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The Role of Local Governments in China's Economic Development

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Abstract

Local governments in China have influenced both the success and failure of economic growth in their jurisdictions, and have shaped the transition process itself through their behaviour and response to Central government incentives. This study investigated the behaviour of China's local governments through the transition period, from a planned economy with state ownership, through the "dual track" economy and hybrid ownership, to the market oriented development today. Creating a nuanced classification of local government behaviour, this study attempts to explain the success or failure of their economic development policies. Two cities, Wenzhou and Yangzhou, were studied and compared to highlight the role of local governments in their development.

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Chapter 1: The local government in China's economic development

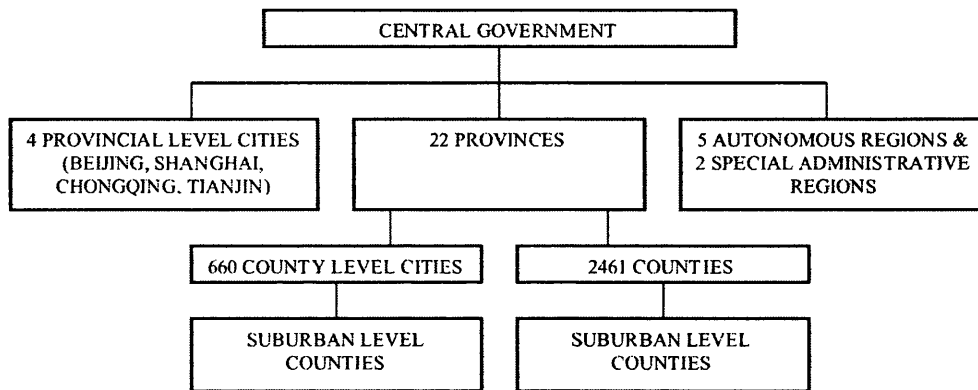
Between 1978 and 2007, China's economy underwent a period of extensive change and growth. In comparison with the "shock therapy" applied to the transitional economies of the former Soviet Union, China's gradual economic reforms has allowed China's formerly centrally planned economy to change into a market economy. Moreover, this was achieved with a sustained, high rate of growth, a shift in ownership patterns from state to semi-private and private ownership, and the restructuring of government at all levels to enable it to facilitate economic growth. These changes have taken place simultaneously through the transition period, without the benefit of a well defined strategy at the start.

One important theme in China's economic transition is the decentralisation that has taken place. The devolution of economic power and government autonomy to the local level replaced the centralised economic planning, allowing localities to act – within constraints – to develop their own economies. The Central government was responsible for macroeconomic regulation, and withdrew from micromanaging individual firms in the economy. This set the stage for local governments at all levels – from the provincial level downwards – to become key actors in their local economies.

China is divided into 33 provincial level territories, with 22 provinces, 5 autonomous regions, 4 municipalities (Beijing, Shanghai, Chongqing, and Tianjin), and 2 special administrative regions (Hong Kong and Macao). All of these nominally occupy the same provincial level status (see figure 1). Excluding the autonomous regions, municipalities and special administrative regions, the provinces has an

average population of 50.2 million, with the most populous being Henan with a population of 96 million, and the smallest being Qinghai with 5.29 million (China Statistical Yearbook, 2003).

Figure 1.1: Territorial division in China



Source: Based on Liberthal (2004)

Provinces differ in wealth, culture, geography and history. Nominally, provinces hold the same rank as Central government ministries, thus they occupy a very powerful position in the government hierarchy. Their powers, delegated to them by the Central government, have been growing since the start of economic reforms in order to achieve economic growth in line with the national strategy (Liberthal, 2004).

There are 2461 counties and 660 county level cities China's government organisation. They fall under the control of the provinces. However, orders from levels above take into consideration local conditions, and county level governments are given discretion when implementing policies. In comparison with the provincial level, county governments have much more contact with the population, serving as the interface between the state and local society. They are involved in making key decisions affecting regional development (Zhang and Wu, 2006).

The focus of this study is on local government at the county level, where policies from the Central government are interpreted and implemented. The success

of China's economic reform process has depended on the actions of local governments at this level, which have been transformed from agents carrying out the objectives of central economic plans, to economic actors in their own right. This change in responsibility and focus has brought about a variety of responses by China's local governments. They have had to continuously adapt themselves to the changing economic conditions at the national level as reforms proceeded, and also react to the evolution of the local economy under their jurisdiction.

The gradual speed of China's economic reforms gave local governments time to adopt development strategies as they saw fit, but without an overall objective they could not guess the future direction of Central government policies. The progress of their development strategies was therefore the result of ongoing interaction between the local government, the local economy, prevailing trends in the national economy, and the Central government. This placed the local governments as actors within a web of interactions in managing and developing their local economies, and they need to be seen in this context. Rather than having an "end state", Chinese local governments constantly evolve in sympathy to the changes in their local economies.

The evolution of Chinese local governments has resulted in an uneven outcome. Some local governments have been relatively more successful than others, both in terms of outright economic growth, as well as in terms of perception. Wenzhou, Kunshan, Shenzhen are all examples of where leading economic growth rates have "placed them on the map", so to speak. The approach they took in order to reach that success have been widely publicised and studied, but when compared to teach other, their actions seem contradictory.

For instance, Chinese local government compliance with Central government policies range from active participation and co-operation (as in Shenzhen), to outright disobedience (as in Wenzhou). However, these extreme examples have both achieved economic success. This strengthens the suggestion that the way local governments implements of the economic reform policies determines the policy's success, rather than the intrinsic worth of the policy itself. This suggests it is the interaction between local governments and the local economy that determine the success of Central government economic policies in a particular locality.

This study is interested in the factors determining the success or failure of local governments to develop their local economies. As all local governments ostensibly operate within the same sets of regulations and constraints, and enjoy the same privileges and leeway, the cause of their success or failure to develop the local economy need to be understood in the context of the approaches taken by Chinese local governments towards development.

Studies on local governments in China's economy have already identified a number of strategies used by Chinese local governments. These include "local state corporatism" (Oi, 1992), "capitalism with Chinese characteristics" (Solinger, 1993) "state entrepreneurialism" (Duckett, 1996, 2001), and "local market socialism" (Lin, 1995). In a review of studies done on Chinese local governments, Baum and Shevchenko (1999) created a simple typology of Chinese local governments using the degree of government connection to local firms and the incentive for local governments to increase productivity within the local economy as variables to determine local government type (see figure 1.2).

Figure 1.2: Typology of local government involvement in local economic activity

		Local government has incentive to increase productivity?	
		Yes	No
Local government connected to enterprises?	Yes	Entrepreneurial	Clientelist
	No	Developmental	Predatory

(after Baum & Shevchenko, 1999)

This simple framework serves as a useful starting point for constructing a new, integrated approach to understanding the actions of Chinese local governments. However, the behaviour of local governments do not fall neatly into the four categories proposed by Baum and Shevchenko (1999). This study proposes to address this shortcoming by viewing local governments in terms of a continuum, and recognising that the close interaction between the local state and the economy means implementing economic development policies can create both positive and negative results simultaneously in the local economy and for the local government. The benefits of a policy to promote economic growth do not necessarily coincide with the interests of the local government, and vice versa. So an examination of development must also see local governments as independent actors with interests that sometimes – but not always – coincide with the interests of economic growth. This study proposes that the contradictions in local government behaviour can be explained by them pursuing their own objectives, which may be at cross purpose to the goal of maximising local economic growth.

This proposed framework places Chinese local governments within three contexts – the context of their objective, the context of Central government influences, and the context of local conditions. This helps to integrate local governments into the wider context of the national economy, while also emphasising

the fact that China's local governments are far from being identical. This variation between them creates a rich backdrop against which to examine the process of economic development.

This study is based on two in depth case studies of the counties of Wenzhou and Yangzhou. They were chosen for their comparable characteristics – size, population, geography, and economic background. By choosing counties of comparable characteristics, this study hopes to eliminate external variables that influence the decision making process of local governments, and thus allow a relatively unbiased comparison to take place between the actions of the local government in the two counties.

Wenzhou and Yangzhou adopted different development strategies from the start of China's reforms in 1978. Wenzhou created the "Wenzhou model" (discussed in detail in chapter 7), encouraging entrepreneurship, small businesses, private ownership, and private investment. It has succeeded in spite of Central government opposition. Yangzhou followed a similar strategy to Sunan (discussed in chapter 8), with an emphasis on developing large-scale industries led by local state firms and managed by the local government. Despite enjoying local government support, Yangzhou's economy experienced a slowdown in the mid 1990s.

This study placed special emphasis on uncovering the developmental history of the two cases, used to understand the responses of the two local governments to the economic and political changes resulting from China's economic transition. This serves to illustrate the adaptability of local governments, as well as revealing fundamental underlying consistencies in their mode of behaviour. By seeing local

governments as responsive entities attempting to reconcile conflicting objectives under rapidly changing circumstances, it becomes easier to grasp the dynamic nature of their decision making processes. Moreover, this no longer limits the debate to whether a certain local government “succeeded” or “failed” in developing its local economy, which may be important but beside the point in understanding local governments. This study hopes to show that success and failure are a function of the attitude and alignment of local governments, fundamental attributes that go beyond the superficial application of particular policies and strategies. This is particularly important in the context of local governments learning and adopting economic models, since the form of the models may arise from particular local circumstances, and may not be applicable outside the original context.

This study begins with an overview of China’s economic history, starting from the formation of the People’s Republic in 1949. This allows the following chapters to be set in the context of China’s 50 years of economic development, and serves to illustrate some of the ongoing issues affecting Chinese economic development. Next, the fiscal relationship between the Central and local governments are explored. This covers the process of fiscal decentralisation, which has been used as an incentive for local governments to pursue economic development. However, a number of issues have arisen from the resulting struggle between Central and local interests which affects Central–local relationships. The relationship between local governments and local firms is then examined, which is necessary to understand the types of local government intervention in the local economy. Refining the simple typology of Baum and Shevchenko (1999), local governments are seen as economic actors with their own agendas, agendas that can coincide and also contradict the interests of the local economy.

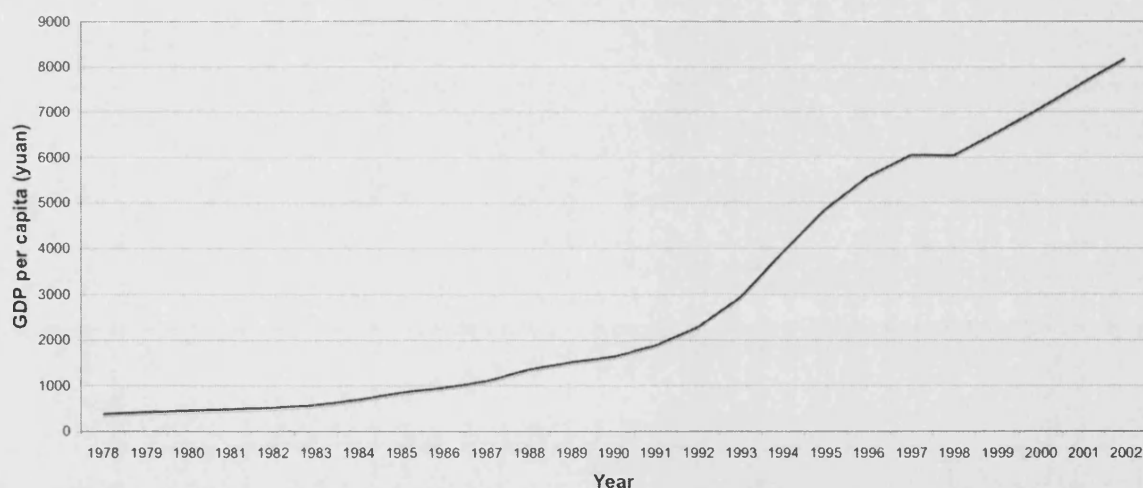
With this understanding serving as the background, the two counties – Wenzhou and Yangzhou – are described, their development history and characteristics outlined. The rich background for both cases demonstrate that both local governments evolve and adapt to new circumstances, though they differ in being active and passive. Interestingly, being active does not necessarily lead to success, nor does passivity result in stagnation. A comparison between the two cases is followed by the conclusion, where the fundamental alignments of the local governments are discussed. It is recognised that even though the Central government hoped to create an economically oriented development, local governments may align their aims differently, towards political gains, or personal gains, or otherwise undermine the development objective. The conclusion then examines future avenues of research based on the results of this study.

Chapter 2: An overview of economic development in China

2.1 Introduction

China's modern economic development can roughly be split into two periods – pre and post reform, with 1978 marking the date of the start of the new economic reforms. It is the speed and success of China's post reform economic growth that has been spectacular and surprising. China's GDP per capita (see figure 2.1) grew from 379 Yuan in 1978 to 8184 Yuan in 2003. In real terms, China's GDP grew 9.5 times over the period (Lardy, 2004).

Figure 2.1: China's nominal GDP per capita, 1978–2002



Source: China Statistical Yearbook 2003

The decentralisation of power and devolution of responsibilities for economic development to local governments made them important actors in determining the development of their own economies, but also in influencing the policies and objectives of the Central government. The size of China's population and territory, its history and culture meant that a single economic policy was unlikely to be suitable for all its regions. Thus China's early effort at economic reform was

characterized by its gradual, experimental approach, more intent on “tinkering” with the existing socialist system than executing a wholesale overhaul (Rawski, 1995). As a result, China’s experimental reforms constitute a continuous process, where Central government policy represents only one facet – albeit an important one – of the whole.

[If] reform is a process rather than an event, policy decisions represent only one aspect of a complex dynamic that revolves around interactions among reform initiatives, decentralized responses to specific policies, economic trends associated with underlying socioeconomic forces, and changes in perceptions and attitudes within and outside the policy elite. Initial conditions influence both the range of feasible reform measures and the impact of policies actually implemented. *The same policy will yield different results if implemented under different circumstances* (Rawski, 1995, p1169, emphasis mine)

The importance of local governments as the implementers of Central government policy is that they operate under very different conditions, depending on their geographical location, local history and culture, previous economic development programs, political links, and so on. Their implementation of Central government policy then feeds back into the system of China’s reforms, initiating new policies and new responses.

The most important impact on China’s productivity has always followed measures to decentralize decision making in agriculture, and rural and urban industry. Success on a local basis of experimentation has spurred

replication and eventual national acceptance. (Gelb et al, 1993, p124–125)

Thus to understand China's post reform development, it is necessary to understand the behaviour and motivations of China's local governments, operating within the historical and cultural context of China's economic development.

One of the most important features of China's development is the emergence of multi-level economic disparity (Fujita and Hu, 2001, Tian, 2001, Wang and Ge, 2004, Chen and Gu, 2005). This can be seen in the regional division between the coastal and inland regions, between urban and rural areas, and in terms of the treatment of different areas by the Central government's economic policies. This difference between separate areas affects the behaviour and response of local governments to particular policies, and needs to be examined. A brief overview of China's economic development since 1949 will help frame the country's subsequent development patterns.

2.2 China's economic development, 1949–1978

2.2.1 The economy of the nascent People's Republic

At the time of its formation in 1949, the People's Republic of China was a predominantly rural and agrarian society. The economy and the population were badly damaged by the Second World War and by the subsequent civil war between the Nationalist government and the Chinese Communist Party (CCP). It was by most measures a backward economy, dominated by traditional handicrafts, and with a modern but small industrial sector that was created by foreign capital from the European colonial powers while they occupied various concessionary territories, and

by the Japanese in Manchuria (Spence, 1999). Thus it was a “two speed” economy, predominantly rural and agricultural, with a modern industrial sector developed generally within coastal enclaves.

Singh (1985) observes that China’s industrial production in 1949 was mainly for consumer goods – textiles and food processing were important industries. Heavy industries were underdeveloped, largely reliant on foreign capital and expertise. Existing heavy industrial capacity was concentrated in the north–eastern regions of China – where the Japanese created a heavy industrial base during their occupation between the 1930s and 1945 – and along the coastal port cities of Shanghai, Tianjin and in Guangzhou province – where the Western colonial powers sought to enter the Chinese economy through the concessions they won in the treaty ports. Thus the modern sectors of China’s economy germinated from those industries created by foreign countries to serve foreign interests, rather than being the result of Chinese economic development.

The transportation network of railways and highways reflected the geographically concentrated needs of the colonial economy, rather than the national need to open up undeveloped areas further inland. Moreover, it was a seriously underdeveloped network even when compared with other economies in the developing world. In 1949 China had only 22000 km of railways of various gauges and 80000 km of highways, as compared to India – a similar colonial economy overlaid on a traditional economy – with 66000 km of tracks and 156000 km of highways. Almost two thirds of China’s railways were concentrated in the northeastern and coastal provinces, and more than half of the provincial capitals did not have rail links to Beijing (Comtois, 1990).

Consequentially, the coastal economy was not well integrated with the more remote and inland areas of China. Physically and economically, inland China remained separate from the colonial economy, and neither economy benefited from the market and resources offered by the other. Inland regions were backward but resource rich – possessing deposits of coal, minerals and so on – which they had neither the need to access nor the means of accessing without the demand of and support from coastal industries.

This lack of mutual contact and inadequate transportation links not only served to divide the coast from the remainder of the country, it also meant that local economies remained closed from each other. Without modern road and rail networks, inland regions were separated from each other as well. The division between urban and rural areas also existed, in terms of the physical separation presented by distance, but also in terms of the mismatch between modern industrial production in the towns and cities, and the traditional agricultural practices in the countryside. Neither was in contact with the other, thus neither had any reason to adapt to the need of the other.

The task facing the newly formed Communist government in 1949 was therefore daunting. China's economy, fragmented and damaged by colonial powers and misgovernment, war and strife, desperately needed stability and coherent, comprehensive economic development. Aside from the need to lift millions from poverty, rapid development through industrialisation was also seen as being necessary in order to strengthen the country against its enemies, which included not only the former Nationalist government in Taiwan, but also the United States and its allies in Asia, as well as most of the Western alliance opposed to the spread of

Communism. China's intervention in the Korean War demonstrated the concerns of its leaders about the strategic vulnerability of China against the industrialised and advanced countries – especially the United States – arrayed against it. Intervention in the conflict on the Korean peninsula was thought to be necessary as China believed it could ill afford to have another potential military threat along its border (Hao & Zhai, 1990). Thus feeling both economically and strategically vulnerable, China began its first phase of development by following the example of the Soviet Union, which displayed both economic and martial prowess in defeating an aggressive and industrialized Germany in the Second World War (Spence, 1999).

2.2.2 The first Five Year Plan

Agriculture was the dominant economic activity throughout China's history, with the majority of the population living in rural areas. In 1952, 88% of China's workforce lived in rural areas, with 95% of those being employed in agricultural tasks, mainly farming (Taylor, 1988, p736). Agriculture was thus not only an important economic activity, it was the biggest employer of China's vast labour force. Industry, by contrast, was relegated to a few enclaves.

In order to overcome this under development, the first five year plan (FYP), from 1953 to 1957, was based on the Soviet strategy for rapid industrialisation. Politically, the Soviet victory in the Second World War against the industrial power of Germany proved to be a strong argument in favour of adopting the Soviet style plan (Spence, 1999). In just 20 years since the revolution in Russia, the Soviet Union had become a world power capable of defeating a major industrial nation and threatening the traditional Western powers. In order to achieve the same rapid development, China's economic planners decided to seek Soviet aid in material and

in terms of copying its economic development strategy.

However, it is important to bear in mind that there were fundamental differences between the economic positions of China and Russia. China's industrial capacity and national infrastructure at the beginning of its first five year plan in 1952 was much weaker than that of the Soviet Union when the first Soviet Five Year Plan was introduced in 1928. China's output of key industrial materials was comparatively inadequate. On a per capita basis, China's electricity output in 1952 was only 37% of that produced by Russia in 1928. Similarly, coal (46%), petrol (1%), steel (8%) and iron (15%) were in short supply (Singh, 1985). Considering the key characteristics of the Soviet industrialisation model – requiring high rates of industrial capital formation, investment in capital goods production, with particular emphasis on developing heavy industries in large scale plants with capital intensive production techniques (Cheng, 1971) – it is surprising that the Chinese economic planners felt it appropriate to transplant the Soviet plan onto the Chinese economy.

In order to support and sustain industrialisation on such a massive scale, the development of Chinese industries depended on the economic surplus produced by agricultural activities. The strategy used to transfer agricultural surplus from rural to urban areas was called the “primitive social accumulation”, or “price scissors”. This entailed fixing the prices of agricultural products at a relatively low level against those of industrial products (Brodsgaard, 1983, p41). Industrial workers in urban areas were thus ensured a supply of food at low prices, while agricultural workers lived on subsistence wages.

National gross investment rose to 20% of GDP (compared with 6% in the pre

war period), with 48% of investment in capital construction for industry (of which 40.8% was invested in heavy industry) (Spence, 1999). Most of these projects were for large-scale industrial plants and were capital intensive. With the increase in total investment and with the lion's share going to industry, it was inevitable that the agricultural sector became continually squeezed for surpluses and resources, and the priority for developing agriculture was placed far below that of industrial development. Although the program enjoyed early success, with GDP growth reaching 8.9% per annum and an 18% increase in industrial production, the development in this period was fundamentally unbalanced and ultimately unsustainable. The pressure on agriculture meant that food production in China barely managed to keep pace with population growth. The rate of agricultural production grew at 3.8% per annum through the period covered by the first FYP. Slow agricultural growth, low rates of investment, coupled with concerns over feeding a growing population, eventually forced a re-examination of the five year plan (Spence, 1999).

Recognising the threat posed by such an unbalanced development plan, a political consensus emerged that the Soviet model may not be entirely suitable for China's development (Brodsgaard, 1983). By 1957 gross investment rates were curtailed to 7.4% of GDP. The Chinese politburo concluded in 1958 that:

All the experience of the Soviet Union, including its fundamental experience, is bound up with definite national characteristics, and no country should copy it mechanically (Rue, 1972).

For a brief period in 1957–1958 the Chinese economy entered a period of

“retrenchment”, where more cautious economic planning took place to rebalance from the excessive concentration on industrial growth.

