fell from 120 in 1979 to 60 in 1987 and the latter declined from 40% in 1984 to 17% in 1987. By 1993 only 36 products or 7% of industrial output were reportedly still subject to mandatory planning.

- Procurement of materials (resources) – the number of materials to be acquired under mandatory planning was drastically reduced. SOEs were permitted to get materials through market channels: marketing by enterprises (self-marketing) and materials trading centres. The centres were set up by the State Material Bureau at various government levels to handle the trading of materials not subject to plan allocation, the number of which increased from 110 in 1984 to 400 in 1992. Furthermore, SOEs gained power to fix prices of their products in accordance with costs and the situation of supply and demand on markets (Gao Shangquan, 1996: p.71).
- Power of recruitment – SOEs received labour hiring flexibility. Since 1985 the labour quota for most large- and medium-scaled SOEs was no longer fixed but rather allowed to fluctuate according to output volume. For small SOEs the labour quota was completely abolished in the second half of 1980s. The SOE's flexibility in hiring and dismissing workers was definitely enhanced by the introduction of the contract labour system which began in 1980 as an experiment. By 1995 some 63% of workers in all (industrial) SOEs were contract workers (see also Chen Jiagui *et al*, 2000: pp.234-235). However, considering the threat of heavy unemployment to social and political stability, SOEs had to recruit more employees than necessary – 35% of the SOE employees were 'redundant' in 1992 (see Wang Xin, 1992), the radical laying off of SOE employees did not occur until the 1990s when the Chinese government implemented a radical 'downsizing' programme which was expected to solve the 'redundancy' problem in 'three years'. This 'big-bang' practice has resulted in the severe unemployment problems and caused significant social unrest¹¹⁹. Since 2000, this radical downsizing has been moderated in order to slow down the drastic increase of the unemployment rate. But up to now, the high pressure of employment is not relieved and providing jobs to the masses becomes one of the central concerns of Chinese economy and the political system.
- Relaxation of foreign trade control. Before 1979, trading rights (for both import and export) had been monopolised in the hands of a few national foreign trade corporations. The decentralization of trading rights was initiated between July and September 1979 with

¹¹⁹ Many scholars have paid attention to the up soaring unemployment rate in urban China. For example, Li Minqi (2001) estimates that China's urban unemployment rate jumped from 2.5% in 1990 to 10.5% in 1997 if the laid off workers are taken into account for the unemployment (the officially registered urban unemployment rate was only 3.1% in 1997). Zhang Juwei introduces another data: according to the Fifth Census of China in 2000, the unemployment rate in urban China reached as high as 8.27% in 2000, of which 9.43% were in cities and 6.24% in towns (news from ChinaBiz, May 25, 2003).

the issuing of several documents by the Central Committee of the CPC and by the State Council. These documents set out the principles according to which local authorities, industrial ministries, associations, and production enterprises were to be granted trading rights and allowed to set up their own foreign trade corporations. By the end of 1992 only a few export commodities and 12 import commodities remained under the control of national foreign trade corporations. Moreover, with a foreign exchange retention system established in 1979, SOEs (and other domestic economic units) contributing to foreign exchange earnings were allocated a foreign exchange use quota in proportion to the foreign exchange they earned.

(b) Profit sharing systems

Due to the recovery of the market since the Reform, profits became available and the distribution of profits between the state and SOEs has to motivate employees. Thus a series of measures of profit sharing between the state and SOEs were implemented to replace the old planning system in which SOEs must turn in all their products to the central government (Chai, 1997: pp.67-76; Gao Shangquan, 1996: p.120):

- In the profit-retention system (1979 – 1980), the SOE share was planned as a fixed percentage of its actual profit; the percentage was decided by the individual bargaining between an enterprise and the government.
- In the profit-contract system (1981 – 1983), an SOE undertook to pay the state a fixed sum equivalent to the actual amount of profit delivered to the state in the base year, and the state allowed the SOE to retain all excess profits; the fixed sum was also an outcome of the individual bargaining between an enterprise and the government.
- In the tax for profit system (since 1983), SOEs had to pay the state profit in the form of regulatory income tax¹²⁰ and had portions retained for free disposal, for example for technical improvement, for the welfare of employees, for bonuses and so on (see more details in Liu *et al*, 1998: pp.39-40).

(c) Incentives for employees

The incentive reform was focused on improving the incentive for the SOE, i.e. from the enterprise perspective. The other concern of the incentive reform was to motivate the personnel. Since the market was reintroduced into China, more and more commodities could be found on markets and stimulated the demand of the masses. People began to think about

¹²⁰ Here, the three systems are only introduced their initial forms. Due to the problems in the practice, there were also some derivative forms to stimulate the SOEs' incentive as protecting the state's interests. More detailed introduction is given by Chai (1997: p.67-76).

improving their living quality. The rationing system was no longer sufficient to meet people's increasing and diverse demands. Hence, people had to gain more money to pay for the commodities on markets. Private entrepreneurs and businessmen became the first group of 'getting rich' by taking advantage of the booming market and rapidly accumulated material wealth – '*wan yuan hu*' (a household having the patrimony of 10000 yuan or more) was a respectful synonym of these rich people in the 1980s. At the same time, wages of SOE's workers increased on average from 615 yuan/year to only 1935 yuan/year during the 12 years after the Reform (He and Nie, 1992). The shortage of material income deprived SOE's employees of the 'privileged identity' as I discussed in the previous chapter. The non-material incentive became less and less important or effective to motivate SOE's employees while the material incentive became the central concern. An SOE's employee began to compare his (her) 'income (wage plus bonus) / working performance' with other employees in his (her) group, in his (her) enterprise, in other SOEs, and even in the private sector. Hard working employees might ask themselves: "Why does he (someone else) work so little but gains the same as me? If *this gain is paid for such little work*, he is right but why do I work so hard?" A result is that shirking behaviour was accepted as conform to economic rationality. Due to this ideological change, the zeal of SOE employees for the 'socialist construction' was eroded and the realistic view of 'working for money' became more and more prevalent¹²¹. A common phenomenon in China since the 1980s is that people engage in a second or even a third job so as to gain more. These people should not be criticized, unless they are shirking in their formal working time in order to accumulate energy for working in their 'leisure' time.

As people became more and more money-oriented, the egalitarian, poorly paid wage system and the non-material incentives in the SOE were difficult to sustain, or to stimulate most of SOE's employees¹²². Therefore, material incentive was emphasised in the incentive system and 'to each according to his work (performance)' was put into practice. A most critical problem is how to measure one's performance. Chai (1997: p.82) summarises four methods of measurement:

- The point system – Individual and group performance were assessed in terms of merit points. The performance indicators usually referred to a set of tasks which were disaggregated into numerous detailed targets and assigned to groups within the enterprise.

121 To be noted that, this ideological change did not only occur in SOEs, but also in the whole Chinese society after the Reform.

122 I must point out that there were and there are always many people, especially in SOEs, work very hard for their belief of 'serving the society' (not only a socialist or communist belief), while paying little attention to their gain. Although this behaviour is not conformed to the economic rationality, I must say that, such people are respectful.

The tasks assigned to each group were further disaggregated into even more detailed ones which were matched to individual workers within the group. At the end of the period both individual performance and group performance were then assessed according to the degree to which the assigned tasks had been fulfilled. Basic points could be earned for target fulfilment. Additional points could be earned if the targets were exceeded. If some of the major targets were not reached the basic wage of the group and the number of workers would be cut.

- The contract system – A group or an individual was contracted by the enterprise for a fixed amount of inputs and was held responsible for meeting a set of specific indicators, such as output and profit. Employees were entitled to the basic wage alone if the contracted targets were fulfilled. A bonus would be provided if the assigned targets were bypassed. If the assigned targets were not reached the basic wage of the group or the individual could be cut.
- The above-norm piece-rate system – Norms that specify the amount and quality of work during a period were established. For over-fulfilment of the norms, the group and individuals received extra pay according to a pre-determined scale, in addition to the basic wage. If the norms were under fulfilled, the basic wage of the group or the individual could be cut.
- The linkage system – the growth of the group's or the individual's incentive pay was tied to the growth of the performance indicators of both the enterprise and individual workers.

In addition, a Shareholding System was introduced in 1984. SOEs could issue shares internally for employees to buy. The main objectives were:

- as the state reduced the subsidies to SOEs, SOEs must accumulate capital for their operation, and thus the Shareholding System is a means to collect some funds from employees; and
- when employees became shareholders of enterprise, they would be more concerned with enterprise's performance in both short term and long term.

However, the shareholders had little impact on the decision-making process and the results. The second objective could not be achieved. The 'share' only functioned like a 'note for dividend'¹²³. In addition, the shares were not transferable or available to the public. Thus, the dominance of state ownership did not change. Although the Shareholding System was

123 A more detailed criticism of the introduction of the Shareholding System to the SOE is given by Fan *et al* (1986).

experimented in the early Reform period, its positive role was not observable. Only the establishment of the stock market in 1990 and the ownership reform in the SOE revitalised this system.

The reform of incentives for directors of SOEs deserves special consideration. When the planning constraints on SOEs were relaxed, the critical role of these directors in improving SOEs' efficiency of organization and the profit-making capability on markets drew the attention of reformers. A director-responsibility system was adopted in 1986 in order to ensure the business decision-making power of the managers and reduce the intervention from the supervisory government institutions. Furthermore, stimulating directors to engage in entrepreneurial activities was a vital measure of the incentive reform. The previous non-material incentives were not able to satisfy the managers any longer¹²⁴, even though managers were granted more responsibilities and power in the enterprise's operation. The managers' income became proportional to their enterprises' performance – the fulfilment of the state plans or the profit-making – and it was authorized to widen the gap between the managers' income and the other employees' income.

These measures were very successful to stimulate SOEs and their employees to improve productivity and the efficiency of the micro economy of the firm (Zhang Huiming, 2000: pp.67-69). SOEs could compete on markets (among themselves and with other economic actors) for their individual economic interests. A series of changes in modes of thought – the understandings of market, competition, cost, performance, quality, time, service, human resources, etc. were reinforced – were observable (He and Nie, 1992). SOEs began to adopt modern management methods to improve their efficiency of organization and business performance. The national economy was thus revalorised owing to the improvement of micro performance: from 1980 to 1992, the gross industrial output increased on average 12.8% per year, the national income 9% per year, the national fiscal revenue 8.7% per year (ibid) and the exports grew at annual rates of 20% during the late 1980s (Jefferson and Rawski, 1994:p.56).

SOE employees could also benefit from the improving enterprise performance to increase their individual income and welfare, and a positive correlation was established between the individual benefit and the individual work performance. As people emphasised more and

¹²⁴ Two nationwide surveys made by Chinese researchers in 1997 and 1999 respectively reflect the situation that SOEs' managers were less satisfactory with their economic benefit (material income) than with their political position and social reputation (Chen *et al*, 2000: p217-218).

more their material interest, labour productivity as a basis for higher income increased. For example, Guo Jin'gang (1992) argues that the employee's wage increased on average 11.84% per year between 1980 and 1989, while the productivity increased 10.08% per year over the same period. Jefferson and Rawski (1994: pp.54-55) also say that "Average monetary compensation of SOE industrial workers rose by 252% between 1980 and 1992 ... nominal labour productivity rose by 231% over the same period, or nearly as much as wages."¹²⁵

Encouraged by the achievement of the incentive reform practices, the 'contract' instrument was affirmed as an efficient means to improve the incentive system for the SOE and SOE employees. But there was no labour market for managers in China in the 1980s. There was no effective mechanism to choose the 'best' director for SOEs neither. Thus, the Contract Responsibility System (CRS) was spread to the SOE sector in 1986¹²⁶. There were various forms of the CRS in practice¹²⁷ but they shared a common principle, i.e. the SOE guaranteed the state a predetermined quota of profit with no regard to the enterprise performance; it retained all the above-quota profit; but if it made loss, the state would not compensate it. The differential share of assets and the differential payment to employees were used as incentives to achieve the quota. For the SOEs in the low-return or loss-making (usually caused by political tasks) industries, a fixed amount of loss criterion replaced the quota of profit. The supervisory government agent of an SOE made an offer to the public. Director candidates could bargain with the government agent and modify their plans of targets (inducing mainly the amount of profit delivered to the state, but also the improvement of technology, the growth in real assets of the enterprise, sometimes also the number of labour, etc.). Finally, after a comparison of the bargained plans, the government agent assigned the candidate who presented the most favourable plan to the state's interest to become director of the SOE. Once the contractor was chosen, the responsibilities and targets of the contractor and the government agent would be determined in the contract. A contract was generally renewable in 3 or 5 years. Following the same logic, the contractor – the director – could divide the targets

125 However, Chai (1997: p.89) summarises some enterprise surveys in the 1980s that the manager-worker income differential did not change much and was still narrow. Two reasons are possible. One is in the actual political and ideological context, managers (including directors) were afraid of the possible political repercussion (ibid). The other one is the income structure of managers' income. The wage and bonus were less significant than the welfare benefit, the 'on the consumption' and the 'grey income' which were not taken into account in the payroll.

126 The CRS was in fact experimented as early as in 1982 in Jilin Province (Du Haiyang, 1987). It was initially inspired by the success of the Household Responsibility System in the rural area in the beginning of the Reform. But it was in 1987 and 1988 that the CRS was adopted by most of SOEs.

127 See a brief introduction of forms of the CRS in Zhang Huiming (2000: p.73-74).

and subcontracts to managers at lower managerial levels. Hence, a hierarchy of contract could be established inside the SOE¹²⁸.

The CRS showed a genuine desire of the state to reward efficient SOEs and penalise the inefficient ones (Liew, 1997: p.80). By the second quarter of 1987, 90% of the industrial SOEs were contracted. Productivity and total output value of the contracted SOEs were constantly improved (Yang Huanjin, 1989: p.122; Lin *et al*, 1997: p.52 – Table2). However, the CRS was far from perfect. In fact, the deficiencies of the CRS were significant¹²⁹:

- The nature and terms of contracts depended on the individual bargaining between the government agents and contractors. So, they varied not only between industries and regions, but also between enterprises. It was difficult to set a reasonable profit quantum (the predetermined amount of profit that should be delivered to the state). An unfavourable result of contracting was observable, i.e. there was no bidding for contracts because the profit quota was fixed at too high level to allow the enterprise to have an attractive amount of retained profit. In some cases, the SOEs made a great success in profit-making and the share of the profit delivered to the state was small. When the contract expired and needed renewal, the supervisory government agent increased the profit for the state to a much larger amount and made it for the SOE very difficult to retain enough profit for capital accumulation¹³⁰. Thus, people were less motivated.
- The contract did not really separate the government intervention from the SOEs' business operation, because many materials and resources were still allocated by the government. Hence, it was difficult to clarify the responsibility of the enterprise's loss making. The state had to continue to offset the SOEs' deficit and the soft budget problem was still prevalent.
- A contractor must raise a mortgage to cover the possible loss-making. But the total wealth of a contractor was generally too small compared to the high risks of loss-making. So, the contractor was 'only responsible for gains, not for losses'. In addition, the rewards to the successful contractors were also very limited. According to an official document in 1987, the material reward to a successful contractor could not bypass the triplicity of the worker's income. That was often trivial to the great profit he made.

128 More introduction of practices of the CRS is given in Liu *et al* (1998: p.451-455).

129 See also Liu *et al* (1998: p.459-461).

130 This is the 'ratchet effect'. For example, a salesman contracts with his director for getting 1000 yuan by selling 1000 units of product in January. He will get less than 1000 yuan if less than 1000 units are sold; while get a bonus of 10 yuan per unit for the extra sale. In January he sells 1200 units. Then he renews the contract with the director for February but the quota is increased to 1200 (or 1300) units. If he succeeds in fulfilling the quota, the quota for March will be continue to increase.

- The short-sighted behaviour of contractors was overwhelming. Since the future of the industry and the enterprise was not predictable, a contractor was only concerned about the enterprise performance in the contract period. The training of labour, renewal of equipments, R&D and technological upgrading were often overlooked so as to maximise the current profit. That was absolutely dangerous to the long-term benefit of enterprises and the industries.
- Bribery, corruption and insider control were impressive. As the bargaining process between contractor candidate and government agent lacked transparency, a candidate might bribe government officers to lower the profit quota. The difficulty for the state to supervise the SOE's performance left much space for the government official to set the quota and assign the director and could not prevent him (her) from corruption. The director had full authority to arrange personnel inside the SOE and could make the SOE his (her) own 'kingdom'. 'On-the-consumption'¹³¹ became a very usual method to compensate the low managerial income. Embezzling state-owned assets was another means to increase the enterprise's assets and personal property. Hence, there were many SOEs making loss, but their managers were well paid (in China this phenomenon is called 'the rich abbot lives off the poor temple'). This problem was observed in the SOE which I investigated for a long period. A small portion of people in China benefited but the state was the victim.
- As Zhao Haiying (1997: p.128) analyses "the CRS, which separates the owner i.e. the government, from the managers, needs to specify both a profit sharing rule and a clause on preserving the value of company assets. Unfortunately, since industrial assets are easily depreciated, the transaction costs of writing an efficient contract on firm assets can be very high. Hence CRS ... only marginally improved enterprise efficiency and led to the loss of state assets."

(d) Outcome of the incentive reform

The incentive reform was in practice applied to all SOEs. The objective of the incentive reform was set to improve the performance of the SOE to better serve society, e.g. fulfilling the social, political and economic tasks while relieving the pressure of the state to finance SOEs. The SOE institution was not changed in nature.

¹³¹ According to Chen Donghua *et al* (2005), 'on-the-consumption' means that managers use enterprise's funds to reimburse their private expenses. The authors choose eight kinds of fees – fees for travelling, reception, communication, training, meeting, transport, board of director and administration – as main fees related to 'on-the-consumption' for their survey on the situation of 'on-the-consumption' in Chinese SOEs.

However, the incentive reform could not walk alone to sustain the SOE in the developing market economy. The incentives to employees were less and less effective – the effect in 1989 was only 17.06% of that in 1980 (Guo Jin'gang, 1992). But the comparative profitability and productivity between SOEs and non-state firms showed the fragile position of the SOE performance and caused a crisis of confidence in the SOE in the 1990s. Due to the boom of the competitive non-state enterprises and the expanding market economy, SOEs had difficulty to sustain their profitability. In fact, both the number of SOEs running at loss and the amount of loss have been increasing – “the total loss of the industrial SOEs was 45,264 billion yuan RMB in 1993, about 14 times that in 1985. The loss-to-output ratio constantly increased from 0.78% in 1986 to 2.08% in 1992. [At the same time, for the entire SOE sector,] the ratio of profit plus tax over sales income for the SOEs dropped from 25.57% in 1980 to 11.65% in 1992, and the ratio of profit plus tax over total output value dropped from 24.23% to 11.38% during the same period” (Lin *et al*, 1997: pp.52-53). In addition, the separation of management from ownership has caused a serious principal-agent problem because of different goals: the agent (here meaning directors of SOEs) were in pursuit of their personal benefit while the principal, i.e. the Chinese state, was concerned more with the political and social tasks although both goals required profitable SOE. Therefore, further institutional reform was needed.

3.2.2 Marketization School

The introduction of the market institution in China did not abolish the old central planning economy, but produced a dual track economy. The scope of planning was gradually reduced and price control on most consumption goods was lifted (for example, the number of industrial products directly controlled by the State Planning Committee decreased from above 120 to about 60 in the period 1979-1992; the number of materials distributed exclusively by the state dropped from 126 to 26; the number of commodities purchased by the Ministry of Commerce reduced from 188 to 23; the proportion of all commodities produced under the planning control and exchanged according to planning prices fell below 30%) and a dual track price system was established for the remaining production goods – both planning and market prices were applied to the same product, thus combining the market adjustment with the planning control mechanism (for example, in 1987, the dual track price system was applied to 40% of all production goods, and accounted for 75% of total transaction) (Lin *et al*, 1997: pp.50-51).

The drastic development of non-state enterprises was a result highly appreciated by reformers. Many forms of enterprise, such as one-person enterprise, urban collective enterprise, township and village enterprise (TVE), foreign enterprise, joint-venture enterprise, etc., boomed in the non-state sector. They significantly contributed to the rapid economic growth and the development of the market economy in China (Mao and Zhang, 2001; Huang Wenfu, 2003). The development of the non-state economy also increased the pressure of market competition on SOEs. SOE problems thus became more and more serious and deteriorated the SOE's competitiveness. The declining profit margin of SOEs aggravated the difficulty of their survival. As under the 'soft budget', the state had to subsidise the loss-making SOEs, the fiscal deficit of the central government and the non-performing loans by the banking system became increasingly serious problems¹³².

The success of the non-state economy and the market institution in China greatly encouraged the reformers. As a result, the reformers decided in 1992 to build up a socialist market economy in China. The market logic has become prevalent since then. The SOE, still monopolizing a part of resources and representing the 'disfavoured state intervention' in the market economy, was viewed by reformers as the obstacle to market-oriented Reform and that of China's economic growth. Hence, the SOE institution must be reformed. Two schools of thoughts were put forward: one stressed an institutional reform to build up a fair market environment for the SOE; the other stressed on the ownership reform (or the reform of property rights) of the SOE. The two schools have aroused a great debate and led the main practices of Chinese SOE reform since the 1990s.

The rapid growth of privately owned enterprises and their contribution to the national wealth creation since the Reform seemed to prove that private ownership in enterprises was more effective in improving enterprise performance (in business operation) than state ownership. But, in the early 1990s, although the market economy was accepted by Chinese socialist ideology, state ownership was still regarded as sacred to Socialism. The ideal SOE reform was thus to make SOEs competitive in the market economy while maintaining state ownership. Hence, a key question the reformers had to face was: Does ownership matter for enterprise performance in the market competition? The remarkable economic achievement of

¹³² Chinese banks were most state-owned and not profit-oriented before 1994 when state-owned commercial banks were created and non-state banks were authorised to do business (see more discussion of the Chinese banking system in Hamdouch and Zhang (2005) for example). The Chinese governments had strong influences on the banks' behaviour and often took the bank loan as complementary to fiscal subsidies.

the TVE provided an answer to the question: as a kind of government-owned enterprise¹³³, TVEs successfully operated in the market (Byrd, William and Gelb, 1990; Weitzman and Xu, 1993; Chen Hongyi, 1997; Che and Qian, 1998; NBSC, 1999; Liu *et al*, 2000). Hence, state ownership is possibly not the culprit of SOEs' problems.

Qian and Weingast make a comparison of SOEs and TVEs in China from such perspectives as ownership, welfare obligations, employment practice, and budget constraints. They provide an explanation for the difference between SOE and TVE performances: "the state saddles SOEs with considerable social goals and punishes managers for failing to meet these goals. These firms cannot go bankrupt, and subsidies are readily provided. Efficient production is clearly a secondary consideration. TVEs, in contrast, do not receive large subsidies or politically motivated loans. They have few politically mandated social responsibilities, and they must operate under competitive conditions for both capital and labour." (Qian and Weingast, 1998: p.255) According to this argument, the SOE's inefficiency lies in multitasks, soft budget and not-profit-oriented operation.

Lin *et al* (1997) assert: the ownership right of SOEs in China has always been clear; in an immature market economy, an ownership reform in SOEs without creating an environment for fair competition under hard budget constraint will not solve SOE problems. Inferring from their discussion of the *gan chao* economy in the pre-Reform China (see section 2.2), they suggest that marketizing the economy is the solution to the SOE problem and should precede the ownership reform. *The marketization school is thus formed.*

Compared to the incentive school which was concentrated on the institutional arrangements inside SOEs, the marketization school linked the SOE reform closely to the whole economic reform. Both the SOE and other economic sectors were hence integrated to the market-oriented Reform. The main methods of the marketization school consisted of relieving multitasks from SOEs – including pension, housing, health care, education, etc; bankrupting the hopelessly loss-making SOEs and improving the quality (profit-making capability) of the state assets; improving product and factor markets – including labour and manager markets, and financial markets as well; correcting the 'distorted' price system (caused by the government intervention) and economic structure to develop the national economy in

¹³³ In China, the connotation of 'government-owned' is broader than that of 'state-owned' because the latter means 'owned by the central government' while the former means also 'owned by the local government'.

accordance with the comparative advantages. The improved market environment would reinforce the incentive reform to improve SOEs' business performance.

However, the marketization is not a new issue for China as various economic sectors have already been marketized from the beginning of the Reform. A key problem is that the market needs time to become mature enough to fully play its role in regulating the economy. In the Chinese experience, the steps of marketization in different sectors were gradualist and not synchronised. So, when the SOE reform was linked to other sectoral reforms, the inconvenience among these unsynchronised reforms became significant. One reform had to be slowed down to wait for the others to catch up with; or else, a singly advanced reform might fail for lack of institutional support. This is a deficiency of the gradualist reform. In this way that, in 1992, the Chinese Reform was decided to be market-oriented was not only an official approval of the marketization, but a declaration to firmly accelerate marketization so as to reduce the inconvenience. As the SOE problem was a central issue in the whole Reform, the SOE reform was chosen to be a break-through for the radical marketization.

I am now making an analysis of the SOE reform practices guided by the marketization school from the perspectives of financial and human capital, and SOE's exit from (competitive) markets. It aims at explaining how the state's infinite liability for SOEs was reduced to limited responsibility, how the government was separated from the SOE, and how the SOE was transformed in nature.

(a) Marketization of financial capital

Chinese SOEs had three channels to obtain financial capital: state subsidies (allocated by the central government), loans from state-owned banks, and capital accumulation of profit gained in the market. But the government subsidies were not sufficient to meet the demands of all SOEs and the severe soft budget problem caused inefficient use of these subsidies. Separating government from the SOE was necessary to make SOEs independent actors on markets. From 1984 on, the Chinese government cut down subsidies to SOEs and obliged them to use the other two funding channels¹³⁴. As the government retained power to control the state-owned banks, loans by these banks could also be considered as government subsidies. Brandt and Zhou (1999) estimate, between 1979 and 1993, on average 84 percent of all new credits from

¹³⁴ However, "since 1986, subsidies to loss-making enterprises have become a regular government outlay, ranging between 5% and 16% of the total budget expenditure." (Sun Jian, 1999: p.7) Such subsidies were in fact aimed at keeping the SOEs out of bankruptcy, rather than supporting their business demand.

the state banking system were allocated to the state sector. The worse was the high number and volume of SOE non-performing loans (NPLs)¹³⁵ granted by the state-owned commercial banks. “In terms of annual flows, the NPLs amounted to between 2 and 3 percent of gross domestic product (GDP), comparable to the government budget deficits in many other countries. In terms of cumulative stocks, they amounted to approximately \$200 billion (at 2002’s price). With a GDP of \$960 billion in 1998, this implies a NPL-to-GDP ratio of slightly over 20 percent, which is quite consistent with estimates by the People’s Bank of China (the Central Bank), and of 25 percent by international credit rating agencies” (Liu, 2002)¹³⁶.

The banking reform that began in 1994 has been concentrated on separating the commercial function of the state-owned banks from the political one (Hamdouch and Zhang, 2005)¹³⁷. In the same year, four state-owned specialised banks were transformed into commercial banks to be operated for profit, while at the same time assuming full market and credit risks as stand-alone commercial banks; another three state-owned banks – the Long-Term Development and Credit Bank, the Import-Export Bank and the Agricultural Development Bank – were established for government-directed lending in accordance with state industrial policy and national plans (Liu, 2002). Profitability has been the prime objective for the commercial banks and their financial risk has required strict credit control. Furthermore, the state-owned banks must be responsible for their own business performance. The central bank, directly under the control of the State Council, manages the banking system. This means local governments have no longer access to allocate banks’ financial resources and must go through the normal money borrow channels. In the present day, according to my interviews with local government officials, the local government can only recommend enterprises or programmes to banks but no administrative order will force the banks’ decision. A problem caused by the banking reform was ‘be loath to loan’ (*xi dai* in Chinese), especially to the low return

135 “In banking, commercial loans 90 days past due and consumer loans 180 days past due are generally classified as non-performing” (Liu, 2002).

136 According to Liu (2002), the SOE NPLs at the State-owned commercial banks can be classified into three categories:

- 1) Loans to traditional industrial SOEs;
- 2) Loans to enterprises established during the mid-1980s in lieu of a founding equity;
- 3) Loans contracted during the overheated period in the early 1990s.

For more discussions on the NPL problem in China’s banking system, see also Bartel and Huang Yiping, 2000; Fan Gang, 1999; He Qingliang, 2004; Peiser and Wang, 2002; Shih, 2004.

137 More discussions on China’s bank reform from various perspectives are given by, for example, Wang Yijiang and Wang Yijing and Tian Guoqiang, 2003; Lo Chi, 2004; Tang Shuangning, 2004; Zhang Yugui, 2004; Luo Dezhi, 2002; Ji Yushang and Zhang Yuewen, 2005.

programmes and the loss making SOEs. The stock market developed in the 1990s provided enterprises with a new channel to collect financial capital¹³⁸.

Another difficulty to separate government from the SOE came from multitasks undertaken by the SOE. On the one hand, the multiple social welfare services became heavy burdens on SOEs and made it difficult to improve their competitiveness on markets, as these services drained enterprises' financial capital; on the other hand, the worsening performance of SOEs degraded their capability to provide these services to large numbers of SOE employees (including retirees). The problem was clearly known by reformers, and in the 1980s, some experiments were made to look for solutions. But all efforts to relieve the social welfare services from SOEs or establish substitute social institutions to provide these services proved very costly for the government's fiscal capability and hard to make the losers endure. There was no doubt about the positive effects (improving business performance) of relieving these burdens from SOEs. The biggest worry lied in its negative effects on social stability. The reformers have expected to strengthen the endurance of the potential losers through the rapidly growing GDP, i.e. making the 'cake' bigger for all the people (see Liu Shijin, 1993). Only when the situation of the SOE severely worsened in the 1990s and challenged China's overall economic performance, radical measures seemed unavoidable and urgent to reformers. In 1995, the State Economic and Trade Commission, the Ministry of Education, the Ministry of Labour, the Ministry of Finance, and the Ministry of Health Care together made a "Decision" to relieve the social welfare services from the SOE. Pension, housing, and health care were three main sectors to reform (see Hu Xiaoyi (1995), Wen and Xu (1997: pp.365-394 and pp.409-463), and Liu *et al* (1998: pp.563-602), for the discussion of respective reform practices). These reforms got different appraisals from different angles as follows.

From the point of view of the enterprise, these reforms actually reduced their costs of operation. But from the angle of SOE employees, these reforms directly and immediately degraded their living quality to a great extent. The welfare services previously provided by traditional SOEs are now either provided by undeveloped specific government institutions or available for purchase from private firms in markets (these markets are also open to other social groups). However, the specific government institutions need many years to build up their capacity. As the Minister of Social Security estimates, a new complete social security net

138 As financing in the stock market involves a change of ownership structure in SOEs, I will discuss this problem in next section.

will be established in 2020¹³⁹. Till then, the lucrative suppliers of welfare services have to fill the vacuum. But the markets for these welfare services are far from competitive. The lack of supply of the services has raised their prices. The prevailing market-orientation and the ineffective government regulation have turned these services to be luxury commodities for most of SOE employees (and also for the low income group of the society). The expensive services for housing and health care sectors have been severely criticized by the public recently in China. The health care industry and the real estate industry (and the education industry) are listed in the Top 10 most profitable industries in 2005 (appraised by *Guangming Daily*). The health care reform is even criticized as ‘basically unsuccessful’ in 2005 by researchers of the Centre of Development Research of the State Council (news from www.sina.com, 29 July, 2005). A popular saying is: “the housing reform makes your pocket empty, the education reform drives your parents mad, and the health care reform arranges your funeral in advance.” (translated by Zhu Kai) More tragic fate hit SOE employees when downsizing, bankruptcy and various transformation programmes together affected SOEs in the late 1990s.

(b) Marketization of human capital

Although the labour contract system had been adopted, dismissing employees was still rarely applied in the 1980s. Under the immense pressure of keeping unemployment low, SOEs had to maintain redundant labour, thus fulfilling a political task for a long time even after the Reform began. So, downsizing SOEs was stressed, to solve the quantity problem – laying off redundant labour. The reformers expected to eliminate unqualified employees through the mechanisms of the labour market (meaning: through competition). So, downsizing was only a tool, and improving the quality of labour was the real objective of the reform. The consequences of the downsizing were remarkable. “From 1995 to 2001 the number of workers employed in the state-owned sector fell from 113 million to 67 million, a decline of 46 million or 40 percent ... employment in the urban collective sector fell by 18.6 million, or nearly 60 percent ... 43 million workers were officially registered as laid off, or *xia gang*, including 34 million from the state sector” (Giles *et al*, 2003: p1). The sharp cost reduction surely improved SOEs’ labour productivity and increased their financial capital. So, once dismissing labour became *truly* applicable, most SOEs took advantage of this measure to reduce costs. The slogan ‘*jian yuan zeng xiao*’ (reducing the number of labourers to improve performance) has become popular and losing their jobs has become a ‘real threat’ for SOE

139 The Minister Zhang Zuoji gave this expectation on November 26, 2002. The news report is available online: <http://news.xinhuanet.com>

employees since the mid-1990s. In addition, the downsizing had a by-product as facilitating labour mobility. Many SOE employees who were not satisfied with their wages liked to be ‘laid off’ and enjoyed more job offers with better incentives (income plus welfare) on the labour market. This by-product caused the ‘drain brain’ for SOEs and in the meanwhile, improved the reserve of human resources in private enterprises.

Two shortcomings have led the downsizing programme in the wrong direction. *First*, if the downsizing does not improve the quality of labour, reducing the quantity alone cannot lead the reform to success¹⁴⁰. *Second*, the material compensation of the dismissed and laid off SOE employees varies across enterprises and localities. Although the government implemented policies requiring SOEs to compensate the laid off employees who were victims of the downsizing programme¹⁴¹ compensation fell short. In many cases, the excuse given to employees by SOE directors is: “We have no money!” But in some cases, the local government and the SOEs retain the state subsidies for themselves¹⁴². The degrading social welfare services and the lack of material compensation have made the reform-stricken SOE employees the most vulnerable social group.

Since the creation of the SOE, besides the redundant labour, inadequate management has been a key problem. The incentive reform put the Contract Responsibility System into practice; but due to the undeveloped market for managers, it has always been difficult to find competent directors for SOEs. The managerial capability of a SOE’s director is a problem and the principal-agent conflict between the state (the principal) and the SOE directors (the agents) is another. The two problems are also serious in the private enterprises, especially in the Western world. But the developed market for managers in the Western economies effectively supervises managers and stimulates them to be responsible for the interests of the principal. Hence, for Chinese SOEs, the problems can also be solved by a developed market for managers. Market selection and professional supervision can be more efficient than the old

140 A case of ‘back-to-back’ method in the SOE that I investigated exposes this abuse. An office has, for instance, a director and 9 employees. It must dismiss two employees at the end of the year. The chief adopted the ‘back-to-back’ method. Each of the 9 employees has 10 points to vote for another comrade and the vote can vary from 0 to 10 points. So everyone at last can gain points from 0 to 80. Then the 9 employees will be ranked according to the points gained. The two who gain the less will be dismissed. As there is no criterion for the vote, everyone votes according to his (her) own taste which has nothing to do with the work performance. Some can even compose a ‘small group’ to exclude the others. As a result, the dismissed ones may be more qualified for the enterprise than the rest do.

141 For example, an employee who is either dismissed or voluntarily retires before the legal retiring age (man: 60; woman: 55) can get a sum of money as compensation according to his (her) years of service, current wage and age, etc. The pension and social welfare services are also accordingly arranged. A normal measure is to buy out an employee’s years of service (*mai duan gong ling*). The sum paid to the employee also depends on the SOE’s financial capability and the state’s subsidies.

142 A case in Heilongjiang Province in my personal investigation exposed this problem.

bureaucratic appointment and supervision. When the market for managers is effective, the reform of state ownership is not necessary.

During recent years, the central government has insisted on recruiting SOE directors from the manager market. In the meanwhile, head hunter companies have shown their efficiency in introducing competent managers to enterprises. Education and professional training programmes (such as MBA) have helped to establish pools of professional managers. These all accelerate the development of the manager market in China. But as some surveys show, in 1996 and 1997, still nearly two thirds of SOE directors were appointed by the government (Chen Jiagui *et al*, 2000: p.196). The market needs time to be improved and in the meanwhile, it also needs time to take better advantage of the market for SOEs.

(c) SOE's exit from (competitive) markets

The numerous SOEs varying in scale, locating all over the country, operating in all economic sectors were a big difficulty for the Chinese government to manage (including planning and supervision) in a market economy. But strict government control on these SOEs was also a big obstacle for the development of markets. Two programmes – bankruptcy, and ‘seizing the large and letting go the small’ (*zhua da fang xiao* in Chinese) – were put into practice in the mid-1990s in order to reduce the number of SOEs and improve the quality of the SOE sector as a whole. The state intention is clear: keep the SOEs alive only if they are competitive and profit making. But the SOEs must be maintained in the strategic industries (high technology, military and aeronautic industry, etc.) and the industries where market competition must be restrained because allocative effectiveness is more important than efficiency (mining, water supply, petrol, electricity, etc.).

‘Seizing the large and letting go the small’ was intended to concentrate state assets (including financial capital, physical equipment and human resources) onto a relatively small number of large scaled SOEs and make them more competitive on both domestic and abroad markets. The small-scale SOEs were either closed, or transformed into non-state enterprises in diverse ways (sale, merger, acquisition, leasing, joint-venture, etc.), or into enterprises under the control of local governments (Chen Jiagui *et al*, 2000: pp.155-159). In practice, transformations depend on the concrete context in which SOEs are embedded (*ibid*: pp.120-123). As the transformation involves the change of ownership structure in the SOEs, I will discuss it in next section “the ownership school”.

In summary, the marketization school defines an SOE as a profit-oriented enterprise and each SOE should have its own profit and loss responsibility. The role of government in operating and supervising (including assigning personnel) should be taken over by the market and the business administration control and supervision system. Accompanying with reforms in relevant sectors, SOEs may have a clear and determined orientation – profit-making (or profit-maximization). A fair competitive (external) environment can be established through marketization. It can impose external constraints and offer market opportunities for SOEs to accomplish their reform so as to improve efficiency of profit-making. A fatal shortcoming of the marketization school is that it overlooks the compensation of the victims of the reforms. When the Reform continues without sufficient compensation, there must be losers in the Reform. Thus, the Reform cannot be a ‘Pareto Improvement’. If the losers as is the case are not evenly distributed across all social groups, but concentrated in a few groups only – the SOE employees and the low income group for instance, social unrest will more easily unleash. Hence, compensation to the losers has two functions: one is to meet their basic needs; the other is to relax the social unrest in order to maintain a stable social and political environment for the Reform. As the marketization school believes that the market can resolve the basic needs problem, its concern with compensation is mainly focused on the social unrest problem. So, the reformers can try the lowest standard of compensation to test how far the losers’ tolerance reaches. The ‘virtue’ of the Chinese people – endure hardships and do not disturb government – allows the reform practices to be smoothly carried out. A part of the population undertake the costs the cost of the reforms.

Furthermore, state ownership is not a problematic in the marketization school because it is neither good nor bad to the enterprises if the government (bureaucratic) intervention in SOEs disappears. But if the SOE was not different to privately owned enterprises in orientation and operation, state ownership would have no reasons for remaining except for the political one that the socialist ideology still maintains. The marketization school in fact paves the way for ownership reform although it seems to maintain state ownership. In addition, transactions in a market economy are based and focused on property rights¹⁴³. As many economists who insist on the ownership reform criticize, without a clarified ownership structure, property rights cannot be efficiently transacted on markets, so that the marketization will fail. These

143 Eggertsson (1990) did a survey on the definitions of property rights. As he says, “it is common to distinguish three categories of property rights: First, there are rights to use an asset – user rights ... Second, there is the right to earn income from an asset and contract over the terms with other individuals; Third, there is the right to transfer permanently to another party ownership rights over an asset – that is, to alienate or sell an asset.” (ibid: pp.34-35)

ownership-concerned discussions are grouped into the ownership school, which will be analysed in the following section.

3.2.3 Ownership School

The differences between the ownership school and the other two schools of thought lie in their understandings of the *origin* of SOE problems, rather than the problems themselves. The ownership school focuses on the role of ownership system (or the ownership structure) in stimulating incentives and promoting marketization. The ownership reform is not limited to the SOE, but also at other kinds of enterprises (e.g. the TVE). It involves the legislation and the socialist ideology as well. Therefore, the ownership school regards restructuring state ownership (system) and clarifying the property rights as the core of the Chinese institutional transition.

'Property rights' is one of the most important concepts in contemporary economics. Eggertsson (1990) provides a survey of the definitions of property rights and concludes: "it is common to distinguish three categories of property rights: *First*, rights to use an asset – user rights ... *Second*, the right to earn income from an asset and contract over the terms with other individuals. *Third*, the right to transfer permanently to another party ownership rights over an asset – that is, to alienate or sell an asset." (ibid: pp.34-35) But that one owns the three property rights of an asset does not mean that (s)he owns the asset *per se*, asserts Demsetz in Palgrave (Vol.3: p.145). *Ownership* can be defined as claims to residuals (Alchian and Demsetz, 1972), or the rights to control residuals (Grossman and Hart, 1986). The concept 'ownership of the firm' is explained by Henry Hansmann in Palgrave (Vol.2: p.735) as "conventionally understood, comprises two rights: the right to control the firm, and the right to appropriate the firm's net earnings, while these two rights could in theory be separated and assigned to different persons, in practice they are typically joined." The term '*state ownership (of an enterprise)*' in Chinese context means (an enterprise is) *owned by all the people*, and the state is the single agent who is responsible to the principals – all the (Chinese) people. Under such state ownership, private property rights are deprived and the state holds in fact the two rights to which the people are entitled. Therefore, the introduction of the market and the later market-oriented Reform which depended on the private property rights inevitably obliged the reform of the ownership structure.

(a) Enterprise ownership

The discussion about the reform of state ownership in China can be dated back to the early 1980s. When SOEs were granted more rights of decision-making and profit-retention (mentioned above in the Incentive school), the boundary between the enterprise assets and the state assets became an important issue. Yu Guangyuan (1988) discusses that, as SOEs could use financial capital which came either from the profit retention or from non-state sources after the SOE reform began, the state did no longer own this kind of capital, and therefore had no right to control the returns. Obviously, the *enterprise-owned* assets appeared. This was named the *enterprise ownership* in China. Then a new problem came into being: Which person(s), own(s) the enterprise-owned asset, or who is (are) the residual claimant(s) if it is not ‘all the people’?

There were two answers in practice: one regarded the enterprise as a collective of all the employees so that the non-state assets are owned by this collective of employees; the other regarded the enterprise as a legal person representing several physical persons who share the ownership of non-state assets of the enterprise, so that the physical persons became residual claimants (Ji Peng, 1988). Whichever was the answer, the ownership structure in SOEs where the state was the *single* owner must be reformed to a shareholding system where the state was a ‘normal’ shareholder among others¹⁴⁴. The establishment of the shareholding system in some SOEs in 1984 was such an experiment. The state became only responsible for the state shares. Thus the state’s ‘infinite liability’ for the enterprise as a whole became impossible.

(b) Shareholding system and stock market

The shareholding system (introduced in the incentive school) received serious criticisms from some economists. For example, Fan Maofa *et al* (1986) assert: the shareholding system was established in order to reduce the SOEs’ ‘short-sighted’ behaviour and facilitate the capital flow and collection for enterprises; but the state was still the biggest shareholder, and the other shareholders had no rights in decision-making. The lack of complementary reforms, unfavourable market environment (due to the government intervention in enterprises), short-term policies and plans, and manager appointment system together constrained the function of the shareholding system. The behaviour of the state as well as the directors and managers did not improve under the new ownership structure. As shares were non-transferable (due to the then existing laws and regulations and non-existence of a stock market) and people’s (SOE

¹⁴⁴ It is to be noted that there are still some SOEs where the state is the single owner in the present China.

employees’) available income was trivial in the 1980s, the shareholding system was less effective than bank loans for enterprises’ capital collection. Furthermore, the dispersion of the ownership among the central government, local government, sectoral supervising authorities and employees formed various interest groups and complicated the decision-making process, aggravated the conflicts among these groups and intensified the short-sighted behaviour. Wu Jianqi (1989) also criticizes that the profit-orientation of the shareholding system was in serious conflicts with some national industrial strategies and the current deflationary policy (Chinese economy had high inflation in the last years of the 1980s).

In reality, these shortcomings did not make the shareholding system *per se* problematic, but showed that it was not adapted to the Chinese situation in its early years; or in reverse, the then Chinese situation was not favourable to such shareholding system, for example, the laws were not effective to protect small shareholders’ interests.

Through the incentive and market-oriented reforms, more efforts were made to develop the shareholding system. For example, with the reform of the incentive system for SOEs, employees began to ‘work for material rewards and for themselves’ (contrast with the socialist ideological education before the Reform). Shirking was then *accepted* by mainstream economists as ‘rational’ behaviour when incentives were insufficient. Even corruption was praised by some economists because it is helpful to improve economic efficiency¹⁴⁵. Furthermore, these economists taught the ‘new ideas’ to the masses by textbooks and public media and played down the social values. Many people took insufficient rewards as the excuse for their *poor* working result (although they did not know exactly how much compensation each should get). Therefore, the ownership reformers suggested establishing a complete and clear property rights system so that every SOE employee could work hard to maximise the reward to the share (s)he owns of the SOE assets.

The marketization of capital allocation in China made a remarkable progress when a stock exchange was first established in Shanghai in 1990 and then in Shenzhen in 1991. “The total

145 Zhang Weiyang (1998) asserts that “corruption might have helped the Chinese economic growth through various ways, apart from mitigating bureaucrats’ resistance to the reform. Firstly, corruption has directly improved the incentive systems for both bureaucrats and managers by giving them more freedom to enjoy rents illegally. Secondly, corruption has improved the efficiency of resource allocations. Thirdly, corruption has helped harden the budget constraint on SOEs. SOEs find more and more difficult to get subsidies from the government. This puts pressure on all enterprises to improve efficiency.” Fan Gang (1996) makes a similar assertion. According to these economists, corruption becomes an efficient incentive and can be, if not the best choice, a ‘second-best choice’ for the Reform as it might remove or reduce the obstacles to the institutional transition as ‘lubricating oil’ for the Reform.

number of firms listed increased from 183 in 1993 to over 800 in 1998. Total market capitalization reached 206 billion US dollars at the end of 1997, accounting for 20% of China's gross domestic product.” (Xu Xiaonian and Wang Yan, 1999: p.79) However, for most of the 1990s, stock market listing was subject to strict ceiling control and administrative allocation of quotas. The companies which could gain listing and the amount of shares to be issued were both determined through a quotas system administered by the China Securities Regulatory Council (CSRC). Only from July 1999, with the effect of the Securities Law, did the government start to adopt a more regulatory approach. Moreover, in order to retain the state control of the converted SOEs, shares in listed companies are classified into five categories. These include state shares, held by state asset management agencies/companies, legal person shares that are usually held by state-owned institutions, foreign shares, individual shares and employees’ shares. By definition, state shares and legal person shares are non-tradable. Employees’ shares can only be traded after three years and with approval. Only the other shares can be traded without restriction. In 1998, nearly two-thirds of the shares were non-tradable. This has hardly changed since. As of 2002, state shares and legal person shares accounted for respectively 39.0% and 25.4% of all shares among listed companies. Indeed, 80% of the listed companies were state-controlled in 2002 (Zhang Leyin, 2004: pp.2034-35).

The stock market and the shareholding system helped clarify the ownership structure and property rights system in SOEs and in the national economy. However, state ownership created new problems such as: who is responsible for state assets, how to reduce costs of managing state assets, and how to reconcile different owners? The theories of property rights mentioned before imply that only a natural person can be wholeheartedly responsible for his (her) assets and private ownership is more efficient than collective/state ownership. Thus, for the Ownership School, a complete privatization of state assets seems to be the best way to solve these state-ownership-related problems. Then the remaining problems in SOEs will only be private-ownership-related and similar to those in the capitalist economies. Thus the SOE reform can be *accomplished*. But a radical eradication of state ownership has been impossible in the socialist China, even though the CPC has gradually degraded the importance of state ownership in the national economy¹⁴⁶. Other solutions than a complete privatization of state assets need to be found.

146 Accompanying the step-by-step establishment of the socialist market economy (introduced in the section “What to reform?”), the ownership structure in the Chinese economy also transited step by step from the single state ownership to state ownership as main body, the other ownerships as supplements, further to the non-state ownerships are important components of the socialist economy, and to the present argument that state ownership is important for its role in macro regulation of the national economy and achieving socialism, rather than for

(c) Corporatization

In fact, if the state is regarded as a ‘person’, a shareholding SOE can be analogue to a shareholding company (*gu fen gong si*)¹⁴⁷ in the developed capitalist countries. Since the early 1990s, Chinese economists have begun to focus their studies on corporation and corporate governance¹⁴⁸ for creating a ‘modern enterprise system’¹⁴⁹ to solve the agency problems of the SOE. Zhang Weiyong (1997) uses the theory of property rights to explain how a corporation’s organization solves the principal-agent problem in SOEs. He argues that, in a corporation, “those who are responsible for management and decision-making should have substantial rights to claim and control residuals and those owners who are willing to assume the consequences of risks should have the final say in selecting managers” (ibid: pp.68-70).

According to Chen Qingtai, the then vice chairman of the Economy and Trade Commission of the State Council, “corporatization would create enterprises that could compete successfully, thus creating one of the three key conditions for a system of market economy. A unified market with a field for all enterprises and a market-supporting regulatory and legal system were the two other conditions. Corporatization was believed to be able to address some fundamental shortcomings of SOEs, especially the lack of separation between the SOEs and the government and the lack of clearly defined property rights. The stated purpose of the corporatization drive was to turn Chinese SOEs into independent, profit-oriented businesses, enjoying clearly defined property rights and scientific management (i.e. efficient corporate governance).” (Zhang Leyin, 2004: pp.2033-34)

A key policy of the SOE reform was made in one of the most famous documents during the Reform – “Decisions of the CPC Central Committee on Some Issues Concerning the

the size (scale and scope) of the state economy.

147 The shareholding company has many forms, of which the corporation is a very popular one which has four essential features: first, the corporation is an independent legal person, separated from its owners; second, the owners’ liability is limited to their equity contribution; third, ownership equities are transferable; and finally, the board of directors is responsible for hiring and firing the managers (Lardy, 1998: p. 24).

148 OECD identifies corporate governance as “the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.” A more comprehensive explanation is given in “OECD Principles of Corporate Governance: 2004” (<http://www.oecd.org>).

149 From the property rights perspective, in the modern enterprise system, an enterprise is a legal person, whose total worth of is divided into shares of stock; each shareholder represents a unit of ownership and faces limited liability (only for his/her share); there is a collective body of decision-making; the right to claim residuals is separated from the right to manage; and the right to claim residuals is transferable (Liu *et al*, 1998: p.84-86).

Establishment of a Socialist Market Economy System” – in November, 1993. The fundamental objective of the SOE reform was then decided as establishing the modern enterprise system and corporatizing SOEs into independent profit-oriented companies with “*chan quan ming xi, quan ze fen ming, zhen qi fen kai, ke xue guan li*” (clearly defined property rights, clearly defined rights and duties, separation between the government and the enterprise, and scientific management)¹⁵⁰. The Company Law on how to govern the corporatization and companies became effective in July 1994¹⁵¹.

The main purposes of the modern enterprise system have been determined as (Gao Shangquan, 1996: p.86):

- to ask owners to take full responsibility for the operation of public enterprises and to enhance their operational efficiency;
- to promote the separation of ownership and management authority in order to produce the capacity for independent management, self-promotion and self-restraint, as well as for assuming sole responsibility for the firms’ profits and losses;
- to enable the rational deployment and optimum organization of the factors of production so as to enhance the performance of the publicly owned enterprises;
- to absorb idle funds in order to transform consumption into production and correct the balance between supply and demand; and
- to take over and control enterprise shares and to coordinate lateral associations so as to produce economies of scale.

“Unlike other governments that choose corporatization as a stepping stone to privatization, the Chinese government has adopted corporatization as a lasting solution for the underperformance of Chinese SOEs” (Zhang Leyin, 2004: p.2034).

The implementation of Chinese corporatization has followed two distinct sub-phases: the period 1994-97; and post-1997. In the first phase, co-ordinated experimental corporatization was carried out among selected SOE groups. This involved 100 SOEs at the national level and 2348 SOEs at the sub-national levels (RIIE, 1998, p. 20). The corporatization programme was

150 This is the 16-word principle of the current SOE reform. Official information can be found online:

http://english.people.com.cn/200410/30/eng20041030_162190.html

151 Three forms of company are governed by the Company Law (Clarke, 2003: p.496):

(a) a company limited by shares (*gu fen you xian gong si*), the approximate equivalent of the large stock corporation in Western countries;
(b) a limited liability company (LLC), intended for a much smaller and more closely knit group of investors; and
(c) a wholly state-owned limited liability company where all the shares of stock are owned by a state agency.

given important impetus by the 15th CPC Congress in 1997, which decided that, though public ownership would remain the mainstay of China's SOE, it could take multiple forms, among which shareholding companies would be the principal one. The Congress also decided to adopt the strategy of 'seizing the large and let go the small' in handling the reform of Chinese SOEs in order to ensure state control of key industries, especially those considered as strategically important (ibid: p.2034).

As the corporatization was applied to SOEs, the non-state assets could then find their residual claimants other than the state. The term 'own' did no longer mean 'own the (entire) enterprise'¹⁵², but meant 'own a share of the enterprise's stock (or assets)'. The mixed ownership structure in the corporations thus began to challenge the term 'SOE'. I need to mention here that I continue to call the corporations (where the state has shares) SOEs for convenience for the further analysis.

But two problems remain unsolved for the corporatization. *First*, there may be conflicts between the interests of the state and other – private – owners (shareholders) as the state had had multitasks for investing in SOEs. Since the state still controls a dominant part of shares in listed companies and other forms of shareholding companies, the interests of private owners – mostly profit-related – might be damaged and this could scare private investors away from the corporatization. Thus, to make the corporatization work, one possible solution is reducing the state's interest to 'stock value-maximization', so as to ensure the private interest¹⁵³. The 'relieving burdens' policies proposed by the marketization were also welcomed by the ownership school and were put into use in 1995. A *second* possible solution is reducing the state share (*jian chi guo you gu*). If private owners are dominant, the corporation's behaviour must be confined to benefit the private interest. However, reducing the state share must be effectuated in the stock market. The implementation of any 'reducing state share' programme must cause a series of problems in the financial domain¹⁵⁴. Hence, the Chinese government has been very cautious about reducing state shares. A *third* possible solution is proposed by Zhang Weiyong (1997: p.73). He argues, "as long as the state is a stockholder, it becomes impossible to separate the government from enterprises. [So his proposal is to] transform the state assets into creditor's rights instead of stock ownership. A creditor's rights are complete

152 To be noted that 'own the entire enterprise' is still applicable for the wholly state-owned limited liability company as an exception.

153 I do not distinguish the different interests among private owners, which may be stock value maximization, dividend maximization, market share maximization, profit maximization, and so on.

154 In fact, the Chinese government implemented a 'reduction' programme on the 12 June, 2002. But its negative influence on the stock market made the government stop the programme only ten days later (<http://www.business.sohu.com>).

when periodic interest payments are made ... Failure to meet their obligations could result in bankruptcy.” So, the state should have no control right on enterprise, only if it goes bankrupt. In fact, the passive stockholder (e.g. the *prior stock* has no right in decision-making) has also this effect. Two implications of Zhang’s proposal are that state stock is only an interest-generating system for the state and the state, as a positive stockholder (having the right in decision-making), must therefore badly damage the enterprise’s business performance. The former has become the guidance for the SOE reform, but the latter has not yet been adopted by policy-makers because the Chinese State still appreciates maintaining certain controls over the decision-making in large-scale SOEs for political concern¹⁵⁵.

The *second* problem is who represents the state to be responsible for the state share or to control the state assets. This is the core of the current SOE reform which is focused on the reform of the state assets management system.

(d) State assets management system

After the foundation of the PRC, state assets were divided into two groups, managed by (i) the central government and (ii) local governments (at the provincial and city levels) respectively. But there were no clearly defined property rights for these governments at various levels. Until 2003, multiple state agencies of the central government (e.g. Ministries) were in charge of the SOE for different aspects of their operation. For example, the Planning Commission was in charge of SOEs’ programme-planning, the Economy and Trade Commission in charge of enterprises’ daily operation, the agencies of labour and social security in charge of labour and wage, the Ministry of Finance in charge of the asset registration and usage, the departments of organization in charge of personnel, and the CPC’s Central Large-scale Enterprises Working Committee in charge of director appointment¹⁵⁶. Hence, an SOE had multiple bosses at different levels in the administrative hierarchy and in different economic departments. But none of them took the responsibility for the state assets especially when the loss appeared. In addition, after SOEs were granted more and more decision-making rights during the reforms, the state assets management system and the property rights system became urgent issues for the Reform.

Since 1988, a series of policies and measures, laws and regulations, and restructuring of government institutions have been put into effect in various localities and the central

155 This relates to the state assets management which will be discussed later.

156 The information is given by Zhang Zhuoyuan in a comment published on www.xinhuanet.com, February 7, 2003 .

government in order to improve the state assets management (Cai Rongmin, 1998; Wang Haibo, 2005). Drawing upon the experiences, a new state assets management system (SAMS) was put into practice at the CPC's 16th Congress in 2002. In this system, state ownership is the prerequisite, i.e. all the Chinese people are principal while the state is agent; state assets are divided into two groups – the central government (represented by the State Council) and local governments (at the provincial and city levels). A three-tier organization is created to manage state assets at each level:

- (i) upper-tier – (state assets supervision and management organizations (SASMOs);
- (ii) intermediate-tier – state assets operation organizations (SAOOs); and
- (iii) down-tier – SOEs, i.e. enterprises which have state assets.

In this new state assets management system, the SASMOs are the only authority to represent the state; they do not undertake other social-economic management functions. While other government organizations have no rights or duties to deal with state assets. The SASMOs granted authorities to the SAOOs to manage state assets. The SAOOs mainly have two forms. One is State Assets Holding Company which is transformed from the previous supervisory state agencies with administrative functions transferring to the government organizations; the other is Enterprise Group in which the well-performing SOEs have the leading role. SOEs at the down-tier are corporatized into independent accounting and profit-oriented companies in wholly state-owned holding, or shareholding forms. Board of directors, the managerial and Board of supervisors compose the management system inside SOEs. Independent public accounting firms are developed to examine and publish SOE's accounting information.

The central State-owned Assets Supervision and Administration Commission (SASAC) was created to take over SASMO functions in March, 2003, under the leadership of the State Council. It directly controlled 169 large-scale SOEs with the total assets amounting to about 6900 billion yuan RMB¹⁵⁷. Till the end of December, 2004, 32 local SASACs were created at provincial level and 203 (among 448) at city level, under the direction of local governments¹⁵⁸. A “Temporary Regulation of State Assets Supervision and Management in Enterprise” was inaugurated on June 5, 2003, and granted SASACs to participate in personnel assignment (selecting CEO, directors, etc.), making decisions for significant affairs (bankruptcy, acquisition, etc.) and programmes (investment, capital collection, strategic planning, etc.) in place of the owners of state assets in SOEs (Wang Haibo, 2005).

157 See <http://finance.sina.com.cn>, May 22, 2003. 1 US dollar = 8.27 yuan RMB.

158 The data is given by the Chief Director of the central SASMC, Li Rongrong, on the 14th January, 2005 (<http://finance.sina.com.cn>).

The SASAC is still young and the state assets management is far from perfect. Two defects are obvious. *First*, the SASAC is under the leadership of the State Council, the apex of the government system. To completely separate government from enterprise is impossible. In order to guarantee the profitability of the state assets, the SASAC can take advantage of the aid from governments to monopolise certain industries (i.e. petroleum, natural gas, mining, weaponry, electricity, aeronautic facilities, etc.) for SOEs under its control. Although the SASAC intentionally operates a few giant SOEs in each industry so as to build oligopoly or monopoly markets¹⁵⁹, and the inter-SOE competition can theoretically improve the efficiency of these SOEs¹⁶⁰, it is a problem that the state monopolizes these industries without competition from private actors. If the inter-SOE competition is really efficient, why should SOEs not operate in the competitive markets?

Second, the authority of the central SASAC over local counterparts is ambiguous. Local SASACs are agents of the locally owned state assets, so they must be responsible to local governments which are (intermediate) principals managing these assets, and at the same time to the central SASAC which is the ‘boss’ of all local SASACs. When there is a conflict between the local and central interests in dealing with certain locally owned state assets, the SASACs and governments at various levels may encounter difficulties.

(e) Criticisms on the ownership school

Although the SOE reform has finally come to corporatize SOEs and include them into the modern enterprise system, the SOE problem is not completely solved yet. The ownership reform and its main method – corporatization – do not cure all ills. Many problems that have emerged since the ownership reform complicated the SOE reform and the institutional transition of the national economy. Three problems resulted from the ownership reform.

First, in practice, the corporatization does not meet the goals set forward by theory. Transforming SOEs into ‘corporations in form’ is not the objective, but building effective and

¹⁵⁹ The SASAC clearly declares that the state economy will monopolise seven industries, including military and weaponry, electronic and electric, petrol-chemistry, telecom, coal, aeronautic, and shipping. The state economy is planned to consist of 30 to 50 giant SOEs, which are internationally competitive large enterprise groups, by 2010 (see news reported on <http://www.sina.com.cn>, December 18, 2006).

¹⁶⁰ According to the information released by the central SASAC, the SOEs under its controlled have made great profit in 2004. By the end of 2004, the total assets in these SOEs had reached 9194.81 billion yuan RMB, increasing 12.3% from the end of 2003. Eight SOEs among them have been listed in the Fortune’s Top 500 of enterprises in the world in 2004 (<http://finance.sina.com.cn>, February 9, 2005). An investigation of the performance of these SOEs in the first half of 2005 is also available (21st Century Financial Report, August 27, 2005).

efficient corporate governance structure is the real purpose of corporatization. It is regretful that in many cases of corporatization, reformers only stress the change as a matter of form. Such corporatization does not help the SOEs to improve their performance, but only aggravates their difficulties, because the corporatization is costly¹⁶¹.

According to the logic of the reformers, as Li Ji *et al* (2005) criticize, after corporatization, private stockholders (both person and enterprise) can participate in governance and be responsible for their stock; the corporate governance seems to be a natural, automatic outcome of the corporatization. However, in China, this outcome is not easy to obtain. Li *et al* (2005) conclude, according to their survey of 587 Chinese listed companies, that, *destatization* is not a necessary factor to improve the managerial performance; managers in the new corporations can still be self-opportunist at the expense of the other stockholders. This is true for, at least, two reasons:

- Some SOEs become ‘corporations’, but do not change the governance structure, and the numerous small stockholders have no de facto rights in important decision-making. In addition, this also causes the misuse of the stock market as a means for ‘money enclosure’¹⁶², rather than for improving the governance structure.
- Means to supervise managers are insufficient. This is a common problem for all corporations. The scandals of Enron and WorldCom in the US in 2001 and 2002 are examples of the abuse of managerial power to mislead the public by accounting fraud. Successful corporate governance depends on a set of institutions for its implementation. As Clarke (2003: pp.503-504) says, “in the United States ... corporate governance of public companies depends not only on the existence of markets for equity, debt, managerial talent, and corporate control, but also on intermediate institutions (such as the financial press and the legal and accounting services industries) and legal institutions such as courts, the Securities and Exchange Commission, and private litigants ... [These institutions] all exist [in China] only with government permission and cannot simply spring up in response to market demand. There is no real market for corporate control, and the market for managerial talent is still very small.” Hence, the undeveloped market economy makes Chinese corporatization not only a solution to the SOE problem, but also a sense of problems.

161 Here I give one example to show how costly the corporatization may be. The SOE that I investigate was following the procedure of corporatization. In 2004, it changed its name from ‘XX Enterprise’ to ‘XX Company’. As a result, it must pay about 2,000,000 yuan RMB (in 2004’s price) to the municipal transport department for re-subscription and printing the new name on its means of transportation. There are also other costs to pay for the procedure. But this SOE has paid only 60% of the due wages to its employees for months.

162 The ‘money enclosure’ is in analogy with ‘land enclosure’ in England from the 12th to 19th centuries.

Second, local governments have shown great enthusiasm to ‘sell out’ (privatise) the state assets under their control, compared to the more ‘conservative’ attitude of the central government that still firmly controls a large volume of state assets in SOEs. There were two stages in this ‘sell out’ movement. Before the establishment of the new state assets management system, the ‘seize the large ones and let go the small ones’ policy had promoted local governments to corporatize small and middle scaled SOEs into shareholding cooperatives, joint-ventures through various ways, such as leasing, contracting, and merging, or privatise some ones. Until the end of 1998, about 80% small scaled SOEs were transformed into diverse forms of self-standing enterprises (Chen Jiagui *et al*: p.155). At that stage, state assets were still under the control of local governments. When the new state assets management system was proposed in the CPC’s 16th Congress in 2003, a second stage of selling out state assets started, followed later by precise laws, regulations, and the establishment of authorities. Some provinces and cities even put forward plans to privatise nearly all the local state assets¹⁶³. Three reasons promoted the local enthusiasm (*ibid*):

- Local governments are tired of dealing with the local SOEs, most of which are loss making;
- Local governments understand that local economic development cannot only depend on local SOEs, foreign capital and domestic private capital have to be promoted to restructure the local economy;
- A part of the ‘local’ state assets must be transferred to the National Fund of Social Security and only the rest will be locally-owned. So, local governments were eager to transferring the state assets to other forms under the control of local governments before returning them to the state.

However, corporatization and privatization in both stages are not targeted at improving the profitability of state assets or SOEs. Many profit-making SOEs have also been corporatized or privatized. An implication of such government-driven privatization was that (local) government did no better than private asset-owners in efficiently dealing with assets¹⁶⁴. The SOE reform ended, at the local level, as privatization. If there was no SOE, there would be no

163 See two news reports for this phenomenon in 21st Century Financial Report, September 8, 2003, and Journal of Economy Observation, November 10, 2003.

164 This idea is proven by my interviews with more than twenty county government officials in China during 2004 to 2005. The interviewees state that government cannot operate assets or enterprises so efficiently as private actors.

SOE problem. But, there is still a problem emerging in the processes of corporatization and privatization. This is the third problem I will discuss – justice.

A key step in corporatization is to turn state assets of SOEs into shares and distribute them among stockholders (not only state agencies). Privatization, in this sense, can be regarded as a subsequent step involving the sale of the state stock to private actors. Both corporatization and privatization involve transaction of property rights of state assets. How to evaluate the assets and who can be the stockholders? These are two questions essential for the transaction. A series of regulations and measures have been implemented since 1991 for assets evaluation (Chen Jiagui *et al*, 2000: pp.265-266). But before they were strictly obeyed, the transaction was a good chance for relevant agents to embezzle state assets through under-evaluating assets. The under-evaluation may have various causes. For example, drawing upon investigations in some localities, Yao Yang criticizes that the local governments are guilty of the loss of state assets as they under-evaluate or sell state assets ‘on discount’¹⁶⁵ in order to privatise the local state assets as soon as possible¹⁶⁶. The insider control also gives some SOE managers a chance to buy out their enterprises’ stock at low price as the procedure is not well supervised by state agencies or the public – like transacting in a black box. Some managers even deliberately let their enterprises run losses to reduce the price of the enterprise’s stock to buy it out.

The identity of stockholders is more troublesome. The state assets are in theory owned by all the people, in consequence state shares should be owned by all the people. This principle is obviously difficult to implement in practice as the cost of transaction is too high. For instance, do the newly born infants have their shares of the state stock, and how to let all the people supervise the utilization of state assets without degrading economic efficiency? Feasible measures are needed to facilitate the transaction.

MBO (Management-Buy-Out of an enterprise’s stock) has been a common means to privatize SOEs in China since 1997¹⁶⁷. “MBOs are transactions in which the management of a company gains ownership by purchasing its outstanding shares from the parent firm or its owners with his or her own money” (Hu Yong, 2005). In China, managers usually do not

165 Yao Yang’s argument is reported in Beijing Morning Journal, December 8, 2004.

166 It is possible that government officials and SOE managers collude with (private) buyers and corrupt during the transaction. Such crimes are often reported in newspapers. See for example, People’s Daily, May 7th, 2003.

167 See a brief introduction of Chinese MBO history in Asia Private Equity Review, February 4, 2003.

have the necessary funds for a MBO. So in many cases the state-owned banks pay the bill. MBO is expected to provide compensation to managers by gains from stock¹⁶⁸ and stimulate them to improve the enterprise's performance. It seems also that SOEs often make losses because their managers *deliberately* make them do so due to the 'insufficient' material incentives, rather than the managerial incapability! As a consequence, managers will not care about the profitability of state assets (or SOEs) unless they own the assets! So, the SOE is doomed to be inefficient according to this proper logical starting point!

A problem is the loss of state assets caused by MBO. There are no sufficient supervisory institutions on the MBO practice in China. As the state stock does not circulate on the stock market, managers gain control of a firm at rock-bottom insider prices through a negotiated transfer of non-circulated shares, rather than an open purchase of outstanding stocks (Hu Yong, 2005). In many cases, MBOs are carried out in a black box. According to his numerous case studies in corporatized SOEs, Lang Xianping has disclosed several methods by which SOE managers have embezzled state assets through MBO since 2001. His studies attracted a great attention of the public to the loss of state assets (see Liu and Zhang, 2005; Deng Yuwen, 2005).

Another problem of MBO is legitimacy. If 'all the people' do not approve the MBO, who has/have the right to permit management buy out? Sheng Hong (1996b) gives an answer as "*jiao yi xian yu chan quan*" (transaction prior to property rights). According to this answer, any arrangement of property rights is the result of a transaction; in order to achieve the transactions which can improve economic efficiency of utilising resources or assets, the existing arrangement of property rights does not matter; specifically in transactions during the Chinese transition, those who have control (not residual claim) over resources and those who have sufficient money to buy the resources can transact, as these resources are supposed to have no owners (if the owners – all the people – are taken into account, the transaction costs are very high to damage the economic efficiency); such transaction is believed to bring efficiency to the economy, but justice must give way for efficiency (this is the very logic of the Reform). It is similar to the 'good corruption thesis' mentioned above. 'Owing to' this thesis, MBO – as a measure that can improve SOE's profitability and the economic efficiency – is good and managers are allowed to embezzle the property of 'all the people'. The debate

168 Some SOE directors and managers have contributed greatly to the success of their enterprises in making profit (e.g. millions of yuan RMB per year), but their material incentives are not significant (e.g. 20000 yuan RMB per year). Hence, the material incentive for these successful directors and managers are not proportional to their contribution.

on MBO is going on in China and no definitive policy is yet brought about¹⁶⁹. The central SASAC is looking for a solution for the corporatization of SOEs considering both efficiency and justice.