China’s centralised planning mechanism subjected the economy to frequent periods of hyperactivity, followed by a forced retrenchment and cooling down while the economy is repaired and the development strategy reconsidered. This tendency for dramatic policy shifts can be seen in the next, disastrous phase of China’s development. Even as economic planners were reining in the unbalanced industrialisation, the Great Leap Forward was beginning to take shape, fuelled by anti rightist campaigns, the call for increased economic vigour, and zealous but often baseless claims by local officials of growing agricultural productivity (Li, 2005). Led by the belief that the communalisation program of the first Five Year Plan had succeeded in increasing agricultural output, the Great Leap posited extraordinary aims for industrial growth and output for the Chinese economy, with disastrous consequences.

2.2.3 The Great Leap – 1956–1960

It is possible to see the Great Leap Forward, beginning in 1957 and ending in 1960, as an attempt to achieve rapid economic growth through a more balanced development strategy. Agriculture and industry were to be developed simultaneously, although priority was still accorded to heavy industry. Rather than employing capital-intensive production techniques as called for by the Soviet model, labour intensive techniques were emphasised. By mobilising the entire population in agriculture, in industry, and in local infrastructure construction, it was hoped that the agricultural bottleneck that had previously impeded China’s economic development could be overcome. Thus mass campaigns were launched to employ idle rural labour

for construction projects such as flood protection and irrigation, and for small-scale industries producing consumer goods and products for large-scale industries. Many of the projects were financed through local savings (Singh, 1985). Labour intensive agricultural techniques were also introduced, and in order to fill the labour shortage (as so many workers were mobilised for large construction projects) communisation was encouraged, which consolidated not only land plots, but also created mass dining halls, child care Centres and so on in order to release the female workforce from housekeeping tasks to work in the fields. This labour intensive approach to agriculture meant that the scarce capital available was concentrated for the purposes of developing industry, and it ensured that all surplus labour was mobilised to increase productivity (Tiewes & Sun, 1999).

The aims of the Leap were varied and ambitious. They included overtaking Britain's steel production in 15 years, the formation of large rural communes from smaller existing collectives on a massive scale, and wildly ambitious growth targets for grain production which was increased throughout the period, from doubling annual production to increasing 10 fold or more annually (Tiewes & Sun, 1999). However, with the goals for industrial production set so high, much of the productive gains in agriculture were directed away from rural households, and farmers did not enjoy any improvements in their standard of living, reducing their incentive for sustaining agricultural growth (Dutt & Costa, 1980). In addition, many of the construction projects were financed through local savings, further draining resources from rural areas (Singh, 1998). Nevertheless, the political climate and the call for sustained enthusiasm meant that criticisms were rarely raised, and it was common for exaggerated production figures to be reported, which resulted in the continuation of policies that were ineffective or harmful.

The Great Leap Forward suffered from a number of flaws in policy and execution. Although it could be argued that the mobilisation of surplus labour made more sense than an attempt to employ capital intensive techniques for economic development, simply because of the relative shortage of raw materials and the relatively abundance of available labour – China's in 1957 population stood at 646 million (Spence, 1999) – the appropriation of food produce away from the countryside was so harsh that those responsible for growing it fell victim to malnutrition and starvation, all the while suffering from additional calls for increased levy because of the unrealistic claims of abundant harvests by local officials (Li, 2005). Furthermore, the development of small scale industries such as the back yard steel furnaces resulted in a massive waste in resources, as the quality of the products were substandard and could not be used, yet diverted both precious raw materials and labour from more critical tasks.

The disastrous outcome of the Great Leap can be measured in the millions of deaths caused by malnutrition. The use of locally available capital, combined with the transfer of labour away from the fields compounded the inefficiencies of the agricultural commune to lower productivity to dangerous levels. Meanwhile, unrealistic expectations, exaggerated reports from zealous local officials concealed the scale of the disaster (Tiewes & Sun, 1999). The unbalanced industrialization program was ultimately wasteful, and the unbalanced program of development eventually collapsed, forcing the Central economic planners to re-evaluate their strategy once again.

2.2.4 Recovery and retrenchment

In the wake of the Great Leap, China's economic planners retreated to developing the agricultural sector, abandoning the fantastic rates of industrial growth they had recently tried to pursue. Capital and labour were reallocated from heavy and light industries to agricultural production. Between 1960 and 1961 some 20 million workers were relocated from the cities to the countryside (Cheng, 1971), while development efforts were focussed on providing agricultural goods such as chemical fertilisers and tractors. Compared with 1960, the use of chemical fertilisers tripled in 1964, and tripled again by 1974 (Singh, 1985). By 1967, agricultural production had recovered from the excesses of the Leap, and output levels had returned to pre Leap (1957) levels (Spence, 1999).

As the Leap slowly ground to a halt, Central government planners refocused their development priorities from industrial development to agriculture. While maintaining that industry was to be the "leading factor" of China's economy, agriculture was to be taken as the "foundation", which warranted higher levels of resources and aid (Brodsgaard, 1983, p54). Although heavy industries continued to receive the lion's share of investment (49.8% of total investment in 1963–65), the share allocated to agriculture increased from 12.3% in 1958–62 to 18.8% in 1963–65 (Brodsgaard, 1983, p72). More importantly, the investment went into the "technical transformation" of agriculture, including the electrification of rural areas, irrigation, mechanisation, use of chemical fertilisers, and so on, making a substantial change to the rural economy. Heavy industries were slated to support agricultural development and growth, providing the equipment and machinery necessary for a modern rural economy to take shape.

2.2.5 Cultural Revolution

From 1965 to 1969, the Cultural Revolution disrupted economic development in China as millions of students around the country were mobilised to attack “old customs, old habits, old culture, and old thinking” (Spence, 1999, p575), paralysing educational institutions, government offices, and destroying many precious cultural artefacts. However, although the Cultural Revolution was undeniably violent, it did not fundamentally damage the economy in the same way as the Great Leap, and disruptions occurred mainly at the managerial levels (Dutt & Costa, 1980). Nevertheless, it did divert attention from the development of the economy, and even though special notice was given to the Red Guards not to attack technical personnel, the education system was shut down and many intellectuals were killed or sent to special “May Seventh Schools” for re-education.

Violent and destructive, the Cultural Revolution did not have a specific economic aim. Unlike previous periods in China’s development, the Cultural Revolution was not an economic campaign, and thus its effects on the economy were mostly secondary, the primary focus of the campaign being politically and ideologically motivated. As it reached its natural conclusion, with the population exhausted from years of feverish terrors, China’s economy entered a phase of stagnation.

2.2.6 China on the eve of reform

As was argued above, the development of the pre reform Chinese economy was influenced by a number of political, ideological and strategic concerns. Although economic policy was ostensibly aimed at developing and modernising China’s national economy, it was more often than not distorted by political and ideological aims. It is not possible to attribute to any one person, group of people or

any agency responsibility for the turbulent economic development process, since it can be argued that all actors were simply responding to the unpredictable political climate of the time:

Mao cannot be entirely blamed because he was deceived by false reports sent by ambitious officials. As always in China, the Emperor is never wrong, only misled by his ministers who flatter him and who in turn are deceived by dishonest lower-ranking officials. On the other hand, they cannot be blamed either, because they have no choice but to follow orders from above. So in the end no one is responsible (a peasant's reflection on the Great Leap, cited by Tiewes & Sun, 1999).

This expressed the significant demoralisation of China's population after the turbulence of the past 25 years. Economic growth took place at an average rate of 7% per annum between 1953 and 1978, and the industrialisation programmes reduced the share of agricultural output from 57% to 28% of GMP (Gross Material Product) in the same period. However, this masked certain underlying deficiencies in the economy. The bias towards developing heavy industries meant that the average annual growth in real consumption per person was at only 2.2%, while an annual 2% average increase in population trades off much of the economic gains. The policy of self-sufficiency and isolation meant that China's share of world trade dropped to just 0.4% in the 1970s (Zhang, 1996). In terms of agriculture, the communisation of rural areas and the abolition of private land holdings, coupled with the introduction of work teams, meant that farm workers have no personal incentive to increase production. China's industries also suffered from a lack of motivation and initiative, compounded by the location of industrial activities on the basis of ideology rather

than efficiency. The allocation of funds and capital for development were issues of political gain, as provincial officials tried to secure projects for their areas, regardless of suitability. Factories located inland lacked the transportation links and communications to operate, far from raw materials, markets, and the human capital necessary to run the machinery, while coastal cities were deliberately run down. Conditions inside factories were similarly uninspiring, with over employment, lack of responsibility, and lack of competition presiding over a stagnant economy.

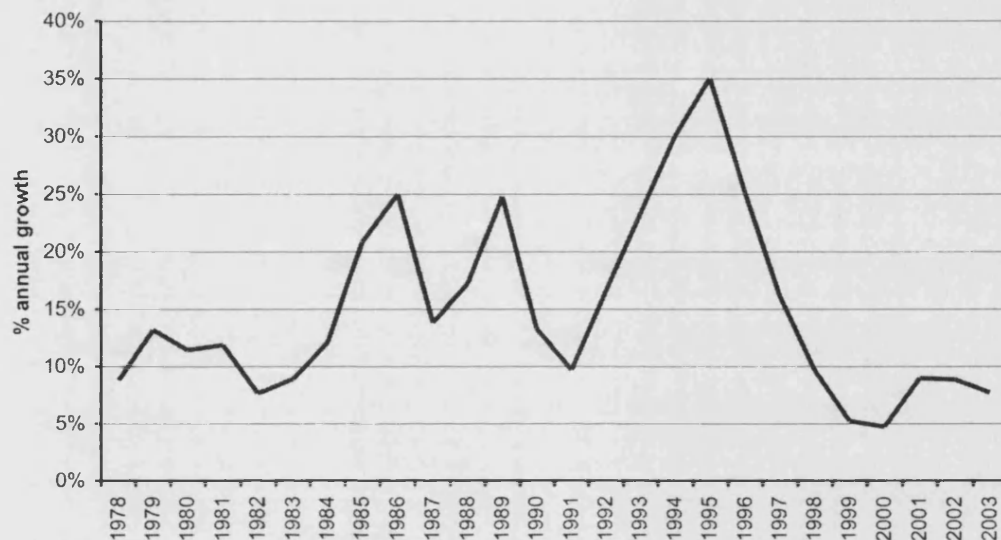
China operated under a centralised economy for 30 years. During that time, there was constant change to the objectives of the planners and the ideologies driving them. Economic power was centralised, decentralised and recentralised. Rather than allowing economic rationality to dictate growth and the allocation of resources, political objectives and considerations shaped China's economic landscape. However, this was to change dramatically in the next phase of China's development, with the introduction of gradual, but sweeping economic reforms.

2.3 Economic development in post reform China

The death of Mao in 1976 marked the beginning of a reassessment of China's socialist economy. The damage done to the economy in the past was put down to the "leftist" policies. Economic imbalance and serious mismatch between economic sectors, consumption and accumulation, and between production relations and productive forces were criticised for being the generic culprits (Nolan & Ash, 1995). Hua Guogfeng, Mao's anointed successor, embarked on a series of readjustments for the Chinese economy between 1976–1978 in order to facilitate the recovery of the Chinese economy. However, these readjustments fell short of being a thorough reform of the underlying economic system, and the task was taken up by Deng

Xiaoping to start the new phase of economic development at the third plenum of the 11th CCP central committee in 1978, where development would be led by economic considerations rather than motivated by politics and ideology.

Figure 2.2: China's post reform GDP growth rate, 1978–2003



Source: China Statistical Yearbook 2004

As can be seen in figure 2.2, China's post reform GDP growth rate has been both breathtaking – reaching almost 35% in 1995 – and volatile. From the peaks and troughs, it can be seen that the economy underwent three phases of extreme growth, followed by periods of cooling down between 1982–1986, 1987–1991, and 1991–1999.

Deng aimed to double China's GDP from 1980 to 1990, and again from 1990 to 2000. The nominal economic growth meant that China managed to double her GDP by 1986, from 451.7 billion Yuan in 1980, to 1020.2 billion Yuan in 1986, and by 2000 the GDP had exceeded 1990 levels by more than four times, growing from 1854.8 billion Yuan to 8940.3 billion Yuan (National Statistics Bureau, 2000). The

rapid growth in the economy caused inflation to rise as well, reaching a peak in 1988–1989 (17%) and 1994 (over 20%) (Lin, 2004), leading the Central government to implement measures to slow economic growth.

Deng adopted a gradualist approach to economic reforms. “Crossing the river by feeling the stones” (Goldstein, 1995) was one way to describe this approach, where each step was the result of pragmatic and practical experience. There were no clear objectives, nor any blueprints to direct China’s economy. Overall, the reforms cautiously allowed for market mechanisms to play a greater role in the economy, pursuing proportionate and balanced growth in all sectors, decentralised the decision making process, and called for a closer integration of China with the world economy (Noland & Ash, 1995).

The lack of an overall blueprint to development led to the emergence of different models for economic growth in China. The gradual decentralisation of economic allowed some regions to experiment with different development policies. Where the policies became successful, they were formalised and promoted as “models” (*mo shi*), held up for other regions to emulate. The Sunan model, Pearl River Delta model (also known as the *zhuhai* model) and Wenzhou model are the three best known models, all named after the regions they originated from.

However, the diversity in economic models also indicated an underlying difficult with China’s gradualist reforms. Legacies from the planned economy introduced distortions into the operation of the economy at both national and local levels while the transition economy ran on the “dual tracks” of planned economy and market economy. At the same time, local governments and other economic actors

operated in a regulatory and policy vacuum as the necessary mechanisms to manage a free market economy were formed out of necessity through the process of trial and error. As Wong (1992) points out, the incremental reforms often created contradictory incentives, resulting in unintended and reactionary development that was harmful to economic growth.

For instance, the decentralisation of fiscal responsibilities, coupled with local governments becoming responsible for their own economic development, created the phenomena of regionalism in China, or what some have referred to as “dukedom economies”, during the late 1980s and early 1990s. With the considerable autonomy that Chinese local governments enjoy – compared with their status before the reforms – local governments were more interested in developing their own economies, creating independent “dukedom” with little regard for regional division of labour and specialisation (Shen & Dai, 1992). This resulted in waste as resources as the lack of co-operation and inter-provincial competition led to duplication and the creation of surplus capacity. This was especially harmful as provinces attempted to invest scarce resources in the same “hot” industrial sectors (such as automobile manufacturing or electronics), leading to the neglect of developing other lower profile industries that were more suitable to regions lacking basic infrastructure and human capital. Moreover, the fierce competition between the localities created overcapacity that did not bring the necessary returns to the initial investments.

This competition also led to distrust between provinces as each struggled to compete in the same market, leading to further isolation and a decline in inter-provincial trade. Kumar (1994) showed that while China’s economy grew in the early 1990s, the share of inter-provincial trade declined as a proportion of China’s

total volume of trade. However, it is necessary to point out that the fragmentation of the Chinese economy occurred under specific circumstances. Naughton (1999) suggests that the emphasis on inter provincial trade barriers has been over emphasised, and Fan and Wei (2006) also conclude that the evidence does not support the view of China as a fragmented economy. Nevertheless, China is challenged by the problem of economic divergence, created by the emergence of high growth and low growth areas. This disparity is seen in a rural–urban, inland–coastal division. What is more interesting, however, is that this economic divergence is in part deliberate and a key component of China’s development policy.

2.4 China’s economic divergence

Although inequality was controlled to a certain extent in the pre reform economy, this was achieved largely through the highly centralised fiscal system. The centralised fiscal system was used for co–ordinating the centralised economic planning, and in combination they allowed for a substantial redistribution of wealth to take place across the country. With its turbulent history of economic development, it is reasonable to conclude that if the role of this centralised system for redistributing wealth was reduced or removed entirely, inequality would return as significant differences remain between the economies of various provinces.

Bias in Central government policies towards coastal regions has been put forward as one possible explanation for the creation of the coastal–interior division. The coastal development strategy was a deliberate policy of the Central government to promote the Chinese economy as a whole by opening up the economically more advanced coastal regions first. The creation of the four Special Economic Zones in 1980 and the opening of 14 coastal Open Cities in 1984 were all efforts deliberately

aimed at attracting foreign investors into China through investment into the coast (Spence, 1999). The origin of special economic areas was based on the idea of Taiwan's Export Processing Zones, automatically ruling out the interior areas as possible locations, and rule in coastal and port cities as possible destinations for greater reforms, more extensive and intensive development measures, greater experimentation and so on. Furthermore, the "two ends abroad" (*liangtou zaiwai*) approach of coastal development called for reliance on world trade. Thus instead of creating backward linkages to the interior for raw materials and capital, the coast was to rely on world trade for both exports and imports (the two ends) (Chang, 1998). This had the advantage of allowing coastal regions to become relatively independent of (slower growing) interior regions, and instead linked the coast to the world economy directly, creating the conditions for rapid growth while insulated from the rest of the country's economy. The coastal regions already possess the advantage of being accessible to world markets. The city ports can take advantage of their proximity to Asian economies such as Taiwan, Hong Kong and Singapore, for investment and trade.

Fan (1997) attributes China's decision to adopt an uneven development strategy to three factors: First, the experiences of the pre reform economy suggested that equality and a redistributive development strategy is inefficient, slowing economic growth across the entire country. Instead, a concentration of resources to develop smaller regions would create much more impact. Second, Western theories of development (most notably Williamson's inverted U model) suggest that regional inequality is a painful but largely unavoidable step in the development of the economy. The Kuznets inverted U curve (Kuznets, 1955), is often cited as an explanation of increasing disparity with economic growth. It suggests that with an

increasing income per capita, disparities between incomes in different regions are expected to widen first, then to decline. Thus regional income inequality is an expected outcome of economic growth that would be eliminated with further growth via the operation of the free market. Empirical studies by Barro and Sala-I-Martin (1991, 1992) of long term regional income trends the United States and Japan suggests that differences in regional incomes tend to be eliminated in the long run. Thus as Western economic theory became more accepted, “temporary” uneven development became more acceptable. Finally, the experience of developed countries seem to confirm that inequality is a function of the stage of economic development, where inequality is reduced with more economic development. Thus it should be kept in mind that while uneven development was part of the Central government’s post reform development strategy, it was seen as the price for rapid development which would eventually benefit the whole country. However, the question of how much inequality was acceptable or desirable in order to achieve eventual development of the entire country remains unanswered. Nor was it known *if* regional income in China would necessarily tend towards convergence.

2.5 Conclusion

China’s economy went through many changes, from an agrarian economy under colonial control, through a period of war and civil strife, to the volatile politics and ideologies imposed through a planned economy, and finally to the transition away from central planning towards a free market economy. Even as economic policies shifted to favour gradual transition, China’s economic growth rate still swung between periods of extremely high growth, and economic stagnation. “Crossing the river by feeling the stones” successfully accelerated economic growth, but it has also created challenges over how to manage the contradictions of old, pre

reform legacies co-existing alongside the new, market oriented economy.

The emergence of economic disparities and the importance of the various regional economic models, mean that local actors, in particular local governments, must be considered when trying to understand China's development. Their interaction with the Central government informs and influences economic policy. The interaction is important in determining the behaviour of local governments in China, and with fiscal decentralisation being a key component of China's economic reform process, it is necessary to understand the potential effects that fiscal decentralization has on local government behaviour. The next chapter will examine the relationship between economic development by local governments and the decentralization process.

3. Relevance of the local government in local economic development in transition economies

3.1 Introduction

There has been a general trend over the past 15 years for countries undergoing economic transition to undergo decentralization and assigning greater economic responsibilities to local governments (Rodriguez-Pose and Bwire, 2004, Martinez-Vasquez and McNab, 2003, Bardhan, 2002). To varying degrees, it is the assumption that local governments are able to achieve economic gains that has driven this trend. This has sparked interest in the function of local government in achieving economic development, and in the potential economic gains to be had from decentralization. Both the theoretical debate and the empirical studies have proven to be inconclusive as to whether local governments and decentralization leads to greater efficiency gains. This has been further confused in the transition economies of Eastern Europe, where intervention from the West after the collapse of the communist economies proved to be heavy handed and largely deleterious to local economies and the functions of local governments (Bateman, 2000).

The debate over the potential gain in economic efficiency with increased decentralization or more autonomous local governments is further complicated by the economic transition process, itself a contentious and complex process. Indeed, Martinez-Vasquez and McNab (2003) point out that the label of “decentralization” can have very different meanings across countries.

Decentralization may actually appear to be more

popular among developing and transitional countries than it truly is because there is often a confusion in terminology. What some transitional and developing governments call fiscal decentralization is actually nothing more than the geographical deconcentration of central government bureaucracy and service delivery. (Martinez-Vazquez and McNab, 2003, p1597)

Advocates of the economic efficiency of local governments and decentralization argue that local governments are better able to efficiently provide goods and services than a single, centralized government. Indeed, in the formerly centralized economies of eastern Europe, the failure of central governments to achieve and sustain economic growth appears to be the most obvious indictment against an overly centralized system for economic efficiency. Decentralization appears to be an effective panacea – or at least a necessary step – towards an effective reform of the old economy.

However, the process of devolution, of transferring new functions and responsibilities onto local level governments is not simple, and the outcome is not assured. Classic economic literature argue that government at the local level are more efficient than central governments, since they can better tailor the provision of goods and services to suit local demand, resulting in less waste and more satisfaction among the population. This has been a highly influential argument in favour of decentralization. Modern economic literature, especially from authors of the new institutional economics (NIE), identify shortcomings with the work of the classic works. NIE authors – such as Ronald Coase (1998), Douglas North (2005) and Barry Weingast (2005) – suggest that local governments, and indeed all organizations, are governed by hard and soft institutions. This perspective brings a key assumption of

the classic writers into question. In particular, it questions the assumption of government benevolence, where local governments are assumed to act in the best interest of the local population. Local government corruption is a common problem, with their closeness to the local population making them vulnerable to being captured by powerful local interest groups that are harmful to the local economy. Even when local government do act in local interests, there are spillover effects and challenges to macroeconomic stability (if enough numbers of local governments acted in the same way simultaneously). Thus, for national governments undergoing decentralization (which includes fiscal decentralization), there is the need to strike a balance:

In light of the possible effects – that depend on the institutional design – of fiscal decentralization on economic growth, macro-fiscal balances and corruption, a key challenge for many transition economies has been to reap the economic benefits of decentralization while maintaining control over public expenditures and borrowing, restoring growth and improving accountability of local governments and officials to limit corruption. (Dabla-Norris and Wade, 2002, p4)

The challenge to decentralize economic functions to local governments rests on the advantage they have over national level governments in their closeness to the local population. This advantage is pointed out by the classic economic writers, examined in the next section. However, the response of local governments depends on their interaction with the national government and the incentives and punishments they are given. This is examined in section 3.3, and it is the local government's response which determines their behaviour towards the local economy and local

economic actors.

3.2 Local government and economic gain in classic literature

In the classic economic literature, there are three main channels whereby the economic benefits from decentralization are realized – inter-jurisdictional competition, informational advantages, and higher population and preference homogeneity (Enikolopov and Zhuravskaya, 2007). This is premised on the ability of local governments to match the supply of goods and services to the preferences of the local population, compared with a national government which provides goods and services uniformly across the whole population, ignoring differences in preferences, thereby creating waste and inefficiency.

Hayek (1939) introduced the concept of differential information, where local citizens, local governments, and the central government have different quality of information on the preferences and demands for goods and services. Local governments close to local citizens will have a much better idea of local preferences than a relatively distant central government. Therefore local governments will be able to make more informed decisions when implementing policies to tailor them to suit local conditions, and also provide goods and services that are needed and relevant to local preferences. In comparison, the national government needs to deal with a relative paucity of information regarding preferences. In addition, the objectives and perspective of national governments can be different or irrelevant to local interests. Thus goods and services provided by the national government for local consumption may not match local demand and this then leads to wastage.

The failure to match preferences occurs not only at the level of individuals,

but also at the intra government level. Weingast (2005) provides an example where federal subsidies for local governments in the United States results in waste because it failed to reflect local priorities, which is often quite different from national priorities.

For example, a recent crime bill provided funds for hi-tech squad cars. These cars are quite expensive, and most smaller jurisdictions would not purchase them if they have to pay for the cars from their own funds. The bill offered to pay for 95% of the cost of the cars, so, at 5% of the cost, a large number of jurisdictions will elect to put up their (small) share and buy obtain the cars. Yet for most jurisdictions, this is not the highest priority use of the subsidy. Some need newer electronic communications; others need more policeman, and so on. But the bill did not offer the items most needed by the local governments; so instead the local governments chose what was available. This example could be repeated almost endlessly given the huge range of federal expenditure programs in the United States that foster local public goods provision. (Weingast, 2005, p152)

This example points out the inherent *inefficiency* of providing goods and services and implementing policy in a uniform way, failing to take into account local needs and preferences. With better access to information, local governments are able to minimize this waste. Tiebout (1956) elaborated on this, proposing that the local population also plays a role in creating an optimal solution for local goods and service provision.

Tiebout (1956) contended that individuals choose to live in areas that provide

the goods and services which are best matched with their preferences. He assumes that taxpayers are mobile and rational, and thus they will move to the region that offers them the best match of goods and services according to their preferences. This will lead to the economically optimal situation where everyone's preferences are perfectly met by the local government, and converse, where the waste of goods and services are minimized. Compared with the national government, providing goods and services uniformly across the whole country, service provision at the local level will enjoy much better efficiency.

Tiebout's (1956) model also introduces the effect of inter-regional competition, further enhancing efficiency. Competition from neighboring regions force local governments to provide goods and services efficiently, and also discourages rent seeking behaviour by local bureaucrats. Furthermore, the competition stimulates local governments to innovate, which can result in greater economic gains. At the same time, the cost of taking innovative risks is reduced. Compared with the cost of the national government introducing a risky innovative policy, the cost of innovating at the regional level is spread across different regions and born by different local governments, and the cost of failure is thus much lower.

While Tiebout's (1956) argument depended on a mobile population of taxpayers for local governments to achieve economic efficiency, Oates (1972) argues that the ability of local governments to match the preferences of local inhabitants means it is more efficient for local governments to provide goods and services than to have uniform provision by a central government, even if the population were not mobile. The greater the variation in local preferences, the more inefficient a uniform provision will be, since a greater proportion of the population will not be catered for

by the uniform provision of goods and services. Conversely, local governments enjoy greater economic efficiency with greater variation in local preferences.

Musgrave (1959) argues that local government efficiency also depends on the assignment principle, where the authority over the provision of goods and services needs to be assigned to the level of government which can most efficiently produce it. This in turn depends on the economies of scale, congestion of goods per additional unit of consumption, and the scope or coverage of the goods and services provided. Defence is a good example which enjoys economy of scale, with small congestion per additional unit of consumption, and which has truly national coverage. Thus the national government is best suited to providing it. Conversely, a school or day centre has low economy of scale, high congestion, and is local in scope, and thus local governments are best placed to providing them.

The level of assignment it also important in dealing with negative externalities that cross local government jurisdiction. Since local governments are assumed to cater only to the needs of their population, negative externalities borne by other regions will be ignored. Overall, this would result in a “tragedy of the commons” problem, with local governments failing to bear the full cost of their actions, and therefore they will not reach the economically optimal outcome for the whole country. In that case, intervention at the national level, or assigning that responsibility to the national government, will be necessary to solve the problem.

The classic theories paint a very favourable image of local governments. The combination of rational, mobile taxpayers, responsive local governments under competitive pressure to provide efficient local services, and the correct assignment of

responsibilities for goods and service provision should create an optimal economic outcome. However, modern economics tend to be more circumspect regarding local government efficiency and local government behaviour. In particular, one criticism is leveled at the assumption of government benevolence that is made by the classic writers. Shirley (2005) points out that government organizations and officials are not necessarily inclined to facilitate economic development, and this can be seen in most of the developing economies, which have remained under developed even with outside support and substantial financial and material aid. Thus an additional dimension needs to be introduced in order to examine local government behaviour. The new institutional economists suggest that it is necessary to examine governments within the context of existing institutions.

3.3 The role of local governments in new institutional economics

The view that institutions play a key role in determining the behaviour of local actors was proposed by Coase (1995), who argues that economics has become too abstract and uninterested with the actual interaction of human beings and organizations, who inhabit a world governed by relationships and the rules – written and unwritten – by which those relationships are formed. A simple definition of institutions is given by Douglas North (2005) who defines institutions thus:

Institutions are the rules of the game—both formal rules, informal norms and their enforcement characteristics. Together they define the way the game is played. Organizations are the players. They are made up of groups of individuals held together by some common objectives. Economic organizations are firms, trade unions, cooperatives, etc.; political organizations are political parties, legislatures, regulatory bodies;

educational organizations are universities, schools, vocational training centers. The immediate objective of organizations may be profit maximizing (for firms) or improving reelection prospects (for political parties); but the ultimate objective is survival because all organizations live in a world of scarcity and hence competition. (North 2005, p22)

Thus the behaviour of local governments – indeed, any economic organization – and whether they achieve economic efficiency, does not depend on their defined functions. In viewing organizations as being interested in survival, operating within the constraints of written rules and unwritten ‘norms’, the assumption that local governments will operate efficiently because they possess inherent advantages (local information advantage) can be challenged. Weingast (2005) states the problem succinctly:

As the Federalist observed more than 200 years ago, “if men were angels” we would not have to worry about structuring incentives through the appropriate design of political institutions; but as they observed, because men are not angels, we must be concerned with creating political institutions that provide government officials with the appropriate incentives. (Weingast, 2005, p156)

Thus the importance of providing incentives (and its counterpart, appropriate punishments) needs to be recognized. In the same vein, Shirley (2005) emphasises the importance of institutional factors in determining the pace of economic development in a country. She argues that the institutional structure in a country is correlated with whether economic actors are encouraged to trust each other and

encourage exchange, and for powerful political actors to protect private property, or if they are encouraged instead to rent seek and engage in short term activities that damage future economic growth (Shirley, 2005, p611). Deformed institutional structures encourage short term behaviour and discourage investment, which in turn feeds back into a destructive cycle.

This does not contradict the classic models of local government efficiency. Regional competition, access to information, the pressure to innovate, and deviation in the preferences of individuals (who may or may not be mobile) all remain important factors affecting economic efficiency. However, from the institutional point of view, without the right institutional structure, these conditions may not exist, or could produce perverse incentives that cause local governments to engage in damaging behaviour. For instance, if local governments were not accountable to the local population or if local interest can be circumvented or superceded, then it is unlikely local governments will strive for local interests. Overly strong central governments weaken the ability and the necessity for local governments to act in local interests, since there is a strong incentive to obey the central government rather than to listen to the local population.

Ultimately then, the survival of the local government as an organization (or, more practically, the “survival” of individual officials within the local government, and their desire to avoid punishment) can be taken as the fundamental objective. However, once the issue of survival is settled, the issue for local governments becomes one of incentives – in this case, incentives to pursue economic growth. If government benevolence is not taken for granted (and neither is the government assumed to be *malevolent*), and the national and local governments are assumed to

behave in response to the necessity of survival and also to maximize incentives, then local government behaviour can be seen in terms of its relationship with the national government and local firms.

The national government is ultimately responsible for determining the terms of devolution and the delegation of responsibilities to the local government. Given that devolution or decentralization aims to improve economic performance, the assumption is that local governments will be rewarded or punished in terms of their ability to produce economic results. Thus local governments will pursue objectives that maximize their rewards, and avoid behaviour which could result in punishment (eg, removal of key officials from office, the removal of local government power and recentralization). Nevertheless, how much effect the incentives have, and whether they produce perverse or undesirable outcomes, can depend on the relationship between the national and the local government.

If local government survival (or avoiding punishment) is contingent on complying with the national government, then the local government is likely to pursue that as a priority. Any benefit accruing from pursuing incentivized objectives is subject to the survival of the local government, and one punishment for non-compliance can be the removal of the incentives. In this case, the local government would choose compliance if the cost of non-compliance is greater than the cost to the economy and to local interests. Thus, if the national government set the cost of non-compliance to be too high, then local governments remain in effect agencies of the national government, regardless of the power and resources devolved to them, and regardless of the incentives given.

However, this also leads to the possibility that if the cost of non-compliance was *lower* than the cost to local economic interests – which could also threaten local government survival – then local government would act in favour of local economic interests, even at the risk of being punished for non-compliance. In the same instance, local government would act regardless of the incentives given.

This does not necessarily mean that a low level of national government oversight and enforcement would persuade local governments to pursue economic growth. On the contrary, Enikolopov and Zhuravskaya (2007) suggest that local officials best serve local interests when their political incentives are aligned with those of the governing party. The appointment of local officials belonging to the government party of the country ensures that the politicians act in accordance to the best interest of the party as the party is held accountable through local elections. Thus in order to gain political promotion, local officials will act in the local interest. This alignment of local officials to the national government also means that their actions will take into account externalities (positive and negative) that cross outside their jurisdictions, since that too will affect the popularity of the party nationally. Thus a strong political system, working on the basis of individual interest – mainly the political prospect of local officials – also provides the local government with incentives to pursue economic growth.

3.4 Local government, local economic development, and incentives

The classic economic literature proposed that local government, by virtue of being closer to the local population, and being in charge of subnational regions, are in a more suitable position to cater for local needs and preferences. However, the models neglect to explain why local governments would be inclined to act in the

local interest. There is no intrinsic reason why local governments would serve the local population, a problem that is particularly apparent in transitional countries, many of which are also simultaneously undergoing political transformation as well. Thus local governments may not necessarily be democratically accountable to local population. Furthermore, the concentration of power – whether held at the national level, or devolved to local levels – leaves local officials scope to abuse their power and to engage in rent seeking activities, if the decentralization process is not careful enough to take this into account.

Institutional economists seek to examine local governments in terms of the institutions they operate within, and emphasise that to encourage local governments to behave in non-corrupt ways and to coerce them to engage in economic development, it is necessary to give them the incentives to do so. However, it is then necessary to consider the response by local governments to the incentives. It is possible for local governments to pursue perverse actions in order to maximize the benefits accruing from specific incentives.

This suggests that, for transitional countries, it may not be the specific allocation of governmental power or responsibilities that underlie a local government's willingness to pursue development objectives. The incentives they are offered may direct them more towards one set of behaviours or another, and given that both formal and informal institutions outside the government structure are likely to be weak or non-existent, the structure of these incentives gain even more influence over local government behaviour.

Having examined the theoretical reasons and potential effects that

decentralisation has on local governments, it will be useful to examine the process in the context of China's economic reform. Fiscal decentralization was necessary for China's local governments to gain the autonomy they needed to facilitate economic development. However, as was pointed out in this chapter, the incentives given to local governments sometimes led to perverse and negative outcomes, some of which became a threat to macroeconomic stability. The next chapter describes the fiscal reform process, and the effect this had on local-central relationships.

Chapter 4: The effects of fiscal reforms on intergovernmental relations in China

4.1 Intergovernmental relations in China

Economic reforms in China since 1978 called for changes to the relationship between the Central and local governments. Under the planned economy, the government hierarchy acted as the channel for the economic plan to be passed down from the Central government to governments at lower levels. The economic plan was formulated in Beijing, and implemented through local governments acting as agents of the Centre. However, with the increased emphasis placed on market mechanisms and the phasing out of central economic planning, it became increasingly important for a new working relation to be forged. Local governments, no longer simply agents of Central government policy, needed the necessary resources and incentives to develop their economies, while the Central government needed to be careful, allowing enough freedom for economic development in the regions, but without losing control over local government behaviour, nor allowing local actors to become a destabilizing influence.

Figure 4.1: Changes to local government responsibilities pre and post reform

	Local government - pre reform	Local government - post reform	Benefits to economic development	Potential negative effects
Assigned responsibility	Responsible for carrying out Central government plans and directives	Responsible for pursuing and maximising economic growth	Free to maximise economic benefits for the locality	Short termism, harmful competition with other regions
Relationship with Central government	Non negotiable relationship with Central government	Negotiation between Central government and local government for policies, budget etc	More flexibility to suit different local economic conditions	Difficult to assess impact of Central government policies in different regions, and difficult to monitor
Budget allocation	Budget allocated and dictated by Central government	Budgetary independence and more expenditure responsibilities	Spending targeted on priority services	Heavy expenditure burden cannot be met, leading to cutbacks
Budget constraint	Soft budget constraint	Hard budget constraint	More responsible fiscal management, more efficient use of existing budget	Uneven distribution of regional incomes, encourage use of unminitored "extra budgetary" funds

(source: various)

The main changes to Chinese local government responsibilities are shown in figure 4.1, a summary of the economic responsibilities assigned from the Central government to local governments. The Central government devolved more economic control to local governments since the start of reforms in 1978, albeit on an intermittent manner consistent with the gradual approach of the reform itself. Periods of decentralization were followed by recentralization and a careful reconsideration of the power of the provincial governments. Nevertheless, the key theme underlying the process of decentralisation was the enhancement of local government powers to carry out more effective economic development, and further measures to facilitate that goal.

A key component of the decentralization process has been the use of fiscal incentives to encourage local governments to act on economic development, which would result in benefits to both local government and to China as a whole. In theory, allowing the benefits of economic development to accrue to the individual local governments responsible for fostering it should lead to more willingness on the part of local governments to pursue economic development. Coupled with the devolution of expenditure responsibilities and the removal of the need for the central Ministry of Finance to approve budgets, this represented a significant freedom for local governments to act.

However, the changes have had unforeseen consequences. In the process of decentralization, the gradual nature of China's economic reforms left many distortions in the economy, as well as weaknesses in the command of the Centre over the regions. As Wong (1992) pointed out, the gradual approach of Chinese economic

reforms meant that the policies lacked a coherent direction, were often reactive rather than proactive to emerging problems, and were implemented in a piecemeal fashion, creating unintentional ripple effects that cause further problems in the system (p198–199). The piecemeal change created a defective institutional arrangement that provided distorted incentives, encouraging local governments to pursue limited development strategies that maximised benefits to the local state rather than to encourage overall local economic growth (Wang, 2002).

Another concern of the Central government was the steady weakening of its ability to exercise macroeconomic control. Between the start of economic reforms and 1994, China's economy grew by more than 5 times, while in real terms Central government revenue remained at 1978 levels (Wang, 1997). The ratios of both Central government revenue to GDP and Central government revenue to total government revenue has been falling since the first major fiscal reform in 1980, and continued to decline after a second attempt in 1985 designed to correct the shortcomings of the first. Both reform attempts failed to increase the two ratios, creating the paradox of the government barely able to meet its expenditure commitments while the Chinese economy continued to grow at astonishing rates (Wang, 2002). Finally, in 1994, the Central government introduced another fiscal reform.

The third reform in 1994 recognised that intergovernmental fiscal relations were defective, and that the incentives for local governments encouraged opportunistic behaviour. Despite the apparent incentive of localities increasing their overall budget through higher revenue collection, local governments nevertheless faced disincentives due to the way their revenue was shared with the Central

government, and were thus reluctant to increase their revenue. The new reform remedied this by implementing a new tax sharing scheme with clearer guidelines on the distribution of revenue between the local and Central governments. All the fiscal reforms from 1980 onwards are discussed in the following section.

4.2 China's fiscal reforms

While operating under a centrally planned economy, China had a simple system that was referred to colloquially as “eating from one big pot” (*chi daguofan*). This is a centralized system where almost all revenue was remitted to the Central government, which was responsible for redistributing it via the Ministry of Finance in accordance to the aims and objectives of the economic plan. All taxes and profits from local governments and state owned industries were remitted to the Central government. The Ministry of Finance was responsible not only for the consolidated (national) budget, but it also approved of the annual revenue and expenditure plans at the provincial level, and determined the appropriate level of revenue to be transferred. Provincial governments were in turn responsible for approving revenues and expenditures for lower levels of government. This meant pre-reform local governments in general (at provincial and sub provincial levels) had very little autonomy or scope for manoeuvring, with both their revenue and expenditures predetermined by higher levels of government. The unified system meant that all taxes were collected by local agencies, although their ability to collect revenue for themselves was limited as rates were set by the Central government and applied uniformly across the whole country. The ability of local governments to allocate resources was also restricted. Major items of expenditure were limited to those prescribed by the plan, and local governments were not allowed to budget for a deficit, ruling out the possibility of borrowing money to finance additional spending

(Wong, 1992).

With the drive towards rapid industrialisation and strategic concerns dictating economic development during the Maoist period, the collection and allocation of revenue from individual provinces were rarely linked. Massive transfers from one province to another were often necessary in order to fulfil development objectives. The centralised fiscal system facilitated targeted regional development, and was used in lieu of fiscal policy. However, with almost no autonomy and little say in the disposition of their budgets, local governments had few incentives for collecting revenues and for keeping to their budget. Since all revenues were remitted to the Centre, any growth in local revenues – either through increased collection efforts, or through prudent management of the local economy – had no impact on the benefits to the local government. Nor did keeping to the allocated budget produce any benefits. Indeed, because it was almost impossible for the Central government to monitor, analyze, and spot irregularities for all local expenditures, it was possible to disguise the losses from poorly planned expenditures and revenue shortfalls at the local level and to pass it up to the state budget.

In order to pursue more rapid economic growth, it was necessary to overcome the inefficiencies of the old fiscal system. In the period immediately after Mao's death, it was recognized that the economy was in a dire position. Hua Guofang stabilized the economy between 1976–1978, but his actions did not alter the fundamental weaknesses in China's economy (Nolan & Ash, 1995). Nevertheless, the urgency of the situation did stimulate critical assessment of the economy, and encouraged a decentralization of the existing economic system. Thus China's fiscal system underwent major changes in 1980, 1985, 1988 and 1994 (Lee, 2000, Wang,

2002). All the changes were designed with the same aim in mind – that is, to maximize resource mobilisation in all provinces in order to promote economic growth while also strengthening the fiscal power of the Central government (Wang, 2002). The main changes introduced in each fiscal reform can be seen in Figure 3.2.

Figure 4.2: Summary of China's fiscal reforms, 1980–1996

The fiscal regimes of 1980–84	The fiscal regimes of 1985–1987	The fiscal regimes of 1988–1993	The 1994 tax-assignment system
Sharing Specific Revenue (15 provinces)	Fixed Rate of Remittance (17 provinces and cities)	Contracted Income Increase (10 Provinces and Cities)	Central, local and shared revenue based on non-negotiable ratios (All provinces)
		Fixed Rate of Remittance (3 Provinces)	
Fixed Rate of Remittance (Jiangsu)	Lump-sum Remittance (Heilongjiang)	Variable Rate of Remittance (3 Provinces)	
Ethnic Minority System (8 provinces)	Lump-sum Subsidy (4 provinces)	Increased Rate of Remittance (2 Provinces)	
The Metropolitan System (Beijing, Shanghai, Tianjin)	Ethnic Minority System (8 provinces)	Lump-sum Remittance (3 Provinces)	
Lump-sum Transfer (Guangdong and Fujian)	Lump-sum Transfer (Guangdong and Fujian)	Lump-sum Subsidy (16 Provinces and Cities)	

(Source: After Wang, 1997, 2002)

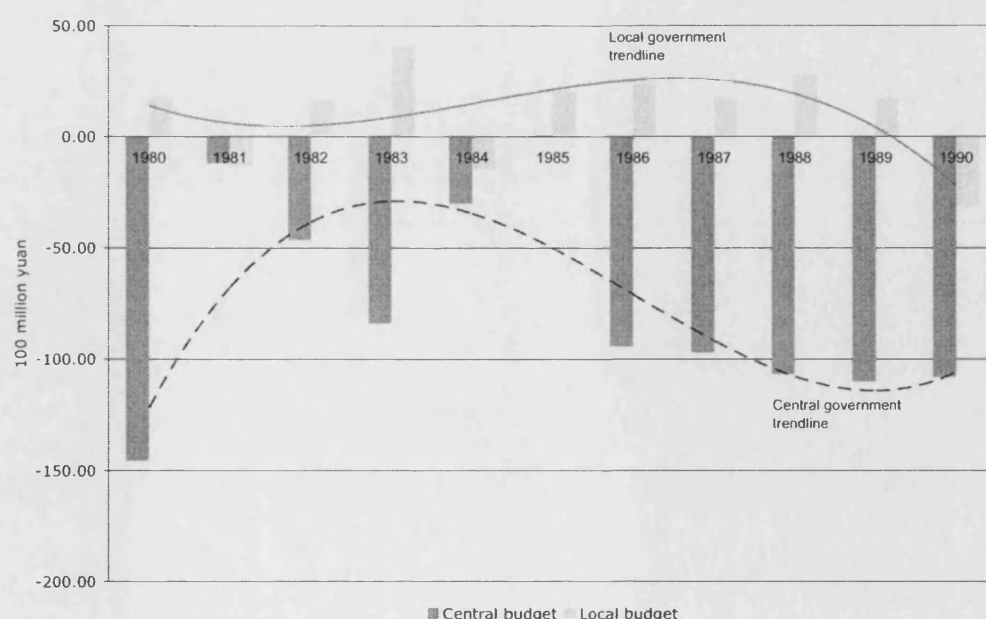
From figure 4.2 it is possible to see the variations and provincially specific fiscal policies adopted by the Central government since 1980. The large number of different arrangements between the Central and provincial governments made it difficult to maintain fiscal control. Both the central and local governments were not able to properly establish a stable effort to increase their extractive capacities and as a result, not only did Central government revenue fall in relation to GDP, total government revenue also declined. This affected the government at all levels, limiting the Central government's ability to maintain macroeconomic stability, and curtailing the services provided at the local level (Wang, 1997).