In addition to the MBO, many other actions in corporatization have caused great loss of state assets. For example, managers in an SOE may use the enterprise's capital to create or invest in a private enterprise, or directly create a new private corporation (an independent accounting unit) under their 'control'. Through a set of accounting operations, the SOE will suffer a loss of assets and go bankrupt. Thus, the managers succeed in transferring the SOE's assets to their personal pockets or new arrangements. Furthermore, when an SOE bankruptcy is officially recognized, the government will offer a sum of funds to compensate the employees. These funds can be secretly retained by the managers as supervision is inefficient¹⁷⁰. Not only the state, but also the involved SOE employees become victims.

The corporatization has become one of the most concerned issues by the Chinese people for the loss of state assets and SOE employees. But, as the Chinese government declares, the orientation of the SOE reform will not change, i.e. the corporatization (the privatization is not mentioned here) must persist. Attention should be paid to improve the legal system and the state assets management system.

Summary

This section has surveyed three competitive schools of thought of the SOE reform. All three schools are targeted at improving SOEs' business performance through stimulating incentives for SOEs (the enterprise) and in SOEs (employees). The incentive school is confined to the incentive itself, while the market economy and state ownership are not the central issue. The marketization school focuses on the marketization to create and maintain a fair competitive market environment, so that the external (market) constraints will improve the incentives. The ownership school uses the theory of property rights to guide the institutional transition. It asserts that only if state ownership is broken down and a clear property rights system (although state ownership is not yet proposed to be abolished) is established, the incentives can be truly stimulated and the marketization can be completed. A synthesis of the three

169 After Lang Xianping raised the debate in 2004, the central SASAC stopped the MBO in large-scale SOEs. But in the beginning of 2006, a new regulation was put into effect to 'partly' recover MBO in SOEs. The result is not observable yet.

170 The director of the central SASAC, Li Rongrong, mentions this problem in his report on the SOE reform, see <http://finance.sina.com.cn>, July 21, 2005.

competitive schools of thought of the SOE reform, with comparison to the SOE model before the Reform, is given in Table 3-3.

From 1993 on, the Chinese government has decided to establish a ‘modern enterprise system’, in which SOEs are corporatized into self-standing units. Following a 16-word-guidance – ‘clearly defined property rights, clearly defined rights and duties, separation between the government and the enterprise, and scientific management’, the three schools have finally been integrated into this system. Although there are many shortcomings in theoretical guidance and mistakes in implementation, Chinese reformers have shown considerable confidence in the modern enterprise system. It seems that the SOE reform reached the end of the system-design stage, and this system now should only be perfected. Efficient corporate governance (in business corporations) is still a central issue in studies of the theory of the firm and the theory of property rights. Since the Chinese market institution is still less developed, with regard to the pricing system, the legal system, and so on, there is no ready-made model of corporate governance for Chinese corporatization of SOEs.

Table 3-3: An outlook of the three competitive schools of thought of the SOE reform in changing the traditional SOE

	The traditional SOE	The incentive school	The marketization school	The ownership school
State ownership & State-Party-SOE relationship	<ul style="list-style-type: none"> ➤ multitasks ➤ the state's infinite liability for SOEs ➤ the four-level administrative supervision system 		<ul style="list-style-type: none"> ➤ separation between the government and SOEs in business operation ➤ relief of multitasks from SOEs ➤ SOE's exit from competitive markets ➤ grasp the large SOEs and let go the small ones 	<ul style="list-style-type: none"> ➤ establishing the modern enterprise system; ➤ transforming state ownership of enterprise into state ownership of assets ➤ dividing state assets into two groups – central government controlled and local government controlled assets ➤ the three-tier state assets management system – SASAC, SAOO and SOE ➤ corporatizing SOEs into various forms of business firms
Management system inside SOEs	<ul style="list-style-type: none"> ➤ the one-man management system ➤ the Party-command system ➤ emphasis on ideological re-education ➤ the mass supervision 	<ul style="list-style-type: none"> ➤ the director-responsibility system ➤ the state assigns directors 	<ul style="list-style-type: none"> ➤ the director-responsibility system ➤ the state selects SOE managers from the market 	<ul style="list-style-type: none"> ➤ corporate governance: <ul style="list-style-type: none"> ○ board of directors ○ managerial ○ board of supervisors ○ self-standing business operation
Incentives	<ul style="list-style-type: none"> ➤ no specific incentive for enterprise ➤ lack of material incentives ➤ emphasis on non-material incentives 	<ul style="list-style-type: none"> ➤ granting enterprises some authority of decision-making: <ul style="list-style-type: none"> ○ relaxation of plan constraints ○ procurement of materials ○ power of recruitment ○ relaxation of foreign trade control ➤ profit sharing systems: <ul style="list-style-type: none"> ○ the point system ○ the contract system ○ the above-norm piece-rate system ○ the linkage system ➤ emphasis on material incentive for employees <ul style="list-style-type: none"> ○ the shareholding system ○ the contract responsibility system 	<ul style="list-style-type: none"> ➤ transforming SOEs into profit-oriented and self-standing enterprises ➤ downsizing SOEs by reducing redundant employees and relevant costs ➤ marketization of financial capital for SOEs: <ul style="list-style-type: none"> ○ reducing government subsidies to SOEs ○ the banking reform ○ the stock market 	<ul style="list-style-type: none"> ➤ transforming SOEs into profit-oriented corporations ➤ emphasis on the managerial incentive

Source: Author's design

Conclusion: Redefining the SOE in a Modern Enterprise System

This chapter has focused on the institutional change of the SOE during China's Reform since 1978. Before addressing the SOE, in section 1, I made an overview of the overall Reform, illustrating how the "rules of the game" spelled out in Chapter 2 have changed on the basis of the Reform's logic. *Firstly*, the answers to three questions – Why Reform? Why Reform then? What to Reform? – are helpful to understand the Reform's rationale, i.e. improving the economic efficiency with the purpose of achieving Socialism. *Secondly*, I summarise five characteristics of the Reform to illustrate how China's economic system has gone through transformations from the traditional socialist 'Game' to the current socialist market economy:

- (1) theoretical hesitation and ideological emancipation;
- (2) state-led and Grassroots-promoted reform;
- (3) gradualist approach;
- (4) from reforming outside-the-Planning to reforming the Planning; and
- (5) Experiment-Example approach

A key 'contribution' of the Reform is the rebuilding of the economy on the basis of the market logic. Drawing upon the experiences of the pre-Reform economy and foreign market or mixed economies, Chinese economists concluded that the optimal allocation of resources in pursuit of profit-maximization is the core of the market logic. This fundamental transition from central planning to market regulation has to a great extent modified the rules of the 'game' (see the conclusion of Chapter 2). Since the Reform began, the whole state apparatus has been redirected towards economic growth. However, the emphasis on economic growth facilitates the rise of *economism* in the reforming China and the traditional socialist ideology tends to be peripherized. Conflicts between the market logic and the socialist politics accompany the evolution of the Reform.

Since the Reform, the traditional SOE found it more and more difficult to operate because the economic system was fundamentally transformed to become market-oriented. The SOE reform has shown a nearly synchronic evolution with the overall Reform. The characteristics of the Reform are also applicable to the SOE reform. For example, the step by step involvement of theories related to the SOE led to a gradualist SOE reform; the Experiment-Example approach was necessary for advancing the reform and offer sources for of theoretical improvements; experiments were either led by the state (owing more to the theoretical

research) or promoted from the grassroots up (owing more to the local context), and they interacted and complemented each other in a more valuable guidance for further reform.

The second section of the chapter has reviewed the backing up of the SOE reform through the contributions of three schools of thought which have guided the reform according to both theoretical and practical dimensions: the Incentive, Marketization, and Ownership schools. These schools have proposed different logics and policies for transforming the SOE. They respectively target at the three components of the traditional SOE model –incentive system, management and state ownership.

The incentive reform aims at improving the efficiency of corporate operation through granting SOEs more rights of decision-making and differentiating material rewards to SOEs and their employees according to their contribution. It is limited to reforming the incentive system of the traditional SOE, with no regard to (state) ownership and the management system. But the traditional SOEs have difficulties in market competition and to make them more market-fit a further reform of the traditional model is needed. The marketization school increases its influence on the reform guidance, owing to the rapid marketization in the overall economic system. It suggests SOEs to compete with non-state firms in markets so as to improve the efficiency of both SOEs and the national market economy. Hence, relieving SOEs from their multi-tasks and transforming them into profit-oriented enterprises are mandatory, while state ownership is not the central type of ownership relation for the reform. Although the SOE maintains its public ownership structure, its economic, social and political functions under the traditional socialist ideology have changed a lot in practice. It is obviously questionable that if state ownership is not favourable, why it must remain. Furthermore, the Marketization school is severely criticized by economists who insist on theories of property rights and emphasise the inefficiency of state ownership. Thus, the concerns about the SOE reform are shifted to state ownership. Non-state agents are permitted to have shares of state stock in SOEs (except for the SOEs that are still wholly owned by the state) so that state ownership of the enterprise is changed to state ownership of assets in an enterprise. Reformers require SOEs to transform into corporations. Corporate governance is adopted to handle the conflicts among diverse owners and solve the principal-agent problem inside the corporations. A new state assets management system is established to distribute state assets to central and local governments and state assets are managed by a three-tier organization. The State Assets Supervision and Admission Commissions are created at central and local levels and function as state agents

responsible for the revaluation of the state assets. Although the three schools of thought dominated the SOE reform in turn, their measures are now often used together – or at least in a partial mix – in practice for reaching diverse objectives over the same period. Since the end of 1993, the SOE reform has been oriented towards the build-up a ‘modern enterprise system’ with ‘clearly defined property rights, clearly defined rights and duties, separation between the government and the enterprise, and scientific management’. The SOE is redefined as a corporation and the state control over SOEs is shifted to the control over state-owned assets. Profitability is the central criterion of the reform.

Even though the ‘modern enterprise system’ has still many deficiencies and needs to be improved (especially improving the state assets management system and the corporate governance inside SOEs), the SOE reform has improved the profitability of the state assets (especially those under the central control). The current SOE reform, according to its logic, can be praised as a success. Although scholars still seriously criticize the SOE reform, their proposals for further SOE reform are all confined to the current reform’s framework, such as stressing social justice by calling for more attention and compensation to the reform’s victims, reducing the loss of state assets, and perfecting the corporate governance, etc. Does this mean that the remaining task for the SOE reform is only to improve the ‘modern enterprise system’? Is the profit-orientation of the SOE finally fixed following criteria that show no intrinsic difference to those applied in private firms? Indeed, perfecting the ‘modern enterprise system’ can only make SOEs profitable on markets and makes it hard to perform other specific functions responding to specific needs within particular institutional, historical and spatial/territorial contexts.

Reviewing the fourth feature of the traditional SOE, i.e. the SOE’s contribution to local development (introduced in section 2.3), is found not to be included within the reform’s concern. From the perspective of local development, the framework of the actual SOE reform has the following deficiencies:

- The policy-makers regard SOE-located spaces homogenous and ignore the diversified local situations. The reform principles are worked out from the central level and standardised for the entire country. But SOEs in different localities may have different functions and values, and their reform faces different problems. The highly standardised principles are not guaranteedly helpful to local SOE reforms and it is still difficult for local reformers to work out concrete measures for the local reform (according to my

investigation in China). So the critical problem is how to implement the local SOE reform. Many localities hold up the local SOE reforms because the reforms are too costly for the local capacities to implement, e.g. paying material compensation to the unemployed workers and the relevant social security services are beyond the fiscal capacity of many local governments.

- The past SOE reform only concerns the SOE-located localities and the existing SOEs. The policy-makers believe that the reduction of SOEs will contribute to the marketization as well as stimulate private enterprises. But is private enterprise sufficient to develop local economies in the current context? The question will be more serious for the less developed localities which are not favoured by private investment.
- The policy-makers take for granted that profit-making SOEs contribute to the local economies by offering jobs and paying tax. But different local contexts may result in different functions of SOEs. The standardized principle of profit-maximization and the relief of multitasks from SOEs diminish SOEs' potential functions in local development.

Due to these deficiencies, the link between the SOE and local economy is broken up. The SOE is abstracted from its local context and is reduced to be profit-oriented. The diverse roles that SOE may play for economic development of LDLs are not an issue in the SOE reform for present. This is the main shortcoming of the framework of the actual SOE reform. So far, combining the previous two chapters, we can recognize the evolution of the SOE from the traditional model to the present profit-oriented corporation and the deficiencies of the latter from the local perspective. In the next chapter, I will integrate the local economy into the SOE study with two objectives: to correct the SOE reform's framework and to disclose the SOE's potential for promote economic take-off in LDLs.

CHAPTER 4

RETHINKING THE SOE REFORM FOR LOCAL DEVELOPMENT

Introduction

The two precedent chapters have reviewed the evolution of Chinese SOE from the traditional mode to the current profit-oriented corporation mode in the context of the institutional transition – the Reform from 1978 onwards. The economic-social uneasiness caused by loss-making SOEs and the mainstream guidance of the SOE reform (which is scientifically legitimated) have convinced the Chinese people – or the public opinion in China - to accept the current SOE reform as the ‘best’ solution to ‘save the SOE’; and ‘closing loss-making SOEs’ is also believed by reformers as a method to ‘save the SOE’. The traditional SOE has been transformed fundamentally according to three dimensions – incentive, management and ownership. But there have been no policies or measures ‘directly’ targeted at the fourth dimension of the traditional SOE – the SOE’s functions for local development. This is not surprising because mainstream economists narrowly limit enterprises’ contribution to the development of a locality (and even to society) to tax payment and job creation.

Corporate social responsibility (CSR) has increasingly become a concern of enterprises, governments and NGOs (see Habisch *et al.*, 2004; Werther and Chandler, 2005; Beth and Ruggie, 2005; Pougnet-Rozan, 2006). People have managed to develop enterprises’ social responsibilities in order to reduce their negative externalities to society. But CSR is not yet mandatory for enterprises and its implementation varies across countries, localities, and enterprises. In Chinese enterprises which are profit-oriented, including the reformed SOEs, it is easy to observe that CSR has to give way to making profit. Thus in China, CSR can hardly enhance enterprises’ contribution to LDLs. Furthermore, CSR mainly concerns existing enterprises. It cannot solve the LDLs’ lack of entrepreneurial activities.

According to ‘reformers’, the LDL problems are mainly due to the undeveloped market mechanisms and the unfavourable environment for the market economy. As solutions, a series of *laissez faire* methods through a market-friendly approach are proposed by Chinese reformers to ‘let the market be’. But the facts show that the market-friendly approach does not

help LDLs as much as reformers propagate. Seen from the perspective of local development processes during the past two decades in China, the developed localities do not only owe their ‘self-development’ to the local markets, but also to their local governments’ intervention and the central policy favouring effective public-private cooperation. Today, LDLs should only exceptionally be criticized for their *laziness* or *resistance* to promote the local market because in fact, most LDL governments are following the centrally required market-friendly approach and making every effort to improve the local business environment. But a big difficulty for local governments is the shortage of effective means, especially restrained by the insufficient local fiscal revenues and the withdrawal of government intervention in the economy. Both heavily constrain LDL governments’ potential to launch new positive initiatives of the kind which benefited the present developed localities in the past twenty years. The consequence is that when every local government engages in improving local business environment and in the ‘war for investment’, LDLs have not become winners as the market-friendly approach cannot enhance competitiveness for local economies if their endowments are poorer from the beginning. Indeed, ‘*to create and maintain a favourable environment to a developed market*’ is not the means for the LDLs to develop their economies, but a possible fruit of economic development itself which needs to be fuelled through other channels. So, the market-enhancing approach needs to revalorise public-private cooperation, hence allowing the state to play its steering role in cooperation with resourceful private partners.

As explained in Section 1.2, the SOE is put forward to be a or rather *the* platform of public-private cooperation. To let SOEs fulfil this task, the current SOE reform is not sufficient, because it emphasises the SOEs’ survival on markets while ignoring their special functions in local development. This chapter will focus on two issues. The *first* issue is: what is the main problem of China’s LDLs with regard to the evolution of spatial development strategies? The *second* issue is: how can SOEs – even though not all SOEs – contribute to the economic development of LDLs when they make profit.

This chapter has three sections. The *first* one gives a brief introduction to the transition of Chinese spatial development strategies since 1949 and explains the institutional context of spatial development. Next, a survey of three local development models in the Reform period is made to show different mechanisms of local development, with different critical roles for public-private cooperation. The *second* section tries to answer the question why the Reform did not succeed in the LDLs. It begins with an introduction of the present endeavours to

develop the LDLs in China, and provides a synthesis of blocks to economic development in LDLs as covered in my investigation in Chinese localities (introduced in section 1.3). The shortage of financial capital and insufficient institutional arrangements are emphasised. The *third* section explains the proposition that a group of SOE can be an institutional arrangement for public-private cooperation in order to help LDLs develop their local economies. Both survival capability and special functions of proposed SOEs are taken into account for a feasibility study.

4.1 Transition in Spatial Development Strategies and Local Development Styles

4.1.1 The Pre-Reform Coordinated Regional Development Strategy

As commonly acknowledged by Chinese scholars, spatial development in the pre-Reform China (1949-1978) followed a balanced and coordinated strategy (see Zhang Wenhe and Zhang Hongfen, 1993; Zhu Houlun, 2004). In fact, this strategy was implemented within the different forms of the economy, which were constrained by the ‘economic legacy’ and ‘international relations’ (see Section 2.1 and 2.2). Constrained by the shortage of foreign trade in the 1950s and 1960s, China must develop her economy through valorising her own (natural) resources. Led by the *gan chao* strategy and its HIODS, the geographical allocation of natural resources which were main production factors for the heavy industries determined the location of economic and social activities, e.g. the newly built SOEs and cities were mainly near resource bases. The inland (in contrast with the coastal land and including the West and the Middle China) and a few industrial bases in the East of China (e.g. Liaoning Province) received a larger part of the centrally subsidised investment for industrial projects. Due to the concern about the military threat from both the capitalist bloc and the USSR, therefore following the logic of the Military Economy, the ‘Three Fronts Construction’ also directed many industrial projects, human resources, enterprises and financial capital to the inland, in particular the less developed West in the 1970s. In addition, a major task for the CPC in the early years of the PRC was to develop the inland, because the larger part of soldiers in the CPC’s army came from the poor inland that was struggling for survival; therefore these soldiers were highly motivated to participate in the revolution. Complying with the socialist egalitarian ideology, developing the (economically) poor inland was an important political task, rather than a single economic task, for the then PRC’s leaders.

Owing to combined efforts, such as the enormous investment and industrial projects allocated under the central planning system, the nation-wide labour mobility as well as the inter-SOE support programme that were successfully implemented under the direction of the central government, a large number of large-scale SOEs, cities, and industrial bases were established in the inland during the pre-Reform period (see Zhang Wenhe and Zhang Hongfang, 1994, pp.126-127; Zhu Houlun, 2004: pp.40-41). The improvement of the physical infrastructure, labour productivity and economic structure remarkably reduced the inequality between the inland and the coastal area. However, regional inequality was reduced at the expense of economic efficiency, because the inland utilised the scarce resources that could produce higher economic rents in the Eastern areas where conditions for industrial production were better. A dilemma for the balanced/coordinated strategy was that scarce resources together with the central planning system were not able to develop the entire country at the same time. Mao Zedong, in his “Ten Relations” (1956), has mentioned this dilemma. A solution to the dilemma that Mao put into practice was ‘walking on two legs’ during the Great-Leap-Forward (GLF) period. Localities, except the centrally subsidised cities, and mainly those in rural areas, could develop themselves on the basis of local self-reliance, e.g. setting up ‘backyard’ production plants. The efforts of developing the economy were interrupted by the wrong practices during the GLF and frequent political struggles like during the Great Cultural Revolution (GCR). The dilemma between the orientation of coordinated/balanced spatial development and improving economic efficiency was left to the Reform for solution.

4.1.2 The Uneven Development Strategy since the Reform

When the Reform began in 1978 and economic efficiency became the central concern for policy making, the previous balanced/coordinated regional development strategy was challenged. Deng Xiaoping, as the new leader of China and the ‘designer of the Reform’, doubted the validity that ‘all regions could develop at the same time’. Accompanying the reform of the incentive system under Deng’s guidance of ‘let some enrich before others’ and ‘to each according to his/her contribution’ (see Chapter 3), an ‘Uneven Development Strategy’ was brought about, i.e. the regions/localities which have economic advantages should be developed first, then they should help the disadvantaged ones develop. As China’s topography follows like a three-step staircase stepping down from west to east, which coincides with the three economic regions (the West, the Middle and the East) whose economic structure shows a staircase transition (agriculture – traditional industry – modern industry), a staircase-shaped gradient development model (*ti du fa zhan*) was brought about to

complement the strategy, i.e. modern industries should be developed firstly in the East, then be transferred to the Middle and finally to the West. Required by the new strategy, the coastal area (i.e. the East) should be given priority for economic development because of its easy access to the global market and good economic infrastructure. While the coastal area was still too 'large' to develop as a whole, some coastal localities were chosen as 'growth poles' (the definition of growth pole can be referred to Perroux, 1955; 1988) – to develop at first. An implication of the new strategy is that a temporary regional inequality was necessary for national economic development. This idea seems to be supported by the hypothesis of Kuznets Curve (Kuznets, 1955), which suggests that economic inequality increases over time while a country is developing, then after a critical average income is attained, begins to decrease¹⁷¹.

A precondition for permitting and stimulating localities to develop their economies is the fiscal reform, by which local governments could retain the local revenue to implement local planning, as opposed to 'all revenue should be handed over to the central government' in the pre-Reform period. A 'fiscal contract system' was implemented in 1980, by which each provincial government signed a contract with the central government to define how to share the locally collected revenues. This system was renewed in 1984 and 1988 with an obligation for lower level governments to hand over a fixed amount or a fixed proportion of their fiscal revenues to higher level governments and to retain all the rest for themselves (Zhang Weiyang, 1998). The fiscal reform has been considered an effective measure to 'liberate' local economies from the central planning system and integrate them into the market economy (Lin and Liu, 1998; Jin *et al.*, 2005). However, it has had different impacts on localities. Only those taking advantage of the market economy could benefit from the fiscal reform, while the others that encountered difficulties to develop the market economy and had to rely on the central allocation of resources were less favoured.

In consequence, the central government led a key change in the socialist ideology and revalorised the roles of the market and private forces in economic development. A set of preferential policies were authorised by the central government to favour the localities which had locational advantages in the market economy. The serious shortage of commodities

171 There is no conclusion on the correlation between economic growth and inequality (see Zen Xiangming, 2003). The hypothesis of Kuznets Curve are both verified and denied by empirical studies. The real issue for further studies is not to verify the hypothesis by theoretical deduction but to reduce inequality in real life.

(especially those for daily use) in the previous planning-dominated economy was even magnified in the newly emerged markets and aggravated pressures on the supply side. This was a good opportunity for various forces, in particular the private firms (both domestic and foreign), to grow. Many local governments led institutional innovation within their own territory and made efforts to motivate private forces to fully deploy their market potential, while other local governments still hesitated in their responses to the institutional change and lost chances to develop their local market economies. The local economy became a stage for the central government, local government and private actors to cooperate for development. Various styles have been developed and three famous among them are often cited in economic studies – the Pearl River, Wenzhou, and Sunan¹⁷² style (see Koo and Yeh, 1997). The Pearl River style shows the effects of the central preferential policies combined with foreign investment. The Wenzhou style is famous for its indigenous private economy owing to the local culture that has always supported entrepreneurship. The Sunan style demonstrates the roles of strong local government intervention in township and village enterprises (TVEs). These styles portray different paths and mechanisms of industrialization and urbanization in poorly resource-endowed (in terms of natural, human and financial resources) and low income localities, which differ from the SOE-based style in the pre-Reform period (see section 2.3). They are introduced as follows with emphasis on the roles of government intervention in local economic take-off.

(a) The Pearl River style

This style is initially observed in the four ‘Special Economic Zones’ (SEZs) – Shenzhen, Zhuhai, Shantou and Xiamen – set up in 1980. The first three SEZs are in Guangdong province and near Hong Kong; the last one is in Fujian province facing Taiwan. All of them are in the Pearl River delta. These four localities are poorly endowed by natural resources. Neither agricultural nor industrial production had been well developed there before 1980. After the reform began and the ‘opening up’ strategy was implemented in China, foreign trade boomed and sea transport became the main means for China to connect to outside economies (especially with European and American countries). The less developed economies of the four SEZs provided a good platform for the central government of China to experiment the newly introduced market economy and the recovery of the private economy, because any failure of reform measures would be confined to a ‘small’ space with limited scope, instead of causing a

¹⁷² Historically Sunan means the area centred around Suzhou, Changzhou and Wuxi, but now it means the entire Southern Jiangsu province.

widespread political crisis. In the early 1980s when other localities were still restricted by the central government for autonomy to do foreign trade and develop the private economy, the SEZs became China's 'windows to the outside world' and vanguards of the Reform (Lu Ding and Tang Zhiming, 1997: pp.39-41).

The SEZs were set up with high expectation to attract foreign investment, absorb foreign advanced technologies and management experiences that come with investment, and introduce the market mechanisms to the domestic economy through foreign investors' behaviours. In an effort to encourage foreign investors, the central government put forward a series of preferential policies for the SEZs, such as a particular tax reduction for foreign investors, authorising certain power to local governments; simplifying administrative procedures; allowing local enterprises to retain foreign currencies (instead of having to deposit all in state-owned banks) for foreign trade, etc..

In the 1980s, as the Reform was implemented in a gradualist way, the Chinese government did not open all economic sectors to foreign investors. The light industries, which mainly produce commodities for daily use, were opened up first. The low cost of labour, the huge market demand and preferential policies made by the central government significantly reduced investors' cost and enhanced their competitiveness on global markets. The SEZs achieved a great economic success and benefited both foreign businessmen and the Chinese. On the one side, more and more foreign investors were attracted to invest in China by the high return on investment and the competitive advantage on the domestic product markets. On the other side, foreign investment facilitated import-export and increased the Chinese government's fiscal revenue and created a large number of jobs and business opportunities, which were rarely seen elsewhere in the then China. The SEZs quickly upgraded to rich and competitive metropolises among Chinese localities. The development in SEZs also involved the neighbouring localities which ensured the supply of lowly skilled labour and land for both industrial and urban expansion. The spill-over effect also promoted the boom of local small-scale (private) firms in neighbouring localities as subcontractors, most of who became leading producers on the global markets and helped their localities enrich quickly. The Pearl River Delta boomed in its regional economy and its experience was named the Pearl River style.

The development of the SEZs also enhanced agglomeration effects which attracted factors of production on a nation-wide scale. Since the last half of the 1980s, the SEZs have become powerful centres absorbing nation-wide human resources – highly educated, skilled, and unskilled labour – and production materials. Private entrepreneurs also went there to develop their own business or create joint-ventures with foreign investors. Many SEZ government officials argue that the development of SEZs did not happen because of central fiscal subsidies but thanks to the market and private investors (both foreign and domestic). They neglect the critical role of central government intervention through preferential policies. Truly, the central government did not *directly* allocate resources through preferential policies as it did under the planning system, but the effects were quite the same.

The Pearl River style illustrates the roles of central government intervention through preferential policies and foreign investment in local development. In the primary stage of the development of the market, the central government adopted the market-enhancing approach through attracting foreign investors. When these investors located in China, they did not only bring finance and managerial experiences, but also market allocation experiences. All of them enhanced economic growth.

(b) The Wenzhou style

Wenzhou, a prefecture level locality in Zhejiang province, is famous for its rapid economic growth owed to locally indigenous entrepreneurship. Similar to the four SEZs, it received little attention from the central government in the pre-Reform period because both agricultural as well as industrial productions were the least developed among Chinese localities. In the early 1980s, Wenzhou was not withheld as a SEZ and did not obtain any support from the central government. Furthermore, the understanding of Socialism at that time still heavily restrained most of central and local governments to accept the normalization of the market economy and private economy, which were believed to be capitalism. The marketization and privatization of the Wenzhou economy in such institutional context – under the ideological restraint involving the absence of the central preference system – have seduced many economists to study the self-reproducing and self-evolving mechanism of the market. In addition to writings based on the market-centred thesis, many other studies identify Wenzhou's local government and local culture as motors of local economic development and warrants of the preliminary conditions needed for local market development. Some put forward a set of explanations from the perspective of local-level institutional transition in

Wenzhou (Shi Jinchuan, 1999; Du Runsheng, 2000; Jin Xiangrong, 2000; Jin Guirong and Zhu Xiwei, 2001; Ren Xiao, 2006), some stress the local government's particular role in local marketization (Parris, 1993; Chen Guoquan and Ma Xiaoli, 2003; Luo Weidong and Xu Bin, 2004) and some attribute Wenzhou's development to the social capital, including local culture and business networks (Cai Kejiao, 1999; Wang Chunguang, 2000; Shi Jinchuan, 2004; Luo Weidong, 2004; Lou Hongping, 2005)¹⁷³.

Wenzhou has had a merchant spirit for a long time, which is deeply influenced by the *Yongjia* School (Shang Huayan *et al*, 2003)¹⁷⁴. Even in the pre-Reform period, when the private economy was almost completely overruled by the state economy, businessmen from Wenzhou could still be found all over the country. When the reform began in 1978, Wenzhou's indigenous merchant spirit was liberated. The private economy was recovered with little difficulty (Jin Xiangrong, 2000) and developed much more rapidly than in other localities (except the SEZs).

Wenzhou's entrepreneurial activities have traditionally been concentrated onto domestic trade and small-scale 'petty commodities' from light industries, because the heavy industries required a large amount of financial investment, high technologies, and a large reserve of human resources, which bypassed Wenzhou's capacity. Unlike the SEZs, Wenzhou received nearly no foreign investment. Owing to their broad business networks all over the country, the Wenzhou people had more access to precarious information about markets. Nurtured in a local merchant spirit, they could swiftly organise small-scale (often family-run) production to meet market demands. Although they did usually not benefit from higher education, local entrepreneurs quickly got rich thanks to the huge market demand, the low threshold for business start-ups and personal talent. The local interpersonal network facilitated the proliferation of information. For example, when a novel product was made in one factory, it was easily imitated by neighbours, and then the production was rapidly expanded within the locality¹⁷⁵ (Hu Dinghuan, 2002). The concentration of similar products enhanced agglomeration effects. Both upstream and downstream industries were attracted into

173 See also Shi Jinchuan and Zhu Kangdui (2002) for a survey of the Wenzhou study.

174 The *Yongjia* School is famous for its utilitarianism, which suggests to unify public interests and private gains. It helps the development of the merchantism.

175 This phenomenon of imitation is also common in the industries which the technology threshold is low for market entry.

Wenzhou and the neighbouring localities. A strong cluster feature¹⁷⁶ has been formed and distinguished Zhejiang's economy in China since the 1990s (see Zhu Huasheng, 2003).

A big problem that troubled the Wenzhou economy in the 1980s was the quality of products. Perhaps due to overstressing cost-reduction, the lack of management knowledge, or the little attention paid to quality control, 'made in Wenzhou' became the label for poor quality (and fake brand products) and was resisted in many local markets in China (Luo Weidong and Xu Bin, 2004). However, although the quality of products was really poor, the huge shortage of supply helped Wenzhou's products to be sold nearly everywhere in China and the producers have gained a great deal of money and succeeded in primary accumulation of capital. But the poor quality of products made it impossible for Wenzhou's producers to establish long-term partnership with external businessmen. The improvement of the market regulations and the increasing public concern with product quality urged Wenzhou's businessmen to improve their quality control. Since as early as 1983, the Wenzhou's government has adopted measures to manage the local market and improve quality control. Many local NGOs and business associations were also established and worked out a series of standards for quality control (ibid). Through years of efforts, the label 'made in Wenzhou' has now gained the respect of Chinese consumers.

Many scholars like to stress Wenzhou's private economy and as a consequence, believe that the Wenzhou government applies a *laissez faire* approach in the local marketization. They argue that Wenzhou's success is owed to a somewhat market-friendly government intervention. But the local government also developed many market-enhancing functions. On one side, it represented local entrepreneurs to negotiate with higher level governments to accept the private economy; on the other side, it put forward a series of institutional innovations to promote entrepreneurial activities. For example, when private firms were still seriously restrained to operate in China at the beginning of the Reform, household or personal firms (privately owned) in Wenzhou were permitted to attach themselves to locally operated SOEs or public institutions by paying certain fees, without change in ownership structure and operation. Hence these *de facto* private firms could act on markets using a public identity. They are also called 'red hat firms' (the red colour has the special meaning of 'the socialist').

176 The 'cluster' is a very hot subject in recent studies of economic geography. It originated from the old tradition of industrial location, industrial district, and agglomeration etc., but it is not a focus here. For more references, see a synthesis of economic analyses of cluster in Wang Jici, ed., 2001.

Later, in 1987, the Wenzhou's government took the lead in implementing the shareholding cooperative system in the country, through which all kinds of firms owned by more than one person were renamed as a shareholding cooperative enterprise. In the following decade, the local government put forward a series of policies to 'legitimate' these privately owned enterprises by classifying them into the collective economy¹⁷⁷. Without the contribution of the local government, Wenzhou's economic development would have been hard to achieve.

(c) The Sunan style

The economic development in the Sunan area¹⁷⁸ depicts well a local development style with "Chinese characteristics", because it was driven by the TVE rather than by foreign investment or domestic private entrepreneurs.

For several hundred years now, Sunan has developed significantly traditional (non-industrialized) agriculture and merchant activities, owing to its location in the Yangtze River Delta with its fertile soil and river transport facilities, and has been the economic and cultural centre of China. After the 1960s, Sunan inherited the strong industrial capability from locally operated SOEs as well as commune and brigade enterprises that were set up during the period of the Great Leap Forward (1958-1960). During the 1970s, the primary opening of the urban markets nearby and the inflow of technicians and urban youths from the cities in the aftermath of the Cultural Revolution helped these enterprises scale up rapidly by producing for growing urban markets nearby (Koo and Yeh, 1997: p.388). In the 1980s, the 'Household Responsibility System' and the policy 'fixing of farm output quotas for each household; production contracted to each household' were applied in China's rural areas against the then inefficient collective production in order to stimulate farmers to increase production. But in some localities, for instance in Sunan's villages, local governments did not disperse collective resources to households, but 'centralised' them to set up collective enterprises on the basis of the previous commune and brigade enterprises. These enterprises developed close cooperation with the SOEs in neighbouring cities¹⁷⁹. For example, the rural enterprises supplied raw materials or produced parts for SOEs, or became subcontractors of SOEs as the shortage of land, labour and capital in the cities forced the SOEs to move some of their manufacturing

¹⁷⁷ In the Chinese definition, the collectively owned enterprise must be fully or partly owned by the local government.

¹⁷⁸ Sunan used to be the area centred around Suzhou, Changzhou and Wuxi, but it now includes the entire Southern Jiangsu province.

¹⁷⁹ Both cooperation and competition of the modern economy between Shanghai and Sunan can be dated back to the early 20th century (see Sun Haiquan, 2002).

activities to the neighbouring rural areas; in reverse, the rural enterprises depended heavily on the SOEs for technology (*ibid*).

These enterprises were called township and village enterprises – TVE (including county-owned enterprises which were less numerous) because they were owned by the local (mainly township or village) governments. The definition of TVE is different from that of a rural enterprise, as the former embodies the local government ownership of enterprise but also local government intervention in the daily operation of the enterprise. Although TVEs were criticized for their ambiguous ownership structure compared to fully privately owned enterprises, they were not inefficient in market competition in their concrete context. A reasonable explanation is that, if no ‘perfect’ property rights system is established, the enterprise with an ambiguous ownership structure (e.g. collective ownership) can be as efficient (or inefficient) as private enterprises.