The ambiguous outcome of China's first three attempts to reform the fiscal system gave rise to a series of debates over whether the Central government was losing control over the provincial and local governments. Falling revenue, and

determined efforts by the local governments to undermine, exploit and resist corrective measures by the Central government painted a rather unpromising picture of Central power, especially in regard to its control over the economy.

The localities have obtained *de facto* control over effective tax rates and tax bases, while the lack of coordination between the decentralization of revenue collection and the decentralization of expenditure responsibility has restricted the center's [sic] flexibility in using expenditure policy. As for monetary policy, it is argued that the central bank has not been able to effectively control money supply as the localities can react strategically to the central bank's policy. [...] As for regulatory issues, [...] under the decentralized system local governments have tended to abuse their (vaguely defined) administrative and regulatory powers in order to protect local economies (Ma, 1995, p2)

Figure 4.3 Central versus local government budget deficits



Budget deficits of the central and local governments, 1980 – 1990 (Tsang & Cheng, 1994)

The mismatch between central and local government budgets can be seen in figure 4.3. Between 1980 and 1990, the gap between the Central government deficit and local government surplus widened despite China's GDP growth averaging 9% annually (China Statistical Yearbook, 2000). At the same time, total government revenue fell from 25.9% of GNP in 1980 to 16.6% in 1990 (Tsang & Cheng, 1994). This suggested that there was a problem with the existing fiscal system in terms of its ability to distribute revenue within the government, and also it indicated a problem with overall revenue collection, which fell despite a rapidly growing economy.

4.3 China's fiscal system, 1980–1993

The first major reform to the fiscal system came in 1980, where a revenue sharing scheme was implemented. The "contract responsibility system" divided revenues into three types: local fixed revenues (revenue for the local government); central fixed revenues (revenue remitted to the Central government), and shared revenues (revenue to be shared between local and Central government). The Central government retained the ability to determine all the tax rates (Ma, 1997). However, the reform was not applied to all Chinese regions (see figure 4.2). Many provinces had different arrangements with the Central government, with fixed remittances and fixed subsidies (for poorer provinces that were unable to finance their own expenditures). Individual expenditure items in provincial budgets no longer need to be approved by the Ministry of Finance, although restrictions were imposed on how the revenue was to be used – for example, limits were placed on government employee wage levels and on the items which government agencies were allowed to purchase.

Figure 4.4 Expenditure responsibilities of China's local and Central governments

Central government expenditure responsibilities	Local government expenditure responsibilities
National defence	Rural production assistance
Foreign aid / foreign relations	Social welfare
Social welfare	Urban maintenance
Agricultural assistance	Administrative expenditures
Environmental conservation at the central level	Environmental conservation at the local level
Running costs of centrally owned enterprises	Running costs of locally owned enterprises
Running of centrally owned universities and hospitals	Education, health, culture and social services
Major construction projects	Obligated to contribute to construction projects
Price subsidies	
Geological surveys	
Repayment of public debt	
Administrative expenditures	

Overlapping responsibilities are marked in bold (after Bahl, 1999)

Expenditure responsibilities were devolved downwards to different levels of government. Figure 4.4 shows the division expenditure responsibilities. Aspects of national security and defence, foreign policy and foreign aid, nationally owned industries, infrastructure construction and industrial and commercial operations of national importance, agriculture, national subsidies and other matters which affect the entire country are the responsibility of the Central government. Local governments are responsible for the maintenance and upgrading of local infrastructure, health, education, welfare and other social services, subsidies and aid to local agriculture, the running of locally owned enterprises, and so on.

In practice, the reform complicated China's fiscal system. The huge variety of revenue sharing schemes and the practice of setting the rate for shared revenues through individual negotiation rather than through the imposition of a universal formula severely weakened the ability of the Central government to impose control. Provinces could renegotiate, and had the incentive to do so if other provinces

benefited from a better rate. This uncertainty was also applicable to the Central government, which could change the set rate for individual provinces. The lack of any fixed rules determining the behaviour of either the Centre or the provinces meant that neither party could truly trust the other (Wang, 2002). Instead of aligning the interests of the Centre and provinces, this served to set up a situation akin to the prisoner's dilemma, with each player seeking to maximize their own advantage.

Another unforeseen consequence of the 1980 reform was the uneven distribution of expenditure responsibilities. The blurred boundaries between local and central expenditure responsibilities means there were a large number of overlaps. For example, universities could be centrally or locally funded, depending on whether they are national or regional, so education is the responsibility of both central and local governments. Large infrastructure projects such as power stations, communications and transportation require both funding and approval from the Centre, but provincial funding is also required.

This confusion over expenditure responsibilities stem from the failure to enact laws and regulations clearly defining what services are to be provided by which level of government. Thus although expenditure responsibilities appear clear enough in principle, there are areas of confusion where administrative responsibilities overlap, or where expenditure decisions can be influenced by their political impact (such as the provision of subsidies to old state industries) rather than by their economic efficacy (Bahl, 1999, p71).

4.3.1 The Central–local government tug-of-war

Two separate sets of problems resulted from the various distortions

introduced by China's fiscal reforms between 1980 and 1993. One is the discordant relationship between the Central and local governments. The other is the implementation of economically inappropriate development policies and objectives because of local governments attempting to take advantage of the distorted incentives. Both were dangerous to the growth of China's economy.

Poor central–local government relations threatened China's hard won economic progress by risking macroeconomic stability (Wang, 1997, Brean, 1998, Lin, 2000). More drastically, some authors claim it threatens the stability of China as a single political entity (Wang & Hu, 1993, cited by Huang, 1996). Viewed through the lens of Central and local government revenue sharing, there does appear to be a struggle, with the Central government constantly attempting to increase its revenue, and the provinces countering its policies while expanding their revenues and reducing their remittance to the Central government.

The Central government appeared to be fighting a losing battle against the provinces, as a quick examination of the division of total revenue between the Central and local governments shows. Local fiscal autonomy came at the cost of central revenues, with local governments exercising what powers they possess to expand their budgets and to reduce their payments to the Centre, through measures such as the use of “extra budgetary funds” that are neither recorded nor reported. Although it may be far fetched to suggest that local autonomy posed a threat to China's political stability, it is nevertheless clear that the Central – local fiscal arrangements needed to be corrected, and the reforms in 1994 could be taken as an admission of this fact.

However, others disagree with the zero sum approach of examining China's fiscal system. Chung (1999) argues that although localities have obtained more discretionary powers over the past twenty years, it is too simplistic to assume that the balance of power has shifted in favour of the localities. Fiscal relations is but one facet of Central – local relations. To suggest that fiscal irregularities on the part of provinces unwilling to hand over their revenues is a sign of local domination over the Central government is misleading, and misses the point. Falling Central government revenues is a cause for concern, but it does not imply that provinces are out of control. Nor does it imply the Central government's ability to bring provinces into line has been reduced. Huang (1996) argues that even with economic decentralization, and the Centre apparently forfeiting control of the economy to local governments, the political position of the Centre has not been weakened. Its ability to appoint provincial leaders means it retained a form of sanction over unruly provinces. Lary (1997) puts it succinctly:

The Centre today faces a continuous series of regional challenges, predictable, aggravating, irritating. Some commentators see these challenges as threatening the continuation of an integrated state, but, if we go with the historical record, none of them threatens the survival of the centre. Instead, they force it into constant negotiations, accommodations and bargaining, in place of the uncompromising combination of tough and subtle means of dominance which earlier rulers used. (Lary, 1997, p192)

However:

Individual provinces are not passive or docile. They

now employ their own repertoire of tactics, some learned during the warlord period, when there was no centre, some during the anarchy of the Cultural Revolution. Compliance with central orders is often discretionary rather than mandatory, directives are watered down, altered or ignored. (Lary, 1997, p193)

Thus the dynamic at work is far more complex than a simple, two dimensional tug-of-war between the Centre and the provinces measurable by the budgetary remittance and balance. Instead, the key change in the Central-local relationship is the introduction of negotiation and exchange. There is a recognition that the interests of the Centre and the localities sometimes come into conflict, but with the series of economic reforms it is no longer possible for the Central government to exert total control over the behaviour of the localities without stifling their ability and / or willingness to pursue economic growth, which remained the overriding objective of instituting economic change in the first place.

It is not necessarily in the interests of local and provincial governments to threaten Central power or to usurp Central control. Indeed, Lary (1997) points out that direct and outright challenges to Central authority and the unity of China have not taken place even under extremely chaotic periods of China's history. Seceding from the state is treasonable and unthinkable, thus most challenges take place in more subtle ways, mainly for economic gains rather than political independence. This can be seen in the progression of fiscal reforms from 1980 to 1994, where measures taken by the Centre to ensure relative equality in budget distribution and remittance was always met with a series of regional and local countermeasures. A common expression used by Chinese local officials during the interviews of this study– *shang you zhengce, xia you duice* – the Centre has policies, the regions have

countermeasures – expresses this dynamic succinctly.

This conflict of interest between the Centre and the regions remains the key cause of this antagonism. The Central government must fulfil very different objectives to those of the local government, and it has the capacity to perform those functions well. Similarly, local governments have the capacity and are suited to serving only certain tasks and functions. Where the boundary between Central and local government tasks is blurred, there is the potential for friction and antagonistic behaviour.

Extra budgetary finance is another important source of revenue for local governments in China. Before the first fiscal reforms, their significance was limited by their relatively small sizes. However, they were significant in that local governments can utilize them without needing Central government approval. Indeed, there is almost no central control over extra budgets at all, and their collection and use is largely unrecorded and monitored, and local governments have almost total discretion over the composition and level of extra budgets (Bahl, 1999, Wedeman, 2000). By shifting the revenue they collected into extra budgets, local governments reduced the amount they paid to the Central government through the shared revenue under the contract responsibility scheme. Bahl (1999) states that by 1995 the total extra budgetary revenue was equivalent to 68% of total budgetary revenue (p75). The attraction of extra budgetary incomes influence the development of local industries, creating distortions in local development policies based on local government revenue rather than rational economic development.

4.2.2 Distorted local policies

The devolution of the responsibility for economic development to local governments is based on the idea that the local government has better access and connections with their locality, better information, and therefore are in a position to make the best and most appropriate decisions for economic development (Young, 2000, Lin, 2000). The incentive for local governments to carry out economic development – rather than to rely on Central government subsidies – was to harden their budget constraint, and to link the performance of the local economy with the revenues received by the local government through taxation. In theory, the better the local economy performed, the more taxation received by the local government. Paradoxically, the incentive to maximise economic growth – and hence maximise financial rewards for local governments – worked too well, and created distortions in the economy. Local governments were more concerned with the “stick” of a hard budget and the “carrot” of higher tax revenues than they were with implementing even, balanced and long term development policies.

[I]n response to fiscal pressures and incentives, local governments have vigorously promoted industrial development in their attempt to build new and profitable industries to offset declining revenues and to finance growing expenditures. In the process, they have created problems of persistent overinvestment, duplication, regional blockades, and continuing bureaucratic management of industry (Wong, 1992, p.198).

Heady (1998) too, argues that because of the importance of indirect taxes in funding local service provision, local governments have a biased incentive to

develop those industries which are taxed most heavily, even if it is at the cost of overall economic well being or at the expense of Central government revenue. For instance, Young (2000) mentions an episode where Zhejiang province took advantage of the price of silk. The price of raw silk was fixed at a low level by the Central government, while finished silk products fetched an artificially high price. Thus Zhejiang stood to gain from the difference in price from local processing and direct export. With the relaxation of Central government control over rural industries, Zhejiang expanded its silk industry to take advantage of this price wedge. Zhejiang also erected trade barriers to prevent silk industries in other areas from purchasing its raw silk at above the centrally fixed price, as this would diminish the rents the Zhejiang government acquired from processing itself. This led to the situation where Shanghai received only 40 tons of its allocated 2000 tons of raw silk in 1988, even though Zhejiang was one of the main suppliers of raw silk in China. Young (2000) continues:

The “silkworm cocoon war” described above was just one of the many interregional trade conflicts, in both raw materials and finished manufactured goods, which appeared in the People’s Republic during the 1980s and 1990s (Young, 2000, p.1093)

This shows that the incentive for local governments to industrialize and promote local growth is not a neutral one. Local governments will concentrate on those industries that can give the highest, and most rapid returns to investment. Given the remaining price distortions in the Chinese economy at the time, some local governments became opportunistic developers, seeking the highest rent. The tobacco industry was another industry that attracted the interests of local governments (Zhou, 2000). Cigarettes were taxed heavily (with 50% product tax and 30% tax on tobacco

leaf prior to 1994), with a substantial part of the revenue accruing to the local government, and being a state monopolized industry the difference between price and cost yielded a substantial profit. Thus local governments were keenly interested in their development. However, following a period of rapid expansion of the tobacco industry in the 1980s, there was a glut of capacity with a bloated and inefficient industry, leading to the creation of trade barriers, price fixing, quota trading and other measures to protect an inefficient industry. Zhou (2000) argues that even though local tobacco firms may be making a loss, their tax revenue to the local government brings continued support.

4.3 China's 1994 fiscal reform

The most obvious outcome of all these pressures on the Central government budget is the deficit of the Central government. Wong (2000) points out that the decline of the central economic plan as a means of controlling the economy has led to the budget and monetary policies becoming increasingly important. They are the tools with which to maintain macroeconomic stability, and to allocate resources according to policy objectives. While these objectives were fulfilled by the economic plan in the past, the reduction of its scope and in terms of the resources available at its command has transformed the plan to a set of general guidelines for local implementers to follow, rather than acting as a tool for micromanaging the economy. Therefore the budget has become the most direct way for the government to carry out its policy decisions. This makes the continued and increasing budget deficits all the more threatening to China's macroeconomic stability as it undermined the ability of the Central government to regulate the economy through fiscal measures (Tsang & Cheng, 1994). The fact that the Chinese economy experienced high growth rates and high inflation also worked against the pre set (and fixed) tax sharing quotas that were

arranged with the local governments.

Figure 4.5 Tax division between China's Central and local governments in 1994

Central taxes	Local taxes	Shared taxes (central : local)
Tariffs	Business tax (excluding insurance, railways and banks)	Value added tax - 25:75
Income tax of central enterprises	Income tax from local enterprises	Stock transactions gains tax - 50:50
Taxes on insurance, railway and banking revenue	Personal income tax	Other resource taxes (excluding oil) - mostly to local government
Income tax of financial enterprises	Capital gains tax on land and property sales	
Consumption tax	Estate duty	
Offshore oil resource taxes	Stamp duty	

Source: Tsang & Cheng, 1994

It was under these circumstances that the Central government announced a new set of reforms to be implemented at the beginning of 1994. It had three main objectives, outlined in the "Decision of the CCP central committee on issues concerning the establishment of a socialist market economic structure" (cited by Tsang & Cheng, 1994). First, it was necessary to correct the falling total government revenues, and to raise the low central to local budget share to a ratio of 60%:40%. By 1993, the ratio had fallen to around 22%:78%. Second, the reform aimed to streamline the revenue assignment system. The arbitrary mix of quotas and proportional sharing systems had by 1993 almost become a completely negotiated system, with individual provinces determining their revenues and remittances on the basis of one to one negotiations with the Central government. This unwieldy arrangement meant that Central government attempts to manage the economy through adjusting tax rates was effectively negated, since tax rates were uniform throughout the country, while individual provinces had different revenue

assignments, and the effects from adjustments was difficult to predict. In response to this, a rule based system of tax assignments was introduced. Revenue assignment was to be determined by three categories of taxes: local, central and shared taxes. Unlike the old revenue sharing system, the rates for taxes were fixed and were not negotiable. Finally, the reform aimed to rationalize the budgetary system, and to control fiscal deficits.

The 1994 reform did succeed in raising Central government revenues. However, in order to push through the reform, the Central government had made a concession to the provinces. In order to make the reform more palatable, the Central government had guaranteed that their revenues would not fall below that of the base year, 1993. When local governments learnt of this in September 1993, they immediately increased their revenue collection efforts, even to the extent of collecting taxes for 1994 in advance in order to increase the amount of rebate they received from the Centre (Wang, 1997). This tied up much of the disposable budget of the Central government, and even though the proportion of central – local revenue increased in 1994, after the remittances were made the Central government's budget was much the same as before. However, this arrangement of remittance is to be phased out slowly, since the growth rate of the remittances is to be slower than the revenue growth (0.3% for every 1% revenue growth). Thus as long as revenue collection from the provinces continues to grow, the amount given by the Centre to the provinces will decrease slowly.

Wang (1997) points out that the 1994 reforms still left many avenues for local governments to reduce the payments made to the Centre. Tax avoidance, tax evasion and tax arrears are all illegal, but their enforcement falls on the shoulders of

local governments. Wang (1997) shows that much of the problem stems from local governments unwilling to enforce these rules because the benefits for them are relatively small. This is illustrated by the collection of the personal income tax. When it was classified as a shared tax, its collection rate grew slowly. However, when it was reclassified as a local tax in 1994, its collection soared. Similarly, two thirds of tax evasion cases in 1994 involved VAT (a shared tax), highlighting the local governments' priority of concentrating their resources on collecting local taxes. The use and collection of extra budgetary funds also remain outside the scope of official monitoring, exposing it to the possibility of abuse by local governments. In 1993, total extra budgetary revenue was up to 16% of GDP, matching total government revenue. In contrast, in 1978, extra budgetary revenue was only 10% of GDP and government revenue was 31% (Jin et al, 2005).

4.4 Conclusion

The process of decentralizing government finances and economic control has changed the relationship between the Central and local governments. Local governments, operating as agents for the Central government in the planned economy, were given the incentives to develop their economies.

However, while China's economy grew spectacularly, both local and Central government revenues remained stagnant, despite repeated attempts to correct this through reforming the fiscal system. The reforms themselves appear to be the problem, as they introduced inappropriate incentives for local governments. The gradual pace of reform also meant that other sources of distortion remained in the economy, such as fixed pricing, which local governments also exploited. In doing so, Central and local governments became locked in a game that neither could win, and

local governments were locked with each other to protect their own interests.

Overall, this situation created a series of damaging outcomes, such as falling government revenue, reduced inter provincial trade, and the over development of inappropriate industrial sectors to take advantage of artificial price distortions, diverting crucial and scarce resources from industries that may be more suitable and sustainable. These did not serve to bring more prosperity to the Chinese economy.

The change in intergovernmental relations, however, has served to highlight the growing importance of local governments in the economic development process. While threats of national disintegration due to poor local–central relations may be exaggerated, the danger to continued economic growth is very real. Governments at the local level have shown that they are now able to bargain with the Central government, and their actions can overcome corrective measures of the Central government.

Chapter 5: Local government behaviour and firm ownership in China

5.1 Introduction

China's fiscal reforms and continuing process of decentralisation aimed to provide local governments with the autonomy and incentives to carry out local economy development. The reforms did not direct the growth in a balanced or sustainable manner, instead leaving most local governments with their own initiatives for pursuing economic growth. This resulted in the multitude of approaches taken by Chinese local governments towards economic development. However, the common underlying theme shared by all local authorities was the fiscal incentive to pursue economic development. Arguably, then, local governments would aim to maximise the potential benefits to them – in terms of official and unofficial revenue, and in terms of other, non financial benefits, such as personal benefits to individual officials (Levy, 1995, Che, 2002).

One important determinant of how local governments could benefit from economic development is the predominant type of firm ownership in their area. The incentives for local government to develop their economies is tied with how much benefit can be extracted from local firms, with firms that are under local government ownership being easier to control than firms that are not under local government ownership.

The gradual nature of China's transitions meant that her economy passed through the stages between being a centrally planned, state owned economy at the start of reforms, and the market driven, privately owned economy that operates now. The Central government did not set out to privatise the economy, but the gradual and

experimental nature of the process resulted in a gradual transition of ownership types, from state ownership to private ownership. The experiments of the local governments were crucial in shaping this transition process, since local governments were the ones “feeling the stones” across the river of economic transition, and their experiences informed further reforms by the Central government. In modelling local government behaviour, Oi (1992) points out that:

By local state corporatism I refer to the workings of a *local* government that coordinates economic enterprises in its territory as if it were a diversified business corporation. [...] Whereas the central state set the reform process in motion and provided localities with the incentives and the leeway to develop economically, it is *local* government that has determined the outcome of reform in China. Hence, my designation *local state* corporatism (Oi, 1992, p100–101)

The process of local government determining the outcome of economic transition – rather than setting the ground rules for it – meant that China’s transition was the result of local government action, and to understand that action it is necessary to examine the relationship between local governments and local firms.

The ownership of a firm is crucial in determining firm performance as well as the amount of benefits that can be extracted by a local government (Oi, 1992, Edin, 2003, Li et al, 2004). Throughout China’s transition, local governments have changed their relationships with firms in order to maximise the benefits to them. Understanding the three main ownership types is therefore useful in understanding the role of local government in economic development.

5.2 The three main ownership types

Firm ownership in China can be divided into three categories: state owned, collectively owned, and privately owned. At any time the Chinese economy is a mix of firms simultaneously operating under these different ownership models. With individual local governments determining the pattern of local firm ownership, each locality is also likely to have a different mixture of ownership types. This is one of the most unique aspects of China's transition, with state, collective and private sectors all responsible for driving economic growth in different areas, sometimes simultaneously.