Different to the ‘red hat firms’ in Wenzhou, in Sunan it was not private persons, but local governments that ran the TVEs. Perhaps due to the newly emerged, less developed market which made the entry into the market too costly for private entrepreneurs, or due to the shortage of talented persons, who had managerial knowledge and skills and did not work in the government, as well as the central government’s real hesitance to develop the private economy from, the Wenzhou style did not occur in Sunan. However, the local governments (and their officials) in Sunan actively participated in local development in their special way. Rather than ‘waiting’ for scarce private entrepreneurs to ‘come’, local governments let their officials ‘go to’ local TVEs to run them. These officials took advantage of the government’s strong capacity of organising local resources, efficiently scaled up local industrial production and made huge profits on markets. The previous political elite – the local government officials – then got a second identity as economic elite¹⁸⁰. The local government was thus labelled as ‘entrepreneurial government/state’ (Walder, 1995; Duckett, 1998)¹⁸¹. If the TVEs

180 The relationship between political elite and economic elite in transition economies has been heatedly studied for more than a decade. Based on empirical studies in central Europe and China, a set of theories are put forward, such as the ‘political capitalism’ (Staniskis, 1991; Rona-Tas, 1994) – in the transition to a market economy, the previous communist cadres can take advantage of their power to establish informal networks by which they can personalise the public wealth; the ‘persistent power’ (Bian and Logan, 1996) – political power over allocating economic resources in the old re-distributive regime persists in the marketization, so political elite can be economic elite in the meanwhile; the ‘entrepreneurial government’ (Walder, 1995) – the government’s power, as a key form of the political power that persists in the economic reform in which government officials get economic return. A detailed synthesis of the literature is given in Li Chunling (2005).

181 Such government behaviour can also be analysed on the basis of the ‘local developmental state thesis’ (Lin Yimin, 2004: p.12) or ‘local state corporatism’ (Oi, 1992; 1995).

made profit, after paying taxes to the central government, the local government could freely use the residual profit. Besides the need for capital accumulation and reinvestment, a part of the profit was distributed to improve the local physical infrastructures and welfare services, which favoured the urbanization in towns and villages. This greatly marked the political achievement of local officials. The residual profit was shared among local officials as a material bonus. Such incentive system was fairly effective to ensure the profitability of TVEs.

The success of TVEs in competition with SOEs and private enterprises on markets, in turn promoted Sunan’s economic take-off. With rapidly increasing fiscal revenue and a part of TVE funds which was reserved for local infrastructure construction, localities in Sunan quickly saw their local production grow and improved their competitiveness for further development in the market economy.

This survey of the three styles shows us the diverse mechanisms of local development (see Table 4-1). Timing, local advantages and effective government intervention in local economy were three critical factors contributing to local economic take-off in the early years of the Reform. The core value of government intervention is the achievement of public-private cooperation, i.e. between the central government, local government and private entrepreneurs.

Table 4-1: Three styles of local development: Pearl River, Wenzhou and Sunan

Style	Pearl River style	Wenzhou style	Sunan style
Features			
Timing	The great demand for and the serious shortage of commodities for daily use and high pressure on the supply side in the 1980s.		
Local advantages for economic take-off	Good location for overseas investment and export-led industries; significant political support from the central government	Culture of private entrepreneurship, local mutual aid spirit and organizations; loose legal environment for the development of the private economy and the production of low quality commodities	Heritage of the pre-Reform local industries and commune or brigade enterprises; good location for economic cooperation with Shanghai and for foreign investment and trade
Driving forces of economic development	Export-led industries and labour intensive manufactory industries	Private small-scale enterprise for the production of commodities for daily consumption	TVEs with local entrepreneurial government; foreign investment

Source: Author’s design.

4.1.3 New Spatial Development Strategies in the 21st Century

The Uneven Development Strategy is planned to be implemented by two steps, i.e. let some localities (including regions) enrich as the first step; then let the developed localities *help* the less developed to achieve common prosperity as the second. The fast developed coastal land proves that the strategy has so far accomplished the first step. But we cannot find any clear timetable or detailed measures for the second step. According to the current knowledge, *help* the LDLs is still confined to providing financial capital, increasing labour mobility, facilitating technology transfers and granting preferential policies. However, resources are scarce and they are critical for the developed localities to sustain their development. In the current contexts of economic decentralization and search for local self-reliance, each locality tries to improve its competitiveness in the global market. It is hard for the developed localities (their residents and economic agents) to help the LDLs by turning to their own resource reserves. The former regards providing such help as a ‘burden’. While the degrading central power to allocate resources (due to the market-oriented Reform) aggravates the difficulty for the LDLs to obtain resources outside the market. Rigid policies that may come from the central government aiming to help the LDLs (e.g. the social policies and welfare policies in the European countries) will inevitably distort the market mechanisms. This is not accepted by the market-oriented reformers. Furthermore, because there is no *ex ante* agreed threshold for *help*, the efforts to help the less developed localities and regions depend much on both the economic performance at the national level and how much the degree of regional inequality is acceptable (or tolerable) for society. Hence, the state policy-making and actions for alleviating regional inequality depend on the masses’ capability to endure inequality. Moving on with the Uneven Development Strategy to the second step – achieving the critical ‘turn’ on the top of the Kuznets Curve — is no longer a ‘natural duty’ of the reformers or a matter of keeping their promise, but an outcome of the economic-political-social ‘wrestle’..

As witness of increasing regional inequality, the state made an early effort to ‘advance’ the Uneven Development Strategy in the Ninth Five-Year-Plan (1996-2000). The central government began to pay attention to the development of inland in policy-making. A regional development planning was brought about with five targets (Zhu Houlun, 2004: p.52-53, translated by Zhu Kai):

- accelerating the physical infrastructure construction, e.g. large and middle scaled irrigation works, transportation, energy exploitation projects, telecommunication and urban construction;

- reinforcing the protection of the ecological environment;
- reinforcing and industrialising agricultural production, restructuring industry and taking advantage of mineral resources, developing the ‘characteristic economy’ (*te se jing ji*) and tourist economy, and developing high-tech industries in the localities where conditions are met;
- developing education and cultural industries, e.g. exchanging state cadres between the East and the West, popularizing the ‘9-year compulsory education’, promoting the development of the university system, advancing the technological progress; and
- deepening the Reform and continuing to ‘open up’, e.g. reforming the SOEs and TVEs under the guidance of ‘seizing the large ones and let go the small ones’, developing economies with diverse ownership structures, and attracting foreign investors.

Since 2000, in line with these targets, a Western Development Strategy has been put forward. It started with ‘Five Grand Projects’ – the project of environmental treatment and protection, the project of the West-to-East natural gas transportation, the project of the West-to-East electricity transmission, the project of South-to-North water diversion (west line), and the project of the Qinghai-Tibet railroad – and in the following five years, 60 state-led large scale projects were implemented in the West with an investment of 850 billion yuan RMB (in current prices)¹⁸². The fund mainly came from specific government bonds, fiscal transfer and loans from banks (see Lin Ling and Liu Shiqing, 2003). To narrow the West-East income gap is the main goal of the strategy. However, Lin and Liu (*ibid*) point out that about 40% of the total investment in these projects was used in buying produce equipments and materials from the East because the West ‘could not’ make these products. As these equipments are highly value added, only a minor part of benefit was retained in the West.

Moreover, the Western Development Strategy does not follow the original staircase-shaped gradient development model, because the emphasis of regional development seems to have shifted directly from the East to the West while bypassing the Middle. This strategic change is supposed to mainly result from the huge domestic demand of resource exploitation. In the 21st century, the supply of natural resources, especially the energy-related ones, will be critical to China’s industrial development. The shortage of electricity supply in recent years in the

¹⁸² The data is published by the Leading Group of Western Development of the State Council in the 2005’s report “Appraisal of the implementation of the Western Development Strategy in the past five years” (translated by Zhu Kai). The report in Chinese version can be find on line: <http://www.cei.gov.cn>

coastal metropolises and the huge demand for petrol and iron ore have already revealed the energy crisis in China. The West is rich in natural resources such as petrol, natural gas, hydro-power, non-ferrous and rare minerals, most of which are still not under exploitation. Hence, natural resource exploitation in the West becomes necessary to ensure China's economic security. In turn, improving the physical infrastructure so as to reduce the costs of exploitation is urgent. This concern is materialised in the Five Grand Projects. The Western Development Strategy is in fact designed and implemented under the guidance of economic efficiency in line with the logic of the Reform. The original logic of the second step of the Uneven Development Strategy, which emphasised social justice and common prosperity, is thus distorted.

However, the Western Development Strategy is not the final step in readjusting China's spatial development strategy. More efforts to alleviate regional inequality have been made since 2003. *First*, the central government implemented a strategy of 'Rejuvenating the Northeast' in 2003. The Northeast (including three provinces: Liaoning, Jilin and Heilongjiang) has been China's industrial base for over a century. Many large-scale SOEs, mineral and heavy industries, and agglomerations of industrial production in this area have contributed greatly to China's industrialization and urbanization in the past fifty years. Liaoning was even named "the eldest son of the People's Republic of China". But the exhaustion of mineral resources in recent years and the slow restructuring of industry due to the lack of financial capital and the institutional constraints from the planning system have caused losses in a large part of the SOEs. When the SOE reform adopted radical measures in the late 1990s, numerous laid off SOE employees have fallen into (economic) poverty and faced degrading social security services. The eldest son became the 'affiliated area of the Reform's negative effects'. As a response to both economic and social requirements, the state implemented the strategy of 'Rejuvenating the Northeast' to help the Northeast restructure its industrial structure and update technologies through a series of preferential policies in project allocation, taxation and fiscal subsidies. In addition, 160 central government led restructuring projects were launched in the Northeast¹⁸³.

So far, the entire Chinese territory except the Middle has benefited from the spatial development strategies. As Heilongjiang and Jilin are taken care of by the strategy of

183 More information about the strategy of 'Rejuvenating the Northeast' can be found in Liaoning Daily's special issues in October, November, and December, 2003, and also on line: <http://chinaneast.xinhuanet.com>.

Rejuvenating the Northeast, and Inner Mongol is a target of the Western Development Strategy, there are only 6 provinces in the Middle of China – Shanxi, Henan, Hubei, Anhui, Hunan, and Jiangxi – that wait for special strategic concern. In fact, the Middle has less natural resources than the West, less developed industries than the Northeast, and less dynamic market economies than the East. Its tradition of agricultural production, light manufacturing industries, cheap (but less skilled) labour only make the Middle a little more developed than the West, but far less developed than the East (see Appendix 1: Table C). According to the staircase-shaped gradient development model, it is now the turn to develop the Middle, but the new spatial development strategy seems to abandon the gradient model. Hence, strong voices arise from the Middle (e.g. from local governments, local scholars, and local population) in favour of a central preferential support to develop its economy. Due to the gravity of the ‘*san nong*’ problems (agriculture, rural society, and farmers) for China’s economic-political-social development, the development of the Middle has critical significance for China. Under the guide of the new concept of ‘scientific development’ and ‘building up a harmonious society’ (see section 1.1), the central government proposed a strategy of the ‘Rising of the Middle’ in the beginning of 2004. The strategy was planned to develop a metropolitan belt (composed by nine large cities and centred at Wuhan) and two economic belts - one of which goes along the Yangtze River (west-east direction) and the other goes along the Beijing-Guangzhou Railway line (north-south direction). Five industries, i.e. automobile, iron and steel, textile, hydro-electricity and high-grade services have been selected to become economic cornerstones. In addition, photoelectron-information, new materials, advanced manufacturing technologies, and biomedical industries are four high-tech industries to develop¹⁸⁴.

The new strategies require the central government to adjust resource allocation among regions, including the ‘allocation of preferential policies’. This of course decreases the privileges and comparative advantages of the East – the coastal land – in developing the market economy. But as economic efficiency is always the primary concern of the state/central government and the economic efficiency of the East is still much higher than other regions, a strategy of ‘Maintaining the East’s leading role’ was put forward as an end for the adjustment of the Uneven Development Strategy. Therefore, the four strategies – Western Development, Rejuvenating the Northeast, Rising of the Middle and Maintaining the East’s leading role – form China’s new spatial development strategy in the 21st century. But, the strategically

184 More information about the ‘Rising of the Middle China’ can be found on line: <http://www.cnhubei.com/xwzt2004central>

favoured regions cover the whole Chinese territory and it seems that in the end, all regions will be developed *at the same time*.

Although reformers and economists call for more efforts to take advantage of markets rather than the planning system or government intervention, the central subsidies and preferential policies remain as two major measures. Private investment and matured markets are not yet available in all over China, especially in the Middle and the West. Local governments have to apply for central subsidies and preferential policies on the one hand, and attract private investment (including foreign investment) on the other. As a consequence, from the point of view of the central government, the fiscal budget would never solve the local ‘thirst’ for financial support and preferential policies would no longer be preferential if they are copied everywhere. Even though in recent years the West and the Northeast have benefited much from the strategies to develop economy, the outcome in these regions is still far from perfect. Without institutional innovation, the new spatial development strategy does not make more sense than psychological encouragement.

Other than the centrally designed strategies for regional development, provinces and cities also spontaneously promote regional integration and, as we saw, some clusters of cities are developed as economic growth poles in China, such as the Pearl River Delta, the Yangtze River Delta, the Beijing-Tianjin-Hebei Circle, and the Rim of Bohai (sea). This wave of regional integration helps to facilitate the mobilization of production factors and improve economic efficiency. But inter-regional competition is fiercer than ever, because the regions’ efforts are quite similar and often concentrate on the same industries. How to allocate resources rationally to fully develop regional advantages is still a problem for economists and policy makers to resolve. Furthermore, a new strategy was proposed in 2005, named ‘building a new socialist countryside’¹⁸⁵. It aims at speeding up the modernization of China’s vast countryside by pursuing five objectives – accelerating production growth, keeping villages clean, improving welfare services, civilized ethics, and democratic management.

The set of new strategies shows a good willingness to develop the disadvantaged economies of the Middle, the West, the depressing Northeast, and rural areas. But under the pressure of maintaining high economic growth (measured by the growth of GDP), the state would not

¹⁸⁵ News about the new strategy of ‘building a new socialist countryside’ was reported by, for instance, xinhua news agency, October 20, 2005 and February 21, 2006; Businessweek online, March 9, 2006. A new publication focuses on this subject, see Qu *et al*, 2006).

slow down the growth in developed regions. Hence, the current strategic planning seems to develop all regions at the same time. The difficulty is obvious and the strategies are not yet fully implemented.

Summary

In this section, I have reviewed China's three-stage spatial development strategies from 1949 onwards. In the pre-Reform (1949-1978) stage, the strategy favoured a balanced, or coordinated, spatial development. The strategy was formed under the constraints of the then economic situation, international relations and institutional arrangements, and intensely related to the five economic forms in that period, as analysed in Chapter 2. After the Reform began in 1978, economic development was put to the centre of the government's work, and has highly influenced the spatial development strategy. With the increasingly important market regulation in the economy, regions and localities were encouraged to develop their own economies by achieving comparative advantages on markets. The uneven spatial development hence was not only a result of the Reform, but also of the initials of the reformers and strategy/policy makers, because they believed that China could not develop its regional and local economies at the same time, so some spaces must develop before others and then help these develop as well. Due to combined efforts such as the 'opening up' strategy, central preferential policies to particular localities and fiscal decentralization, the central government, local governments and private entrepreneurs adopted various styles in localities to develop local economies during the transition to the market-based economy. Among them, three development styles were emphasised by economic studies, because they provided valuable experiences of economic take-off in LDLs (see Table 4-1). As a part of Chinese localities became wealthy, the uneven development strategy achieved its first step. But the spatial (economic) inequality became increasingly severe, the question 'how make the developed ones help the others which lag behind' must be answered in the second step for economic, social and political development. Since the end of the 1990s, a new spatial strategy has come step by step into effect. With the goal of building up a harmonious society, the less developed West as well as the Middle and the depressing Northeast (suffering the industrial restructuring) receive currently much attention. Nevertheless, the developed localities do not lose their advantages in receiving policy support. The transition in the spatial development strategies explains well the formation of China's current spatial inequality. Even though the latest strategies begin to pay attention to reducing inequality, they cry for effective measures to accomplish more equality. To put forward effective measures, the problems that block the

economic take-off in LDLs must be sufficiently acknowledged. This is the task for the following section.

4.2 Why the LDLs Are Still Less Developed? An Empirical Analysis

While rapidly developing and enriching localities are used as icons of the successful Reform, the uneven occurrence of success among China's territories makes that success imperfect. The pertinent large number of less developed localities (LDLs) with still more than 161 million people whose income is below US\$ 1/day in 2002 (Wang *et al*, 2004: p.5) and localities that went into depression in the economic transition, heavily burden the Chinese government's initiatives to improve the Reform's performance. A first question we will naturally ask is: if the Reform is so successful, why are there still so many LDLs? The uneven development strategy gives a good answer to this question, as reformers always assert that all the Chinese localities cannot develop at the same time. But this answer will, still naturally, provoke a second question: why are these LDLs less developed? In other words, why did the Reform succeed there – developed localities – rather than here – LDLs?

It is true that the preferential policies have helped the development of some localities, but the policies did not prohibit development of other localities¹⁸⁶. The styles of local development are available to all localities, but apparently, they were not always successful everywhere. The studies on the three styles only explain why they succeeded in the localities where they emerged and were implemented, but cannot explain why these or similar successful styles did not occur in the LDLs. Which factors make the development styles perform differently across localities? As the central government has implemented so many large-scale spatial development strategies and has placed the less developed regions in the focus, why have the LDLs not renewed the success of the Reform yet? The LDLs themselves must be understood.

The present endeavours to develop the LDLs come from various sources, such as: the poverty reduction programmes financially supported by China's government and international

¹⁸⁶ It should be noted that some policies seriously constrain economic development in the LDLs. A Provincial Poor Locality (PPL) that I investigated in Zhejiang is a victim of such policies. 80% of the local territory is mountain area, the other 20% is equally shared by river and cultivated land, the local agriculture is historically less developed. When the neighbouring localities rapidly developed their local economies following the Wenzhou style, this PPL lagged behind because the second largest dam in the province is situated on a river that goes across the locality. According to the national regulations, no industrial activity is permitted to locate in the 'preserved zone' within 200-metre distance to the riverbank (the regulation is also valid to the national highway), except for ecological agriculture. Developing ecological agriculture in the PPL is constrained by a set of shortages in technology and human resources. Therefore, this PPL can not invest in any industry even though it can benefit from a large amount of financial aid from the sovereign city's budget and private charities.

organizations, individual donations to charities (both public and private), academic studies on the LDLs addressing economic, social and political issues, and indigenous efforts undertaken by local governments and entrepreneurs. These endeavours provide rich and helpful references to understand the LDLs. Their perspectives to and emphases on developing the LDLs are quite diverse. This diversity also causes controversy, for example, the government's role in local economic development is at the heart of this controversy. The normative theories that reformers advocated are particularly faithful to the pursuit of market equilibrium and minimal government intervention in the economy. However, such theories can hardly be adopted as guidelines for policy practice. Observed from successful cases, the government's role is critical to local development, while such success cannot get support from normative theories. Hence, reformers *simply* owe the local successes to talented officials¹⁸⁷. Another popular explanation assumes that government officials are self-interested; they develop the local economy in order to get political promotion. The entrepreneurial government thesis represents this explanation and can be understood as good government intervention led by self-interested government. Nevertheless, do all self-interested governments succeed? Are there non-self-interested governments and have they successfully promoted local economic take-off? Answers to these questions are not yet available.

To make up for the shortage of the information sources, I have done an investigation in 22 Chinese localities which consist of NPCs, PPCs, not-poor localities, and cities (see Section 1.3.4 (a) for details). The interviews with local government officials during the investigation provided me with rich information about the various local difficulties of and endeavours to develop the local economies. Within the problematic of this dissertation, I focus on themes that characterize the local situation: transportation; natural resources and industries; local social and human capital; and local governments as well as officials. I emphasise on analysing the blocks to economic development in the localities, addressing the paradox of capability, duty and power of the local government in promoting local development.

4.2.1 Present Endeavours to Develop the LDLs

The spatial development strategies are guided by the principle of 'efficiency first'. Although the strategies have begun to pay more attention to the development in the less developed West and Middle than in the previous 20 years, most beneficiaries are still growth poles. The LDLs,

¹⁸⁷ As an interviewee (a provincial government official majoring in policy analysis) says, talented people can do well in any system of economy, market regulated or central planning, in any type of enterprise, whether state-owned or private.

for example at the county level, have a hard time to benefit directly from the strategies. The present endeavours to develop the LDLs in China are focused on poverty reduction. The Chinese government (here, particularly meaning the central government) is a main force in poverty reduction efforts, especially with regard to financial support and multi-sectoral programmes.

Various efforts from domestic and supranational non-governmental organizations also favour the LDLs. Academic studies suggest useful ideas, experiences, theoretical guidance and technologies. Last, but not least, the indigenous efforts made by local governments and private entrepreneurs also play critical roles in local poverty reduction, according to their own advantages; both of them often try to interact with each other to pursue more efficient coordination. An overview of present endeavours to develop the LDLs can be organized according to four categories of intervention: central government's roles in poverty reduction; non-governmental aid; academic studies; and indigenous efforts in LDLs. The indigenous efforts are referred to the on-site investigation explained in methodology.

(a) Central government's roles in poverty reduction

Since 1949, the Chinese government has made great efforts to reduce poverty and develop the LDLs. During the first thirty years, these efforts were integrated in other spatial and industrial development strategies. The general spatial development strategy was not effective for LDLs as it was for the easily enriched localities as their problems (for development and for growth) were of a quite different nature. Therefore, the Chinese government had to design specific policies for different kinds of localities. A set of poverty reduction measures and government agencies targeting the LDLs were put forward¹⁸⁸. The Leading Group of Poverty Reduction and Development under the State Council, which was established in 1986 and was renamed as the Leading Group of Poverty Reduction (LGPR) in 1993, is China's highest authority in charge of poverty reduction. Its main responsibility is to design China's poverty reduction policies and programmes, allocate poverty reduction funds, and coordinate the relationship among the different ministries, departments and agencies participating in poverty reduction. The Office of the Leading Group for Poverty Reduction and Development (OLGPR) is LGPR's permanent working body in charge of the day-to-day operations. Poverty reduction

¹⁸⁸ The following introduction of China's poverty reduction is mainly referred to in China's official reports, such as "The 8-7 National Poverty Reduction Program in China – The national strategy and its impact" (Wang *et al*, 2004) and "White Paper: China's poverty reduction in rural areas" (published in People's Daily, October 16, 2001). More information can also be found on the official websites such as <http://www.fupin.org.cn> and <http://www.cpad.gov.cn>.

offices have been set up in the provinces, cities and counties. In line with the principle of ‘four to provinces’, which was established in 1997 and meant ‘funds to provinces, power to provinces, tasks to provinces, responsibility to provinces’, provincial governments are responsible for local poverty reduction performance.

The central government offers three categories of special funds for poverty reduction: government budgetary grants, food-for-work funds and subsidised loans (micro-finance). The effective allocation of poverty funds mainly reflects the number of poor counties and the size of the poor population in each province as well as the bargaining power of local governments. Poverty funds are distributed by the central government to the provincial governments according to a set of weighed criteria. Among these, the number of poor residents has the greatest weight. Others include: rural net income per capita, local economic resources, GDP per capita, and factors of policy adjustment. Within provinces, allocation to counties follows different criteria. Generally, provinces allocate poverty funds to specific projects submitted directly by county governments in a competitive process. The allocated funds are transferred via the respective prefectures (cities) directly to poor counties. All funds were to be used in the approved projects within the county. In order to make up for the shortage of government funds for all LDLs and to release the heavy burden on the central fiscal budget, the central government demands provincial and prefectural governments to provide matching funds for the approved projects.

In 1994, the Chinese government launched an ‘8-7 Plan’ (National Plan for Poverty Reduction) during 1994-2000, aimed at lifting the remaining 80 million poor above the government’s poverty line (annually modified but always lower than the US\$1/day income measure) through a series of large-scale and comprehensive measures. Under the 8-7 Plan, the central government funding of poverty programmes totalled 113 billion yuan RMB (US\$ 13.6 billion equivalent) and annually accounted for 5-6% of total government expenditures. The allocation of funds among sectors was to benefit production activities and infrastructure construction. Between 1998 and 2001 and in 519 NPCs, 46% of poverty reduction funds were allocated to agriculture, 20% to infrastructure, 14% to industry, 6% to transportation and 3% to education and health care. This related to the 8-7 Plan’s emphasis on raising the income generation capacity of the NPCs, i.e. the blood-generation approach of poverty reduction.

Under the 8-7 Plan, six eastern provinces – Guangdong, Fujian, Zhejiang, Jiangsu, Shandong and Liaoning – had to use their own resources to alleviate local poverty. The central government stopped financing poverty reduction in the six eastern provinces so as to allocate more funds to help the LDLs in the West and the Middle¹⁸⁹.

Besides the direct financial support, the central government has introduced a fixed-target poverty reduction programme that mobilised party and government bodies, agencies and social organizations to assist the NPCs, especially taking advantage of their professional knowledge. Moreover, in 1996, the LGPR decided that the 13 relatively well developed provinces and cities in the East should help the 10 poor provinces and autonomous regions in an ‘East-Supports-West’ programme: Beijing would provide support to Inner Mongolia, Tianjin to Gansu, Shanghai to Yunnan, Guangdong to Guangxi, Jiangsu to Shaanxi, Zhejiang to Sichuan, Shandong to Xinjiang, Liaoning to Qinghai, Fujian to Ningxia, and Shenzhen, Qingdao, Dalian and Ningbo together to Guizhou. The support mainly involves four types of activities (Wang *et al*, 2004: p.32):

- free donations of funds for schooling, health care and infrastructure;
- donation of materials to farmers for their production and daily life;
- economic and technical cooperation, i.e., cooperation between the developed and poor regions in production and management by using the capital funds, technical know-how, management skills and markets of the former and the resources and cheap labour of the latter; and
- personnel exchange, with developed provinces and cities sending technical personnel and young volunteers to provide services in poor provinces and autonomous regions, and the poor provinces and regions sending administrative and technical cadres to the developed provinces and cities for training or sending workers for employment.

By the end of 2000, when the 8-7 Plan was more or less accomplished, the remaining poor population was concentrated on 148,000 poor villages in the inland border areas, and remote mountain areas, the revolutionary bases and some ethnic minority zones. The poor natural conditions in these localities make the poverty reduction efforts more difficult and more costly than elsewhere and those living there who had escaped poverty easily fell back to

189 Accompanying the new spatial strategies, the West and the Middle are in priority to apply for the industrial projects organised and partly (to a large extent) financed by the central government funds. However, these projects are not included in the poverty reduction programs.

poverty¹⁹⁰. Drawing upon the experiences from the seven years' efforts, the Chinese government launched a "New Century Rural Poverty Alleviation Plan for the period of 2001-2010". The new Plan targets 50,000 poor villages and will particularly benefit poor villages in non-poor counties excluded from the 8-7 Plan.

According to the new Plan, the poverty reduction in these ten years targeted eight foci¹⁹¹:

- the animal husbandry is the main industry to develop;
- promoting the agro-industrialization and forming some local cornerstone industries;
- improving the basic living conditions in the LDLs;
- sciences and technologies should contribute more to poverty reduction ;
- improve the educational level of the residents in the LDLs;
- strengthening professional training for local labourers and help them to find jobs in local and external markets;
- promoting the resettlement of the residents in the LDLs on the base of their free will; and
- encouraging organizations and enterprises (irrespective of their ownership structures) to participate in poverty reduction.

(b) Non-governmental aids

Other than the government, a number of domestic nongovernmental organizations (NGOs) have been involved in complementary activities of poverty reduction. Compared with government-organised programmes, the scales of NGO poverty reduction activities are usually small, specialized and focusing on a few areas according to their specific objectives (see Annex 7).

China's poverty reduction has also received significant aid from international organizations (see Annex 8) during the past two decades. These aids "cover most sectors and involve numerous different types of programmes, including micro-credit, small-scale infrastructure construction, community development, environment protection, technical assistance and capacity building, and multi-sectoral rural development". For example, the World Bank has up to now financed more than 300 programmes in China (see useful reports in the online databank of the World Bank) and "directly contributed to the results of the 8-7 Plan,

190 According to the news reprinted in <http://www.sina.com.cn> (September 5, 2006), about 10 million rural residents fall (or fall back) into poverty every year in China due to disease.

191 Cited from an official report on the website <http://www.fupin.org>, translated by Zhu Kai.

particularly with its Southwest Poverty Reduction and Loess Plateau projects” (Wang *et al*, 2004: p.34). In total, international development agencies, international financial institutions, bilateral agencies and international NGOs contributed some 10 billion yuan RMB to China’s poverty reduction during the 8-7 Plan. As it is difficult for international organizations to reach China’s numerous LDLs to study the local situation and allocate their funds, some administrative agencies under the direction of Chinese central government act as intermediaries between the two ends. The long-term or multi-sectoral programmes also need the governmental (at the central level) cooperation for implementation and supervision. Therefore “International organizations contributed knowledge and ideas as well as significant funds to poverty reduction in China. Even more importantly, their poverty reduction activities in China have influenced and changed government perception of poverty and enhanced understanding of approaches to address poverty. The introduction of participatory poverty reduction practices, integrated poverty reduction planning and micro-credit in China can be to a large extent credited to international organizations” (ibid: p.42).

(c) Academic studies

As the Chinese government intervention has centred its work on economic development since 1978, the focus of Chinese academic studies has meanwhile shifted from ideological struggle to economic development. Governmental research institutes – e.g. the Chinese Academy of Social Science, domestic and foreign universities, and institutional organizations – e.g. WB, IMF and ADB are important contributors to the academic studies.

Economists analyse the less developed economy in China from various perspectives. Some depict development styles by use of case studies of developed localities in order to learn from experiences for the development of other localities (e.g. Yuan Peng *et al*, 2004). Some focus on spatially economic inequality in order to find out the causes and solutions for reducing the inequality (e.g. Liu and Zheng, 2004). Some emphasise the industrial transfer from the developed localities to LDLs (e.g. Zhao Gongqing *et al*, 2001; Lu Lijun and Zheng Yanwei, 2004). As the LDLs are mostly located in rural areas, the rural economy is stressed. Rural urban divide and the so-called dual-economy, industrialization of the rural economy, urbanization in rural areas, creating jobs for redundant rural labourers, reforms of the tax system and the government system in rural areas, the introduction and improvement of technologies, are frequently addressed (e.g. Knight and Song, 1999; Zhang Mei, 2003; Ho,

2004; Lu Xueyi et al, 2001). There are also studies directly targeting the LDLs by case studies for the local poverty reduction and economic development¹⁹².

Although economics consists of the main body of the studies, other fields of social sciences have seen a remarkable development in the recent years, especially when focusing on the concept of ‘development’ and the better understanding of its processes. Sociology, anthropology and political science are robustly developing in rural studies. The research on social stratification and mobility, social relations and networks, local culture and tradition and the reform of the political election system at grassroots level, etc. has been fruitful (e.g. Yan Yunxiang, 2000; Bian Yanjie *et al*, 2002; He Xuefeng, 2003; Zhang Liwei *et al*, 2004; Zhou Daming, 2006).

A recent research focus is on the county economy because in China’s territory of 9.6 million km² (the sea area is not included), only 31000 km² is urbanised, while the rest is under the jurisdiction of counties which accommodate more than 85% of the Chinese population. The study focus on county as the core of the rural economy is therefore critical to economic development in China. In 1998, the Chinese institute of county economy was founded. In the next year, a special Edition was added to the Economic Daily to report regularly news and studies of the county economy and an official website (www.china-county.org) opened in 2000 as a platform for information exchange. In 2001, the first edition of “Evaluation of Competitiveness of Chinese counties” was published and in the same year, the first national conference of Chinese county economy was held under the governmental organization. The special edition of the county economy in the Economic Daily was upgraded to the “County Economy Weekly” in 2002. The “Annual of Chinese County Economy” has been published since 2003 as the highest authoritative reference of county studies in China. With the newly proposed strategy ‘building a new socialist countryside’ launched in 2005, more trans-disciplinary analyses will flourish in county and rural studies.

(d) Indigenous efforts in LDLs

The previous efforts are based on resources external to the LDLs. They do significantly contribute to poverty reduction and development, but shortcomings are inevitable. The current academic studies on the LDLs are comparably inferior to those on developed ones in terms of quantity and quality. A large part of local studies are meant to explain success stories (e.g.

192 Such studies can be easily found on the official websites of the World Bank, UNDP, Chinese government, etc..

development styles), clusters and agglomerations, and growing metropolises; while valuable proposals for developing the LDLs are rare¹⁹³. Local people have made specific and important contributions to develop their localities. Local entrepreneurs bring in financial capital and business opportunities, create material wealth and jobs, and improve economic dynamism to localities. Local residents are immediate beneficiaries (or victims), but also creators and maintainers of their local situations, through their contribution to formation and transformation of local culture, tradition and mentality. Local governments, depending on their better understanding of local situations than the external actors, make Local Development Plans and establish local regulations (some are even in conflict with the national policies and laws), organise infrastructure construction and improve the investment environment, apply for a diversity of programmes (including those for poverty reduction) and actively import external resources as well as directly organise local business activities. Local researchers also make remarkable studies. The outcomes are not published in high-ranking journals, but in “Local History” (*di fang zhi*), local investigation reports and government reports. Although on average less scientific than academic studies, they are rich of local information and most of them are precious materials for scientists to design realistic plans. Moreover, a large part of local actors have difficulties to publish their experiences, which are valuable of the in-detail information and practical knowledge. This has inspired me to do on-site investigation and face-to-face interviewing with local actors.

After having reviewed the present endeavours of assisting LDLs to develop their economies, we wonder why LDLs still have difficulty to sustain their development. These endeavours seem insufficient. But why are they insufficient and why are the necessary resources not yet fully utilized? Understanding the problems of LDLs, especially those in a concrete context, is still the preliminary task of policy-makers and scholars¹⁹⁴. Thus, I was inspired to do on-site investigation in LDLs aiming at identifying the blocks to economic take-off in LDLs.

4.2.2 Blocks to Economic Take-off: Investigation in Chinese Localities

As introduced in Section 1.3.4 (a), my on-site investigation in localities covers 15 NPCs, 2 PPCs, 1 ordinary (not poor according to the Chinese norms) county and 4 cities. Rich

¹⁹³ Many studies on LDLs are repetitive, without innovating theses or effective measures. This will be better explained in the synthesis of my investigation.

¹⁹⁴ When I did investigation in a NPC, a national workshop on county economy was held near the County Poverty Reduction Office. It must be helpful to the local government officials. Indeed, the latter were not invited to the event, nor interested in the workshop. They criticize that the academic studies are not originated in the real life, nor oriented to solve the concrete problems. When I did investigation in a NPC, a national workshop on county economy was held near the County Poverty Reduction Office.

information was obtained through interviews with local government officials. The economic transition to ‘a market economy’ in the mode of ‘uneven development’ by way of many uniform national policies was frequently complained about. The economic transition to a market economy within an economic system with significant uneven development but many uniform national policies incapable of addressing the specific needs of poor localities was frequently complained about. The interviewees also disclosed the paradox between duty (developing local economies) and absence of authority (improving local economic environment without intervening in the economy, especially in the operation of firms) of the local government and the lack of effective means to develop its economy. Most of the results from interviews are very new to the current academic and local studies. A synthesis of the interviews is given herein below by focusing on five aspects and each aspect is summarized by an Observation.