The sections below examines the three different ownership types in more detail. Each ownership type places different constraints on how local governments may influence or manage them, as well as requiring different actions from the local government to promote their growth. State ownership, for instance, places the greatest number of restraints on local government to act, since Central government control curtails individual local action, while local and collective ownership allows the greatest flexibility for local government action and rent extraction (as evidenced by Oi's (1992) theory of local corporatism). Private firms suffer from the lack of legal protection and regulations against local governments, although they are less pliable than locally owned firms.

5.2.1 State ownership

China's reforms exposed state enterprises to the influence of the market. The state retained ownership over these firms, but they were to operate in a market, rather

than under the structure of a planned economy. It was hoped that the pressure of market competition would increase efficiency, yet at the same time the ownership rights remained with the state.

The reason for the insistence on retaining ownership is both ideological and practical. Ideologically, China remained committed to the socialist vision, and this commitment was particularly strong at the start of the reform period, with fierce debates over the future direction of the economy. Practically, aside from their productive functions, China's state enterprises perform a variety of important social and political functions that would be disrupted by outright privatisation. In the absence of a nation wide medical, welfare and social security system, the Central government was unwilling to upset the existing set up and risk social instability through privatisation. Thus the path of enterprise reform was pursued, instead of outright privatisation (Cao, 2000). The reforms sought to transform the way in which state firms were managed, rather than to transfer their ownership into private hands. Management contracts were introduced, in much the same way that contracts for the agricultural sector was introduced in the early 1980s. Production from state enterprises was to be split into those fulfilling the plan quota, sold at a price level set by the state, with any surplus production above quota allowed to be sold at a higher price on the free market, the profits retained to be distributed or used as the managers of the firm saw fit. The government (here, the local government) and its agencies were to stop their micromanagement of the economy, concentrating instead on implementing their governmental duties. In theory, this allowed local governments to benefit from the tax base of more efficient and better managed state firms without actually going through the process of privatisation. However, as Cao (2000) points out:

Decentralization has broken up the command economy, as it indeed was intended to do, but it has also resulted in a disaggregated state consisting of numerous decentralized agencies and departments from various central, regional, and local ministries and their respective branches, each eager to exercise jurisdiction over the firm and correspondingly, “extractive authority over firm assets.” (p36–37)

Some local governments, their departments, and agencies, were not satisfied with the prospect of an expanding tax base through the growth of these reformed, privately managed, publicly owned firms. The separation of ownership and management created confusion over how to demarcate control and management rights, resulting in conflicting claims over the ownership of a firm. Within this confusion, it was easier for local governments to acquire retain de facto management rights, and the right to intervene when it felt suitable. Rather than separating the state from the firm, these reforms produced a perverse situation, where the overlapping claims to ownership and control, and conflicting interests between local state and private management, caused confusion, facilitating rent seeking and predatory behaviour.

Chinese local governments were able to exert additional control over local state firms by controlling their access to loans. The growth of many local state firms in China depended on their ability to secure loans. Whereas under the planned economy, firms were given grants from the state, and had many options to delay or reduce repayment (Chang, 1983, 1282–1283), the newly introduced reforms encouraged firms to access their capital from elsewhere. Being able to obtain grants

from the local branches of state owned bank was the easiest way to expand firms, and it was the simplest way to expand the local state sector and increase potential remittances to the local government. The tendency for over investment is termed “investment hunger” by Kornai (1986a). Chang (1983) also describes the tendency for bureaucratic organisations to expand their sphere of influence through growing their organisations, which drives investment. Furthermore, the old style planned economy evaluation of gross output (rather than profits) as a measure of progress meant that there was constant competition on local governments to obtain grants from the Central government to invest in local projects. The consideration of cost was secondary, as interest and repayments can be deferred. Under a planned economic system, there existed the central planners to curb the over enthusiasm of local government investment. However, the introduction of reforms for firms removed this restraint, and local governments and local firms alike found many ways to increase their investment.

5.2.2 Collective ownership

Many authors agree that local governments were responsible for leading China’s economic growth (Hubbard, 1995, Unger & Chan, 1999, Oi, 1992). The political acceptability of local collective ownership (Cao, 2000) – as contrasted with outright private ownership (or privatisation of existing state firms) – makes them a natural transition away from state ownership whilst avoiding the stigma of being “capitalist”, a term that was still contentious in the early part of the reforms.

Collectively owned firms were the fastest growing firms in China in the 1980s and early 1990s. Their success seems paradoxical given that collective firms were often controlled and surreptitiously owned by the local state. According to

Kornai (1986b), state ownership of firms was highly inefficient, even under conditions of market competition, and this situation led to the failure of Hungary's economic reforms in the 1980s. However, China's collective sector grew rapidly, seeming to contradict Hungary's experience.

Walder (1995a, 1995b) suggests there were three commonly offered explanations as to the Chinese economy was successful. First, it has been suggested that the small collective rural industries crucial to China's economic growth – and ostensibly operated by the state – in fact fall under a different form of ownership to the larger industries more traditionally assumed to be SOEs. Unlike larger industries constrained by the state plan – as well as having a soft budget provided by the Central government – smaller, local authorities run local enterprises. These small firms face much fiercer competition, and unlike the Central government, local governments could not afford a “soft budget” to keep uncompetitive firms alive. It would therefore be a mistake to assume the same failures in large, centrally managed firms would also happen in these smaller, locally managed firms. Furthermore, the label of “public ownership” may disguise a high degree of privatisation that has taken place in the firm. Thus “collective” ownership may be no more than a shield for entrepreneurs to operate under the aegis of local government protection.

A second explanation suggests that the transition to markets has been successful in China due to the incentives given to firms to operate profitably. The gradual transition to a market, as opposed to a big bang, introduced competing companies and exposed SOEs to increasing competition for both resource inputs and for markets for finished products. The transition is therefore able to provide managers with the same incentives that would face a private firm and hence replicate

the same behaviour. A variation of this explanation suggests that, since market forces are driving state owned firms to behave in much the same way as privately owned firms, the most dynamic of these would be found where the market has become more developed, since that is where the greatest competitive pressures would be found. Nee (1992) suggests that rural collective industries are closest to having a market system, and are thus the most competitive, because they were the first sector to have benefited from the economic reforms in 1978. In this explanation, the question of actual ownership of the firm becomes less important, since they face the same incentives and thus act in the same way as a privately owned firm. The emphasis is instead on the competitive pressure faced by firms.

The third explanation offered revolves around the fiscal incentives given to local officials to generate revenue. The reforms in the fiscal system created what could be described as a form of fiscal federalism. It was designed to encourage local officials to increase their revenue through achieving economic growth, and collecting more taxation from the local economy. By allowing localities to retain a proportion of tax revenue, instead of requiring them to remit it all to the Central government for redistribution, local governments stood to benefit from increasing total revenue, so they would encourage local economic development. Furthermore, since local authorities still faced a hard budget constraint (as the Central government was no longer redistributing resources to bail out enterprises that were in trouble), they were forced to manage the local firms in a prudent manner.

There is a striking difference between the first explanation and the others – its insistence on the importance of clear property rights and ownership. North and Weingast (1989) stated that the existence of secure property rights is a necessary

precondition in order for economic development to take place, and this discussion has often been framed in terms of property rights for individual entrepreneurs in market economies. However, Oi (1992) argues there is no reason why property rights should only be an effective incentive when applied to individuals, as opposed to any other entity (which includes the Chinese local governments). Furthermore, there is no reason why any entity other than private individuals cannot become effective entrepreneurs. So long as the correct incentives are present, Oi argues, the question of ownership is a moot point. The same incentives were given to the local state through China's economic and fiscal reforms as would be given to individual entrepreneurs.

In Unger and Chan's (1995) analysis on the East Asian and Chinese corporatist models of development, they suggested that corporatism in China, in contrast with other East Asian economies, was used as a form of deregulation, which freed firms from the direct interventions from the state. Under the pre reform planned economy the government had total control, micromanaging the economy through detailed economic planning. With the economic reforms, instead of direct economic control, the Centre instead allowed various surrogate institutions more freedom to make economic decisions. Since most of these consist mainly of bureaucracies and local governments, the Centre maintains a degree of control that it would otherwise not have if completely independent organisations were created instead. Nevertheless, this meant that the structure of the Chinese economy is such that certain forms of corporate governance may be favoured more than others. Nee (1992) argues:

The transition economy, characterized by weak market structures, poorly specified property rights, and institutional uncertainty increases the relative cost of

redistribution even while rendering costly market transactions (Nee, 1992[a]). This characteristic condition of partial reform creates an institutional environment in which hybrid forms [of corporate governance] enjoy a transaction cost advantage over alternative governance structures. (p4)

Thus, although the intervention of the local government in the running of local enterprises may lead to a softening of the budget constraint (Kornai, 1986b), and hence lead to inefficiencies, it is possible that under certain circumstances such a relationship may be a beneficial one, promoting efficiency and profitability rather than the behaviours of a stagnant monopoly. Local governments can enhance the domestic and international competitiveness of a firm by providing much needed infrastructure support (in the forms of education, training, health and so on), facilitate horizontal and vertical interactions along the production chain (through information exchange between different local firms), provide subsidies, act as a source for physical or human capital, and act as a conduit for information on markets, new technologies and opportunities. Thus:

In short, local governments may provide the backing and resources needed by entrepreneurs to compete effectively in an economy characterized by partial reform, in which the still dominant redistributive institutions interact with market forces in a manner that subordinates market institutions. (Nee, 1992, p4)

This suggests that the economic conditions in China between 1980 and 1990 may have been more suited to local state corporatism than it was to private enterprises. This is more so for smaller, rural collectives, who share a bilateral

dependency with their local government. In theory, rural collective enterprises were owned by all who live within the jurisdiction of the local government, which meant the local government had greatest claim over managerial and de facto ownership rights. Professional managers may be hired to run the enterprise, but their actions remain at the discretion of the local authorities. Maintaining a good relationship between the local firm and the government is a necessity, on a collective level, and on a personal level. This aspect of social networking, or *guanxi*, can be found all over China, at all levels, so a brief diversion will be made here on a more formalised approach to viewing the game of *guanxi*. As Wu (2001) points out, the nature of *guanxi* means that it is dynamic, without a certain end state, unlike an exchange taking place in a market.

This characteristic has important implications for calculation in personal connections. *Guanxi* exchanges as a form of 'gift economy' stands in sharp contrast to market exchange. In a pure market situation, a transaction is completed when goods and payment are exchanged, whereas in a gift interaction, exchange is not yet finished when the gift is offered and accepted. For instance, one may intentionally present a gift to commit a friend to repay favours in the future, but at the present moment, one would not know what one will require in return and when such a need may arise. The moratorium makes the values of future goods unknown (Wu, 2001, p30)

In this sense, the local officials can be seen as an entrepreneur as well, even if they are not directly involved in managing an enterprise themselves. Krug (2000) suggests that political entrepreneurship can be seen as a suitable explanation to the success of collective enterprises in China. The idea of the individual entrepreneur

appears to be out of place in the Chinese economy, since private individuals lack the option of obtaining capital, credit, and land, through the market. Thus the establishment of a firm depended on an agreement with those who possessed the necessary resources. Krug points out that the village, and by extension, the local government, is a collective of those who have the necessary resources.

5.2.3 Private ownership

Private firms found it necessary to cultivate good relations with the local government in order to operate successfully. Since the formation of the People's Republic of China, the official stance regarding "individual economy" (firms owned and operated by individuals) has fluctuated, but the general trend is unmistakable. Between 1952 and 1978, the number of people employed in the private sector (sometimes referred to as the "individual" – *geti* – sector) declined from 8.8 million to 150 000 (HersHKovitz, 1985). Although permitted to come back again since the start of reforms, the Central government was initially cautious about the introduction of private ownership. The euphemism "non-state sector" neatly encapsulated this ambivalent feeling, qualifying the presence and necessity of private enterprises, yet avoided having to admit to their existence. In the absence of clearly defined property rights and the enforcement of those rights, as well as the ambivalent political atmosphere, establishing relations with the authorities became a necessity to compensate for the marginal status of the private firm. In this case, it was easiest to access local officials, since they were the most immediate interface between the general populace and the state.

The numerous difficulties and restrictions imposed on private firms meant that a personal relationship between an entrepreneur and receptive local officials was

one way to bypass the regulations imposed by the state. Furthermore, the upheavals in China's politics made it difficult for any particular set of political institutions to become securely established. The network of personal relations (*guanxi*) thus became an important variable to consider when examining businesses in China. It seems that in the face of bureaucratic intransigence, China's historical preference for a personal and moralistic relationship (Dittmer, 1995), rather than impersonal, authoritarian relationship, has resurfaced.

Private firms were restricted in their access to capital, since state banks and other official sources of credit often consider loans on political rather than economic criteria, and private firms on their own lack the political credentials to be considered. Funds were therefore available only from private, sometimes informal sources – such as friends and family – at substantially higher cost (Nee, 1992). A good relation with local authorities is useful here since local governments at county, municipal and provincial levels have become increasingly influential over the credit decisions of local branches of both the central bank and other specialised banks (for example, the Industrial and Commercial bank of China, the Agricultural Bank of China, the People's Construction Bank of China) (Qian, 1999). The ability to access capital is especially crucial in a transitional economy. The experience of other transitional economies shows that the process of transition leads to the creation of many new firms, but that they start out undercapitalised and ill equipped since, in the early stages of a transition economy banks usually lack the ability to handle small scale loans (Naughton, 1994). In China, the situation is similar, in that it is difficult for individuals to obtain loans from banks. Thus having a local government serving as a financial intermediary is one way to access capital that would not otherwise be available.

There are other benefits to forging a good relationship with local officials, who may be willing to overlook tax evasions and other regulation infringements, or provide a certain amount of political protection for firms by registering them as collective enterprises, or to collude in exploiting existing loopholes for corporate profit (White, 1996).

What is important to note is the interplay between the wish of local governments to maximise the benefits to them, and the performance of the firms. An inefficient firm may provide the local government with revenues even though it is a loss maker. Many of China's tobacco firms fall into this category (Zhou, 2000), due to the distortions introduced by fixed pricing and China's structure of taxation. However, the effect of distorted economic development will eventually impact the health of the local economy, and force local government to change their actions.

5.3 Conclusion

The ownership of local firms changed as China's economic reform progressed, from state ownership, through mixed collective ownership, to private ownership. This change affected the relationship between local governments and local firms, as ownership and control over local firms determined the degree to which local governments intervened in the local economy. There is obviously greater scope for local government intervention with local government owned firms, or with collective firms under local government control, than with privately owned firms.

The relationship between local firms and local government also affected the development path of local governments. The relative cost and risk of pursuing

economic development versus the potential gains might be seen in the light of short term benefits and gains. Firms under local government control and management provided local governments with greater opportunity to benefit, which was sometimes found to be preferable to the risk of developing a privately owned economy. Thus economic reform for local governments with a higher degree of control over local firms would be expected to be slower than in places where local governments had a lower degree of control.

Chapter 6 Types of local government intervention in the local economy

6.1 Introduction

China's fiscal reforms have provided local governments with the incentives they needed to develop their local economies. The reforms themselves produced a range of effects, some positive, some unforeseen and undesirable. However, in the main they stimulated efforts by local governments to maximize the use of available resources in their local economies, thereby gradually introducing elements of the market into a command economy, without the need for the "shock therapy" of the Eastern European countries.

The success of this transition raises the question of the role of local governments in this process. The variety of "economic models" (*jingji moshi*) in China is impressive, but most are limited to the regions they were named after, being the products of specific circumstances which brought about their creation, rather than being the result of thoughtful planning or deliberate planning. The geographical specificity complicates the task of identifying the specific role played by local governments in these models. As Baum and Schevchenko (1999) point out, China's institutional landscape is complex, polymorphous and prone to changes, and its current and incomplete transition away from a totalitarian state is unprecedented. Furthermore, China's economic reforms encourage experimentation in order to find the most appropriate pathway for economic transition. Variety, rather than uniformity, was the outcome.

A number of labels were created to classify the actions of the local governments, separate from their geographical locations, including "local state

corporatism” (Oi, 1992), “capitalism with Chinese characteristics” (Solinger, 1993) “state entrepreneurialism” (Duckett, 1996, 2001), and “local market socialism” (Lin, 1995). These describe the types and degree of local government intervention in the developing the local economy. Baum and Shevchenko (1999) synthesized these into a simple table of local government typology in figure 6.1.

Figure 6.1: Typology of local government involvement in local economic activity

		Local government has incentive to increase productivity?	
		Yes	No
Local government connected to enterprises?	Yes	Entrepreneurial	Clientelist
	No	Developmental	Predatory

(after Baum & Shevchenko, 1999)

The two key variables in this model are whether the local government has incentives to improve productivity or not, and whether the local government is connected with local enterprises or not. The two variables help classify local governments into four types – entrepreneurial, corporatist, clientelistic, and developmental. However, this model excludes the possibility of local governments exhibiting behaviours that fit into more than one category. It presents a neat typology of government types, but the pairings are not necessarily mutually exclusive. A developmental government may behave clientelistically as well, and an entrepreneurial government may at times engage in predatory activities. Thus a more sophisticated system is needed to capture the full richness of local government activities. By incorporating the four categories from Baum and Shevchenko’s (1999) model as a means of classifying local government *behaviour*, rather than local governments themselves, it is possible to construct a more nuanced model that may be a more useful tool for examining China’s local governments.

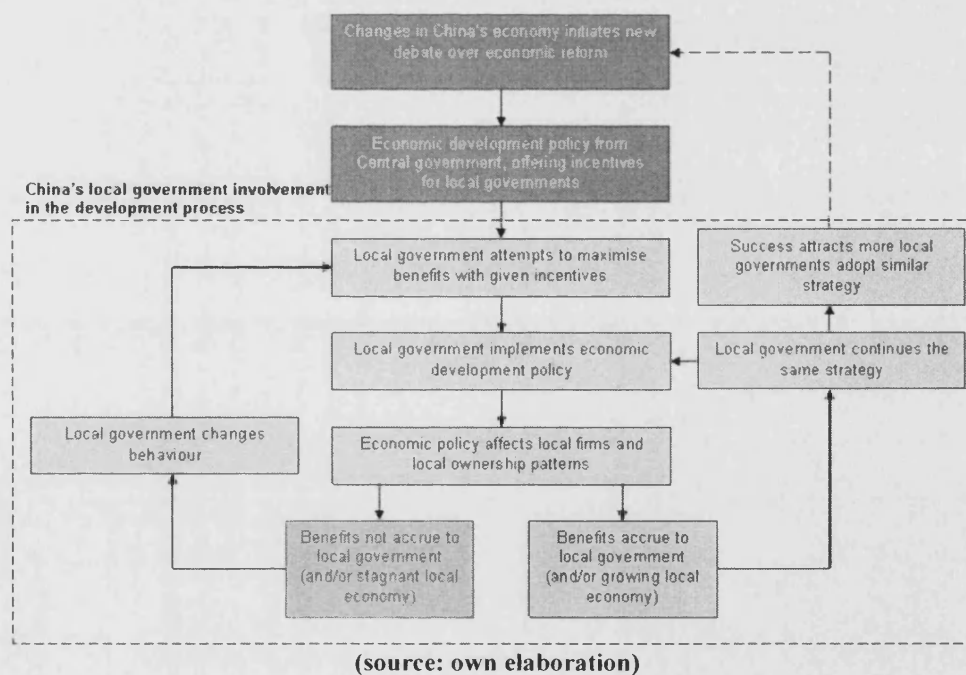
The discussion of incentives from the previous chapter suggests that local governments are motivated by self interest to develop their local economies. China's fiscal reforms linked local government income with local economic growth so that it was in the interest of the local government to encourage local economic growth. It is also necessary to consider the additional freedom of action that local governments have gained from the reforms. The introduction of market transactions in China's dual track economy, and the devolution of economic control to the local level, coupled with the incentive to maximize tax revenues at the local level, transformed the role of local governments. This decentralization process allowed local governments more freedom to respond to their pursuit of the carrot dangled by fiscal reforms, and the outcome of their pursuit dictated the path of their local economic development. This response by local governments will be used as the main criteria for classifying local development.

The outcome of local government action may contribute to either a successful, growing local economy, or an unsuccessful and stagnant economy. The difficulty lies in determining the link between local government action and its actual influence on the local economic outcome. Since local government incentives were linked with their ability to extract revenue, the link with local economic performance was indirect.

Figure 6.2 illustrates the process for local governments and local economic development. So long as revenue can continue to be extracted from the local economy, there would be no incentive for the local government to change its behaviour, as there are costs associated with a change in strategy and direction.

When the benefits to local government are not forthcoming, then the local government will eventually be forced to re-examine its policies and act accordingly. This includes influences from the examples of other local governments, who are more successful economically, or changes through introduction of Central government policies that alter the set of incentives and constraints local governments operate under. Central government policy can be affected in turn by the behaviour of local governments, which could prompt a re-evaluation of Central policies that are successful and need to be expanded in scope, or unsuccessful policies that have been widely circumvented or negated by local governments. This then becomes a mutually dependent system that feeds back into itself.

Figure 6.2: China's local government economic development process



Given the variation in local conditions and backgrounds, local governments will differ in terms of their strategies for extracting benefits from the local economy. Moreover, their behaviour is subject to continuous change, since, as shown in figure 6.2, there is a continuous process in terms of the changes in China's economic

development. With changes to China's economy, as well as Central government policies, local governments have to change their strategies to retain the benefits that can accrue to them.

Thus the role of the local government becomes relevant at the stage where they maximize their benefits and to implement economic policies. Between their incentives and the outcome (i.e. whether they succeed in realizing the incentives), lie the behaviour patterns proposed by Baum and Shevchenko (1999) – developmental, corporatist, clientelistic, and predatory. The following sections will describe the four behaviours.

6.2 Entrepreneurial local government

By 2001, almost 38% of all firms remained state owned and managed (Jefferson and Su, 2006). Local governments also control collectively owned enterprises, which were highly successful especially in rural areas, where they are known as township–village enterprises (TVEs). Harrold (1992) reviewed statistics that suggests state enterprises grew at an average rate of 9.8% between 1982 and 1988, while TVEs grew at an astonishing 38.2%. The tremendous success of these enterprises is due in large part to their special relationship with the local government. The arrangement between them has been likened to that which exists within a corporation by Jean Oi (1992, 1995), with hierarchical arrangements of governments controlling the means of production and ownership of assets much like corporations and divisions and subsidiary companies within them. Walder (1995a) conceives local officials as economic actors, and their actions can be understood in the same terms as the incentives and pressures that drive the managers of private firms, with profit being the key motivation.