(a) Geographical conditions and transportation networks

Geographical location is traditionally a critical factor for a locality to develop its economy. This has been especially true since China’s ‘opening up’ strategy (to the outside world) during the Reform. The coastal localities are geographically better located for overseas business than those in the inland because they have easy access to the global market. The increasing West-East income gap¹⁹⁵ and the concentration of FDI in coastal localities clearly indicate the importance of geographical location for economic activities. It is not surprising to see that the three development styles all originate from the coastal region (the East).

The topographical situation is another critical factor. Many NPCs are located in mountain areas with only small plots of land that are convenient to economic activities. For the NPCs that still concentrate on the primary industry – farming in particular – with traditional technologies, the topographical conditions are decisive for the outputs of production. Climate, sunshine, soil, precipitation should also be considered here because of their influence on the farming-related activities. Furthermore, less comfortable topographical and climate living conditions also hinder the settlement of enterprises and residents. Setting up enterprises underground and in caves was only achieved by the Three Front Programme was rapidly abandoned after the Reform began but because the low economic efficiency proved such behaviour as irrational.

¹⁹⁵ This argument was proposed in a national conference organised by the China Political Consultative Conference on September 5, 2006, reprinted by <http://www.sina.com.cn>, September 6, 2006.

Reminding the discussion about why the market economy did not develop in the pre-modern China in section 2.1, the third explanation is still valid in the contemporary China. Geographical conditions and transportation systems still heavily restrain the expansion of the market and hamper large scale production and exchange. The inefficient transportation system is always a big obstacle for NPCs to integrate their local economies into the national or global market-based economy.

One may wonder, if a locality is not fit for living, why do its residents not move out? In fact, the current ‘resettlement of all residents of a hamlet’ programme for poverty reduction in China is following this logic. However, the big size of the involved populations is a problem. The high cost of resettlement and insufficient creation of jobs make the resettlement very difficult to achieve. Neither residents nor government can support larger-scale resettlement programmes. Furthermore, with the help of modern technologies and modern consumption concepts, many ‘disfavoured’ localities have great potentials of enrichment through production of locally specific products (including tourism). Therefore, the solution to helping NPCs must be based on ‘developing’ rather than ‘abandoning’ (just like saving a patient does not mean to let him/her die or move him/her elsewhere, but to cure him/her within his or her biotope).

Transportation is a critical factor to mobilise resources. Building railways or highways in remote or mountain areas is the main way to connect the NPCs with the ‘outside world’. All require large-scale constructions and large sums of financial investment. Compared to the Three Fronts construction period (1960-1970), when the Chinese state followed the ‘all in one game’ logic and funded the large-scale construction in the inland, current investors must make a cost-benefit analysis before engaging into new business projects.

The central government is the unique authority competent for railway construction. But building railway lines in all NPCs is nearly impossible in the present day for the sake of low economic return – especially when a market calculus is applied. In South-western China, many deteriorated physical infrastructures that were constructed as part of the Three-Front Programme are still in service. The poor quality of railway transportation directly hinders resource mobilization and in turn restrains industrialization in NPCs.

Road construction (especially highways) is now the main means to connect localities because it is cheaper than railway construction (with regard to cost per kilometre). As the highway construction get also full economic return in the long term, the central government does not regard highway construction as profitable and supports such construction by poverty reduction funds (see case study on Food-For-Work Projects in Zhu Ling, 1990). Local governments have the obligation to improve local road quality, which is a key indicator for local government officials' evaluation. But their efforts are seriously constrained by their insufficient fiscal revenues. The fiscal shortage has become increasingly serious as local government is not allowed to do business or holding shares in TVEs (see Mao Dan *et al*, 2002). Introducing private capital into road construction may be a solution. Some experiments were made during the past years in Zhejiang and Jiangsu provinces, but the outcomes are not positive¹⁹⁶ because the government regulations of credit funds, land use, and modes of profit-making strictly constrain the access of private investment in the construction projects¹⁹⁷. So, **Observation 1:** Geographical conditions and transportation networks are important to local economy. The improvement of transport infrastructure depends on the supply of financial capital and institutional arrangement between public and private investors. But both are insufficient to develop NPCs for present.

(b) Natural resources and locally specific industries

Most of the NPCs are rich in resource endowment, such as minerals, hydro-electronic and wind power, special agricultural products, etc. A problem is that the resources do not contribute to the NPC's wealth. In the mineral-resources-rich NPCs, the investment in mineral exploitation is not optimal. The reasons is on one side that, mining requires certain technologies and a large amount of financial capital, both of which are very scarce in the NPCs; on the other side, exporting mineral products is very costly due to the insufficient transport facilities. The increasing concern with environmental protection in the recent years has also significantly increased the costs of developing mineral-resources-based industries which are normally heavy polluters. Private investment requires at least an equivalent profit to the opportunity cost which is rarely possible in the NPCs. Under the contemporary terms of

¹⁹⁶ It is reported that at the end of 2004, Zhejiang government offered a public bid for a highway construction with the investment amount to 50 billion yuan RMB; but that the bid was miscarried (new reprinted by <http://finance.sina.com.cn>, January 12, 2005).

¹⁹⁷ A story was reported in September 2004 that a local entrepreneur financed 40 thousand yuan RMB to repair a bridge in his hamlet (in Lianyungang City), but the construction was held up by the village government using the excuse of 'illegal construction' (news reprinted by <http://news.sohu.com>, September 2, 2004).

Chinese economic policy, state investment is also profit-oriented and is hard to achieve in the NPCs following the private logic.

Another problem is that, even though a few NPCs have received private investment, negative externalities degrade the sustainability of local economic growth. Under the pressure of rapidly growing local GDP and the principle of developing the local economy through the market, local governments provide private entrepreneurs with a set of preferential policies, for instance, tax reduction, cheap land use, exemption of payment for pollution, indulging the relaxation of production security measures and so on. Private enterprises have also been permitted to minimise the wage of employees so as to maximise their profit. Some local governments even suppress strikes – workers cannot tolerate the low wage that does not even afford them the living necessities – to maintain the ‘exploitation’ for ‘economic growth’. Such exploitation only enriches entrepreneurs and involved government officials, while local residents and localities gain little, even lose much, as they suffer from the worsening natural environment, economic restructuring, the polarising income inequality and the consequent social ills¹⁹⁸.

The manufacturing industry has significantly enriched the eastern localities while is not dynamic in the NPCs. Neither private entrepreneurs of the Wenzhou style nor TVE in the Sunan style are robustly present in the NPCs. The heavy industries are even more difficult to locate there because of the insufficient transport facilities and the lack of skilled human resources. The manufacturing industry is still difficult to develop in the NPCs¹⁹⁹.

The local populations of the NPCs vary from 400,000 to 1 million, with more than 70% of the local population of each county engaging in agricultural production. An extreme case is a county of 740,000 residents of which 720,000 work in the primary sector. Agriculture is the cornerstone industry for the local economies in NPCs but it is highly unproductive. In many NPCs, the numerous farmers can hardly feed themselves. The poverty-stricken farmers scatter in small hamlets in the mountain areas far away from downtown. The natural resource systems (e.g. the *karst* topography, unfertile soil, small plots of cultivated land, climate, etc.) make it very difficult to have large-scale production and to apply advanced technologies to achieve higher productivity.

198 See for example news reprinted in <http://www.xinhuanet.com>, May 22, 2006.

199 For the division of industries, see Annex 2.

Since it was implemented as the first step of the Reform, the Household Contract System has greatly stimulated farmers to produce for their individual interest at the family scale. But it also quickly abandoned collective production or mutual aid patterns at the second half of the 1980s. This aggravated the shortage of collective infrastructures and weakens farmers' ability to resist natural catastrophes.

The central government has promoted some programmes to transfer agricultural technologies to NPCs in order to improve productivity and quality of products. However, in many NPCs the programmes are not as welcomed as the government expected. For family-scale farming, which is limited to small plots of cultivated land, it is not worth applying the technologies which require heavy inputs of financial, technological and human capitals.

According to the current macro-economic regulations, prices of primary agricultural products are not primarily decided by the market, but mainly controlled by the government in order to avoid severe inflation. Moreover, most of NPC's farmers are in a disadvantaged position in negotiating prices with intermediaries, and selling primary agricultural products is not an easy way to make farmers rich. As the land can bring them little income, youngsters often leave their localities for jobs in cities while women and old people keep on farming with low technology.

A way to benefit from agricultural production is to process primary products for high added value. For example, products of high quality become more and more demanded in the urban markets as the enriched urban residents have begun to appreciate living quality; prices of processed and valued-up products are less controlled by the government, thus giving more room for profit-making. Agricultural industrialization is thus an effective means to develop an agricultural area. Fortunately, in many NPCs, the soil and climate are, although not always convenient to farming, fit for locally-specific products. Learning from the successful stories, a model of cooperation "enterprises + farmers" is popular. For example, in a PPC, an agricultural processing enterprise (privately owned) signs contracts with farmers and promises to buy all their farming products at a negotiated price²⁰⁰. Hence, the enterprise can reduce

200 The negotiated price is usually farmer-favoured. But there are also cases where enterprises maximally undercut price and harm farmers' interests. Such a case was reported in China Economic Times, May 17, 2004.

business risk by stabilising the supply of raw materials and the farmers can be guaranteed to sell their products.

The difficulty is to turn resource-endowment into business opportunity and to make profit on markets. In fact, the markets for the locally specific products are usually not available. To develop the markets requires combined efforts, from knowing the real value of the resources, and employing specific technologies for efficient production, to marketing and industrial organization. All these efforts can only be achieved through sufficient supply of financial and human capital. However, business risks are very high. Information on markets, technologies, managerial skills, and capital and, to not forget, business opportunity, must be well integrated to be successful in business operations. A successful story is found in the ‘ordinary’ county (neither NPC nor developed locality) that I investigated. This county is situated in North-western China and all its neighbours are NPCs. A few local businessmen became millionaires owing to their investment in the real estate sector in the provincial capital and returned to their native county with great enthusiasm to develop the local economy. They met a businessman from Hong Kong and introduced him to a local product – a kind of *Ginseng*. The Hong Kong businessman found the business opportunity interesting. They created joint-ventures in the county, developed the technologies for plantation, and opened up a big overseas market. More and more businessmen came to this county for business opportunities and many other local products were later valorised, which brought more investment and entrepreneurial activities into the county. The county’s economic development also attracted attention of the superior government level and a large amount of government funds was offered to improve local physical infrastructure. A virtuous cycle was formed and the local economy has since then grown quickly. By contrast, a story of failure in a NPC in North-eastern China is also instructive. This NPC has the largest base of flax production (*linum usitatissimum*) in Asia. But the rich resource endowment is not fully explored due to many factors, among which the inefficient market promotion of the local products is a main one. Both private entrepreneurs and local government wait for each other to do something to develop the market. Till now, this NPC can only ‘*beg money while standing on a golden hill*’.

More lessons of failures are found in other counties. The county governments actively urged local farmers to plant some special products because these products were found feasible and profitable on the markets. However, in part of the cases, the government officials overlooked that the products they suggested to grow were inapt to the local soil and the investment was

doomed for loss. In some cases, when the farmers brought their products to the market, they found that the products were no longer profitable. Market demand is always changing and difficult to predict. Therefore, the lost investment and loans became heavy burdens on the farmers. In the end, all criticisms targeted the government's misguidance, and worsened the relationship between local governments and local population. The governments thus drew the lessons and stopped administrative intervention in the local economy. In such cases, both governments and farmers are victims; the local economies are still stagnating and becoming more and more difficult to stimulate.

Many economists strongly propose to rapidly develop the service industry in LDLs to reduce the agricultural population and improve the economic structure in NPCs to achieve a 'leaping development'. But its achievement is seriously constrained by the lack of human resources. In many NPCs, the growth of service industries is significantly supported by the small-scale enterprises, focusing on services for low-quality food and hotel industries, retail/wholesale, transportation, art/craft, etc. The knowledge-based services (e.g. R&D institutes, financial markets for derivative products, consulting, press, information, etc.) are hard to scale up in LDLs²⁰¹. The distribution sector is growing to support services for agricultural production, yet far from the economies of scale needed for sustainable economic development. Private entrepreneurs take over enterprises in this sector, which were previously run by the state. In this way, they bring the distribution services to the NPCs and become intermediary between agricultural producers and external markets. Hence, their entrepreneurial activities have positive effects. But the negative effects are also observable. It is not rare to hear complaints from local farmers about the low prices of their primary products and that the large part of profit goes to the intermediaries. Shortening distribution chain and regulating the market so as to help local producers gain is urgent for reducing local poverty.

Another growing sector is tourism. However, considering the size of the local population, tourism itself is not sufficient to enrich the NPCs. For example, Lijiang (in Yunnan Province, in the south-western China) – the unique Chinese city titled 'the City of World Cultural Heritage', is very famous for its dynamic tourist economy. But the economic dynamism is limited to the old city (the tourist zone) and the revenue from the tourist sector is insufficient to enrich the city – the local GDP per capita of Lijiang is far below most that of the cities in

201 We can find provincial data for the three industries in the national statistical yearbooks, but for counties, the data on branch or activities within each industry is provided by local statistical yearbooks.

Yunnan Province – population and industrial scale matter! A populous LDL is difficult to develop by a single industry. Therefore, developing the tourist economy should go together with other industries.

The economic synergy between a city and its countryside as well as neighbouring counties creates hope to reduce the urban-rural divide and to accelerate industrialization and urbanization in rural areas – geographical proximity matters! Urban agglomeration can stimulate the economic dynamism in neighbouring counties through technological diffusion, subcontracting, and industrial transfer, etc. (the synergy between Sunan and Shanghai is an example, see Section 4.1). Some NPCs supply agricultural products in the nearby urban markets, offer cheap land to relax the excess demand of land in nearby cities and at the same time absorb industrial dynamism. By contrast, many LDLs locates far from larger urban centres hardly benefit from urban agglomeration – the remote location effect. The centre-periphery problem is often observed there. A city or urban centre may absorb and valorise a diversity of resources from neighbouring counties – the agglomeration effect. As a consequence, these counties lose their potentials to develop local economies. The poverty belt around Beijing gives such a lesson (see ADB, 2005).

Rich resource endowment may be an advantage for NPCs to develop local economies only when the resources bring business opportunities to the localities. Considering the Pearl River, Wenzhou and Sunan styles, we can see that the shortage in natural resources will not decisively hinder the local economic take-off. So, **Observation 2:** According to the experience of local economic development, the endowment with natural resources is not a decisive factor. For the current NPCs, rich natural resources endowment is only a potential for local economic take-off, but without industrialization, things will not work. How to make NPCs benefit from their resources is a key subject.

(c) **Human capital**

All the interviewees from the NPCs admit that local residents are not satisfied with their low income and living conditions. Information from other areas is now easily available in the NPCs through the improvement of telecommunication infrastructure. The great progress of the living quality in the developed localities is vividly laid out by television programmes and incites most of the NPCs residents to get rich. However, willpower is not enough to achieve wealth. Human capital needs to be (re)skilled.

In many NPCs, the poverty-stricken residents have no effective ways to become wealthy. The transition to a market economy has put the private economy upfront. But entrepreneurship is not a gift to everyone. Even if an individual is free to make decisions for his/her economic behaviour, he/she may not have enough knowledge to make the best decisions²⁰². Interviewees from some local OLGPRs complain that although local governments subsidise regularly the poor (meaning low-income) population, the latter do not know how to use the subsidies as ‘financial capital’ to move away from poverty, but spend them on food and drink for a short period, then wait for new subsidies. While interviewees from other local OLGPRs complain that while the local governments help the poor residents by loans and technological assistance for developing special products, many poor residents are not capable of applying what they have been taught and make losses; next, they criticize the governments for indicating the ‘wrong’ direction. There are also a small number of the poorest people who are not motivated to work hard to move away from poverty but only wait for the government to provide aid for survival. .

According to interviewees, human capital is defined in terms of local features. Three types of ‘talented’ persons are included in their definition of human capital:

- (a) those who have business plans and financial capital (entrepreneurial investor);
- (b) those who are capable to attract investment; and
- (c) those who have good educational background (white-collar) or have qualified skills (blue-collar).

The a-type and b-type persons are greatly welcomed by all localities. They are easily promoted by local governments in political positions (e.g. they are appointed to be deputy to the National People’s Congress or deputy to the Political Consultative Conference, or directly work in local government). In contrast, c-type persons are not preferred in LDLs. Generally, local governments organise skill-training programmes to train local youth. But when the youth become c-type persons, they usually start searching jobs in other localities, often in metropolises, for better payment. They can hardly work in their native localities due to the lack of firms. Furthermore, local governments have to send unemployed youth, whether

202 For example, Simon (1957) reminds us of the theory of the bounded rationality.

talented or not, to other localities for job in order to reduce the pressure on local labour markets. The unequal treatment between the three types of persons can be explained by:

- The values of a-type and b-type persons are in fact based on the financial capital that they can introduce to localities. Such kind of human capital is better regarded because of it holds financial capital.
- The c-type persons are not urgently needed in NPCs because the available industrial programmes are low-technology-based so that simple labourers (with low level of training or low quality of skills) can meet the demand. High-technology-based programmes are rarely allocated to NPCs.
- The c-type persons are not locality-dependent. But their demand for high payment and high living quality is not easily met by NPCs. As non-material incentives become less efficient than material ones, it is very hard for NPCs to attract these persons. Moreover, it is not worth paying the c-type persons for simple work.

Immigration can improve the local reserve of human resources and the skill qualities of local residents. During the pre-Reform period, numerous technicians, skilled labourers, and their families were allocated by the state to support the construction in the West and the Middle through, for example, the Three Front Programme, the nationwide inter-SOE support programme and some programmes during the Cultural Revolution. However, since the Reform, these programmes have stopped working. New programmes are brought about to support NPCs, for example, the Young Volunteers Programme selects undergraduates and makes them teach in primary schools in NPCs, universities send students and researchers to NPCs for technical assistance, and the 'East-Supports-West' programme exchanges government officials between developed localities in the East and NPCs in the West and the Middle. Another remarkable change is the spontaneous movement of human capital through market allocation. People are now free to go to NPCs for business opportunities. Such immigrants are generally entrepreneurs. Even though they do not aim at helping the poor, they bring entrepreneurship, skills and knowledge, novel business ideas, and financial capital to the LDLs. All these could increase the level of local human capital, lead transformations in modes of thought and economic traditions. But the entrepreneurial immigrants also have shortcomings, acknowledged by some interviewees from local governments. *First*, they emphasise the short-term profits. Many NPCs attract few immigrants because their potential for economic development can hardly reward investors in the short term. *Second*, as mentioned before, the locality may be harmed by the entrepreneurial behaviour in terms of

negative externalities when regulations are insufficient or inefficiently enforced. Many cases were presented by interviewees and their negative effects were easily observed in the localities, although most of them are not reported or studied. Therefore, entrepreneurial behaviours may have both positive and negative externalities.

Education is a main mode to improve local human capital if immigration is not efficient. NPCs understand this very well but have big difficulties to improve local education system. The 9-Year Compulsory Education is a basic policy of China, but is not yet ensured in NPCs because of the shortage of schools and teachers; and the quality of education is also a problem. The project Hope of China – funding to build schools and support dropout children (see Annex 7) – and resources from the central fiscal budget have greatly contributed to primary education in China but not yet enough. There are not many high level schools, let alone universities, in NPCs. For the youth who finish the middle school or senior school without continuing their studies, local governments organise professional training and help them find jobs in cities or elsewhere in order to release the pressure on local employment. Furthermore, the students of NPCs rarely return to their native localities after study. The outflow of human resources damages the development potential of NPCs.

Due to insufficient education, residents of LDLs generally work in low income occupation, e.g. farming, non-skilled work in private enterprises and so on. Only a small fraction of them may grasp business opportunities and become entrepreneurs. Hence, for most local residents, to work in government is the best choice because the stable and considerable salary is sufficient to make a good living in the poor locality²⁰³. Also benefiting from the various programmes of exchanging high-skilled managers, local government becomes the biggest reserve of ‘talented persons’ among local institutions (both public and private). Therefore, in the current reform of the government system, how to fully utilize the reserve to develop local economy is an important subject.

The state recognizes market failure to allocate sufficient human capital to NPCs. Thus it has launched various programmes to correct the market allocation and helps NPCs improving their reserve of human capital, such as the exchange of government officials from the East to the West, sending voluntary well-educated young people to NPCs, etc. As the market logic

²⁰³ Especially because the salary of government staff was significantly increased in several rounds in the latest years, even in cities, many people try to pass the exams to work in government.

prevails in the current China, these efforts are not sufficient to correct market failure. More and stronger state intervention is believed to provide effective measures to benefit NPCs. So, **Observation 3:** Human capital is important to promote local development but its content should be filled in according to concrete local needs. Funding of education is necessary to improve human capital but not certain to benefit NPCs because of the outflow effect. The market alone cannot improve human capital and state intervention is wished to be effective to help NPCs improve their human capital.

(d) Financial capital

A common knowledge held by the interviewees is that financial capital is vital to local economic take-off and its shortage is the main block to economic take-off in their localities. Some government officials declare that there are many industrial programmes and business opportunities waiting for financial investment. Some others believe that *if only* and *only if* financial capital is available, local economies will develop. It sounds that financial capital is a dominant factor of all economic activities.

As repeatedly mentioned before, a rational investor looks for localities to invest where (s)he can get the highest return. (S)he may not have particular interest in LDLs Further, his/her decision for investment may not put the interests of localities into consideration, especially when the relevant law or regulation is largely absent. Moreover the opportunity cost of investing in NPC, compared to the favourable investment environment in the developed localities, with regard to physical infrastructure, human resources reserve, information flows and economic initiative, is high. Hence, the rational investor will not invest in NPCs except when he really believes that his investment can get more return there²⁰⁴.

In both pre-Reform and Reform periods, the state has always been the main investor in large-scale industrial and construction programmes. The state sets its investment policy according to mixed economic-political-social criteria. Indeed, the state's fiscal expenditure is always insufficient to meet the full demand from all localities for programmes. In the pre-Reform period, the state managed to reduce the demand of financial capital by a low wage policy and through non-material incentives (e.g. the discussion of the traditional SOE's incentive system in section 2.3). Following the HIODS, financial capital was concentrated on the large-scale industrial programmes (see section 2.2). Labour-for-capital was frequently used to save

²⁰⁴ The political influence on investors is not considered here, but it really exists.

financial capital in order to support the HIODS. This method fitted the then Chinese political regime and institutions, especially the communist ideology and effective ideological education. But the Reform has broken up the whole system and market logic has been prevailing in Chinese economic decision-making. The central government has to adopt the market logic to ‘rationally’ allocate its scarce funds. But unlike private investors, the central government cannot become a purely rational investor because of its economic-political-social responsibility. Government-led poverty reduction programmes and other social-efficiency-oriented programmes launched in NPCs are necessary to local societies although they have a hard time to receive as high a return for capital as other investments (elsewhere). The difficulty for the central government is to decide ‘where to invest and in what’ with the aim of balancing economic efficiency with social efficiency, because it is not capable to subsidise all NPCs. So, it expects the market mechanisms to allocate private funds to NPCs. NPCs must compete with each other but also with developed localities for private funds. Developed localities also have huge demand of financial capital for their diverse industrial programs and in competition leave no mercy to NPCs. NPCs are in disadvantaged position for acquiring financial capital if they are not given preferential policies by the central government.

Local governments are the last ‘investors’ to be considered. But the recent Reform has prohibited local governments and their officials to do business or claim shares in corporatized TVEs. This reduces the local government revenue which in turn downsizes the local budget for local infrastructure construction. The mere legal solution for localities to receive financial capital is to attract private investment. Local governments have to convince investors that their investments are highly profitable. Hence, on the one side, they spend the scarce local budget on, or even get loans from banks for emblematic projects; on the other side, they try their best to grant investors preferential policies, simplified administrative procedures and supervision. However, their efforts can hardly offset the disadvantaged investment environment and in many cases, local governments can only *positively wait* for investors (this will be discussed later).

Learning from the three development styles analysed in section 4.1.2, less developed local economies could take off under the constraint of the lack of financial capital. Why do the current LDLs not follow these styles?

To reuse the styles in these fundamentally different institutional and historical contexts will doubtfully achieve the same results. *First*, economists argue that all three styles have fatal shortcomings and cannot persist in a mature and healthy market economy. For example, the preferential policies damage the fair competition for an efficient market economy; the government-run TVEs suffer from the ambiguous property rights and tend to be inefficient for further development. Only the Wenzhou style is favoured by mainstream (free market) economics because local government now intervenes little in the economy as the ideological constraint is no longer an obstacle to the growth of the private economy. Since the market mechanisms are rapidly evolving and show efficiency in regulating the economy, the government intervention in local economy was transformed by following the market-friendly approach. Hence, the three styles are 'obsolete' in the current 'market economy' in China, as many scholars and policy makers believe. A significant convergence of the three styles has been observed over the recent year. The local governments are transformed to be market-friendly through focusing on attracting private investment, improving infrastructure quality, and providing civil services with little direct intervention in local economy. Weak support can be found now to reuse the three styles.

Second, many advantages that helped SEZs, Wenzhou and Sunan to develop are not available for LDLs:

- The national markets of 'petty commodities' which enriched the localities and regions are now saturated. The excess productive capacity in many light industries aggravated the fierce competition so that LDLs cannot benefit from development in these industries;
- LDLs could have advantages in competition with developed localities only if they were given more preferential policies than those for SEZs. But this is very hard to obtain from the central government because the latter now try to minimise the negative effects caused by preferential policies, such as the reduction of fiscal revenue and the harm to market competition;
- In the primary stage of Wenzhou's take-off, the market was not 'healthily' developed (e.g. the quality of products was overwhelmingly poor), although Wenzhou merchants managed to accomplish the primary accumulation of capital. But now, markets are nation-wide regulated by the government. The Wenzhou road is not easy to step on. Resistance from developed localities is strong.

The insufficient supply of financial capital is not only a financial problem, but it reflects also the insufficient institutional supply. Institutional innovation should be made to develop the economy in the situation of insufficient financial capital. So, **Observation 4**: Financial capital is a dominant factor to NPCs' economic take-off, but it is insufficiently supplied to meet local demand. Neither the state, nor the market can individually efficiently support NPCs. At present, the cooperation between public and private investors is not yet developed. Local governments are only permitted to attract financial capital from the central government and private investors, but strictly restrained to intervene in local enterprise operation, To improve physical infrastructures is suggested by mainstream economists as the main way to attract financial capital, but in fact every improvement requires a large amount of financial capital, too. NPCs are difficult to get enough financial capital to take off and fall into a vicious cycle of 'investment thirst'.

(e) Institutional constraints

When discussing the previous four blocks, institutional arrangements were frequently highlighted. According to Chapter 2 and 3, institutions are not complementary but instrumental to build a 'free market' in China. Since the state is a major institution-provider, and in the Chinese context, the government is the most important agent of the state, government behaviours should be at the heart of institutional analysis. The Chinese economic-political regime requires multilevel governments to be responsible for local development. But the central government and local governments have different interests and impose different institutional influences on the local economy (examples can be found in the three local development styles). As the Reform has decentralised the government, local governments are no longer the command receivers or executors, but now have direct and overall responsibility for their local economies; the fiscal reform has allowed them to share the fiscal revenue with the central government. For the study of less developed economies where the market is not fully developed, local government behaviour must be emphasised, while they do not have the power to invest in them.

In the NPCs, poverty reduction is a main task for local governments. It is mainly undertaken by two local government agencies. The Civil Service Department (*ming zhen bu*) allocates a limited amount of money and food to the poorest residents in order to ensure their survival – the 'blood-transfer' function. The Poverty Reduction Office (*fu pin ban*) is in charge of the 'blood-generation' function. It has four tasks:

- Reporting on the local situation of poverty, applying for poverty reduction programmes from higher government levels, implementing or supervising the implementation of these programmes. Some programmes need coordination among government agencies, e.g. the Agriculture, Transportation Departments. These programmes are mainly targeted at constructing physical infrastructures.
- Resettling the poverty stricken population. A current popular method is resettling all of a hamlet's residents. There are two ways: the residents are either resettled in near locations with better infrastructure, keeping their jobs in the previous places, or resettled in distant towns or villages with new jobs offered by local governments or the market. The central and provincial government together subsidise resettlement. Each household may get 3000-10000 yuan RMB according to their counties. But insufficient government subsidies and job offers heavily constrain the scale and effect of resettlement.
- Allocating subsidised loans to low-income population and local largest enterprises. Most of the loans are directly funded by provincial and city-level governments and amount to several millions yuan RMB. They target agricultural industries and give priority to the entrepreneurial activities that can improve productivity and utilize more or higher technologies. The loans to poverty-stricken people are micro-finance with low interest (or interest-free), which can help them scale up farming, improve productivity, utilize new technologies and develop new products, so as to break free from the 'trap of poverty' (i.e. vicious circle of poverty). The loans to enterprises are expected to release the pressure of capital shortage in order to foster the "enterprises + farmers" mode of production. The performance of loans varies across counties. Evaluation of candidates (persons or enterprises) and supervision on the loan-utilization determine the performance on one side; the risk and uncertainty of the market are constraints to the performance on another side.
- Training local workers. County governments allocate local fiscal revenue to subsidise local professional schools to train youths who graduate from high school but cannot enter university. The training programmes are focused on farming skills and basic manufacturing techniques to allow the trainees to work in both agricultural and manufactural industries.

Poverty reduction programmes are insufficient to achieve economic take-off due to the lack of financial capital, so local governments have to actively make use of local resources. A common belief shared by county officials is: "For a county, the primary industry is essential to survival, the secondary industry produces wealth, and the tertiary industry promotes

economic dynamism”. Every county government makes a growth-oriented Development Plan for one year, three years or five years with objectives like ensuring a high growth rate of local GDP (e.g. 15% per year), launching large-scale industrial programmes, and promoting the newly emerged, highly profitable industries. Generally, the core indicator is the growth rate of local GDP and the plans are very ‘ambitious’. But county directors have no other choice because the local economic performance determines their political promotion. Among the numerous counties in China, the chance for promotion looks too small for each county director. So, the planned objectives are more and more exaggerated and difficult to achieve. To supply the financial capital, local government has traditionally four sources:

- Local governments can ‘negotiate’ with local state-owned banks to get loans (Lin Yimin, 2004). But this is becoming increasingly difficult due to the banking reform in the past decade. Local governments no longer have ‘administrative power’ to allocate bank loans; each bank has to be responsible for its loss or profit. NPC’s governments have less ‘power’ in negotiation than those in developed localities because most of the programmes in NPC’s are estimated less profitable than those in developed localities because less favourable business environment increases transaction costs.
- Local government could centralize local funds to create and directly operate TVEs (for example the Sunan style) or develop other kinds of collective economy initiatives. However, the reform of the ownership system (guided by the property right theory) led the large scale privatization of TVEs during the last decade. No government-run TVE will be created any more. In addition, government officials are heavily influenced by mainstream economics that devalue collective economy and pay tribute to private economy. Few of them now believe that they can run TVEs in a profitable way²⁰⁵.
- The third source is central funds. The result of applying for central funds and industrial programmes depends on many factors, such as feasibility, economic efficiency (cost-benefit) and bargaining between local and central governments (see Lin Yimin’s thesis of ‘Particularism under plan’, 2004). However, the personal connection between the local government officials, especially the county directors, and the officials in higher positions is a decisive factor. Such kind of connection only benefits a small number of localities.
- As the traditional sources are not available any more, governments of LDLs must rely on the last source – private capital. In many county governments, there are (annual) quotas for importing private investment (i.e. financial capital). Usually, government officials share quotas and their income (salary, bonus, etc.) as well as political promotion are

205 According to my interviews, even the Sunan officials now deny the government-run TVE model.

directly linked to the amount of investment they attract. They often promise preferential policies to investors on tax reduction, cheap land offer, simplified administrative procedure and loose government supervision. Among the policies, some are legal while others not. Constructing physical infrastructures is another priority. Many local governments, even in the NPCs, use their scarce fiscal revenue or apply loans from banks to improve their 'local images' by building large squares, greenbelts, beautiful city halls, even airports that are not necessary or urgently needed for economic take-off in their local contexts²⁰⁶. It is the so-called 'emblematic projects' (*xing xiang gong cheng*) or 'project for political achievement' (*zheng ji gong cheng*). However, few localities successfully attract investment even when they are 'good looking' because such projects do not always improve return on capital investment.

Other than the financial shortage, administrative sovereignty often restrains local governments to efficiently allocate resources. The agglomeration economy teaches local governments to promote the inter-governmental cooperation. In some cases, a few neighbouring localities cooperate to develop regional tourist resources. But the fiscal decentralization makes such cooperation difficult because there is no effective arrangement for benefit assignment among stakeholders. Bargain is very costly to achieve agreement. Usually, coordination from higher level governments is accepted but rarely works because the administrative command could hardly satisfy everyone.

Local government behaviours in both developed and less developed localities demonstrate the role of institutionalized behaviours on the one side and that of personal behaviours on the other side. Academic studies both emphasise the roles played by local officials in importing investment and developing their local industries (see for example the discussion about the Sunan style and numerous news reports about 'talented persons' in journals) and criticize the misuse of administrative power (e.g. making obstacles for private entrepreneurs in order to meet personal interests or wasting local budget in unnecessary 'emblematic project') of local officials. There are also cases where local economies are growing but the interests of local

206 Such constructions are in principle good to improve local residents' living quality (especially for entertainment) and helpful to attract investment. But considering the local situation, many constructions are 'not urgent' or 'not necessary'. For example, it is reported that in Beipiao, a NPC in Liaoning Province, the local government began to build a 'Century Square' in 2004, which was estimated to cost 8 million yuan RMB on 30 mu of land. The official objective was to improve the image of the city. As it was also too expensive for the local government to pay off a bank loan, local farmers rented the land to plant wheat (see www.sinhuanet.com, October 1, 2005, for a special report of the project of political achievement and emblematic projects in LDLs).

residents are harmed, i.e. the local residents do not benefit from local economic growth²⁰⁷. Therefore, views and behaviours of local officials are important subjects for my investigation in NPCs.

When summarizing their understandings of ‘what the market and the market economy should be in China’, interviewees who make local economic policies and planning, give diverse answers:

- Some admit that they do not know what a market economy exactly means. They only follow the guides given by the central government.
- Some equal the market economy to the laissez-faire economy. According to them, the local government should and can only ensure a favourable environment to private investment, rather than intervene in private business.
- Some insist that the economy should be regulated by both planning and market mechanisms. The strict division between the planning economy and the market economy is not useful but an outcome of the ideological conflict. Developing the so-called market economy exaggerates the contribution of the market and private forces to economic development.

When asked to give his opinions on economic inequality across localities, an interviewee says, “Economic inequality is a normal phenomenon in the real life; but to make economic inequality an objective of national development strategy is wrong.” Nearly all the interviewees admit that economic inequality across localities is *normal* and *objective* in a market economy. Many of them believe that the state has a duty to reduce economic inequality through correcting market failure, and poverty reduction must be undertaken by and only by the government.

When talking about duty and right of local government, many interviewees complain that there is a severe conflict between the two: local government must be responsible for local economic development when the political reform and newly proposed laws do not allow them to intervene in economy. They know well that if they follow the central guidelines and laws to

207 For example, it is often reported that in order to attract investment, local governments promise to provide investors with cheap land, by taking over the land from farmers at a very low price and through coercive means. The term ‘losing-land-farmer’ (shi di nong min) has become very popular in the recent years.

emphasise civil services and environmental construction in a market-friendly approach, the market will not spontaneously benefit their disadvantaged economies.

In addition, encouraged by Deng Xiaoping's 'cat theory' (see section 3.1) and the success stories of other localities, many local government officials believe that ends (economic growth) justify means (development styles), so any kind of initiatives are acceptable (including underground economy) before getting success. If an illegal behaviour improves economic performance, nobody will be punished and the behaviour will be legalized. Many local government officials obey the 1984's administrative regulation²⁰⁸ and do not intervene in firms *in public*, but *in deeds* they abuse their administrative power to build complex personal connections with corporate managers for personal and/or local interests. Local residents tacitly accept officials' *grey* behaviour as long as their own income grows. To them, the negative effects of abusing power (by local officials) on national economic and political systems are less important than their growing income. The market-friendly approach is hardly appreciated in LDLs, while the market-enhancing approach is. The problem is that the market-enhancing approach is not sufficiently studied or institutionalized to guide governments and their officials. Furthermore, the authority of laws and central commands are not fully respected. This makes it hard for macro economic regulations to achieve its objectives in China. So, **Observation 5**: Local government behaviour affects the performance of local poverty reduction and economic take-off, but its behaviour is influenced by the central government. The central government requires local ones to follow the market-friendly approach, but this approach is inefficient to achieve economic take-off in LDLs. The market-enhancing approach is really appreciated, but local governments and their officials are intervening in local economies without scientific guidance. Intervention is often done secretly, for both local interests and officials' personal gains. Without the central authorization, local governments are restrained to remove the other blocks.

Due to the five blocks, the development styles (as introduced in section 4.1) which succeeded in developing foreign trade, TVE or private economy in many localities, cannot be easily 'transplanted' to LDLs. To learn from these styles does not mean to copy them. The precious experience of the styles is how public-private cooperation was developed by various institutional efforts to overcome the blocks for local economic take-off. By contrast, today,

²⁰⁸ The central government put forward a regulation in 1984 that has forbidden Party and government agencies, and their personnel to do business or run firms since then.

there is no efficient institutional arrangement to promote public-private cooperation in LDLs. Hence, removing the institutional block and replacing it by market-enhancing institutions are the breakthrough for LDLs.

Since both the growth-orientated economic reform and the developing market institutions hardly benefit LDLs, and the market-friendly approach fall short in making efficient institutional arrangements but indeed forms an institutional block, the government's regulation in the economy at both central and local levels should not be limited to redistribution. Market-enhancing state intervention should be revalorised to develop public-private cooperation among the central government, local government and private entrepreneurs according to the concrete local contexts. So far, the sub-problematic **SP2** (about the blocks to economic take-off of Chinese LDLs in the actual market economy and the necessity of public-private cooperation in the market-enhancing intervention approach to remove the blocks) are covered by the previous two sections.

In the following section, I will integrate the SOE with economic development in LDLs to address the sub-problematic **SP3**. Combining the analyses on **SP1** and **SP2**, I will analyse the potential of the SOE to develop public-private cooperation under the market-enhancing state intervention, by referring to both the traditional model and the reformed corporate model.

Summary

This section's objective is to explain why the Chinese LDLs are still less developed. It begins with an introduction of the present endeavours to develop the LDLs in China, which include government poverty reduction measures, non-governmental aids, academic studies and local indigenous efforts. But these endeavours are insufficient to help LDLs develop. A personal investigation in 22 counties – concentrating on NPC – was done during 2003-2004 to understand the real situation and problems in LDLs. A synthesis of the outcome discloses five blocks to local economic take-off in LDLs: geographical conditions and transportation networks, natural resources and locally specific industries, human capital, financial capital and institutional arrangements. To remove the institutional block is the key to overcome other blocks. Public-private cooperation supported by the market-enhancing approach is necessary to economic take-off for present LDLs.

4.3 The Rationale of the SOE for Public-Private Cooperation

Public-private cooperation, often called with a technical term ‘public-private partnerships’ (PPP or P3)²⁰⁹, has adopted various forms/models in today’s world (see Brooks *et al*, 1984; Davis, 1986; UNDP, 2000; Wong and Anthony, 2000; Akintoye *et al*, 2003; Grimsey and Lewis, 2005; Nikolic and Mikisch, 2006; Pascariu, and Gabriela, 2006). Although its definition is not yet unified and varies according to national and regional contexts²¹⁰, PPP generally considers the involvement of the private sector in the delivery of public services with the purpose of offering better quality of services from a social and economic viewpoint or mobilising sufficient resources more easily. It is recognised that “a PPP programme offers a long-term, sustainable approach to improving social infrastructure, enhancing the value of public assets and making better use of taxpayers’ money.” (Akintoye *et al*, 2003) However, such PPP experiences are not sufficient to meet the need of Chinese LDLs to provide the institutional leverages for economic take-off. As discussed in the previous section, public-private cooperation in the LDLs should stimulate private investment and entrepreneurship through multi-level government intervention. Hence, not only public forces (mainly from the government) need active involvement of private forces (mainly from business world), but also private forces need positive intervention from public forces. Public-private cooperation has a specific connotation in this study. *First*, it promotes both public and private entrepreneurship. *Second*, it helps industrialization and marketization in LDLs. *Third*, it requires a mechanism for sharing business profits and risks among public and private cooperating partners.

According to Bennett *et al* (2000), there are four levels of public involvement (meaning here government intervention) between fully public sector and fully private sector (in decreasing order): agreement frameworks, traditional public contracting, joint ventures and passive public investment. The government is not only a regulator or policy maker, but can also participate at the firm level. As the lack of the ‘entrepreneurial government’ (Lin, Yimin, 2004) is often a major cause of the institutional block, public-private cooperation in entrepreneurial initiative has special value for the economic take-off in Chinese LDLs. Both the traditional SOE (see Section 2.3) and TVE (see the Sunan style in Section 4.1.2) can be referred to as government intervention at the firm level. But the TVE model is difficult to revalorize in the present China because, on the one side, the central government has no

209 The term PPP is defined in many ways, see Yescombe, 2007: p.4.

210 See for example, the difference between the definitions of PPP used by the governments of Canada (http://www.pppcouncil.ca/aboutPPP_definition.asp) and the UK (HM Treasury, 2000).

interest in investing in TVEs (as it still emphasizes the SOE), and, on the other side, local governments can hardly provide sufficient financial support to private entrepreneurs (in fact, as we saw, local fiscal revenue is mostly spent on infrastructure construction; local governments are forbidden by the central government to do business). The SOE is very different from the TVE because it is invested by the central government with the participation of local governments. The traditional SOE in the pre-Reform period fulfilled ‘multitasks’ to achieve both economic and socio-political objectives, and it was a main operational agent in the planning system. The reformed SOE adopts the corporate model and accommodates both the state and private investors, while it is profit-oriented with limited socio-political objectives. Can an SOE combine the pursuit of economic and socio-political objectives in a market economy? Such a multi-functional SOE cannot yet be found as a prototype in China; it needs more theoretical debate and deeper reflections on the necessary institutional innovation.

This section tries to address the sub-problematic **SP3**: How to combine the model of the traditional and corporatized SOEs to help LDLs’ economic take-off? A new form of multi-functional SOE is proposed for LDLs as an institutional innovation. The institutional innovation for the new SOE should be supported by efforts in several domains such as legislation and spatial policies in favour of LDLs, new initiatives and organization for diverse SOEs, new mechanisms for public-private cooperation, etc. But to offer a complete discussion about necessary institutional innovation is beyond the capacity of this study. Here, the new SOE is explained from three perspectives. *First*, it suggests three functions that the new SOE may undertake for socio-political objectives. *Second*, it analyses three organizational issues of the new SOE, which may ensure its survival within market competition: hard budget, governance structure (solving conflicts among interest groups), scope and scale. *Third*, it discusses Anti-Poverty legislation which may facilitate the proposed SOEs to function in China’s market economy.

4.3.1 Special functions of the new SOE

Fulfilling multitasks is an important contribution of the traditional SOEs to the national economy and society, but it has made them inefficient in the market economy, as pointed out by the reformers. In fact, the experiences of public-private partnerships in the world show that a large part of public services can be provided with profit-making at the firm level, although failures are numerous too (see Rosenau, 1999). Since the SOE reform has released a lot of social functions from the SOEs, such as provision of housing, pension, health care, nursery

service, and primary education, what functions should the ‘new’ SOE undertake? As the new SOE is proposed to locate in LDLs, their specific problems should be addressed. Three functions are suggested as follows.

(a) Implementing poverty reduction projects

For present, China’s poverty reduction projects centre on infrastructure construction in LDLs. They are generally undertaken by temporal construction project teams led by specific government agencies. The teams consist of local residents who have no jobs or low income. The projects are mostly led by the programme ‘Food-for-Work’. But, as the poverty reduction projects are not profit-oriented, the return on capital investment must be kept at a very low level. The profit-oriented private investors may not be interested to participate in the projects. That means the central government has to commit itself to the projects, with no significant participation of private partners. The huge demand for poverty reduction funds causes a big supply shortage. So, if private capital is introduced to the projects, poverty reduction projects should be more efficient. The proposed SOE model should make it possible to integrate government and private forces into poverty reduction projects. The central government decides on social objectives and allocates government funds which are non-profit-oriented. Local government follows up the project through regular financial audit and represents the central government to communicate with private investors. Private investors could be responsible for day-to-day operation and organizational management; they are allowed to gain according to a contractualized profit rate (the rate can refer to bank’s interest rate). Although the opportunity cost might be high, private investors can be compensated by preferential policies. For example, when a construction project finishes, private investors may enjoy tax reduction for their future investment, or enjoy priority in other public bidding procedures or government purchase projects. More cooperative forms can be adopted to share the risks and profits, such as BOT (Build-Operate-Transfer) and similar practices²¹¹.

It is to be noted that, the participation of private investors must be on a voluntary basis. Unfortunately, this principle is often neglected. Evidence from China shows that, when new private investment is insufficiently introduced to local projects, local governments tend to

211 The BOT model is an integrated partnership that combines the design and construction responsibilities of design-built procurements with operations and maintenance. These integrated PPPs transfer design, construction, and operation of a single facility or group of assets to a private sector partner (wwwcf.FHWA.dot.gov). This model has many forms in practice, such as build-own-operate-transfer, build-own-operate, build-own-operate-subsidy-transfer, build-lease-transfer, build-transfer, build-transfer-operate, investment-operate-transfer, rehabilitate-operate-own (see also Zhao Liqiu, 2006).

apportion expenses to existing private firms. Such kind of public-private ‘cooperation’ often damages private interests and further restrains private investment. Therefore, voluntary participation and mutual benefit are two principles to be followed.

(b) Stimulating private investment

Promoting the ‘characteristic economy’ (i.e. producing local specialty) is a key to local economic take-off. As we argued before, private initiative is insufficient to serve this purpose. The state may intervene through supportive policies, e.g. protection policies (industrial norms and standards, administrative permission, etc.) or preferential policies (tax reduction, R&D and technology transfer, etc.). But many of these policies may distort the market mechanisms (e.g. pricing) and generate negative effects on economic development. Another approach of intervention is to directly invest in economic activities by setting up public-private joint ventures, as in the suggested multi-functional SOE. This approach has at least two advantages. *First*, the investment of central funds can show the high interest of the central government in the locality or the locality-specific economic products. This should encourage potential private entrepreneurs to invest. Industrialization will become easier when investment scales up and the central government can have an influence on this. *Second*, the participation of multi-level governments may reduce the cost of information search and R&D (which can be very high for private investors) and improve administrative efficiency; the participation of private investors can help avoid the soft budget problem and improve the operational/organizational efficiency through recruiting qualified managers. The industrial projects would be profit-oriented, different to those for poverty reduction. Hence, the proposed SOEs must ensure investors an ‘acceptable’ return on capital.

The industrial transfer from the East to the Middle and the West has been proposed by the Chinese government and economists (i.e. the staircase-shaped gradient development model) for several years. But until now the transfer mechanism has not worked properly (Zhao Gongqing *et al*, 2001). Undeveloped local production systems, labour market and financial markets are no doubt obstacles. Another disadvantageous factor is the location logic. As mainstream theories assert, the (re)location of private firms should be a market’s spontaneous activity; therefore assistance from the state to influence location seems not reasonable from this perspective. The survey by Lu Lijun and Zheng Yanwei (2004: pp. 182-183) indicates that, among the eastern enterprises which invested in the West, 53.1% adopted the form of a joint-venture, while 9.4% created new private enterprises. Joint-venture is much more

appreciated as an organizational form, owing to its risk-sharing mechanism. If the state can intervene with preferential policy, and especially through direct investment in joint-ventures, industrial relocation and national economic restructuring will be much more efficient.

At the same time, the wholly-state-funded investment may suffer risks. If private capital is not tempted to follow state investments, central government can in a first step set up a wholly state-funded SOE. When the SOE performs well in profit-making and proves the potential of the industry/product, private investors will reinforce their confidence to invest. With private capital joining in, the SOE can choose from various organizational forms for public-private cooperation, or simply let private investor(s) buy out. But if the SOE cannot guarantee profit-making on markets, private investors will not follow up. Then the state must decide whether continuing to invest and run the SOE or not. Closing down the loss-making SOE is easy to avoid more losses, but perhaps also means losing a business opportunity. Thus, the supervisory institution of the SOE (e.g. SASAC) should clarify the causes of the loss-making. If the losses are caused by managerial mistakes, a new managerial team may help the SOE to become profitable. If the specific industry/product is not yet favoured by the market, by running the SOE with more efforts, it may show the state's interests in this industry/product and improve the business environment; private investors will be encouraged to follow up.

(c) Increasing human capital

The new SOE can also help LDLs enhance the reserve of human capital and improve productivity of the local workforce through learning-by-doing. As few private firms locate in LDLs, most of local labourers have to go 'outside' the locality to find a job after being trained in local schools. Those who work in private firms are only trained for 'appropriate skills', which may be firm-specific and low-tech. After all, private firms locating in LDLs must consider the cost of training workers and worry about the possible 'brain drain' of well trained workers. By contrast, training workers must be set as a social objective for the new SOEs. The traditional SOEs had very effective training institutions, such as apprenticeship and 'labour emulation'. Skilled SOE workers can train unskilled local workers in a bilateral relation. There is a living example in a locality (not NPC) where I investigated. I was told that, "In the locality, there is a small-scale SOE which is famous for a special manufacturing know-how. Local young people are recruited year after year and trained by the traditional SOE's apprenticeship institution. Many of them left the SOE once they mastered the know-how, and created their own firms in other localities. The SOE is still making profit because

the market demand is not yet fully met.” For those who only care about the SOE’s profit-maximization, this SOE must be reformed to improve its profitability; but taking the SOE’s contribution to society into account, the technology-proliferation effect may justify the SOE’s ‘irrational’ operation. In this case, how to improve the SOE’s profitability while keeping its technology-proliferation effect is perhaps a subject worthy of further study.

The ‘inter-SOE support programme’ addressing the traditional SOEs is also valuable today. For example, in the stage ‘*jian yuan zeng xiao*’ (reducing the number of labourers to improve performance) during the SOE reform, millions of SOE workers were laid off and many of them are still unemployed (especially in the Northeast region), while they are very demanded by the new SOEs in LDLs for their skills and rich experiences. Unfortunately, the present undeveloped labour market hardly mobilizes these labourers to meet this demand. Information cost is too high for each labourer who has few ways to know where to go, what to do, how much money to earn but also worry about the false or out-of-date information, the life in a new locality, etc. If the state uses its efficient, nation-wide information network, (e.g. the administrative system and the public media), and compensates the laid-off SOE employees to go to the new SOEs in LDLs, advantages and benefits are evident. It helps to re-employ laid-off SOE employees in the urban area so as to relieve the burden of job creation; in rural areas, indigenous labourers can be kept in their localities to be trained and to work for their hometown, so their belonging could be easily built up and checking rural emigration to urban areas would relieve the burden on over-populous cities.

In addition, when traditional SOEs were corporatized or privatized during the reform, in many cases, the state-owned technologies and equipments were sold at incredibly low prices. Why not sell them to the new SOEs in LDLs? Indeed, many technologies and equipments are ‘appropriate’ and greatly demanded by LDLs. The state may invest through technologies or equipments; the local government may invest with land; they could cooperate with private capital to set up the proposed SOEs. As these SOEs have special functions, in order to distinguish them from the traditional pre-Reform SOEs and the reformed SOEs, they can be called multi-functional SOEs.

4.3.2 The multi-functional SOE’s survival within market competition

According to the reformers, multitasks made the traditional SOEs fail to make profit to survive in the ‘marketizing economy’; the state had to allocate a large part of resources to

subsidize the daily operation of the SOEs. Hence, the SOE reform emphasizes SOEs' profitability. Most of loss-making SOEs are not assisted or subsidized but are 'judged' by the market for survival or bankruptcy. As a policy, SOEs are relieved from multitasks to ensure their profitability. However, if the proposed multi-functional SOEs must undertake the special functions for socio-political objectives, a critical problem is how to survive from competing with other types of firms in the market. Experiences from the reformed SOEs and non-profit organizations could be helpful to steer the multi-functional SOEs. This section makes an analysis of the new SOE's survival challenges according to three dimensions as follows.

(a) Hard budget control

The market provides selection mechanisms to eliminate disadvantaged enterprises (see Vromen, 1995, Chapter 2). Profitability is a key criterion. If a corporation cannot pay off its debt, its creditors can apply for bankruptcy; if its profitability cannot satisfy the stockholders, the latter will 'vote by feet' – sell their stock to find dividends elsewhere. What role should profitability play in an SOE?

Theoretically, from the viewpoint of the state (or the government), an SOE is worth existing on the market if the contribution it makes to society exceeds its costs or losses. But such contribution is somewhat difficult to quantify. In real life, if an SOE makes losses, it is perhaps not the beneficiaries (e.g. the public) but the investors who suffer. Although the public investors (i.e. the government) may compare the social gain with financial loss to avoid the bankruptcy of the SOE, profit-oriented private investors do not want to be affected by financial loss. However, to avoid the dominance of the profit-orientation, profit and cost should be contractualized in detail and hard budget control must be adopted. My on site investigation in SEM-MASSY (in France) provides an example. For each territorial revalorization project, the SEM signs a principal contract with local government and subcontracts to private investors. All political tasks (for example, offering social houses to low income habitants), but also the profit rate (fixed according to the current real estate market) are clearly declared in the contracts. Costs of materials of construction, of recruitment, of daily operation, etc. are also precisely calculated or estimated according to previous projects' experiences and the current market price. The budget is strictly controlled by local government and SEM. The Federation of SEMs makes annual audits to evaluate the performance of each SEM and modify the indicators for new budgets. The hard budget control aims at cost reduction, rather than profit-maximization. This principle could be

applied in the proposed SOEs in China, especially those who implement poverty reduction projects; because the projects are replicated, both profit and cost can be precisely controlled. The SOEs implementing industrial projects can also adopt hard budget control to reduce cost although the budget impact from market risks is hard to predict.

(b) Governing conflicts among interests

Investors in the proposed SOEs may have various interests. Since a contract is never complete in *ex ante* agreements on every single issue, conflicts among investors are plausible and especially occur when promised profitability is hardly reached. Furthermore, stakeholders may pressure enterprise managers to avoid negative externalities, for instance, with respect to environmental protection, land use, labour safety, social security, etc., which might decrease enterprise's profitability. Hence, handling diverse interest groups for an all-win outcome is a critical issue for corporate governance, and, in turn, is vital to multi-functional SOE's survival.

As the proposed SOEs are not strictly restrained in choosing their governance structure, the structure may vary in order to be efficient in diverse contexts. For many cases, investors' direct participation in corporate daily operation is not necessary to improve the business performance; investors mainly act as creditors eager to obtain a certain amount of profit based on a negotiated rate of interest, without becoming involved in daily operations of the SOE. This credit-based governance structure is effective for the SOEs which deal with projects undertaking political objectives (e.g. poverty reduction projects) and projects with easy-to-be-controlled market risks. Government would prefer this governance structure to collect financial capital from private forces for 'simple' projects.

For the SOEs which undertake profit-oriented industrial projects, risk and uncertainty are always hard to be controlled due to the rapidly changing markets. Entrepreneurial and managerial capabilities are thus vital to SOE business performance. Private investors may want to keep their decision-making power within or become involved with the SOE's daily operations because, according to the primary assumption of mainstream economics, a private investor minds more the return to his/her investment than public agents who manage other's investment. From the private investors' perspective, shareholding-based corporate governance could be more efficient than credit-based governance. So, developing shareholding-based corporate governance is a core issue in the current corporation-oriented SOE reform (see

Zhang Weiying, 1997). But it still needs efforts to develop the legislation system to clarify rights and obligations of shareholders, Board of Directors and managers, and to protect minor shareholders, in order to solve the principal-agent problem.

(c) Scope and scale

SOE reformers suggest withdrawing SOEs from competitive markets and concentrating them on a few strategic industries, because they believe that: *first*, SOEs are not as competitive as private enterprises on markets; and *second*, the government ‘should’ not intervene in market competition. Still these two statements remain unsubstantiated.

Are private enterprises always more competitive in the market than SOEs? Whatever normative theories assume there is no convincing proof found from the real world. In fact, since the Reform, SOEs have found themselves more and more competitive in market competition. Strategic industry SOEs have become significant players on their markets.

Still following the reformers’ conviction, the so-called strategic industries are more and more challenged by Marketization. As a consequence, the scope of SOEs is gradually reduced. An industry under state monopoly is not always monopolized by a sole SOE. Competition mechanisms have been introduced to strategic industries. Competition among SOEs and between Chinese SOEs and foreign firms in the global market has become quite normal to the Chinese people.

Furthermore, local context should be taken into account. In many localities, especially LDLs, local markets accommodate very few firms, whether state- or privately owned, and whether the industries are competitive or not. If SOEs are obliged to withdraw or are forbidden to enter the ‘competitive industries’, private firms will not certainly take their place in these localities. As evidence from my investigation shows, some local economies quickly lost dynamics when local SOEs were closed. In other words: the withdrawal of the SOEs also reduced the market potential. To make the markets competitive and to attract private entrepreneurs, SOEs can be the first ‘gold miners’, help private investors recognize the local potential of specific industries and show the way to potential joint-venture.

If a multi-functional SOE performs well and becomes the leader in the local or even national market, must it be privatized? There is no definitive answer from economic theories. As

multi-functional SOEs are oriented to spur economic take-off in LDLs, once the objective is achieved, they can be sold to private investors, and the state can use the surplus to invest in other projects and localities. But it can also keep a successful SOE running if it continues to improve economic and social efficiency.

As LDLs are concentrated in rural areas where agriculture is the main dominating economic sector, developing agriculture and agriculture-based industries is critical to local economic growth, besides infrastructure construction. But as we learned from the Observations, the current situation of agricultural production in China is very uneasy. *First*, the cultivated area is decreasing rapidly because of desertification, reservation for industrial use, or by being laid waste due to the emigration of local labour force. *Second*, advanced farming technologies are not used as quickly as industrial ones; although it has succeeded in stimulating farmers to improve productivity for their own benefits, the Household Contract System has hindered collective production and intensification of land use. *Third*, prices of agricultural products have been limited at a very low level during a long time by the state regulation which is set to avoid inflation. In the meanwhile, governmental funds help keep the prices low but insufficiently compensate farmers for the low margins. In consequence, the small-scale – household – agricultural production does not return to its producer to the same extent manufacturing industries do. *Fourth*, farming accounts for a large portion of agriculture, while the other agricultural production (e.g. fishery, animal husbandry, forestry, etc.) and agriculture-related industries (e.g. food processing, biological and ecological research, logistic, trade and the future market) are hardly developed. If no strategies are set up in time, agriculture will enter a serious crisis. Once the state opens the markets of agricultural products, the shortage of supply will be reflected by the market price. The Chinese central government has made efforts to open the food markets, but the dramatic rise in food price since 2007 has forced it to slow down its pace. The multi-functional SOEs can enter the agricultural industry. Through promoting public-private cooperation the production factor market can be developed and the risk of freeing the product market with quickly rising price could be reduced as well.

The scale of an SOE is also an important issue. The current SOE reform insists on the measure ‘grasp the large ones and let go the small’ (*zhu da fang xiao*); see Chapter 3. An excuse to focus on the big fish only is that the central government and SASAC find it too difficult to supervise multiple levels and numerous SOEs. In practice, the central SASAC

regroups small SOEs (according to industrial process or geographical proximity) and scales them up to make them competitive on markets, meanwhile privatises the others or leaves them under the direction of local SASACs. Today, the central SASAC supervises less than 200 large-scale national corporations. However, these corporations can hardly benefit LDLs due to their location strategies. Setting up large-scale SOEs in the geographically dispersed LDLs is not realistic in China. In fact, the multi-functional SOEs are should not necessarily be large-scale. Small- or middle-scale firms can be effective to undertake special functions for socio-political objectives as discussed above. The corporate scale depends on local context, e.g. the industries to engage with, the socio-political tasks to fulfil, local economic situation and business culture, local regulations, and so on. Foreign experiences have shown the importance of small- and middle-scale enterprises to local/regional economic development (see Danson, 1996). To supervise the localized small-scale SOEs, local SASACs should take more responsibility and receive decision-making power in place of the central SASAC. But to prevent local SASACs from abusing their power, financial audit and accounting transparency must be ensured. Furthermore, the SOEs engaging in the same market can be grouped (referring to the SEM system in the EU) so as to facilitate the central supervision.

4.3.3 Anti-Poverty growth legislation

Legislation is an important part in institution building. The legal system is itself an institution designed through political processes and reinforced by the state power, it is also a fundamental institutional base on which other institutions should be established and according to which they should be put into practice. As China is improving its legal system in order to build up a law-based society, development strategies, economic policies, government functions and operation of firms are all required to be in consistent with the Constitution and specific laws. Hence, a specific concern should be raised as to the legislation for the multi-functional SOEs. It needs to pay attention to three aspects.

First, Anti-Poverty legislation should be developed. As explained in Section 4.1.2, the Uneven Development Strategy has achieved the objective of its first step – to enrich a group of Chinese people and regions/localities, but the objective of the second step – to enrich the others – lacks clarity as to timing, actions, and mechanisms of implementation as well as evaluation. Chinese government has made Anti-Poverty efforts by adjusting spatial development strategies (see Section 4.1.3) in order to help less developed regions, localities and people to develop. However, under the pressure to accelerate economic growth, growth

maximization policies still dominate the economy, while Anti-Poverty policies are easily overlooked because of the lack of Anti-Poverty legislation.

Up to date, there is no legislation for even regional development targeting poverty and inequality reduction. Drawing upon experiences of the previous poverty reduction achievements in China (e.g. the “8-7” Plan and the guideline of poverty reduction in rural areas 2001-2010), but also experiences from the EU (e.g. the structural and social policies, the Structural Funds, and so on, see cohesion policies and reports of the EU), Anti-Poverty legislation can be prepared to cover a set of dimensions, for example:

- Establishing a dynamic observatory to identify the poverty-stricken people and localities: e.g. defining criteria of poverty that are automatically updated on the basis of the changing national income index; setting up an information system of poverty-stricken people and households; determining periodic objectives of poverty reduction;
- Defining rights of the poverty-stricken people, e.g. rights to participate in local decision-making;
- Designing preferential policies for poverty stricken localities to facilitate private investment;
- Determining actors of poverty reduction: state agencies, firms, domestic residents, foreign institutions and people, etc.;
- Determining duties and rights of the state, multi-level governments, and other poverty reduction actors;
- Designing diverse means to poverty reduction: programmes and projects for “blood-transfer” and “blood-generation”, as well as social assistance (e.g. charity, etc.);
- Determining the administrative procedure for applying, implementing and evaluating poverty reduction programmes;
- Establishing a supervision mechanism for utilizing poverty-reduction funds: sources of funds, allocation of funds, accountability of funds; and
- Designing preferential policies for individuals, firms and localities who contribute to poverty reduction.

Second, the current multi-level government’s economic functions should be revised, especially at the local level. Reminding the Observation 5 in Section 4.2.2, local governments face a paradox that they are responsible for local economic development, but have no rights to intervene in business operation (e.g. running firms except for local SOE). The relevant 1984

regulation (forbidding Party and government agencies, and their personnel to do business or run firms) was expected to check corruption, abuse of administrative power and distortion of the market economy, while the negative effects are obvious – do less is better to avoid mistakes. Now, the government market-based social indifference receives as many criticisms from the public as the totalitarian government does. The misunderstanding and misuse of the government's economic functions is an urgent problem to solve for the economic and political reform in the future. The market-enhancing interventionism requires governments to do something, proactively, learning from the diverse development styles, their strengths and weaknesses. If it cannot receive support from legislation, proactive action can only be taken illegally or secretly. As acknowledged by local practices, actions have a hard time to achieve all positive expectations on the one side, and not to harm the authority of the law and the state on the other side. As a consequence, it is strongly suggested to make legislation that would facilitate the development of public and state economic functions.

The central government should integrate social responsibility into economic growth and development approaches. Poverty reduction should be set as a long-term mission and economic inequality should be limited at an 'acceptable' level which will be and could only be determined by the National People's Congress. Local governments, at each sub-national level, should be allowed to develop various market-enhancing intervention measures. Local SASACs could be granted as the only public agency to manage state assets. It is truly necessary to avoid local governments abusing their administrative power for private benefit (which harms the fair market competition), but rent seeking is a normal behaviour of government to increase fiscal revenue. No prohibition measure (e.g. administrative command or Party's discipline) will be effective if not matched with law enforcement and sanctions. Hence, the emphasis on regulating economic functions of local government should be on:

- Clarifying the decision-making procedures, for example, by improving public participation;
- Reinforcing the supervision system on the utilization of local funds; and
- In multi-functional SOEs, or other forms of public-private partnerships, the government or its agency's functions, duties and rights must be clearly defined by contract.

Third, legislation on the SOE must be adjusted to promote multi-functional SOEs and other forms of organization which utilize state-assets. The SOE reform has revised the Company Law, which is applied to all types of firms including the SOE. The SOE is thus homologue to other types of capitalist firms, while its socio-political functions are not defined in the law.

Hence, various forms of the SOE, e.g. the proposed multi-functional SOE are not covered by the law. The current legislation homogenises the SOE, which causes the loss of institutional diversity and might limit the evolutionary potentials of the SOE²¹². The ongoing corporatization of the traditional SOE only serves a profit-oriented SOE reform, but does not contribute to the multi-functionality explained above.

Returning socio-political objectives to a group of SOEs (e.g. the multi-functional SOEs) can be regarded as an effort to improve social welfare, but economic efficiency is also considered to measure the overall social efficiency. Legislation should now further the SOE reform by:

- Improving the participation of private capital;
- Clarifying the decision-making procedure within the multi-functional SOE;
- Clarifying shareholders' duties and rights; and
- Taking into account stakeholders' interests by reinforcing social responsibility and state subsidies to multi-functionality.

Mainstream reformers may be resolute opponents to these proposals. Some are vested interests and oppose them because their interests might be harmed by Anti-Poverty policies; others oppose because of their short-sighted considerations or academic prejudice. However, the reformers have difficulty in sustaining an overall development of China that offers solutions to LDLs' economic problems. These solutions include poverty and inequality reduction, reinforcement of subsidies to LDLs, and setting up the multi-functional SOEs. Although the market-oriented Reform is not necessarily re-oriented should not be questioned, reformers now must rethink "Where should the Reform go from here, growth with more or less inequality?"

Summary

This section proposes multi-functional SOEs, which help to promote economic take-off in LDLs. Such SOE draws upon experiences from the traditional SOE and the reformed SOEs to undertake special functions among their market orientation. Three functions are suggested: implementing poverty reduction projects, implementing industrial projects to stimulate private investment, and increasing human capital. The SOE's survival within market competition is discussed according to three dimensions: hard budget control, governance structure, scope and scale. At last, efforts leading towards modified legislation for the proposed SOEs are

212 See Grabher and Stark (1997) for the discussion of the relationship between institutional diversity and evolution.

emphasized in order to support Anti-Poverty growth legislation and promote public-private cooperation in LDLs.

Conclusion: Multi-functional SOEs as a Platform for Public-Private Cooperation in Chinese LDLs

This chapter has put forward a new type of SOE as a platform for public-private cooperation to promote the economic take-off in LDLs by addressing the sub-problematics **SP2** and **SP3** (see the end of Section 1.2). It consists of three sections. The *first* section presents the evolution of Chinese spatial development strategy, i.e. from the pre-Reform coordinated strategy to the uneven development strategy during the past thirty years of the Reform; then to a set of new strategies which plan to develop all regions at the same time. Learning from this historical review, experiences of local economic take-off are summarized according to three development styles. For example, the Pearl River style takes advantage of favourable location and preferential policies from the central government to develop foreign trade and attract foreign investment (but also domestic human resources); the Wenzhou style shows the dynamism of the private economy owing to local entrepreneurial culture and local government's market-enhancing efforts; and the Sunan style distinguishes itself from the other two styles by local entrepreneurial governments which are identified by the direct and strong intervention in local firms. Even though the styles owe their success to different driving forces (see Table 4-1), public-private cooperation among the central government, local governments and private investors is found a core mechanism for successes.

As the styles are available and well-covered, why are the LDLs still less developed? This question has been examined in the *second* section. Before giving an answer, Section 4.2 introduces the four efforts, in the present China, to help LDLs: poverty reduction programmes implemented by the central government, non-governmental aids, academic studies and indigenous efforts led by local government and entrepreneurs. Despite the efforts, however, LDLs are still struggling to reduce poverty. The concrete situation of LDLs, especially the blocks to economic growth, explains why the policy efforts are ineffective, why the styles are not valuable, and why LDLs' problems persist. Through my on site investigation in 22 LDLs, 15 of which are NPCs, five blocks to local economic take-off have been observed.

The *first* block is caused by a disadvantaged geographical conditions and insufficient transportation network. Local residents are concentrated on farming and have uneasy access

to the outside world. The local market is somewhat isolated from the national and global markets. Production factors provided by market allocation are expensive. *Second*, most of LDLs are rich in natural resources, but this potential has not been transformed into advantages for profit-making on markets. Due to the first block, exploiting local resources are very costly. To attract private investment, local authorities have to undertake a part of obligations of investors (e.g. environment protection), promise them preferential measures (e.g. tax reduction) and transfer a large part of profit to investors (e.g. allowing low wage and less social security for workers). In addition, LDLs' industrialization lags behind that of other localities and their locally specific industries produce very little added value and hardly develop competitiveness on markets. Hence, resource exploitation does not necessarily benefit localities. The *third* block is the lack of human capital although this varies in terms of local features. Three types of talented persons are identified. The a-type and b-type persons are those who can bring entrepreneurial activities and financial capital to localities, so they are greatly welcome. But if both of them are absent, the c-type persons (well educated or skilled) cannot be easily employed in LDLs but prefer to go elsewhere. However, the loss of c-type persons will further aggravate the lack of human capital and degrade local attractiveness for investors.