However, there is a more nuanced view of local government behaviour than to simply reduce their actions to that of a profit seeking firm. Entrepreneurial local governments seem to occupy the middle ground between the pre-reform, planned economy and a liberal, market oriented economy. Francis (2001) identified the trend towards quasi-public, quasi-private institutions in China's transition, where the conventional boundaries of state and economy are blurred, and become difficult to distinguish. She identifies four main areas where this has been the case:

1. *The proliferation of para-governmental organizations* to deal with the new monitoring, regulatory, welfare and other responsibilities required to operate a market economy.
2. *Integration of nongovernmental entities into the state structure*, such as private subcontractors and suppliers to local state firms, as well as local firms that the local government pressure into organizing and providing the welfare functions which used to be provided by state enterprises.
3. *Corporatist trends* that further blur the boundary between state and market, creating financially independent organizations that have their own economic interests, but which remain within the formal state structure, pursuing their own goals while being required to follow the directives of the central state.
4. *Commercialisation of the state – government agencies in business*, such as the local government, individual departments within the local government and other local state organizations which, in addition to their original functions, have become profit seeking actors in the local

economy.

From the descriptions above of China's economy, the key feature identified by Francis (2001) was the mutual interpenetration of the government, society, and the economy. Rather than the local government being the board of advisors and governors, appointing managers and overseeing local firms, as suggested by local state corporatism, Francis (2001) suggested that the local economy also plays a part in determining the functions of the local government, capturing local government interests through their connections within the local government. The reliance of local governments on para-governmental organizations to regulate the economy, for instance, is a two-way exchange, with the organizations regulating local firms, but also lobbying the local government on behalf of the firms. This becomes more complex with the addition of local government departments and agencies that have their own business interests. Saich (1999) gives two examples in Beijing, where the Shaoyang branch fire brigade used their high pressure water hoses to operate a carwash, and of the Qianmen police station purchasing a Sichuan restaurant to generate funds in order to pay informants. This suggests that rather than viewing the entrepreneurial local government as a hierarchical arrangement, with orders and control imposed "top down", it is enmeshed in a network of local interests, serving as the nucleus for the exchange of information and material within the economy, and acting as an interface between the local economy and the state.

The degree to which the entrepreneurial local government can attempt to extract rents from the local economy, and the degree to which it is obliged to act in the interests of the local population, seems to be dependent on the type of local industry and the vulnerability of local government officials to local pressure. Unger

and Chan (1999) suggest that the variety of arrangements between local governments and the local economy has created a gradation of the amount of influence exerted by the local government on the local economy, and by the local economy on the local government. They have outlined their findings by viewing the differences in local government behaviour with regard to the type of industries in the area (see figure 6.3).

Figure 6.3: Characteristics of China's local government with regard to local industry

	Predominant local industry type			
	Private industry	Collective industry	Foreign industry	Little or no industry
Societal pressure on officials	High, especially in villages	Low	Low	Medium to high, possibly predatory
Local government control of patronage	Limited	High	Medium	Low
Welfare provision	Yes	Yes	Yes	Limited
Passive developmental approach	Medium to high	High	Medium	Low

After Unger and Chan, 1999

In areas dominated by local collective industries, Unger and Chan (1999) found that the local government and its associated organizations and agencies had a high degree of dominance over the local economy, which was reliant on government patronage to provide access to government resources.

However, an entrepreneurial local government would not necessarily reject developing the private sector of their economy. Figure 6.3 suggests that even with a predominantly collectively owned local economy, there is simultaneously a considerable degree of “developmentalism”, with local government concentrating on developing local infrastructure and attracting industries. This contradicts the conventional assumption that collective industries and private industries are mutually exclusive, where an interest in developing one led to bias against the growth of the

other. However, Unger and Chan (1999) and Edin (2003) both suggest that even local governments with a vested interest in supporting local collective enterprises may be inclined to develop private enterprises as insurance, particularly as private firms became more widespread in China's economy.

From this, it would appear that the entrepreneurial local government could be a highly adaptive model of local governance, embracing the opportunities to create and utilize new institutions to regulate the emerging market economy, while also being able to adapt to circumstances by fostering the growth of local private enterprises. The ownership and control of local firms is a salient feature of entrepreneurial local governments, but the adaptability of the local government suggests that the overriding concern is not ownership and control *per se*, but rather accruing benefits to the local state.

6.3 Developmental local government

The role of China's local governments have been compared to that of other East Asian governments, where economic development takes place under government direction, and investments in private industries are influenced heavily by government policy. This close involvement of state and economy in producing growth describes the dual nature of China's local governments. Studies of East Asia's economies suggested that the involvement of "strong" developmental states were vital in their success, while "weak" developmental states met with failure (Grabowski, 1994), with most of the emphasis placed on the role of *national* level governments. Capital was directed with the aid of the national government targeting particular sectors for development, or market institutions are created through national policies that facilitate the functioning of a free market economy, within which firms

operated with greater efficiency and thus achieved success. Thus the “developmental government” in studies of East Asia’s economic development referred to a national level entity.

However, Segal and Thun (2001) suggest that the initiation of economic growth takes place at the local rather than at the national level. China’s experimental and gradual approach to development facilitated the Central government’s *withdrawal* from micro economic management and its devolution of economic power to the local level. Thus Xia (2000) suggests that China’s economic development is a function of the co-operation between local and national level governments. The initial wave of China’s “opening up” to the world can only have been initiated by the Central government. The creation of the four Special Economic Zones in 1980, followed by the opening of 14 coastal cities in 1984, relied on the Central government’s political power and subsidies for the building of infrastructure and the creation of a suitable labour force (Spence, 1999). However, once these experiments became politically acceptable due to their economic success, the remainder of China’s economic transition was increasingly placed in the hands of local governments

Thus there is an issue in the use of the term “developmental” to describe local government behaviour. The term was originally created to describe national level governments. Howell (2006) provides a summary of the ideal type development state.

[It] has a political and policy elite committed to economic growth and transformation, with the power, authority and legitimacy to promote a developmental agenda. Often motivated by strong nationalist

sentiments, such elites strive to modernize their countries, raise economic living standards and bridge the technological gap. Second, complementing such a development-focused elite is a competent, authoritative state administration, particularly in the economic sphere, with the technical and managerial capacity to guide and steer economic and social development. [...] Both the political and policy elite and state institutions in general are relatively autonomous from particular vested interests, allowing them to stand above the demands of specific social groups [...] to shape policy for a broader, national interest. Third, developmental states tend to have weak civil societies, poor civil and political rights records and repressive political regimes. [...] Finally, developmental states are defined not only by their normative agendas, their political and institutional structures, and state-society relations, but also by their achieved outcomes. Developmental states deliver rapid economic growth as well as general well-being, measured in terms of social indicators such as literacy, health status, life expectancy and per capita income (Howell, 2006, 275–276).

China's local governments do not seem to fit within the context of the "developmental state" as outlined by Howell (2006). However, Chinese local governments do share some salient features of the developmental state. The existence of a "political elite" in the local government is undeniable, with their power unconstrained by the conventional, democratic processes of accountability through elections. The autonomy of the local government is also not in dispute, for as Leftwich (1995) points out:

‘Autonomy’ in this context also does not mean isolation. The reality [...] is more like ‘embedded autonomy’. This means that despite the power and autonomy of state bureaucracies, they have become embedded in a progressively dense web of ties with both non-state and other state actors (internal and external) through which the state has been able to coordinate the economy and implement developmental objectives (Leftwich, 1995, 409).

The issue here is that there appears to be some confusion between the developmental and entrepreneurial state. Both employ the power of the state to influence the local economy. The “strong” developmental state as described by Howell (1996) directs and targets investments, manages firms, and otherwise behaves much like the developmental state. The entrepreneurial local state, is also involved in owning and controlling local means of production, directing local capital, and operating with a strong profit motive, necessitates a strong local state with a high level of local governmental capacity (Grabowski, 1994).

On the other hand, development under a weaker local government might take place without such direct involvement in the economy. The “developmental” category, as used by Unger and Chan (1999) and shown in figure 6.3 suggests a more “passive” approach to encouraging local growth, especially through the development of local private businesses.

At this point it is necessary to introduce the idea of the informal channel of communications used by both local governments and firms to communicate. As was mentioned in chapter 6, maintaining a good relationship with local governments facilitated the conduct of business for private enterprises. In a developmental

government, with private firms playing a greater role, this unofficial channel of communication becomes more important as private businesses sought to enlist government help and gain support without being captured by government interests.

One method for local government and local firms to communicate and influence each other was through the use of informal, social relations. Wank (1995) identified that two strategies were commonly adopted by private enterprises facing government bureaucracy. One is the total avoidance of local bureaucracy (insofar as it was possible), which was used mainly by owners of smaller businesses and shops. They viewed the fees and charges demanded by local government as being predatory. More relevant here is the second strategy, usually adopted by larger firms which have more to gain from a solid relationship.

[The second strategy] takes bureaucracy as a source of opportunity and seeks to increase contacts with officials. It is pursued by entrepreneurs running the private firms. They often benefit from close association with the officialdom. [...] These affiliations give entrepreneurs access to scarce commodities and restricted opportunities as well as to bureaucratic protection from policy fluctuations, central state campaigns, and harassment by local officials. For the officials, these affiliations institutionalize channels to the market economy through which they can turn control of public resources into cash profits. *As the scale of the private enterprises expands, connections with the bureaucracy proliferate, blurring the boundaries of “public” and “private”* (Wank, 1995, 67–68, emphasis mine).

Here, the developmental state is seen as a *resource* to local private firms, allowing them to develop in an environment that lack the formal regulations and institutions needed for a market economy to function, while the local government adapts its behaviour (albeit unofficially) to suit the development of local private enterprises. This mutual, unofficial adaptation by both parties to each other creates an informal arrangement to allow the development and growth of the local private economy. So even with a “weak” local government, the channel between the government and local firms is likely to be beneficial to both the government and to entrepreneurs. Thus the “developmentalism” here refers to the development of an atmosphere conducive to economic growth, first through unofficial channels, then later to be formalized into official regulation and institutions. This view of the developmental government allows a local government to be both “entrepreneurial” and “developmental” simultaneously, with no categorical conflicts. A local government can adopt either or both strategies at different times, depending on the appropriateness of each strategy, and the incentives for the local governments.

6.4 Clientelistic and predatory governments

Baum and Shevchanko (1999) characterize a clientelistic local government as one which has no incentive to increase productivity, but which is connected with local firms. However, the prevalence and variety of ties between Chinese local governments and local firms requires a better understanding of these ties and their impact on the local economy. The difficulty lies primarily in determining the impact of clientelism on development, and to distinguish between clientelism and predation, which share many similarities, as well as to reconcile the use of social networks and relations (*guanxi*) within this context.

Clientelism can be defined as an exchange of political support for material benefits between patron and client. The patron, usually the local government, has multiple clients, and patron and client are tied together in a relationship that is voluntary and informal, though this does not preclude the use of coercion and manipulation (Kurer, 1996). In the context of economic development, this does not preclude the possibility of clientelism either facilitating or being detrimental to economic productivity. However, clientelistic behaviour is usually seen as being “corrupt”, in that it is an abuse of government power in exchange for material gains. In this respect it shares some common features with a predatory government, which also uses its powers for illicit gain. This requires some clarification.

White (1994) proposes that corruption in China can be set along a continuum and divided into three classes, A, B and C, varying in the degree of their illegality and prevalence. The characteristics of these can be seen in figure 5.4. This continuum provides a useful reference point to examine the actions of the local government. White (1996) goes on to elaborate that class A and B represent the illegitimate use of official power. The difference lies in who benefits – private individuals (or groups of individuals) in the case of class A, or local corporations and organizations (including local government departments) in class B. Class C is a far more prevalent and widespread phenomena across all sections of Chinese society, and is not limited to government behaviour.

With reference back to the classification by Baum and Shevchenko (1999), it can be argued class A activities by the local government are clearly predatory, as it is a clear abuse of official powers, reduces local productivity, harms the local economy, and benefits only a private individual or group of individuals. While the process of

economic transition in China may have produced an environment susceptible to such behaviour, it is clearly and unambiguously harmful and illegal.

Figure 6.4 White's continuum of corruption in China

Class A corruption	Class B corruption	Class C corruption
Clearly illegal practices infringing institutional rules for purely private purposes (eg stealing, embezzlement, fraud, large scale bribery, illegal fees and fines)	Semi-legal practices exploiting existing loopholes in official policies and regulations for personal or corporate gain (eg exploiting fixed price system, using local state powers to establish trading companies, development zones)	Use of personal social ties (guanxi) to bypass institutional boundaries and gain preferential treatment (eg gaining access to information, bypassing regulations, allocating privileges to friends and family)
Predatory behaviour	Clientelistic behaviour	
Benefits private individuals	Benefits the individuals and organisations involved	

(source: own elaboration based on White, 1996)

Class B and C corruption are more equivocal, and such behaviour can have both positive and negative consequences on the local economy. However, here a difference can be seen between the harm done by clientelistic behaviour as compared to predatory behaviour. While a predatory local government seeks to gain through the exploitation of local firms, clientelism allows entrepreneurial activities to be carried out, albeit through illicit means. The issue remains however, whether clientelism improves the local economy or whether it is a harmful activity. Kurer (1996) suggests that clientelism may influence governments in developing countries to adopt and persist with development strategies that are not in the interests of developing the economy. The relationship between patron and client begins the transfer of resources from the private to the public sector, from economy to state, and encourages this flow through the workings of the political process of gaining increasing political influence. In the case of China, clientelism – the process of exchanging political or bureaucratic favours for material gains – was classified by White (1996) as a “corrupt” activity. Nevertheless, there are studies to suggest that while clientelistic behaviour is undesirable, its effects are not outright harmful.

For instance, Wank (1995, 1996) argued that the clientelistic tie is a solution for businesses operating in an economy that has not completed its transition to operating in a free market, where property rights are uncertain, government policies are changeable, and where some resources remain under the control of the bureaucracy. With the formation of the patron–client relation, businesses receive more information regarding upcoming policy and regulatory changes, and can call on favours to negotiate particular difficulties or gain access to scarce “resources”. This provides a certain degree of stability and removes uncertainty, allowing businesses to operate with a greater degree of freedom knowing they are “protected” against the actions of the bureaucracy. Wank also suggested that the ties improved competition, encouraged innovation, and facilitated market links (1996). He argues that since bureaucratic favours are in short supply (for instance, in the form of license allocation and permits), entrepreneurs are in competition for these favours. Only those entrepreneurs able to afford the material or other benefits for their patrons receive the licenses, and as these licenses (or favours) may be due for annual renewal, only those entrepreneurs with sufficient resources (those successful enough to make a profit) will succeed in the long run. Similarly, only those bureaucrats with the most political acumen and ability will be able to grant those favours, and only the successful will remain as patrons in the long run. Entrepreneurs with strong ties with bureaucrats are also able to gain tacit support and some protection when attempting innovations that circumvent state regulations. Both the private entrepreneur and the patron must be sufficiently in tune with the pervading attitude and possible future changes in order to assess the risks entailed and the potential benefits, otherwise the clientelistic relationship would break down.

Xin and Pearce (1996) make a similar argument, although in more detail.

They identify that clientelistic ties matter more to private enterprises than enterprises owned and run by the local state:

In interviews with executives in Chinese state-owned, collective hybrid, and private companies we found, as expected, that private-company executives in this developing economy sought to compensate for their lack of formal institutional support by cultivating personal connections. Even after controlling for organizational age and size, we found that private-company executives' business connections were more important to them than the connections of collective-hybrid and state-owned company executives were to them. Further, as expected, private-company executives relied significantly more on building connections with government officials to defend themselves against threats like appropriation or extortion. Finally, the private executives made more extensive use of gift giving to build these connections and maintained business connections of greater trust than did executives in the more structurally secure collective-hybrid and state-owned companies. Private-company executives counteracted their formal structural disadvantages by building good *guanxi* with government officials as protection from unstable conditions. (Xin & Pearce, 1996, p1654)

The use of *Guanxi* as a “manager initiated substitute for the kind of formal institutional support taken for granted in countries with more reliable business environments” (Xin and Pierce 1996, p1642–1643) suggests that it was not a government initiated behaviour at all, but rather is the reaction of local businesses

and entrepreneurs to the environment they found themselves in. On the other hand, the devolution of power to local governments contributed to the increased opportunities for corruption. Thus, for a clientelistic relationship to exist, the participation of both the local government and local businesses is necessary. Moreover, Xin and Pearce’s (1996) study suggests that the relationship is strongest between the owners of private businesses and local governments. This differs from predation, where the local government uses its power to extract rents from local enterprises without any returns. Thus in order to understand and clarify the relationship between corruption, predation and clientelism, the behaviour of both local governments and local firms must be taken into account

Figure 6.5: Distinguishing between predation, corruption, and clientelism

	Local government	Local firms
Predation	Local government misuse political and bureaucratic power to extract rents from local firms	Local firms and entrepreneurs operate under local government predation
Clientelism	Local government exchanges political power for economic gains	Entrepreneurs exchange material goods for resources and materials, which are otherwise inaccessible
Corruption	Local official(s) exchanges political power for personal gains	Entrepreneurs exchange material goods for political power for personal gains

(source: own elaboration)

In the definitions given above (figure 5.5), the distinction between corruption and clientelism is not based on the collusion that takes place between government and officials with local firms and entrepreneurs, but that the intention and end of that collusion differs. Clientelistic behaviour allow firms to gain access to resources – including administrative resources, such as licenses and permits – that were otherwise limited or unavailable because of underdeveloped regulations and institutions. This was especially the case for privately owned firms, which were more

prone to being exploited by local government. Predatory behaviour extract rent without providing an equal or greater return in favours and benefits to the private firm.

6.5 Local government behaviour and local economic development

The typology of local governments and behaviours suggests the need for a more nuanced analysis of local economic development in relation to local governments. A basic list of behaviours categorising local governments can be constructed using the discussion above of developmentalist, corporatist, clientelistic and corrupt local governments (figure 6.6). This can be a useful rule-of-thumb list in assessing local governments.

Figure 6.6: Indicators for categorising local government behaviour

Developmentalist	Corporatist	Clientelistic	Corrupt
Low local government ownership or control	high local government ownership or control	Close personal relationships with local businesses	Rent seeking behaviour
Low levels of intervention	High level of local government intervention	Evidence of exchange of favours	Behaviour that accumulates benefits to individuals at the cost of the local community
Encouraging development of local businesses and entrepreneurs	Concentrating on developing government owned and controlled firms	Communications through informal / unofficial channels	Damaging behaviour to local economy with short term benefits to local government
Reforms to facilitate growth of local firms	Resist changes that threaten local ownership and control	Illegal behaviour that favours local interest against Central government	
Communication with local entrepreneurs	Direct management of local firms to fulfil government objectives		

However, the previous discussion also called for caution, and for the need to take a nuanced approach. Local government behaviour can fall into two or more categories simultaneously. Thus the indicators in this list are not meant to label a

government as belonging in one column or the other. Rather, it is a summary of local government behaviours that need to be combined with an understanding of the history of the development process in order to be truly useful.

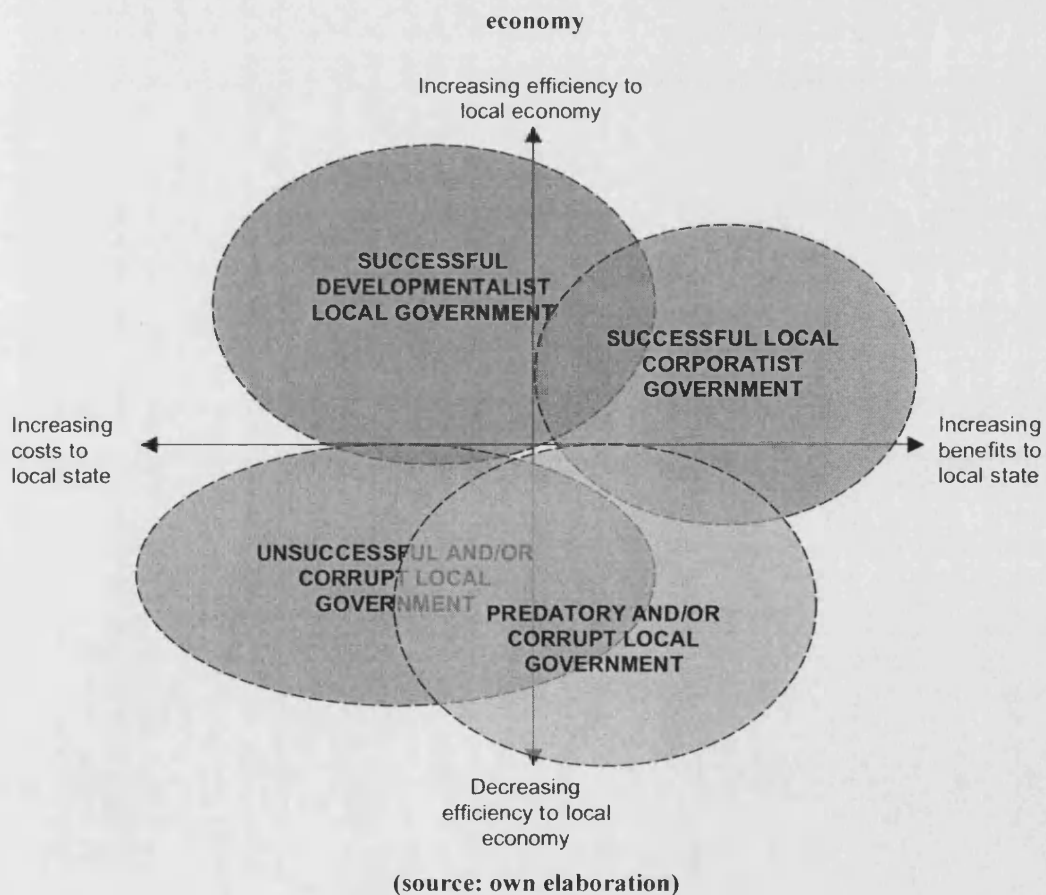
Two major themes emerge from the discussions of the previous chapters – that there is local economic development in terms of benefit or loss to the local economy, and development driven by the realization of benefits to the local state. A successful local economy may indirectly benefit the local state through increased revenues. By comparison, a successful local state – which includes the local government bureaucracy and administration *as well as* its economic functions – is more interested in maximizing benefits for the local government. This may benefit the local economy as well, but could also be detrimental to the development of the local economy *per se*, since the interests of the local state do not always intersect with and contribute to the best interests of the local economy.

This provides two axes within which to place local government behaviours and their outcomes. Figure 6.7 is an attempt to illustrate this, separating local economic productivity from benefits to the local state. Compared with the rigid categorization shown in figure 6.1 from Baum and Shevchenko (1999), this is a more flexible approach, allowing areas of overlap between local government types.

By disassociating the benefits to the local state and the local economy, it is possible to explore the difference between Chinese local governments interested in maximizing their own benefits (i.e., maximizing benefits to the *local state*) and local governments that attempt to maximize local economic benefits. Neither approach is exclusive – as can be seen in figure 6.7 below – there is an intersection between

China's "local corporatist" (interested in the local state) and developmentalist (interested in the local economy) governments. A successful local corporatist government achieves higher levels of benefits for the local state, while a developmentalist local government may achieve lower levels of local state benefit with higher levels of local economic productivity. As was discussed in section 6.4, the two local government types can overlap, as a local corporatist government adopts more developmental strategies for their local economy. This also suggests that the local government typology is not fixed, since a local government can shift strategies (voluntarily or not) and can thus move within the behaviour categories.

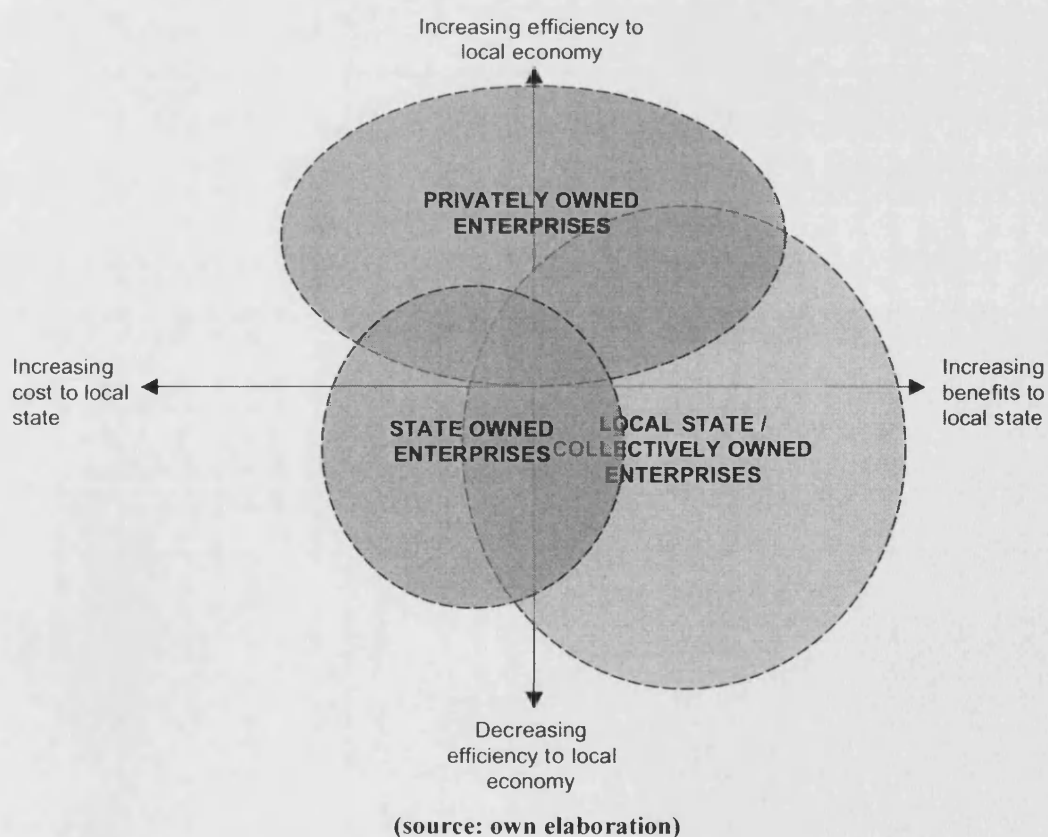
Figure 6.7: Chinese local government types with respect to benefits to local state and local



The categories also illustrate the difference between predatory and corrupt local governments, recognizing that there is a significant overlap between them. The predatory local government may be able to achieve high levels of benefits to the

local state, but at the cost of local economic productivity as the predation decreases the willingness and ability of local firms to operate efficiently and effectively. A corrupt local government undermines both the local economy *and* its own ability to function – since corruption through individuals or groups of officials can target both local firms *and* harm local government organs by generating mistrust, decreasing local government efficiency, etc – resulting in a failed local state where both the economy and local government suffer. Of course, there is significant overlap between the two, and features of predation as well as corruption can be present in both developmental and corporatist type local governments.

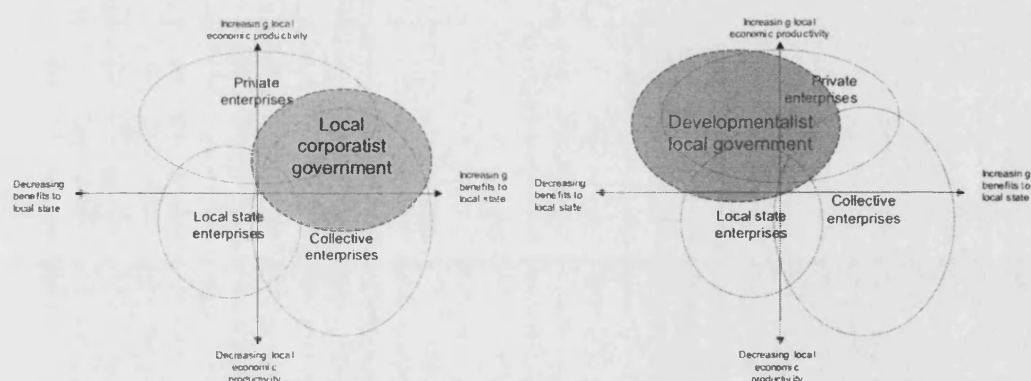
Figure 6.8: Local firm ownership types with respect to benefits to local state and local economy



Using the same axis of local state and local productivity, the three main ownership types can also be plotted on the axis (figure 6.9) – Central state owned

firms (SOEs), local state and collectively owned firms, and privately owned firms. China's economic transition has created an environment where all three ownership types can co-exist simultaneously. State owned enterprises, which are relatively inefficient, provide limited benefits to the local government and local economy. They may even become a drain on the local state, requiring additional support and subsidies. In comparison, local collective enterprises are more economically efficient and can potentially provide much more benefits to the local state, through taxes, remittances to the local government, and employment. Private enterprise are more economically efficient, but may "cost" the local state in terms of their ability to out compete local state firms and reduce the total revenue available to the local government.

Figure 6.9: Overlaying local government types with local ownership types



By overlaying local government types with different local firm ownership types, it is possible to see the co-incidence between the local government type and the corresponding firm ownership pattern (see figure 5.8). The co-incidence of interest between different types of local governments with the development outcome of different local firm ownership types suggests that local corporatist governments were more likely to support locally owned or collectively owned enterprises, while developmental local governments were more likely to foster the growth of privately

owned enterprises.

6.6 Conclusion

China's local governments have taken a range of different approaches to developing their local economy. Through intervening directly in the management of local firms as the head of a corporation, or developing the regulations and policies that foster growth in particular ways, local governments have had a range of choices over the most appropriate course of action. However, two factors need to be considered in understanding how the local government took their decision.

The type of development chosen by China's local government affects the type of local ownership patterns, with the outcome of different ownership types (increased benefits or cost to the local state, increased or decreased local economic efficiency) coinciding with the desire of the local government to benefit the local state or to foster greater economic efficiency. In order to maximize the available benefits, local governments have behaved in such ways as to develop the type of firms that most closely matched their aims. The cost of developing state or private firms was dependent on prior factors, such as previous economic development, or the relationship between local government officials and local economic actors and the state. For example, the presence of collective industries make the development of more collective industries easier than developing a new private sector. This path-of-least-resistance approach was in turn affected by Central government incentives.

Given that local government incentives rely on Central government reforms, and the potential cost of developing state, collective, or private firms also depend on Central government regulations, Central government action had an indirect but

important effect on local government behaviour, and local economic development.

In the case studies, the local government, their relations with the Central governments and their local economic structure were examined and compared, in order to provide a subtler model of the development behaviours of China's local governments.

Chapter 7: Case studies and methodology

7.1 Introduction

This chapter is split into two parts: exploring and introducing the case studies, and presenting the methodology used to obtain the necessary data.

As was outlined in chapter 1, the purpose of this study is to create an integrated framework within which the different approaches taken by Chinese local governments to pursue economic development can be examined and compared. The aim is to include the specific characteristics of the local governments and their jurisdiction, local economic conditions, and their relationship with the Central government. A combination of all these factors affect the process of economic development by local governments, and they provide a rich background with which to understand the motivations and actions of local governments. Within the context of China's economic transition, it is also necessary to appreciate the evolutionary nature of China's local governments as they adapted to the changes as economic reforms progressed. A static interpretation of local government behaviour in one single time period would omit an important aspect of their dynamism and flexibility.

In order to highlight the importance of the local government's role in determining the direction of local economic development, two local governments were chosen for comparison and contrast. They were chosen on the basis of having comparable economic backgrounds and location, with similar characteristics at the start of China's economic reforms in 1978. This would allow the effect of the local government's development policies to show up clearer, and make comparison easier.

To understand the development history of the case studies, interviews, statistical data, and local official documents were all required, plus information from existing reports and studies. The use of several types of data allowed the rich texture of the development process to be captured as much as was possible.

7.2 Selecting case studies: Wenzhou and Yangzhou

China's rapid economic growth was largely concentrated in the eastern coastal provinces. The dynamic economies here were fertile soil for the seeds of economic reforms to take root and sprout. The two biggest economic clusters – Shanghai and the Pearl River Delta near Hong Kong – managed to lead the development of cities in the surrounding provinces. Their growth have been well documented and studied. However, it was decided that the case studies needed to be located outside the area of influence of these two economies, as local government behaviour would otherwise be skewed and be dominated by the actions of Shanghai and the Pearl River Delta. To eliminate this possibility, the case studies needed to be relatively isolated.

Wenzhou, a medium sized county in Zhejiang province (see figures 7.1 and 7.2), was chosen as the first case study. It is historically isolated, located 300km away from Shanghai, its contact with other cities made difficult by surrounding mountain ranges. This choice was influenced by the success of the Wenzhou model of economic development (discussed below). In spite of its isolation, Wenzhou managed to successfully develop a thriving local economy based on private entrepreneurship, and its actions were (eventually) lauded as an example for other Chinese local governments to follow. This extraordinary achievement marked Wenzhou out as a place of special interest, and the second case study was selected on

the basis of being a contrast – albeit a comparable companion – to Wenzhou’s success.

Wenzhou’s unique success started from a foundation of a predominantly agrarian economy, with only small handicrafts and household industries supporting the economy. Before the formation of the People’s Republic, it was a commercial port, but the centralised economy stopped that. The selection of the second case study was thus limited to these criteria – that it is located outside the economic influence of Shanghai, predominantly agrarian and commercial in nature, with low levels of industrial development. Moreover, it must have developed in a different way from Wenzhou’s private entrepreneurship, with less successful results.

Sunan, the southern part of Jiangsu province bordering the north of Shanghai, experienced rapid economic development, relying on Shanghai’s economic influence for its success. Just further north, in Central Jiangsu (Suzhong), economic development was not as successful. Historically, the Suzhong region was a prosperous commercial area, enriching itself from the trade along the Grand canal. This is the location of the second case study, Yangzhou (see figures 7.1 and 7.2), through which the Grand canal runs.

Yangzhou’s economic statistics in 1978 is comparable to those of Wenzhou, being dominated with agriculture and light industries and handicrafts. The historical source of its wealth – trade – declined in line with the physical infrastructure and importance of the Grand Canal system, and its remaining commercial activity with surrounding areas was curtailed by the communisation of agriculture and the centralised economy. Yangzhou’s reliance on trade and commerce meant its

industrial sector was under developed. Moreover, Yangzhou's transportation link with the rest of Jiangsu province was relatively poor once the Grand Canal fell into disuse, and the city was bypassed by provincial railway links. Lying across the Yangtze river from Shanghai, Yangzhou was also economically cut off from Shanghai. Though physically closer to Shanghai than Wenzhou, the Yangtze river acted as a barrier between Yangzhou and Shanghai. Figure 6.3 shows that the population of the two counties. Yangzhou's territorial boundaries were redrawn in 1996 to form a new county, Taizhou, and all statistical data used in this study are disaggregated to reflect Yangzhou's new, smaller size.

Figure 7.1: A map of the location of Jiangsu and Zhejiang provinces in China



Figure 7.2: Location of Wenzhou and Yangzhou in Zhejiang and Jiangsu provinces

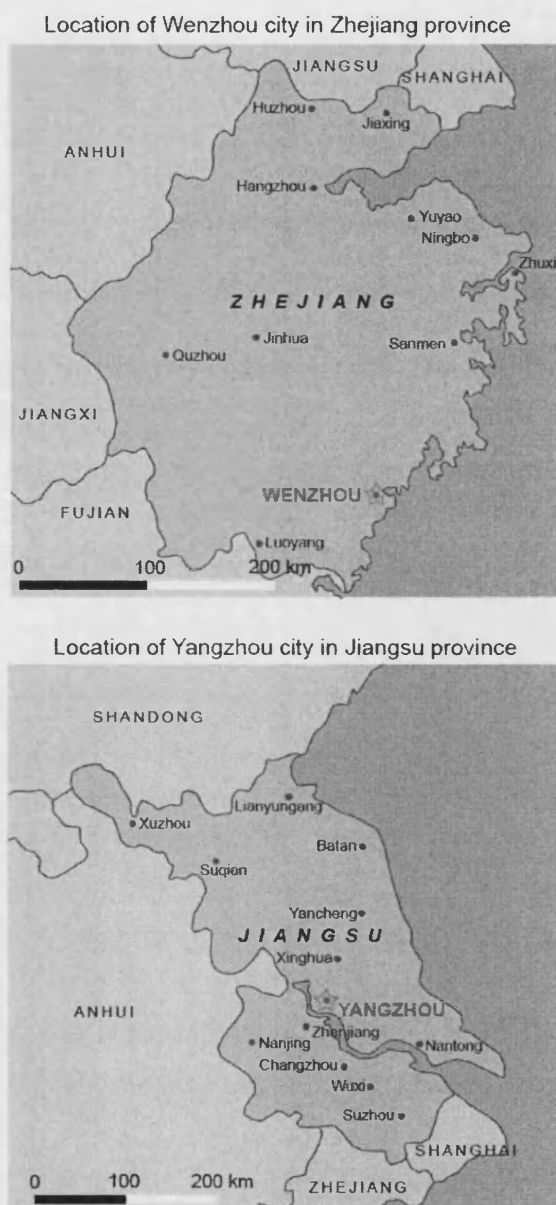


Figure 7.3: A comparison of Wenzhou and Yangzhou

2003 Data	Wenzhou	Yangzhou
Population	7.4 million	4.52 million
Urban population	1.9 million	1.1 million
Land area	11748 sq km	6638 sq km
Total GDP (billion yuan)	106bn	55.9bn
GDP per capita (yuan)	14357	12368

Source: Wenzhou statistical yearbook, Yangzhou government website

Major projects and investment bypassed Wenzhou and Yangzhou, their

location making them vulnerable to attack by sea and air from Taiwan. Denied state funding, their industrial sectors were both undeveloped. After China's economic reforms started, Chinese local governments faced the challenge of securing sources of capital for development, as well as deciding how to regulate and direct the use of that capital. The local governments of Wenzhou and Yangzhou approached this challenge in very different ways, and these are outlined below.

7.2.1 The Wenzhou model

The "Wenzhou model" is one of China's best known economic models (*jingji moshi*), due to its rapid economic growth. Wenzhou's economy is based on the three pillars of household industries, sales agents, and market towns (Liu, 1992a). All three were vital components of Wenzhou's flexible economy, which also relied on the high degree of initiative and mobility of the Wenzhouese people conducting long distance trade. They produced goods for China's "excluded middle" – i.e., those goods neglected by large scale, soviet style industries that were developed under China's planned economy (Liu, 1992a, p702). Through fulfilling the pent up demand of a "shortage economy" for consumer goods, Wenzhou was able to produce and prosper in the niche left unfilled by China's state owned industries early in the reform process.

The Wenzhou model depended on the mass initiative of local entrepreneurs and the large diaspora of Wenzhouese all over china to create a network for trading and gathering information. Moreover, it relied on the co-operation of the closely knit community, in pooling locally available resources without material support from the Central government. Local government support was also vital in allowing money lending, disguising local private enterprises and so on. The cooperation between the

Wenzhou government and local firms, serving to enhance their growth prospects, is another vital aspect of the Wenzhou model. This will be discussed in more detail in Chapter 8.

7.2.2 Yangzhou's economic development

Yangzhou's economy roughly followed the Sunan model, with an emphasis on state led development of collective enterprises. The Sunan model's heavy emphasis on the collective sector stems from China's rural industrialization program in the early 1970s (Yehua, 2002), when small scale industries were to be developed in rural areas in order to support agricultural development. These collective enterprises became the seeds of industrial growth in the 1980s as China's economy underwent the process of reform and transition. The collective enterprises were able to transform their production from agricultural tools and machines to basic consumer products, and they were already served with a network of basic infrastructure, lowering the cost of development (Spence, 1999).

However, Yangzhou's distance from Shanghai meant it was too far to benefit from Shanghai's economic growth, and thus its development was not tied into the economy of the Sunan area. Yangzhou's historical background as a trade and commercial Centre also meant its industries were relatively under developed.

7.3 Case study methodology

The decision to use case studies to understand Chinese local governments was made with consideration to the large number of relationships that needed to be explored. The intention to avoid isolating local governments as singular actors from

their relationships and their local conditions also influenced this choice. Yin (1993) suggests that case studies are particularly suited where the phenomenon (the economic development process and the local government) is difficult to separate from the context (local economic and cultural conditions and China's economic transition process):

The case study is the method of choice when the phenomenon under study is not readily distinguishable from its context. Such a phenomenon may be a project or program in an evaluation study. Sometimes the definition of this project or program may be problematic, as in determining when the activity started or ended – an example of a complex interaction between a phenomenon and its (temporal) context (Yin, 1993, p3).

Orum et al (1991) argue that a case study takes a holistic approach to understanding a subject or phenomenon, a prerequisite for studying

[Another] feature of case studies is their holistic approach. Since the case study seeks to capture people as they experience their natural, everyday circumstances, it can offer a researcher empirical and theoretical gains in understanding larger social complexes of actors, actions, and motives. (Orum et al, 1991, p8)

Orum (1991) goes on to point out that a study that is heavily reliant on statistical surveys may omit critical factors – such as social networks – that may affect people's decision making process. It is vulnerable to dis-integrating or

isolating actors and individuals from the context within which they act.

The intention of this study is to construct an integrated approach to framing the actions of China's local governments in local economic development. With the specific understanding that Chinese local governments exist and operate under varied and different local circumstances, case studies seem particularly suited to exploring their behaviour. Moreover, this exploration takes place through the period of China's economic transition, which Orum et al (1991) points out, is another strength of the case study approach:

[A] case study of a single phenomenon, let us say a city's public decision making or an organisation's informal operations over a long period of time, allows the observer to examine social action in its most complete form. The investigator is better able to grasp the total complex world of social action as it unfolds (Orum et al, 1991, p9).

This study emphasises the dynamism and evolutionary adaptations that Chinese local governments have undergone in order to face the challenges of economic transition, thus understanding their change over time is crucial. The use of case studies for this investigation was thus thought to be suitable, for its flexible, multifaceted and holistic approach over time.

7.3.1 Data collection

Data was collected from three major sources: through official government statistics, through interviews with participants in the economic development process,

and through official reports. Statistical information were gathered from published sources, such as statistical yearbooks and almanacs. Interviews were conducted with local officials and businesspeople through personal introduction.

It is interesting to note that the process for data collection was in itself a revealing exercise, albeit a subjective one. There were two major issues with the data, which can be split between the issue of Chinese official statistics, and the issue of interviews.

7.3.2 Statistics

With the switch from centralised planning to a market system, coupled with rapid growth and changes to the economic structure, China's system for collecting and collating statistics was put under strain. Rawski (2000, 2001) discussed the reliability of China's statistics, and pointed out several issues underlying their weaknesses. Incompatibilities between the old statistical measures used during the planned economy versus the new statistics entailed a rapid change in categories, and local bias in statistics are all responsible for raising doubts and creating difficulties when using Chinese statistics.

Multiplication of the number and the variety of industrial enterprises, in combination with rapid changes in the statistical system, including the new focus on value added, repeated changes in the definition of key indicators, and growing demands to execute surveys and collect census information, have overwhelmed the capabilities of local and regional statistical agencies. [...] At the same time, the shift from plan to market has redirected the attention of

enterprise leaders away from government mandates, including statistical reporting, toward clients, sales, and profits. Many enterprise leaders "pay little attention" to statistical reporting, which is widely seen as a burden that "does not produce the information that operating units really need." Statistical agencies complain of firms that assign untrained staff to compile statistics, look for chances to cut positions assigned to statisticians, or refuse to submit standard reports (Rawski, 2000, p7–8).

While Rawski (2000) point out the practical difficulties facing China's statistical agencies, Holz and Lin (2001) highlight concerns with the way the data makes standard interpretations difficult.

Overall, Chinese official statistical data are beset by three major problems. First, some data may have been purposely misreported (such as data on GDP). Second, data such as those on fixed assets and farm employment are of dubious economic meaning due to the way in which they were constructed. Both of these shortcomings have been widely noted. A third, largely unnoticed problem is the frequent re-definition of economic variables and enterprise categories. Such adjustments are often not accompanied by a revision of the variable or category name(s), and few indications are given of such statistical breaks. The resulting inconsistencies in time series data are perhaps most pronounced in the statistics on the industrial sector (Holz and Lin, 2001, p30).