Financial capital is key to remove the above-mentioned three blocks and its insufficient supply is indeed the *fourth* block. The government has difficulty to fund economic take-off in LDLs, so a cost-benefit analysis of Anti-Poverty efforts is mandatory. Local governments are seriously restrained by the scarce local fiscal revenue which may always be insufficient for infrastructure construction. Anti-Poverty programmes and projects often end in the stage of planning and are not implemented. In addition, as the economic reform is market-oriented, the central government expects that market mechanisms allocate resources more efficiently than state allocation. However, private resources will not spontaneously support economic growth in LDLs, as a high return to investment is usually not guaranteed. Therefore, LDLs have no advantage in competition over investment with developed localities due to the first three blocks. Neither government nor market alone can supply financial capital to LDLs. Institutional arrangement should be taken into consideration for promoting public (mainly represented by the government) – private cooperation. Unlike under the pre-Reform planning system (all national resources were controlled and allocated by the government), in the current developing market economy, resources allocated under government control have been largely limited, while those under the control of private investors have been dramatically

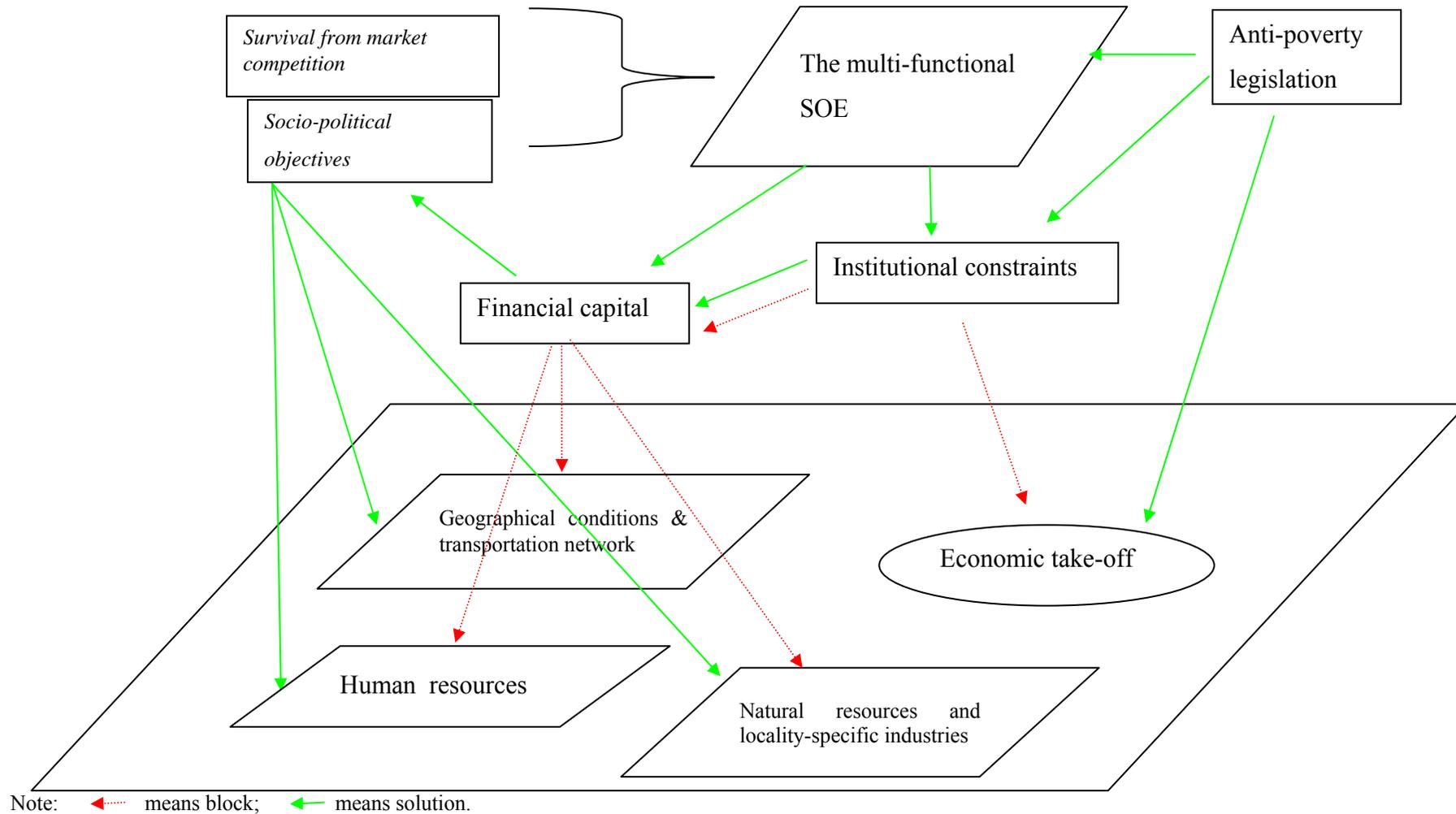
increased. Through the proposed public-private cooperation, private resources can be introduced to the state planning initiative so as to make up for the shortage of the central or local government funds and remove the financial block.

Furthermore, the three development styles (see Section 4.1.2) have provided experiences that LDLs may promote economic take-off under conditions of insufficient financial capital through effective institutional arrangement. But, the final Observation identifies institutional constraints as the *fifth* block. To fully develop a market economy, the Chinese government has reduced its intervention in the economy, but as a consequence, local authorities have lost their intervention power. They can only spend fiscal revenue to attract investment but have no rights or means to subsidize local industries and firms. This institutional block has seriously weakened the market-enhancing capability of local governments. This made LDLs completely dependant on investment from other localities. There is little chance for local governments to alter development styles in order to make up for their disadvantaged situation caused by the other four blocks.

Figure 6 here-in-below shows the relationships among the five blocks. To remove the institutional block is a prime condition to let present efforts on developing LDLs be effective. Market-enhancing government intervention should be rejuvenated to promote public-private cooperation. Worldwide public-private-partnerships (PPP) are references for such cooperation. Institutional innovation is necessary for future reform. In this way, the sub-problematic **SP2** is covered.

Learning from the institutional evolution of the SOE (see Section 2.3 and 3.2), a group of SOEs could be transformed into a platform for public-private cooperation by combining socio-political objectives (feature of the traditional pre-Reform SOE model) and capability of surviving within market competition (feature of the corporation model). Table 4-2 below makes a comparison among the traditional, reformed and proposed SOEs. The multi-functional SOEs targets promoting economic take-off in LDLs. Hence, their guidelines promoting them should be different to these in the current SOE reform. Although the proposed SOEs are not wholly state-owned, the term 'SOE' can be reserved for the public-private partnerships which own state assets.

Figure 6: Five blocks to LDL's economic take-off and the proposed SOE as a solution to remove the institutional block



Source: Author's design.

Table 4-2: Differences between the traditional SOE, the reformed SOE and the multi-functional SOE

	Traditional SOE	Reformed SOE	Proposed Multi-functional SOE
Objectives	<ul style="list-style-type: none"> ➤ Achieving government economic planning ➤ Fulfilling multitasks for socio-economic functions 	<ul style="list-style-type: none"> ➤ Profit-maximization of state assets ➤ Controlling strategic industries ➤ Controlling monopoly industries 	<ul style="list-style-type: none"> ➤ Public-private cooperation ➤ Improving LDLs' competitiveness with developed localities ➤ Surviving in the market ➤ Poverty reduction
Functions to local development	<ul style="list-style-type: none"> ➤ Job creation and labour training ➤ Local infrastructure construction ➤ Local social security 	<ul style="list-style-type: none"> ➤ Tax payment ➤ Job creation ➤ Stabilizing specific markets by state monopoly 	<ul style="list-style-type: none"> ➤ Implementing poverty reduction projects ➤ Implementing industrial projects for local economic growth and industrial take-off ➤ Financial capital accumulation ➤ Labour training and technological proliferation
Profitability	<ul style="list-style-type: none"> ➤ Not-for-profit ➤ Cost-control ➤ Soft budget control 	<ul style="list-style-type: none"> ➤ Profit-oriented ➤ Hard budget control 	<ul style="list-style-type: none"> ➤ Profit-making for survival ➤ Optimizing the use of non-profit state assets ➤ Hard budget control
Governance structure	<ul style="list-style-type: none"> ➤ Director responsibility system 	<ul style="list-style-type: none"> ➤ Corporate governance 	<ul style="list-style-type: none"> ➤ Various governance structures
Scope	<ul style="list-style-type: none"> ➤ All industries 	<ul style="list-style-type: none"> ➤ Strategic industries ➤ Monopolistic industries ➤ Non-competitive markets 	<ul style="list-style-type: none"> ➤ Local undeveloped industries for special products ➤ Infrastructure and city services
Scale	<ul style="list-style-type: none"> ➤ All scales 	<ul style="list-style-type: none"> ➤ Large-scale corporations ➤ Group of SOEs 	<ul style="list-style-type: none"> ➤ Small- or middle-scale for an individual SOE ➤ Chain/group of small- or middle-scale SOE
Asset management	<ul style="list-style-type: none"> ➤ Managed by ministries, multi-level government and other state agencies 	<ul style="list-style-type: none"> ➤ Managed by the central and local SASACs 	<ul style="list-style-type: none"> ➤ Managed by local SASACs ➤ Managed by special state agencies with the participation of the central government, local government and private entrepreneurs

Source: Author's design.

Unlike multitasks undertaken by the traditional pre-Reform SOEs (which comprised fulfilling the state planning, providing employees with welfare services and constructing physical infrastructures for localities, and were totally funded by the state), the socio-political objectives undertaken by the multi-functional SOEs are limited to Anti-Poverty efforts. According to the needs of LDLs, the socio-political objectives may include: implementing poverty reduction projects, stimulating private financial investment and reserving human capital. Poverty reduction projects are not new, but they are never implemented by the reformed SOEs and rarely by private forces. If government and private agents cooperate to run project-driven SOEs, the financial pressure on government could be relieved and more private forces could be motivated to participate in local socio-economic construction. Poverty reduction projects are usually less profitable, so government can transfer its share of profit to

private investors and enjoy the socio-political achievement. For many industrial projects which are not included in the national poverty reduction programmes, but hinder private investment because of high risks of profit-making on markets, government-led public forces may set up SOEs independently in the early stage of business operation. Good business performance may stimulate private forces to follow up and public-private cooperation could be achieved for further development. The proposed multi-functional SOEs could also improve local human capital by revalorizing 'labour emulation' and 'inter-SOE support programme', but also by combining them with programmes for exchange of talented persons across localities.

In China's market economy, firms must make profit, or at least, not make loss. This is also the principle for the proposed multi-functional SOEs. Especially for private investors, acceptable profitability is mandatory. Considering the socio-political objectives that may weaken the SOEs' profitability and even the survival within market competition, a series of rules should regulate the SOEs' operation. Hard budget control, governance structure, scope and scale have been discussed here. As soft budget is a fatal shortcoming for the traditional pre-Reform SOE, both public and private agents should impose hard budget control. Transparency of the accounting system and an efficient audit system are basic requirements. Governance structure is a critical issue to manage various shareholders and coordinate stakeholders. This is not a problem that is unique to SOEs. So the proposed SOEs can learn from other types of firms. The current SOE reform has largely limited SOEs' scope and scale. Mainstream reformers insist on the withdrawal of SOEs from industries where market competition has been formed. However, there is no evidence proving that SOEs cannot compete with private firms, if they are allowed to compete under the same conditions. In many LDLs, SOEs are important players on local markets. The withdrawal of SOEs would hinder LDLs' competitiveness and industrial development. Considering scale, nearly all small- and middle-scale SOEs have been privatized, closed, or transferred to local authorities, i.e. multi-level SASACs. But creating large-scale SOEs is too difficult and unnecessary for LDLs. Experiences from other countries prove the effectiveness of small- and middle-scale SOEs in promoting local development. Establishing an alliance among SOEs in a same industry could improve efficiency of resource mobilization, information flows and supervision from the central SASAC. Both scope and scale should be responding to local contexts, rather than to abstract theories.

The proposed SOE addresses the sub-problematic **SP3**, but is not yet available in China. The proposal is controversial with current reform measures which are growth-maximization-oriented, Anti-Poverty legislation is thus necessary to facilitate and ensure the institutional innovation. It should involve three types of legislation:

- legislation facilitating specific spatial policies targeting developing LDLs;
- legislation on the multi-functional SOEs targeting socio-political objectives and public-private cooperation; and
- legislation on (multi-level) government's economic functions to motivate and implement Anti-Poverty policies.

China's Reform has achieved to enrich a part of the Chinese population, but poverty and inequality are still serious problems challenging further economic, political and social development. "Feeling for the stones to grasp as one crosses the river" is really effective in the early stage of the Reform for promoting economic growth, and it will still be valuable in the sequel of the reform. However, thanks to the experiences from both success and failure during the pre-Reform and Reform periods, Chinese leaders can now work out a clearly defined overall development plan. Anti-Poverty efforts are urgently needed to sustain China's development. The multi-functional SOEs are proposed in this chapter as solutions to implement Anti-Poverty measures. They are expected to advance theoretical studies and break up the limit of the previous Reform framework; they are also expected to provide guidance for practice.

CHAPTER 5

GENERAL CONCLUSION:

FURTHERING THE SOE REFORM FOR LOCAL DEVELOPMENT IN CHINA

China is preparing for a celebration for the 30th anniversary of the Reform. The fast growing social wealth (measured by GDP growth rate) greatly reinforces the Chinese people's self-confidence in China's future development. But the high speed of economic growth cannot hide the increasingly serious problems, for example, the 'new three mountains' (burdens on the people's living): expensive health care services, education and housing, '*san nong*' (the development of agriculture, rural economy and farmers' prosperity) and the degrading environmental quality (see Section 1.1). These problems urge policy makers to renew their understanding of the relationship between economic growth and development. The growth-based Reform has recently been challenged in its conception, and how to maintain the high speed of economic growth in a socially and ecologically sustainable way is now a core issue in China studies. As a consequence, a concept of 'scientific development' was put forward by the Chinese government at the beginning of the 21st century in order to build a harmonious society²¹³.

China's Reform has followed an uneven development pattern. Economic growth with inequality was adopted during the past thirty years because reformers believed that inequality reduction would slow down economic growth. But recently, the fast increasing economic inequality has become a key challenge to economic development and social stability in China. Inequality also means a constraint on efficient resource allocation and further marketization of the national economy. Therefore, inequality reduction is key to achieve scientific development.

This dissertation has also studied solutions to reduce inequality in China by focusing on promoting economic take-off in less developed localities (LDLs) at the county level. There solutions are not limited to fiscal re-distribution policies; they are also about institutional

213 The concept of the harmonious society has been explained in section 1.1, see also footnote 7.

innovation by integrating corporate economy and government intervention in the economy into local economic take-off endeavours. The dissertation has proposed an institutional innovation – refining a group of state-owned enterprises (SOEs) to become a platform for public-private cooperation. “Can, and how do such SOEs reduce economic inequality in China’s market economy?” is the problematic of this thesis. After having explained its logic and methodology of analysis in Chapter 1, the problematic is divided into three sub-problematics identified according to the SOE’s evolution, the transformation of government’s economic function, public-private cooperation, the local situation and blocks to economic take-off in LDLs, and functions of the proposed SOEs. The general conclusion of the thesis is organized in three sections. In the *first* section, the analyses of the problematic and the three sub-problematics are summarized. The *second* section explains from the perspective of methodology why the answers are different from the mainstream. Prospects for further studies on SOE and local development are discussed in the *third* section.

5.1 Addressing the Problematic and Sub-Problematics

Chapter 2 and 3 have been devoted to **SP1** concerning the SOE’s evolution in China. The Chinese SOE has been historically and institutionally embedded in the economy. Unlike capitalist firms, it embodied both enterprise and government functions. In the pre-Reform period (between 1949 and 1978), five forms of the economic system – Planning, *gan chao*, Military, New Democracy Economy and Great Leap Forward – were mixed and adopted under the constraints stemming from economic legacy (tracing back to pre-modern and modern China) and international relations (in modern China). The SOE adopted a traditional form respecting four fundamental characteristics: state ownership and state-party-SOE relations, management system inside SOE, incentive structure, and contribution to the local development. Based on the logic of ‘all in one game’ (see the conclusion of Chapter 2), the domestic market was replaced with a central planning system to allocate resources, i.e. the traditional SOE was not profit-oriented (even the concept of ‘profit’ was prohibited to use in the then socialist economy) but designed to achieve the state’s overall development planning goals. The state had infinite liability to SOEs and established a close supervision system to SOEs’ operation. So, SOEs seemed to be productive government agencies. According to the then communist/socialist ideology, but also limited by the fiscal basis, the Chinese government preferred non-material incentives to motivate labourers; SOEs were required to fulfil both production tasks and a diversity of socio-political tasks like providing employees with a full range of social security services. In particular, the traditional SOEs contributed to

localities more than by just offering jobs and paying taxes. They also directly participated in local infrastructure construction and provided a part of civil services.

The rule of ‘all in one game’ has been broken since the Reform began in 1978. The Reform at first focused on micro-economic efficiency through market competition. Then, the fast economic growth encouraged reformers to deepen the Reform by removing obstacles on the way of marketization. The traditional SOE was found ill adapted to the market-based economy, and thus had to transform its objectives, incentive systems, management and ownership structure to survive within market competition by making profit. Therefore, the traditional SOE had to be reformed according to the transformation of the whole economic system. Three schools of thought led the SOE reform in a time sequence.

In the early stage, the SOE reform was directed by the incentive school, focusing on micro-economic efficiency at the enterprise level. Non-material incentives gave way to material ones. SOEs were stimulated by a set of fiscal policies to maximize their economic gains. They were urged to buy production factors and sell products on markets beyond the targets set by the state’s plan. In the meanwhile, the government introduced market mechanisms to regulate the Outside-the-Planning economic sectors and later to regulate the Planning sectors little by little. When marketization and profit-making became increasingly critical to SOEs’ performance, their traditional multitasks were regarded as ‘harmful’ to SOEs’ interests. Withdrawing SOEs from competitive markets, diversifying financial sources, relieving socio-political objectives, reducing governmental (administrative) intervention, improving quality of labour and management were guided by the marketization school in the 1990s. A main goal was to help SOEs to become as efficient as private firms to make profit on markets. However, the profit-orientation challenged the initiatives of the traditional SOE. The dominating state ownership made sure that no natural person was responsible for the state assets/capital. According to the mainstream property rights theories, state ownership is less efficient than private ownership and is the root of all problems of the traditional SOE. A little later than the marketization school, the ownership school took the dominant place in driving the SOE reform. Since the mid-1990s, a complete SOE reform guidance, i.e. the 16-words principle – ‘clearly defined property rights, clearly defined rights and duties, separation between the government and the enterprise, and scientific management’ has been put forward to privatize and corporatize (by various shareholding systems) all SOEs. The SOE reform entered *in the second stage*. A hierarchical administration system – State Assets Supervision and

Administration Commission (SASAC) – was established in 2003 to manage state assets. About 200 large-scale national corporations are under the direction of the central SASAC while the other SOEs are either privatized or corporatized under the direction of local SASACs. So far, the term SOE means, in a narrow sense, the wholly state-owned enterprise; but in a broad sense, it includes all corporations with state shares.

The reform has transformed the traditional SOEs into profit-making large-scale corporations conform to the market economy. But criticisms of the defects of the SOE reform are concentrated on two issues. One is the insufficient compensation to losers caused by the reform. The losers are mainly SOEs' laid-off employees. Their income suddenly dropped. The newly built social security system was not efficient enough to maintain social welfare services which were no longer provided by SOEs. As a consequence, millions of SOE employees became vulnerable to poverty. This is a huge social cost of the SOE reform. The other defect is the huge loss of state assets during the reform. Due to the insufficient supervision on the property rights transactions, SOE managers and government officials easily colluded to 'legally' (taking advantage of loopholes in laws) pick state assets for their own benefit. Insider control and information asymmetry facilitated the embezzlement of state assets.

However, these two defects are found within the reform's framework. Reformers believe that they are unrelated to the reform's orientation and design. Recalling the traditional SOE's contribution to the local development, a third deficiency should be added here. The reformed SOE's contribution to the improvement of local and social wealth is limited to tax payment and job creation, as is that of private firms. This might be sufficient if the market economy were fully developed (even if less than perfect), but it cannot benefit LDLs where local markets are undeveloped and hard to integrate into national or even global markets. The SOE reform has improved the profitability of SOEs, but aggravated the difficulty of developing LDLs. This is another social cost that is increased by the reform. So far the **SP1** about the functions of the traditional SOE, the transformation of the SOE during the reform and the deficiencies of the corporatized SOEs from the local perspective have been covered.

Although the SOE's contributions to the local development cannot follow the traditional way and must be renewed according to the conditions of the new economic system, it is still

worthwhile to reflect on the question “do firms need to undertake various socio-political functions?” The subject has been studied in Chapter 4 by addressing **SP2** and **SP3**.

The transition in Chinese spatial development strategies according to three stages can explain how regional disparities have been aggravated since 1949. In the pre-Reform period, guided by the idea “all in one game”, a coordinated spatial development strategy was adopted by the Chinese government. Under the serious restraint of fiscal capacity, the government developed the traditional SOEs to participate in the local construction of economy and society. A series of policies like developing local (small-scale) industries according to the possibilities of local natural resources endowment, the Three-Fronts Programme and the Inter-SOE Support Programme, reduced regional disparities, but, in the meanwhile, degraded national economic efficiency because some policies were not conform to micro-economic rationality. After the Reform began in 1978, economic growth came prior to political struggle. An Uneven Development Strategy was put forward with the introduction of market mechanisms. Relieved from the previous communist/socialist ideological constraints, localities and individuals that could better adapt themselves to the market economy were encouraged to become rich in a legal way. From the economic perspective of local development, three styles are now available to summarize the successes of the quickly enriched localities. The Pearl-River style illustrates how a group of localities benefited from their location advantages and enjoyed many preferential policies (granted by the central government) to develop foreign trade, high-tech industries and export-oriented small-scale (almost family run) production of petty commodities. The Wenzhou style shows the great dynamism of private entrepreneurs in developing domestic trade and small-scale production of petty commodities, with assistance from the local government. The Sunan style proves that local entrepreneurial government and government-run township and village enterprises (TVEs) could be efficient in market competition when private entrepreneurs were scarce. All these styles owe to the successful public-private cooperation through market-enhancing government intervention. This finding shows a glaring example of the positive role of public-private cooperation and helps to cover **SP2**.

The Uneven Development Strategy has quickly enriched a large part of localities and individuals but has also increased economic inequality to a high level. Since the beginning of the 21st century, the Chinese government has made efforts in favour of a strategic transition that emphasizes both economic growth in developed localities and economic take-

off/economic restructuring in LDLs. A set of spatial development strategies was adopted to develop the West, the Middle and the Northeast of China. It requires a great effort to challenge the Uneven Development Strategy, i.e. reducing regional disparities in economic development and maintaining the high rate of economic growth in the meanwhile. A big difficulty in practice lies in the lack of effective means to implement the new strategies.

The present endeavours in China to develop the LDLs can be grouped into four categories: central government's roles in poverty reduction; non-governmental aids; academic studies; and indigenous efforts in LDLs. Although poverty-stricken population has been constantly downsized in recent years, there are still hundreds of LDLs that have difficulty to promote economic take-off. The second section of Chapter 4 helps to understand what the problems of LDLs are and why they persist.

Through a synthesis of my on site investigation in 22 Chinese localities, mainly the NPCs, five blocks to their economic take-off are observed:

- (1) Disadvantages in geographical conditions restrain local agricultural production. Insufficient infrastructure for transportation networks increases transaction costs in LDLs to develop the market economy. Industrialization and urbanization are both heavily restrained in LDLs. Financial and institutional factors constrain the improvement of transportation networks.
- (2) Natural resources endowment is not very important to localities that have location advantages to enjoy the Pearl-River style. However, in LDLs where costs are too high to develop the market economy, natural resource exploitation and locally specific industries are cornerstones of the local economy. A problem is that such efforts do not necessarily contribute to the development of the local economy because in face of financial incapacity, local governments have to attract private investment by granting preferential measures such as tax reduction, low thresholds for environmental protection, and low wages to labourers, etc. Hence, local residents have to suffer most of negative externalities. The exploitation of natural resources is hard to sustain the development of the local economy.
- (3) All of the LDLs' officials acknowledge the importance of human capital in local development, and admit the lack of it in their localities, but few of them have made efforts to improve the local supply of human capital. Human capital is defined differently according to concrete needs. Those who can introduce investment in the

locality are regarded as most needed ‘talented persons’, while those who have followed high education or acquired high skills levels are less favoured because the local governments believe that these persons can be easily found on markets whenever investment is available, and it is too costly for LDLs to keep them. Insufficient investment in LDLs burdens local employment, so local governments have to train local labourers with basic skills and send them to other localities for jobs. As a consequence, LDLs are not interesting to investors because of the shortage of skilled labourers. Once the vicious cycle is formed in an LDL, local economic take-off will be very difficult and completely depend on investment.

- (4) The lack of financial capital is a common block to local economic take-off in LDLs. Local fiscal revenue is only permitted by central regulation to improve local infrastructure and insufficient to meet the demand. So, to promote more entrepreneurial activities, local governments have to attract external financial capital. Private capital and state funds are two main sources. As a consequence, all Chinese localities compete for them and the main means is to improve local infrastructure and the business environment. LDLs are in disadvantaged position in such competition because of their insufficient fiscal capacity. But they cannot directly invest in their locally specific industries (according to the 1984 regulation, see footnote 207) to adopt the Sunan style. They have no alternative means but can only invest in local infrastructure to attract external investment.
- (5) Facing the previous four blocks, governments at various levels have made institutional efforts. Poverty reduction programmes are led by the central government and implemented by local governments. These programmes include local poverty evaluation, resettling the poverty stricken people, allocating loans to low-income population, subsidizing local leading enterprises and training local labourers. These programmes are primarily funded by the central government. But to promote economic take-off, they are not yet sufficient. Local governments have to look for more financial capital. According to the current legal system, local governments must get business loans by negotiating with banks rather than by administrative command; they must attract state-led industrial programmes by bargaining with the central government, in particular with the help of personal connections among government officials; they must stimulate private investment rather than centralize local private funds through political power. Many government officials in LDLs complain that only developed localities benefit from market-friendly intervention, because their

developed markets can provide effective means to compete with other localities and efficiently allocate local resources to support economic development.

The financial block also directly constrains the removal of the first three blocks. Many local government officials believe that once financial capital is ‘sufficient’, the local economy could take off quickly. However, the demand for financial capital is endless, whether in LDLs or in developed localities. Shortage of financial capital is normal. So, it needs bypassing the financial block to remove the first three ones. Learning from the three development styles, public-private cooperation among the central government, local governments and private investors could offset the shortage of financial capital. Institutional arrangements are hence important. But, seen from the perspective of the institutional block, the market-friendly intervention approach that the government currently adopts cannot be effective in fostering the expected public-private cooperation in LDLs. Therefore, policy-making must consider the concrete local context. For LDLs, institutional innovation is welcome if it can promote public-private cooperation in the market-enhancing intervention approach. So far the **SP2** about the blocks to economic take-off of Chinese LDLs in the actual market economy and the necessity of public-private cooperation in the market-enhancing intervention approach has been addressed.

Public-private cooperation can be achieved at the firm level. The proposed SOE can be a good platform for such public-private cooperation in China. The traditional SOE embodied the socio-political objectives (representing the state intervention) while today’s corporatized SOE has developed the capacity to survive within market competition. The key question is how to integrate the traditional and corporatized models to innovate the SOE institution in order to help LDLs’ economic take-off? This is sub-problematic **SP3** which is covered by the third section of Chapter 4. Numerous references to good worldwide practices of public-private partnerships are available for such innovation.

The proposed multi-functional SOE integrates three dimensions. *First*, it pursues socio-political objectives through special functions like implementing poverty reduction projects, stimulating private investment and reserving human capital in LDLs. It is noticeable that, unlike the current reformed/corporatized SOEs which maximize profit within their strategic roles and contexts (e.g. in monopolistic industries), the proposed multi-functional SOE should not be a short term profit-maximizer but should emphasize long-term interests and social

benefits which are not easily quantitatively measured. Through various interests-sharing mechanisms, public investors can pursue cost-efficiency and guarantee private co-operators profitability. Different from the traditional SOE, which was run by administrative command in the planning system, the proposed SOE should implement the multi-functions in accordance with the allocation signals of the market economy. Therefore, the proposed SOE's capability of survival within market competition is the *second* dimension to study. Hard budget control, governance structure, scope and scale are addressed here. Accountability, decision-making transparency and managerial improvement are keywords for studies on organizational efficiency. NGOs and non-lucrative organizations are also instructive to the proposed SOEs. Anti-Poverty growth legislation is the *third* dimension. China is improving its legal system in order to build up a law-based society. So, institutional design should be in consistence with the Constitution and specific laws, as only the legal system can enforce institutions. Concerning the proposed SOE, efforts to improve Chinese Anti-Poverty legislation can be made on three aspects: Anti-Poverty policies, government economic functions and the SOE. Thus, the **SP3** is covered but it needs more practice case studies to verify the proposition.

Through the analysis of the three sub-problematics, the **Problematic** of this dissertation has been covered: based on the review of the SOE's evolution and the empirical analysis on LDLs' problems, a selection of SOEs can be innovated to undertake socio-political objectives with the capability of surviving from market competition; following the market-enhancing approach of government intervention in the economy, such SOEs can form a platform for public-private cooperation among central and local government, and private forces, so as to promote economic take-off of LDLs within the context of China's market economy.

5.2 Contribution of the Methodology

The proposals are not in line with either the current reform's guidance or mainstream research results. Two divergences are sticking out: the proposed SOE is different from the corporation-oriented SOE required by the ongoing SOE reform; and this dissertation proposes that local government intervenes in the local economy by a market-enhancing approach, rather than as proposed by the current government reform, adopting a market-friendly approach without any real steering measures. The divergences are attributed to the methodologies that researchers use. Section 1.3 has explained why this dissertation adopts a holistic methodology and four

analytical modes. Their contributions to the results of this study are summarized here-in-below.

- (1) The part-whole analysis helps to recognise the social embeddedness of the economy and the inter-relationship between economic institutions. In this dissertation, society is studied as a whole, the economy as an embedded part (sub-whole) of it, and economic institutions as socially embedded actors. Each part must comply with the rules of the whole and its value can only be measured by its contribution to the sub-whole and the whole. So, the SOE is not an abstract institution, detached from the economic or social system, is determined by both economic and social efficiencies. Therefore, the traditional SOE fitted well into the economic and social systems in the pre-Reform China (see Chapter 2), although its economic efficiency was low according to neoclassical economic theories. When the society and the economic system both experienced a ‘great transformation’ during the Reform, the SOE institution also needed to evolve. However, its evolution has been driven by the free market logic, which has focused on economic efficiency – improving profit-making capability of each SOE, but overlooking the huge social costs of the reform – the degrading SOE employees’ welfare, the loss of state assets and the missing social efficiency of the traditional SOE, and not embedded in the social logic of the LDLs (see Chapter 3). As a result, this dissertation suggests furthering the SOE reform to integrate the SOE into China’s undeveloped market economy. Therefore, the SOE should not only improve its capability of making profit – economic efficiency, but also reinforce its capabilities of creating jobs, innovating technologies and fulfilling social responsibilities – social efficiency (see Chapter 4). SOEs may adopt different forms across industries or localities. Hence, the new multi-functional SOE is proposed to focus on LDLs for economic take-off.
- (2) Historical analysis addresses institutions in their historical contexts. *First*, unlike mainstream reformers who criticize state-ownership and multitasks of the SOE according to a normative model of the (neoclassical) firm, this dissertation returns to the ‘real’ historical context – social values, political ideology, institutional constraints (e.g. forms of the economic system), etc. – to evaluate the SOE’s value. So, in Chapter 2 and Chapter 3, the pre-Reform economic systems and the Reform’s logic as well as characteristics were introduced before analyzing the SOE. Within this reference frame, referring to the part-whole analysis, the traditional SOE is not as ‘inefficient’ as reformers declare while the reformed SOEs are not that ‘efficient’. The present

undeveloped market economy is a relevant historical context for the SOE study, and the profit-oriented corporation model should not be the 'end' of the SOE reform as it has few contributions to offer to social efficiency. The SOE should and could contribute more to society than just making profit, by developing public-private cooperation mechanisms. The experiences of traditional and reformed SOE models should be used to innovate the SOE institution in order to improve both economic and social efficiencies, especially for LDLs.

Second, the historical analysis reconsiders the government's role in economic development. It acknowledges that China's market economy is undeveloped. Mainstream economists urge the Chinese government to adopt the market-friendly intervention approach in order to achieve a free market. However, this approach is efficient for *maintaining* rather than for *building up* a free-market economy. Many development styles brought about in the early stage of the Reform were quickly abandoned because they were exposed as abusing (unclear) property rights, holding a policy bias (harmful to the 'fair' market competition) and excessive government intervention at the firm level (see Chapter 4). Public-private cooperation in the market-enhancing approach that has proven effective in East Asian countries and in the early period of China's Reform is now disabled. For economic development in Chinese LDLs, the urgent question is not *how to benefit from* the market economy but *how to achieve* it.

- (3) The process analysis emphasizes path-dependency in institutional evolution. In this dissertation, the process analysis is especially helpful to studies of the SOE, local economy and government's roles in the economy. *First*, mainstream studies always try to use neoclassical (later, neo-institutional) thought to simplify SOE objectives, but do not consider the socio-economic and socio-political characteristics of the SOE. Hence, the ongoing SOE reform has not been guided to 'improve', but to 'completely reform' the SOE institution. Some mainstream economists even make radical suggestions like that the SOE reform should be ended because there is no further need of SOEs. In contrast, the process analysis, with the aid of historical analysis, distinguishes the path of the SOE's evolution, which is dependent on the evolution of the economy and the whole society. It helps to understand the nature of the SOE and furthermore, suggests, on the basis of lessons from the past and from elsewhere, new multi-functional SOEs for economic take-off in LDLs.

Second, the process analysis helps recognize that economic problems and paths of development are different between developed localities and LDLs, but also among LDLs. Hence, a strategy, a policy, a development style or an institutional innovation may succeed somewhere but fail elsewhere. Measures to reform SOEs may vary across localities because they are embedded into various local contexts and follow various paths to evolve. To homogenise SOEs everywhere will abstract them from local contexts and ignore their potentials to contribute to local development along various locality-specific paths.

Third, the process analysis accepts that governments at various levels (national, regional and local) and in various locations may play different roles in their economies. For example, the market-friendly, market-substituted and market-enhancing approaches of state/government intervention can all find social contexts to work. The roles of government are formed and developed on the basis of social values, cultures and concrete economic situations. Hence, throughout this dissertation, the roles of the central and local governments in both pre-Reform and Reform periods have been reviewed to verify the necessity as well as potential of a market-enhancing government intervention.

- (4) Conclusions from the empirical analysis disagree with those from the normative analysis for the China study. Even though the normative ideas sound good, they are always difficult to achieve because their assumptions are never met by the real contexts. Rather than ‘what should be’, this dissertation aims at exploring ‘what is’ and ‘what to do now’. The empirical analysis is thus vital to fully apprehend real life problems. In this dissertation, the empirical analysis is based on three sources. *First*, field studies were conducted in 22 Chinese LDLs (including 15 NPCs) in 2004 and 2005 respectively. Interviews with local government officials provided rich information on local economy, culture, government behaviour and views of officials. The real situation in LDLs was assessed so as to provide a proper context for theoretical studies. *Second*, case studies of two SOEs are combined with the existing SOE literature to identify both positive and negative results of the SOE reform. This helps to deepen the understanding of the SOE institution. Many practical problems are never mentioned in the literature of SOE studies. In particular, a long-term observation on one SOE (which is still struggling in transformation) enriches the debate on the current corporation-oriented SOE reform. *Third*, references from Europe can help Chinese economists to broaden their frames of thought. For example, the idea of

integrating poverty reduction with local economic take-off is nourished and encouraged by the relevant researches led by Prof. Moulaert. The case study of SEMMASSY provides a valuable reference for the multi-functional SOEs. The empirical analysis can help Chinese economists to pay more attention to practical problems and rethink the Reform's framework and measures as to their effectiveness in practice.

The figure below makes a brief review of the four methodological modes and their contributions to the outcome of this dissertation.

Table 5-1: Methodology's contribution

Mode	Method	Conclusion
Part-whole analysis	The part's value can only be measured by its contribution to the whole.	<ul style="list-style-type: none"> * The SOE reform is not only an economic task. It should not only improve its capability of making profit – economic efficiency, but also reinforce its capabilities of creating jobs, innovating technologies and fulfilling social responsibilities – social efficiency. * Integrating the SOE into China's undeveloped market economy.
Historical analysis	To judge an institution in its historical context	<ul style="list-style-type: none"> * Returns to the 'real' historical context – social values, political ideology, institutional constraints (e.g. forms of the economic system), etc. – to evaluate the SOE's value. * The traditional and corporate models are references for the institutional innovation of the SOE in order to improve both economic and social efficiencies, especially concerning LDLs. * The market-enhancing government intervention is to replace the market-friendly approach in order to promote public-private cooperation in the present undeveloped market economy.
Process analysis	Path-dependency matters in institutional evolution	<ul style="list-style-type: none"> * Distinguishes the path of the SOE's evolution, which is dependent on the evolution of the economy and the whole society. It helps to understand the nature of the SOE and furthermore, suggests new multi-functional SOEs for economic take-off in LDLs. * A strategy, a policy, a development style or an institutional innovation may succeed in some places but fail elsewhere. Measures to reform SOEs may vary across localities because they are embedded in various local contexts and their functions as well as problems are locally specific. To homogenise SOE functioning modes everywhere will abstract them from local contexts and ignore their potentials to contribute to local development along various locality-specific paths. * The government's roles are formed and developed on the basis of social values, cultures and economic conditions.
Empirical analysis	Not 'what should be' but 'what is' and 'what to do now'	<ul style="list-style-type: none"> * Field studies in 22 Chinese LDLs (including 15 NPCs) in 2004 and 2005 respectively. The real situation of LDLs was recognised to provide a right context for theoretical studies * Case studies of two SOEs are combined with the existing SOE literature to disclose both positive and negative results of the SOE reform. This helps to

		deepen the understanding of the SOE institution * References from Europe: - Integrating poverty reduction with local economic take-off (Prof. Moolaert's research); - Case study of SEMMASSY as reference for the proposal of multi-functional SOEs.
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Source: Author's design.

5.3 Prospects for Further Studies

During the Reform, economic, political and societal systems all underwent great transformations. To sustain China's fast economic growth and to achieve an overall development, there is still a lot to do. Actually, Chinese mainstream economists are seriously criticized by the public, in particular by 'the poor', because of the radical (here meaning neoclassical or new institutional – market friendly) economic rationality they adopt in policy proposals. When emphasizing rapid economic growth and stimulating the private dynamism by increasing benefits to private actors (e.g. entrepreneurs), they fail to protect 'the poor' and reduce economic inequalities. They are often named 'defenders of the vested interests' or 'capitalist economists'²¹⁴. However, this criticism mostly comes from the emotional or perceptual perspective of the public which is to a large extent composed of low income people. Little academic research has been made or published to dispute and correct the mainstream view²¹⁵. In consequence, the proposals for building up a harmonious society, pursuing an ecologically sustainable economic growth, poverty and inequality reduction sound reasonable, but lack support from economic research. To make up for this shortage, two trends in economic research need to be changed.

First, a part of the market feverish Chinese economists neglect the achievement of the Chinese economy in the pre-Reform period and exaggerate the success of the Reform. As a consequence, the previous planning system in the pre-Reform period has been over-criticized. Indeed, the inefficiency of the pre-Reform economy was to a large extent caused by mistakes in implementation and interferences from political movements (the latter is called "irresistible force" in business literature). The Chinese planning system failed to take the feasibility of

214 For example, some economists insist on increasing returns to entrepreneurs because they are the main contributors to China's economic growth while reducing returns to ordinary workers because they are cheap labour which should be paid according to the market price; some assert to protect proprietors on the basis of property rights theories, but they do not mind about the means by which people become proprietors.

215 In China's universities, neoclassical and neoinstitutional economics are named 'Western economics' in textbook, while other schools of thought are rarely mentioned or taught as heterodoxy.

great blueprints into consideration. Political and ideological constraints have always distorted the economic system. Furthermore, many of the Reform's achievements, especially the rapid economic growth, are results of material and technological accumulation in the planning system. The inter-generational link is now cut while the planning and market systems are put in opposition with each other. In contrast, Japanese economists have well integrated the two systems in developing their modern economy (market-enhancing state intervention in the modern market economy). Therefore, it is not necessary to play up the market-oriented Reform by playing down the planning system. The questions should not be 'which system is better?' but 'how to take advantages of the two systems?' Unfortunately, many mainstream economists actually do not accept criticisms on the ongoing reform measures. They regard the criticisms as negating the Reform, and often lead economic debate to political struggle – in the same way the most passionate Party ideologists did before the Reform. They label the criticisms on the problems in the current market economy 'efforts to return to the planning economy' because they believe the problems are caused by the pernicious influence of the planning system and only the transformation into a free market can solve them. However, many problems are in fact caused by the transformation and the undeveloped market. Even a perfect market cannot solve all economic problems (e.g. market failure occurs very frequently) and the best functioning markets are socially embedded with a significant role for governments to play. Due to the absence of market-enhancing government intervention, known and new problems are accumulating, and provoke serious economic, social and political unrest.

Second, a part of Chinese economists insist on neoclassical or new institutional rationality and refuse to incorporate value judgement into economic studies. They argue that the duty of economists is to maximize material wealth, while value judgement is an issue taken into account by scholars in other disciplines. According to this logic, economic growth is regarded as the only goal for economists. The fast growing GDP can represent the success of economic policies and the economic reform, and conceal their shortcomings until crises break out. Hence, growth with inequality, pollution, corruption and social illnesses are all permitted, publicly or secretly, in order to achieve that goal, even at the expense of social and ecological justice. Although Adam Smith, the vanguardist of modern economics, worked out "The morality" soon after publishing "The wealth of nation", the morality and value judgement have been overlooked by many mainstream economists for a long time. But fortunately, in the so-called capitalist countries, government-supported programmes, non-governmental

organisations, mutual aid mechanisms, trade unions, academic researchers, and so on, are dynamically making every effort to reduce negative outcomes of the capitalist regime. The situation seems to be contrary in China. The state adopts a socialist/communist regime, but many economic policies are now radically capitalist. Perhaps this is encouraged by the Chinese decision-makers who assert to promote economic growth by any means whatever ‘-ism’ they are labelled. Today, China’s economy is still classified as ‘Low and Middle Income Economies’ according to the World Bank, but its economic inequality is at the very high level according to Gini coefficient and other measures. Is it too early or too late to deal with value judgement, morality and social justice? China is growing too fast, so that many contradictory outcomes appear together. What model of growth should China follow to meet the rapidly increasing demand of improving the income at one side, and keep the society develop in a socially, ecologically sustainable way at the other side? The Chinese government has already planned to make a balance between the two sides. But after putting forward the slogan of ‘building a harmonious society’, people are urgently waiting for more pro-active efforts to get tangible results.

This dissertation has targeted Chinese LDLs and managed to offer solutions for local economic take-off. First of all, it must be acknowledged that helping LDLs does not necessarily happen at the expense of economic growth of other localities. Indeed, when LDLs ‘catch up with’ (not necessarily following the same path) the other localities, the market economy will develop its capacity and improve its dynamics, benefiting both developed and less developed localities. In addition, contrary to LDLs, developed localities have more financial sources, so they do not heavily depend on central funds. Therefore, within the central budget, it is time to give priority to LDLs.

Some economists propose a leap forward development style for the LDLs. Inspired by successful cases in other countries, they expect to establish Technology Parks, high tech poles, ecological valleys, etc., to step into the most advanced industries while bypassing the stage of manufacturing with high pollution. The proposals sound appealing, but they must be backed up by large amount of financial and human capital. Unfortunately, both are in shortage in LDLs. True, the central government has the capacity to support a few localities, but it is not reasonable or rational. At present, industrial transfer and developing ‘characteristic industries’ are two feasible solutions for LDLs. Efficient measures should be a focus for further studies. The measures should be flexible according to the diversity of conditions in localities. To

develop a locality, policy makers must understand the local context and true facts. Neoclassical theories and Keynesian policies have both proven unable to provide solutions for LDLs' economies to take-off. Therefore, more economic theories and transdisciplinary research should be introduced into China to enrich the knowledge of Chinese economists.

Both central and local Governments have proven effectiveness in developing LDL, as shown by cases in other countries and in China's recent history. But their capacities are limited by the administrative reform which forbids governments and their officials to do business or intervene at the firm level. This reform has helped, to a certain extent, reduce the occasions of corruption or abuse of administrative power, but, has also limited the potential of local public authorities to develop efficient intervention measures for economic take-off. Taking Western local governments as examples to limit the economic functions of Chinese local governments does not work, and is proven by LDL experimentations. It is really necessary to learn how to improve the quality of civil services, introduce public participation into local decision making, and make government work transparent to the public; but it is a big mistake to deprive local governments of their market-enhancing intervention capacity, when the pressure to accelerate economic growth is still very heavy. Letting localities compete for investment is a normal means taught by 'Western economics', but in China it can only benefit developed localities. In LDLs, governments have to give many preferential policies to investors, whether legally or illegally, to get investments, ignoring the long-term effects and externalities. Such market-friendly government intervention will not benefit LDLs, let alone the 'sustainable' development of the country. How to define a government's economic functions is country specific, even locality specific. To promote public-private cooperation is a key idea for government intervention. More transdisciplinary research of economics and political science will help Chinese local governments verify 'what to do' and 'what not to do'. To share risks and gains between public actors, among different levels of governments, and between public and private actors is a crucial problem to solve.

The ongoing SOE is criticized by this study, because the nature of the SOE is gradually, but completely transformed. The SOE's socio-political objectives are regarded as burdens on the state and are removed in order to give place to profit-maximization. However, SOEs should be an instrument of state policy to intervene in the economy, to correct market failures, to make up for institutional shortages of less developed market, and providing special functions to society if private firms fail in this respect. Profit-maximization should not be the goal of the

state economy, which should aim to maximize social wealth and welfare. As the fiscal decentralization during the Reform has largely limited the central capacity to collect financial resources from firms, localities and people, a part of SOEs can be used as ‘money-machines’ to support the state’s programmes, e.g. poverty reduction. But a part of SOEs must pursue socio-political objectives, especially when relevant mechanisms and institutions are not available or sufficiently developed in China. The traditional SOE, instructive for its fulfilment of socio-political objectives, and the reformed SOE, instructive for its survival capability within market competition, are both references to the new multi-functional SOE. The SOE reform is not achieved, but it should enter in a new stage.

When this dissertation is finished, the Reform has been going on for thirty years. The market is not a myth any more for Chinese people. Therefore, the blind worship of the free market must cool down in China. The four analytical modes used in this dissertation provide a holistic methodology for further economic studies within a transdisciplinary research, involving policy makers and corporate leaders, but also interest groups representing consumers and workers. Limited by the author’s theoretical capability and the shortage of empirical data, this dissertation emphasizes the analysis of problems; it opens new discussions on multi-functional SOEs, of economic take-off in LDLs and market-enhancing government intervention; it does not end the discussion but leaves a great space for further studies. All these studies may help implement this ‘thoughtful wishing’ for the future of the Chinese people and its economy.

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ANNEXES

Annex 1: The three regions in China

The Chinese Seventh Five-Year-Plan (1986 – 90) divided the country's territory into three grand regions (Taiwan was not included in statistics):

- the **East** – Liaoning, Hebei, Beijing, Tianjin, Shandong, Jiangsu, Shanghai, Zhejiang, Fujian, Guangdong, Guangxi, and Hainan;
- the **Middle** – Heilongjiang, Jilin, Inner Mongol (or Nei Menggu), Shanxi, Henan, Hubei, Anhui, Hunan, and Jiangxi;
- the **West** – Ningxia, Gansu, Shannxi, Sichuan, Guizhou, Qinghai, Yunnan, Xinjiang, and Tibet (Chongqing was separated from Sichuan Province and became the City directly controlled by the State Council in 1997).

But this division of grand regions has been confused by four development strategies since 1996. The Western Development Strategy includes Ningxia, Gansu, Shannxi, Sichuan, Guizhou, Qinghai, Yunnan, Guangxi, Xinjiang, Tibet and Inner Mongol; the strategy of Rejuvenating the Northeast targets Heilongjiang, Jilin and Liaoning; the strategy of Rising of the Middle concerns Shanxi, Henan, Hubei, Anhui, Hunan, and Jiangxi; and the other 10 provinces are left for the strategy of Maintaining the East²¹⁶.

In addition, Liu Shiqing (2003) adopts a division which is often used by economists. According to Liu, Heilongjiang, Jilin, Inner Mongol and Guangxi are grouped into the West, rather than the Middle. In this dissertation, the division of three regions is in line with Liu's usage (see Map B). A China's administrative map is given herein below in Map A; Map B shows a division of the three regions and Table C gives a comparison between the levels of economic development of the three regions with regard to some key economic indicators (according to Liu's references);

Map A: China's administrative division



216 See the special issue of China's 11th FYP: <http://www.china.org.cn/chinese/zhuanti/quyujingji/1111327.htm>

Map B: Regional division by the spatial development strategies



Note: The colourful spots symbolise the localities where I did investigation.

Table C: Levels of economic development in the three regions (in 2001)

Indicators	Proportion of the country (%)		
	East	Middle	West
Population	37.8	33.45	28.75
GDP (regional)	57.5	25.4	17.1
Total investment in fixed assets	58	22	20
Gross industrial product value*	70.52	18.20	11.28
Industrial value added of foreign-invested enterprises	88	8	4
Provincial government budget revenue	64.15	19.18	16.67
Revenue from taxes	64.94	21.19	13.87
Import-export value	92	5	3
State-owned economy	50	26	24
Residents' saving	58.57	23.68	17.75
Structural analysis within a region			
Economic structure – proportions of three sectors (primary: secondary: tertiary)	11 : 49 : 40	19 : 46 : 35	21 : 41 : 38
Ownership structure in gross industrial product value (SOE : Non-SOE)	35 : 65	66 : 34	71 : 29

Note: * calculated according to the data collected from all SOEs and non-state-owned industrial enterprises whose sale values were more than 5 million yuan RMB (in 2001 price).

Source: selected from Liu Shiqing, 2003: pp.320-343, Tables in Appendix.

Annex 2: The categories of economic activities in China

In Chinese statistics, producing units are often classified according to the “historical sequence of economic development” namely primary, secondary, and tertiary industries:

- Primary industry refers to the production of primary products, i.e. agriculture (including crops and animal husbandry), forestry and fishing.
- Secondary industry typically involves the processing of primary products and covers mining, manufacturing, electric power, gas and water production and supply and construction. It is broken into "Heavy" and "Light" industries. Heavy industry consists of the following three branches:
 - Mining, quarrying and logging industry, including extraction of natural resources, petroleum, coal, metal and non-metal ores.
 - Industries producing raw materials, fuel and power, including smelting and processing of metals, coking and coke chemistry, chemical materials and building materials, power, petroleum refining and coal dressing.
 - Industries producing machines, metal structures, cement products, agricultural equipment. In addition, enterprises engaged primarily in repairing products of heavy industry, are classified with heavy industry. Light industry consists of all other activities classified as secondary industries.
- Tertiary industry produces services of various kinds for production and consumption. It consists of all activities that are not classified as primary or secondary industries. It is divided into four tiers:
 - The first tier is the “circulation sector” and consists of communications and transportation, warehousing, post and telecommunication, wholesale and retail trading, hotels and restaurants.
 - The second tier consists of producers providing services to production and daily life. These include finance, insurance, geological prospecting, water resource management, real estate, social service, support services for agriculture, forestry, animal husbandry and fishery, auxiliary services for communication and transportation and general technical services.
 - The third tier consists of producers providing services designed to improve the scientific and technological level and competence of the public. It covers education, art and culture, radio, film and television, public health, sports and social welfare and scientific research.
 - The fourth tier consists of producers catering to public needs and covers the government and party organizations, the military and police and non-governmental organizations.

Source: OECD, 2003.

Annex 3: The SOE reform: objectives, measures and effects by stages (from 1978 to 1997)

Time	Objectives	Measures	Effects
Decentralization and profit sharing (<i>fang quan rang li</i>)			
10/1978	Stimulate SOEs to increase productivity	Granting a part of decision-making power (for enterprise operation) to six SOEs in Sichuan Province under the direction of the Provincial Party Committee	It was an experiment for the SOE reform and it achieved the objective
06/1979	Stimulate SOE's work incentives	redistributing fixed assets among SOEs with material compensation to source/product exporting SOEs	It indirectly admitted the property power of enterprise, but the power was still very limited.
01/1980	Stimulate SOE's work incentives	Implementing a profit-sharing system which permitted SOEs to retain a proportion of profit	SOEs were stimulated to improve their profitability
10/1981	To promote labour mobility, reduce labour costs of SOEs, and improve labour efficiency	Encouraging SOEs to employ labourers through multi-form (e.g. contracts, and permitting the labour mobility in SOEs	The SOE's tradition of labour-employment began to change
03/1982	To standardise the national SOEs management system	Standardising the administrative rank and corresponding treatment of managers in national SOEs	It prepared for creating large-scale enterprise groups
10/1982	To relieve unreasonable social responsibilities of SOEs	No detail	It was difficult to implement
Tax-for-profit (<i>li gai shui</i>)			
04/1983	To clarify government-SOE relations and the status of the SOE	SOEs would pay the State a proportion of profit in the form of tax	SOEs began to be conscious of tax payment, but the tax could not reflect SOE's actual operating situation
05/1984	To stimulate SOE's work incentive and improve SOE's economic efficiency	Granting SOEs more decision-making power in ten aspects/items/dimensions???	The institutions for a market economy was not yet established; relations among interest groups were complex; SOEs did not fully get the power as the policy declared
10/1984	To adapt the State-SOE profit-sharing relations to a market economy and ensure SOEs to have certain rights of controlling their financial capital	subdividing tax categories and imposing new taxes	Due to the lagged reform of the planning system and the price system, the tax-for-profit reform did not reduce, but in fact increased SOEs' tax burden
Furthering the marketization (<i>shi chang shen hua</i>)			
09/1985	Enhance the vigour of large and middle-scaled SOEs, improve external	SOEs were permitted to sell products in markets after fulfilling the state plan; the State would reduce the commands on	These measures developed the market economy, but the administrative restraints on

	environment of SOEs and macro economic regulation	SOEs' operation and grant to some SOEs the right of doing foreign trade; and separating government from SOE	SOEs' business operation were still difficult to remove
1985	To enhance SOEs' economic duty, impel them to attach great importance to the profitability of capital-using	Transforming the means for state investment in SOEs from fiscal budget (according to state plan) to bank loans	It changed SOEs' manner of investment and financing; but due to the lack of strict supervision on banks' loans to SOEs, it was a main cause for the later over-debt problem
09/1986	To reform SOE's management system	Clarifying duties and rights of Party's delegation, director, and employees' congress, perfecting the director-responsibility system under the leadership of Party's delegation	The management system inside SOEs was still in problem due to the lack of relevant laws and the institutional arrangement for protecting property rights of investors
12/1986	To protect stakeholders' interests, optimise SOE's organizational structure, and set up a competition mechanism	Permitting SOEs to go bankrupt; a 'Law of Bankruptcy' was put into practice	It was difficult to implement
12/1986	To enhance SOEs' market-orientated operation and prop advantaged SOEs	Reducing the commands from state plan, promoting the Contract system, reforming SOE's management, financial and wage systems, encouraging and supporting the creation of enterprise groups	The Contract system and enterprise groups were greatly developed; they helped improve the economic structure.
Spreading and perfecting the Contract-Responsibility-System <i>(tui guang wang shan cheng bao ze ren zhi)</i>			
06/1987	To standardise the duties and rights of the government and SOEs through contracting	Expanding the Contract-Responsibility System (CRS) to all SOEs	The CRS improved the government-SOE relations to a limit extent and increased the central fiscal revenue, but it had many deficiencies in practice
02/1988	To perfect the CRS and improve SOEs' economic profitability	Separating ownership rights from management rights, and defining duties, rights and interests of both the State and SOEs through contracting	The details in the procedure of contracting were normalised
04/1988	To clarify duties and rights of SOEs by law and protect SOEs' legal interests	A 'law of industrial enterprise owned by all the Chinese people' was put into practice	Legislation was paid attention to, but the enforcement was in serious problem
06/1988	To normalise the operation of leasing small-scale SOEs	A temporary regulation was put into practice to standardise the leasing behaviour	This regulation was important to regenerate small-scale SOEs
05/1990	To regenerate large- and middle-scale SOEs and deepen the complementary reforms inside SOE	Perfecting the CRS; enhancing SOE's supervision system; promoting organizational restructuring inside SOE; expanding the experiments of shareholding system and tax-for-profit reform	Management system inside SOE was emphasised and the Shareholding System began to develop
Clarifying objectives of the socialist market economy Reform <i>(ming que she hui zhu yi shi chang jing ji gai ge mu biao)</i>			
1992 to 1998	To enhance the role of property rights in economic system, establish a scientific and efficient	Making efforts to expand the Shareholding System	The Shareholding System could not solve all SOE problems and became a main approach to financing

	enterprise's governance structure, and optimally use social resources		
04/1993	To restructure the economy as stabilising the society	Regulating the assurance for laid-off SOE employees and solutions to allocate redundant SOE employees	The regulations improved the environment for the market economy
Overall and coordinated institutional innovation, transforming the enterprise system <i>(quan mian chuang xin, xie tiao pei tao, qi ye zhuan xing)</i>			
11/1993	To transform the SOE in the modern enterprise system	The central government promulgated a document –“Decisions of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economy System”	This document decided the ‘modern enterprise system’ to be the fundamental objective of the SOE reform
12/1993	Standardise company's organization and behaviour, protect company, stockholders and creditors, maintain social economic orders, promote the market economy	A “Company Law” was put into effect to regulate the transformation of the existing enterprises and the creation of new companies	The law standardise enterprise operation in most of SOEs
02/1994	To optimise the capital structure in SOEs	Launching experiments to help some SOEs merge or being merged; establishing provisional fund in banks for charging off SOEs' non-performing loans; enhancing technological upgrading in SOEs; relieving social responsibilities from SOEs; developing the property rights market; and letting the qualified SOEs go bankrupt	The experiments achieved to some extent, but many conditions were not met and held up the expansion of experimental experience in the country
07/1994	To enhance the state supervision on SOEs' assets	The State Council put a temporary regulation into effect, by which principles and measures of supervising state assets were decided	This measure reduced the losses of state assets
10/1994	To restructure the economy, optimise the structure of the state-owned capital	The State council promulgated a ‘Notice’ to normalise principles and methods for SOE's bankruptcy	It was still very difficult to let SOEs go bankrupt because banks lost much
11/1994	Standardise the labour market, control the reform rhythm	The Ministry of Labour promulgated a regulation to standardise the conditions for enterprises to dismiss employees	The regulation was difficult to implement
01/1995	To restructure the economy, help laid-off SOE employees find jobs, and stabilise the society	Practising a ‘reemployment project’	Helped many laid-off employees find new jobs
02/1995	To explore approaches for transforming SOEs in the modern enterprises system	Selecting 100 large-scale SOEs to experiment the modern enterprise system	The modern enterprise system began with experiment
04/1995	To enhance the supervision on SOEs' assets and improve the profitability of state asset	Implementing a Asset-Management-Responsibility system	This system could be expanded in all SOEs to improve management, but it could not solve the fundamental problems of institutional transition to the modern enterprise system
05/1995 to 06	To improve the environment for the market economy and the modern enterprise system	Relieving SOE's social responsibilities and laying off a part of SOE employees according to a ‘Decision’ promulgated by five ministries together	The measure got a good effect

03/1996	For a strategic restructuring of the SOE, seize the large SOEs and let go the small ones, develop the market economy	Focusing on 100 large-scale SOEs for a series of restructuring programmes: investment-for-loans, reforming investment and financing methods, implementing a Enterprise (legal person) -Responsibility System for construction projects, establishing Reserve Fund for enterprise capital, establishing a social security system, and transforming the government function	These measures achieved much in experiments, and could still achieve more if the complementary reforms were implemented in the meanwhile
06/1996	To improve the bank-SOE relations, enhance banks' support to SOEs through loans and various services	Launching a banking reform by experiment in terms of banks' loans to 300 key SOEs	The result was not so good as expected
07/1996	To regenerate small-scale SOEs	Permitting small-scale SOEs to be sold, leased, contracted (by the CRS), merged, and transformed into shareholding companies, and to adopt various ownership structures and management systems, establishing intermediate agencies for relevant services to such transformation	The reform of small-scale SOEs formally began, and achieved to some extent; but very soon 'laissez faire' for small-scale SOEs became popular, which disbenefited these SOEs' survival and development
01/1997	To standardise and protect rights of state-owned stock holders in limited liability companies.	The State Assets Management Bureau and the State Institutional Reform Commission promulgated a document to standardise rights of the agents of State-owned stock	It helped regulate the state assets management
04/1997	To create large enterprise groups and develop the modern enterprise system	The State Council approved a document for furthering the experiment of creating large enterprise groups	The organizational restructuring of SOEs and state assets was promoted

Note: rights of autonomous management = RAM

zhu da fang xiao = grasp the large ones and let go the small ones

Source: adopted from Zhang Huiming, 2000: p20-25, translated by Zhu Kai.

Annex 4: An overview of Chinese SOEs from the perspective of scale

(A) The criteria for Chinese enterprise scale

Sector	Indicator	Unit	Large-scale	Middle-scale	Small-scale
Industry	Number of employee	Person	> or = 2000	300 – 2000	< 300
	Turnover	10000 yuan RMB	> or = 30000	3000 – 30000	< 3000
	Capital	10000 yuan RMB	> or = 40000	4000 - 40000	< 4000
Construction	Number of employee	Person	> or = 3000	600 – 3000	< 600
	Turnover	10000 yuan RMB	> or = 30000	3000 – 30000	< 3000
	Capital	10000 yuan RMB	> or = 40000	4000 - 40000	< 4000
Wholesale	Number of employee	Person	> or = 2000	100 – 200	< 100
	Turnover	10000 yuan RMB	> or = 30000	3000 – 30000	< 3000
Retail	Number of employee	Person	> or = 500	100 – 500	< 100
	Turnover	10000 yuan RMB	> or = 15000	1000 – 15000	< 1000
Transport	Number of employee	Person	> or = 3000	500 – 3000	< 500
	Turnover	10000 yuan RMB	> or = 30000	3000 – 30000	< 3000
Post	Number of employee	Person	> or = 1000	400 – 1000	< 400
	Turnover	10000 yuan RMB	> or = 30000	3000 – 30000	< 3000
Hotel and restaurant	Number of employee	Person	> or = 800	400 – 800	< 400
	Turnover	10000 yuan RMB	> or = 15000	3000 – 15000	< 3000

Note 1: The Industry in the column 'sector' includes three lines: Mining, Manufacturing, as well as Production and Supply of electricity, gas and water.

2: Large-scale and Middle-scale enterprises must meet all of the three requirements together.

Source: information on the website of China's Statistic Bureau: <http://www.stats.gov.cn>, translated by Zhu Kai.

(B) Information of the SOEs in 1996 and 1997 from the perspective of scale (sum: 100 million yuan RMB, at the current price)

	Number		Total product value		Added value		Capital amount		turnover	
	Sum	%	Sum	%	Sum	%	Sum	%	Sum	%
Large SOEs	4946 (4800)	5.7 (6.5)	17282	63.3	5948	68.0	34223 (39760.1)	64.9 (89.6)	17662 (19096.6)	65.0 (68.2)
Middle SOEs	10817 (10123)	12.4 (13.6)	5227	19.2	1432	16.4	10013 (2140.4)	19.0 (4.8)	5144 (4657.5)	18.9 (16.6)
Small SOEs	71219 (59465)	81.9 (79.9)	4779	17.5	1360	15.6	8519 (2459.1)	16.1 (5.6)	4357 (4231.7)	16.1 (15.2)

Note: The data between brackets is for 1997.

Source: the data for 1996 is cited from Zhang Huiming (2000: p193); that for 1997 is cited from Chen *et al* (2000: p.115).

Annex 5: A time axe for the analysis of SOE and local development in China

Subjects Time periods	Analysing the forms of the economy and economic functions of the government	Analysing the SOE and its reform	Analysing the spatial development strategies and local development styles
Pre-Modern (before 1840)	A survey of three theories to explain why the market economy did not develop in China (section 2.1).		Natural conditions held up the expansion of the market across localities for a large-scale production or market exchange (section 2.1).
Modern (1840-1949)	Introducing the then economic situation as a disadvantaged economic legacy for the then China's leaders on developing a market economy (section 2.1).		Regional inequalities and concentration of wealth in a few metropolises (section 2.1).
Pre-Reform (1949-1978)	A survey of five competing forms of the economy adopted in China (section 2.2): <ul style="list-style-type: none"> ➤ Planning Economy ➤ <i>gan chao</i> Economy ➤ Military Economy ➤ New Democratic Economy ➤ Great Leap Forward 	The traditional SOE (section 2.3): <ul style="list-style-type: none"> ➤ State ownership and State-Party-SOE relations ➤ Management system inside SOE ➤ Incentives ➤ SOE's contribution to local development 	Introducing the coordinated spatial development strategy and local autarky (section 2.2 and 4.1).
Reform (from 1978 to now)	Explaining the logic and characteristics of the Reform (section 3.1): <p>Logic:</p> <ul style="list-style-type: none"> ➤ Why reform? ➤ Why reform then? ➤ What to reform? <p>Five characteristics:</p> <ul style="list-style-type: none"> ➤ Theoretical hesitation and ideological emancipation ➤ State-led and Grassroots-promoted reform ➤ Gradualist approach ➤ From reforming outside-the-Planning to reforming the Planning ➤ Experiment-Example approach 	Introducing the SOE reform – theoretical arguments and practices guided by three schools of thought (section 3.2): <ul style="list-style-type: none"> ➤ Incentive school ➤ Marketization school ➤ Ownership school <p>(The stages of the SOE reform are listed in Annex 3)</p>	<ul style="list-style-type: none"> ➤ Introducing the uneven development strategy and diverse styles of local (economic) development (section 4.1); ➤ The empirical analysis of the less developed localities (LDLs) (section 4.2)
The future (from now on)	Emphasising economic take-off in LDLs in the socialist market economy; promoting industrialization through redefining the enterprise-locality relation; revalorising the market-enhancing state intervention by multilevel governments (section 4.2 & 4.3)	Setting up SOEs which are hybrid of the traditional SOE and the reformed corporation, undertaking special functions for economic take-off in LDLs on the basis of survival on markets (section 4.3)	Permitting and promoting diverse local government intervention in a market-enhancing approach; rethinking the central-local relation and enterprise-locality relation (section 4.2 & 4.3)

Source: Author's design.

Annex 6: The Questionnaire for on-site investigation in China

Date of interview:

Locality:

Name of interviewee:

Function of interviewee:

Duration of interview:

Local situation

- 1) The general situation of the local economy: natural resources endowment, physical infrastructure quality, local living standard and income level
- 2) The main economic activities: agriculture (food production or food processing), industry (manufactory or raw material production) or service (tourism, transport or hostelry)
- 3) The main economic agent: local government (including government funded programmes), NGO, private investors (domestic -- indigenous or exogenous -- or even foreign)
- 4) Is there an industrial agglomeration in the neighbourhood? Which type and what situation?
- 5) Has local economy been part of the agglomeration?
If yes, which position the locality holds in the agglomeration?
If no, what holds up the locality to integrate into the agglomeration?

Government behaviour

- 6) The development strategy or planning of the locality:
 - Who decide(s) the strategy or planning (is there a democratic/participatory mechanism for the local residents and localised agents?)
 - Which economic sector will be the leading force?
 - What are the conditions and constraints on achieving the objectives? Because the lack of financial support, lack of technology, lack of human resource (e.g. entrepreneurs, managers, technicians), or lack of policy support?
 - What is the development model: export-oriented, import-substituted or autarky economy?
 - What are the roles of local government in local economy?
- 7) What programmes are implemented? Why such programme in this locality? What are effects of such programmes (expected and unintended)?
- 8) What are the supports from the local government to local enterprises, if any?

Local culture and local residents' attitudes

- 9) What is the attitude of the local residents to the current situation of local economy: satisfied, not bad, unsatisfied, or indifferent?
- 10) What is the attitude of the local residents to the current situation of their living quality, measured by welfare service and personal or household income?
- 11) What is the acknowledgement of the local economic actors to the market economy? (Maybe some choices need to be offered to interviewees: efficient and good to improve material wealth; expected good but still not available—then what are the constraints on local marketization; market economy will not maintain personal welfare or income and so causes the deteriorating living quality; or no idea of the market economy)
- 12) What is the typical/dominant local culture or tradition?
- 13) Are there important ‘immigrants’ changing the local culture? If yes, what are they and what are the changes?
- 14) Do local residents like to work more for more material benefits?
- 15) Do local government officials have willingness to intervene in local economic affairs? Do they intervene in? What is their power/force/motivation/right-duty to intervene? What are the effects of intervention in a historical view?
- 16) What is the political task of the local ‘director’ and what is the political impact on the economic decision making and the director’s behaviour?
- 17) Why emigration is not chosen to be the main approach to reduce local poverty? Does the locality itself worth regeneration or promotion?

Annex 7: Chinese NGOs and Their Poverty Reduction Activities

NGO	Poverty Reduction Activities
China Foundation for Poverty Alleviation	Micro-credit, capacity building, applicable technology extension, emergence relief, health care for women and children, and primary education
China Charity Federation	Income generation activities, relief, medical subsidies, subsidies for students and schools, professional technical training
Women's poverty reduction action of the All China Women's Federation	Technical training, micro-credit, paired assistance, labour migration, assistance for female students, small scale infrastructure construction and health care for women
China Disabled Persons Federation	Applicable technical training, micro-credit, repair of endangered house, establishment of service centre
Project Hope of the China; Youth Development Foundation	Fellowship for dropout children from school, construction of hope primary school, teachers. training, teaching equipments
China Society for the Promotion of the Glorious Cause	Project investment, donation for education and support for other public affairs
Happiness project of the China Population Welfare Foundation, the China Family Planning Association and the China Population News Press	Micro-credit
Song Qingling Foundation	Subsidies for female students, construction of primary and middle schools, library on wheels for children, fellowship for female students attending normal colleges, teachers. training and reward fund for teachers
Microfinance Centre of the Chinese Academy of Social Sciences	Micro-credit and micro-credit training

Sources: Wang *et al*, 2004: p.33, Table 5.

Annex 8: Main International Organizations Contributing to Poverty Reduction in China

International development agencies	UNDP, FAO, WFP, UNICEF, UNIDO, ILO, UNFPA
International financial institutions	IBRD, ADB, IFAD
Bilateral agencies/governments	AusAID, CIDA, DFID, GTZ, JICA, the Netherlands, Finland, Sweden
International NGOs	The Ford Foundation, WWF, Oxfam Hong Kong, KfW, Aide Foundation, World Vision, Save the Children of Britain, International programmes, the International Crane Foundation, Trick-up USA

Sources: Wang *et al*, 2004: p.34, Table 6.