Rawski (2000) and Holz and Lin (2001) both also agree that China's statistics are subject to manipulation for political ends (as statistics are elsewhere in the

world), adding a further layer of distortion. Nevertheless, given the timescale and scope of this study, and the fact that statistical data forms only one part of the case studies, it was not possible to collate an alternative set of data to replace or supplement those from official sources. Thus official data has been used as is through the rest of this study, in order to illustrate the trends of economic development.

7.3.3 Interviews

The purpose of interviews with local officials and businessmen was to gather primary data that was not available from statistical sources or from existing reports and studies. It was hoped that the interviews would give a more human face to the story of economic development and transition. More, it was hoped that interviews would clarify information from other sources of data.

In all, 30 interviews were conducted with officials, academics and businessmen in Wenzhou and Yangzhou, individually and in groups. Interviews were conducted between 2002 and 2006, over 6 field trips to Wenzhou and Yangzhou, each lasting about one week. Interviewees were contacted via a “snow ball” effect by asking one interviewee for suggestions as to who may be contacted next. This method creates a bias in the sampling process, since the interviewees are all selected from the same pool of social contacts and within certain social networks, and it is recognised that the opinions given in the interviews may represent only a small proportion of the total populations. However, the close knit social networks – especially within governments and between businessmen – poses a challenge to finding an entry between unconnected social groups. Personal introductions, or the knowledge of existing social connections was critical in securing interviews, and the

closer the connection the better. This is illustrated in the following example.

Interviews in the city of Yangzhou were arranged through the Wenzhou trade association in the city. As the interviews progressed, it became easier to contact local government officials and gain interviews because of personal introductions.

However, while local officials in charge of economic development and reforms were able to give their own time for interviews, accessing local government reports were more difficult. Local officials were not familiar with the department archiving local official reports, and it was not possible to use the archives. This was not unusual, as in Wenzhou, government reports were accessible (thanks to academics at the local Communist Party College), but could not be photocopied.

In order for interviews to be comparable, a structured set of questions was assembled for each interview. Permission to record the interview was sought from every interviewee at the start. However, the structured interview was abandoned for three reasons. The questions were found to be too limiting, and interviewees were not able to follow the questions, which they found too repetitive or irrelevant to them. Second, the answers that were given often developed well beyond the scope of the interview script, and it was difficult to return to the set of questions without disrupting the flow of the interviews. Interviewees found the question – answer style of a structured interview very uncomfortable, and the answers that were elicited were terse and unrevealing. Finally, many interviews took place in very informal settings, with large groups gathered in restaurants or cafes, resulting in a dialogue between all participants, again making it difficult to focus on the questions. The structured questions were thus abandoned in favour of an unstructured approach, allowing interviewees (individuals and in groups) to develop their narratives and dialogues

with prompts to keep the discussions relevant.

Most interviewees opted to remain anonymous, and did not allow recording in their sessions, though notes were allowed to be taken. Interviews typically lasted an hour, depending on the schedule of the interviewees. All interviewees were accommodating in their answers, and sought to present a complete version of their experiences, sometimes including digressions and personal anecdotes, which added colour and interest to the interviews. However, it was often difficult to confirm specific anecdotes, since interviewees were rarely willing to give specific names and dates.

Figure 7.4: Number and position of interviewees in Wenzhou and Yangzhou

	Wenzhou	Yangzhou
Local officials involved in economic development process	9	5
Local academics studying development	4	2
Local businessmen and others in economic associations	7	3
Others met through informal gatherings (approx)	80	50

Figure 7.4 shows the number of interviews conducted with local officials, academics and business people who either took part in influencing the development process, has studied it directly, or were affected by the changes. Only those interviews that took place in a relatively quiet and contained setting (eg, in offices or private rooms) have been counted individually. These interviewees were key, however, since the close contact and personal interviews allowed further meetings to take place, though usually in an informal setting (eg at restaurants and in more social settings) with many more people. Although the large settings provided historical

context and anecdotes relating to local development, the evidence collected from them were used in support of the main interviews, and were given much less weight in constructing the main narrative of the development process. The people that were met at informal gatherings were counted if they shared information that was recorded, as adding the total number of people present at those gatherings would have given an unnecessarily and misleadingly inflated figure.

The interviews were assessed using the responses given as indicators of local government behaviour within the four categories given – developmentalist, corporatist, clientelistic, and corrupt behaviour. The indicators used was based on the discussions from previous chapters (figure 6.7).

As the analysis is concerned with a historical perspective, it was necessary to take into account that some of interviewees' responses dealt with the historical development process, which further complicated the issue. Typically, the interviewee would give a brief history of local development or the background of the firm or organization. Questions were then asked to elicit responses regarding the developmentalist or corporatist stance of the government. In addition, as has been argued in previous chapters, some local government behaviours can fall into more than one category at the same time. Thus the indicators given in figure 6.7 were used as a guideline only, rather than as a rigorous assessment criteria.

Chapter 8: The role of Wenzhou's local government in local economic development – the development of a private sector within a socialist state

8.1 Introduction

Wenzhou's economic development is an interesting example of a developmentalist local government (as outlined in chapter 6) successfully fostering economic growth through the period of China's economic transition. The success of Wenzhou's economic development has been attributed by scholars (Shi et al, 2004, Zhu, 2003, Dong and Ma, 2003) to a combination of local cultural, social, and historical factors, with the efforts of local private entrepreneurs. It is argued that this specific mix of Wenzhou's characteristics and its people succeeded in transforming an undeveloped region dominated by agriculture and few industries to a national model for economic development.

This chapter will discuss the role of the Wenzhou government in the process of its economic transformation. Although Wenzhou suffered from political stigmatisation in the 1980s, its government nevertheless protected the interests of the local economy. It continued to do so throughout the 1980s and 1990s, presiding over a private sector which grew vigorously. Wenzhouese entrepreneurs were able to use their business acumen to take advantage of China's transition towards free markets, creating small manufacturing firms using local capital, and trading their products through an informal social network (described later). In essence, the inventiveness and opportunistic behaviour of local entrepreneurs propelled Wenzhou's privately owned economy in the 1980s and early 1990s when private ownership was still restricted in China. However, the entrepreneurs relied on the co-operation and support provided by the Wenzhou government, which has been historically close to

its population.

The actions of the Wenzhou government were heavily influenced by local culture and the entrepreneurial tradition in the region. Its close connection with the local population and culture is in contrast with the weak and ambivalent relationship that Wenzhou shared with the Central government. Paradoxically, the negative relationship with the Central government arguably allowed Wenzhou's local government more scope for carrying out its own policies, aided by the weakness of Central government monitoring.

Thus Wenzhou's development depended on the local government's developmentalist policies for facilitating private sector growth, and the local government's close relationship with local entrepreneurs, as well as the ambivalence with Central government. By considering all three aspects, it is possible to gain a deeper understanding of Wenzhou's development process, and to see the role of local government in that process.

8.2 Wenzhou's economy

Wenzhou is one of the largest counties in Zhejiang by population, with 7.29 million people. It had the fastest economic growth rate in Zhejiang between 1988 and 2002, in terms of GDP growth and GDP per capita growth (see figure 8.1).

Wenzhou's government expenditure can be seen in figures 8.2 and 8.3. From the start of China's reforms in 1978, Wenzhou's annual government revenue per capita and expenditure per capita has been lower than the provincial average. Thus not only does the Wenzhou local government receive less income per person than

other counties in Zhejiang, it also spends less. Wenzhou's local state capacity, at least in financial terms, is thus weaker than those of other counties in Zhejiang, and it also supports the contention that Wenzhou's economic development was placed on a lower level of importance by the central state, which allocated less funds to Wenzhou than to other counties in Zhejiang.

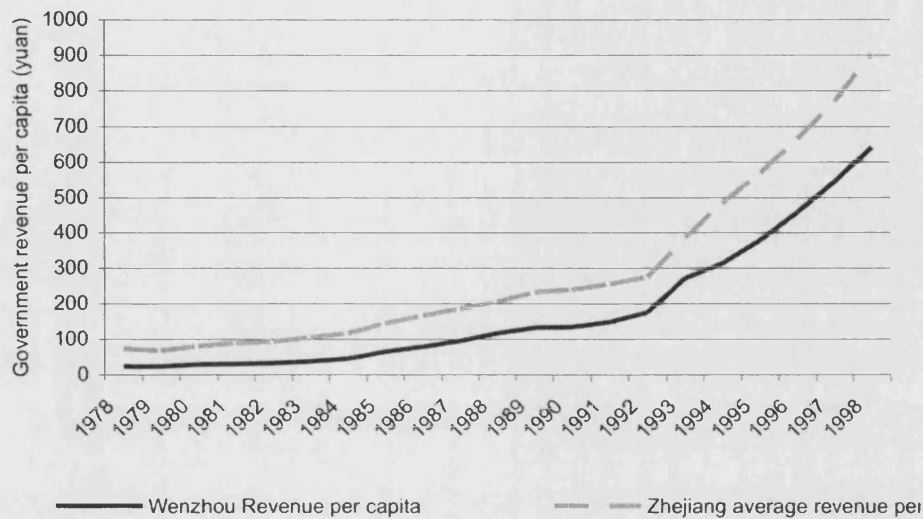
Figure 8.1: Comparison of cities in Zhejiang, ranked by GDP per capita growth 1988–2002

		1988	1994	2002	Growth 88-02
Wenzhou	Population (millions)	6.53	6.92	7.39	113%
	GDP (billion yuan)	11.258	29.678	106.097	942%
	GDP per capita*	1724	4307	14357	833%
	Area (sq. km)		11784		
Taizhou	Population (millions)	5.09	5.26	5.51	108%
	GDP (billion yuan)	10.811	24.257	85.831	794%
	GDP per capita*	2124	5122	15620	735%
	Area (sq. km)		9496		
Jinhua	Population (millions)	4.19	4.33	4.49	107%
	GDP (billion yuan)	10.568	25.346	68.041	644%
	GDP per capita*	2522	5857	15169	601%
	Area (sq. km)		10918		
Shouxing	Population (millions)	4.07	4.22	4.34	107%
	GDP (billion yuan)	15.208	30.781	92.815	610%
	GDP per capita*	3737	7316	21414	573%
	Area (sq. km)		8256		
Ningbo	Population (millions)	5.03	5.22	5.46	109%
	GDP (billion yuan)	25.607	46.351	150.034	586%
	GDP per capita*	5091	8889	27541	541%
	Area (sq. km)		9365		
Hangzhou	Population (millions)	5.66	5.92	6.37	113%
	GDP (billion yuan)	33.37	58.552	178.183	534%
	GDP per capita*	5896	9924	28150	477%
	Area (sq. km)		16596		

* 1988 figure approximate

Source: Zhejiang Statistical Yearbook 1989, 1995, and 2003

Figure 8.2: Wenzhou government revenue per capita



Source: Comprehensive Statistical Data and Materials on 50 years of New Zhejiang, 2000

Figure 8.3: Wenzhou government expenditure per capita

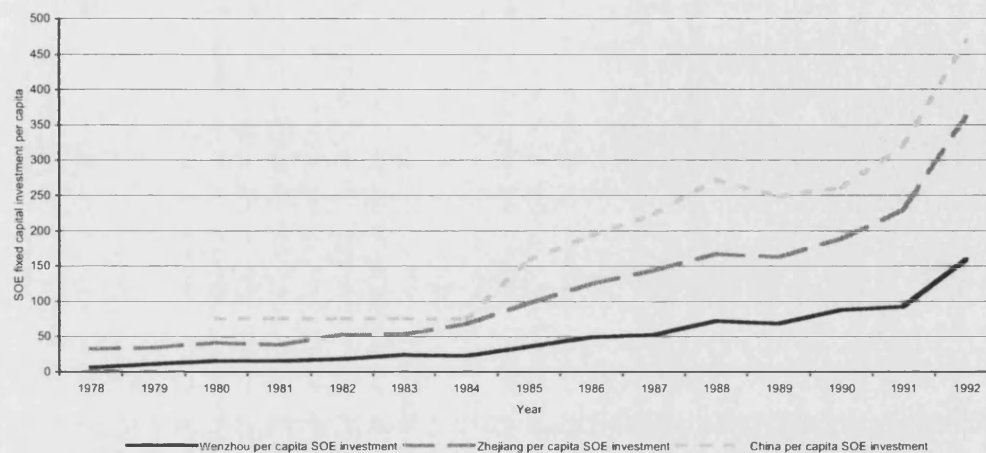


Source: Comprehensive Statistical Data and Materials on 50 years of New Zhejiang, 2000

As a vulnerable “front line” area against Taiwan, Wenzhou was felt by Central government planners to be vulnerable to attack, so relatively little investment went into Wenzhou, with a total Central investment of just 655 million Yuan

between 1949 and 1981, compared with 2.8 billion Yuan invested in Ningbo over the same period (Parris, 1993).

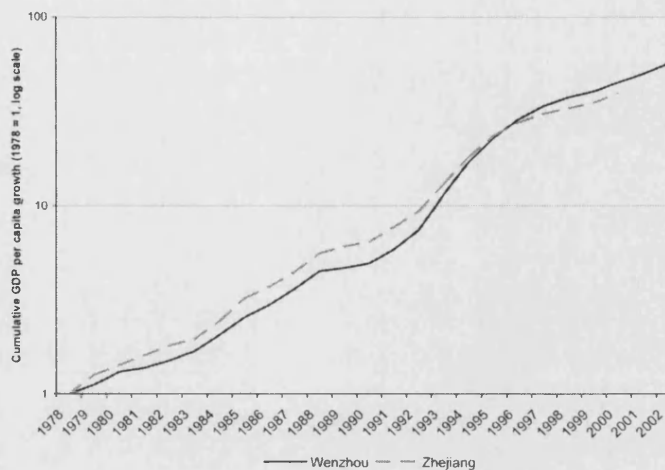
Figure 8.4 SOE fixed capital investment per capita, 1978–1992



Source: China Statistical Yearbook 2000, Zhejiang Statistical Yearbook 2000, and Wenzhou Statistical Yearbook 2003

Another feature of Wenzhou's economy worth noting is its relatively low starting point. Figure 8.4 shows that Wenzhou received very low levels of investment to its state sector since 1978. On a per capita basis, fixed capital investment remained below the provincial and national average from 1978–1992, supporting the notion that Wenzhou had a weak state sector that was not well funded. With low levels of funding for local government and local state industries, Wenzhou's economic development relied on local resources and capital rather than investment from outside.

Figure 8.5: Cumulative GDP per capita growth in Wenzhou and Zhejiang since 1978



Source: China Statistical Yearbook 2000, Zhejiang Statistical Yearbook 2000, and Wenzhou Statistical Yearbook 2003

An examination of Wenzhou's rate of GDP growth begins to reveal why it is considered to be a unique model for economic development. Between 1978 and 1991 Wenzhou's GDP growth rate just about kept pace with the Zhejiang average. However, by 1992, Wenzhou's growth rate overtook that of Zhejiang as a whole. During the period 1992–2000, Wenzhou's GDP grew at 4% above the Zhejiang average. The effect of Wenzhou's growth can be seen in Figure 8.5, which is an index of the cumulative GDP per capita growth of Wenzhou and the average cumulative GDP per capita growth in Zhejiang province starting in 1978. Until the early 1990s, Wenzhou's performance was only marginally above the national average but below the Zhejiang average. However, by the early 1990s it began to speed up, eventually overtaking the provincial average in 1995. It is therefore reasonable to say that one reason the Wenzhou model is so distinguished is due to its high growth rate in the 1990s compared with other areas in China. Other models for economic development – especially those involving local government entrepreneurship – were over taken by Wenzhou's small scale, market based economy.

8.3 Initial conditions for local development in Wenzhou

Interviewees from Wenzhou often introduce Wenzhou by describing its terrain: seven parts mountain, one part water, two parts flatland. This picture of Wenzhou's geography explains its isolation from the rest of China, with the populated urban areas along the coast being surrounded by mountains in the north, west and south, hindering communications by land (Liu, 1992a). The local population is also distinctive for its dialect, which is only spoken within 40 miles of Wenzhou city and serving to create a very close knit community in this isolated area.

Wenzhou's rugged terrain was not endowed with many natural resources, and even agricultural activity was constrained by the local mountains. Wenzhou city was a trading port, but otherwise did not command any major trade routes. The area also faced a growing demographic crisis. Between 1906 and 1921, its urban population grew by 148% as a result of the Chinese civil war and the Japanese invasion (Liu, 1992a, p697). Its vulnerability to invasion by sea from Taiwan in the 1950s also meant it remained deliberately under industrialised, with little state investment in the area. However, all these contributed to Wenzhou's isolation from the Central government, which paradoxically proved to be a valuable resource for the development of its private economy.

8.3.1 Distance from the Central government

There are three tangible measures of Wenzhou's distance from the Central government. Its physical distance is the most obvious. By road, Wenzhou is located 300 km away from Hangzhou, the provincial capital of Zhejiang, and approximately

1500 km away from Beijing. The city of Wenzhou and its port are separated from the rest of the Zhejiang province by the Yandang mountain range, making the area difficult to access.

Under the centralised command economy, the Wenzhou government received a small budget according to its size and relative unimportance in the planned economy. Although state industries were set up in the area, they were small and almost a third became bankrupt by the early 1980s (interview 2004, Wenzhou CCP college). Furthermore, the low priority accorded to Wenzhou's SOEs meant investment in the local infrastructure was relatively low. From figure 8.4 it is possible to see that government expenditure in Wenzhou falls well below the average for Zhejiang province. With few state industries of importance and the low amount of investment, Wenzhou's state sector was not well integrated into the provincial or national economy.

Politically, the Wenzhou government has had a history of independence from the Centre. The Wenzhou communist party was cut off from all contact with Mao's communist committee during most of the Second World War and the Chinese civil war, and they developed a self-reliant system, which allowed the communist ideology to co-exist with local entrepreneurs (Liu, 1992b). Although the Central government attempted to intervene to bring the area under its control, so long as elements of the local communist party remained, it was able to reinstate a situation of semi-independence once the pressure applied by the Central government was removed.

Central government work teams sent to Wenzhou had to go back [to their posts], they couldn't stay forever.

When they left, things would be quiet for a while, but then [private trading and the black economy] would slowly go back to normal (interview, 2003, Wenzhou economic reform office).

Thus even with work teams sent in by the Central government to solve the “problem” of Wenzhou’s capitalistic tendencies (as well as to sort out the lawless local situation) did not successfully bring the local government – or, more importantly, the local area – into line with the Central government’s policies.

Wenzhou’s isolation from the Central government meant it did not benefit, in terms of any significant subsidies and aid it might have received from the Centre, but this also enabled it to minimise the ability of the Central government to monitor and enforce Central policies, and reduced Central government intervention in the local government. Without a strong tie between Wenzhou and Beijing or Hangzhou, the Wenzhou local government was able to act with a greater degree of freedom to experiment with developing the private sector.

8.3.2 Poor local state and weak local bureaucracy

Prior to 1978, Wenzhou’s local government was weakened by the low level of funding from the Central government. It also suffered from a poor and inefficient structure, with three separate and independent components, with duplication and conflict eroding its ability to operate effectively. This weakness in the government structure provided an incentive for local government officials to develop close relations with local private entrepreneurs. One interviewee explained, it was more effective to use personal connections and social networks in some cases than to go through government channels (interview 2003, anon, Wenzhou local government).

There is a historical precedent for this, since, the Wenzhou local government allowed private businesses to operate in the period of civil war before the formation of the People's Republic, when the area was cut off from Mao's Communist government. Even with the contact with the Centre re-established, the local state was not in a position to completely eradicate private enterprises (Liu, 1992b).

8.3.3 Weak state sector and low levels of investment

The weak local state economy, population pressure, and lack of arable land created tremendous social pressure for massive out migration from Wenzhou. It was not possible for local state enterprises to absorb the local workforce, nor it possible to redirect workers to rural areas as arable land was scarce. Thus many Wenzhouese sought work away from home. This started the legacy of outmigration from Wenzhou. Currently there are some 2 million Wenzhouese people living outside Wenzhou in China. This created a business network for those who remained in Wenzhou, and has been highlighted as one of the features of the Wenzhouese economy that has contributed to its success.

Another consequence of a weak state economy was the creation of the local black market and unofficial trading by private individuals, even though such practices were forbidden under the command economy. This was the case especially in more remote areas, where officials allowed the trading to take place secretly, with lower risk of being discovered by higher levels of government.

We started the household contract system well before villages in Anhui promoted it, but we couldn't announce it at the time. So we were far more advanced

before the rest of the country took on the idea
(interview 2004, Wenzhou CCP college).

A creative solution to the problem of unemployment was the creation of household based workshops creating handicraft items and small components for consumer goods, which were in desperately short supply under China's state industry oriented development plans. Local entrepreneurs took advantage of this shortage to produce and distribute their products nation wide. These small scale, clandestine operations were cheap to capitalise, and eventually became the backbone of Wenzhou's flexible, consumer oriented industries.

8.3.4 Independence from Centrally imposed social structures

The work unit, or *danwei*, is a hugely important part of an urban worker's life, providing housing, education, healthcare and having massive influence over the personal life of its members. Issues such as marriage and family planning fall under their remit too (Bjorklund, 1986). However, in an area with few state enterprises, most of the local population in Wenzhou did not belong to a work unit, and were thus not subject to their control. In rural areas, the creation of communes for agricultural production teams was also limited, with peasants resisting collectivization.

[The] first experiment with private household farming took place in Wenzhou in 1956, a result of strong local resistance to collectivization [...] Household farming, regarded as a setback to communism, was later denounced as anti-revolutionary and the cadres who supported it [...] were purged in the 1958 Great Leap Forward movement. Nevertheless, peasant household

farming was never completely eradicated [...] in the following years. As soon as each political campaign subsided it returned. (Liu, 1992b, p307).

Coupled with a local traditional culture that recognised the importance of individual entrepreneurialism, the political pressure applied by the Wenzhou government against local entrepreneurs was considerably weakened. Along with an ineffectual local government, local private enterprises were able to continue to operate.

8.4 The 3 phases of Wenzhou's economic development

Wenzhou's developmentalist local government was successful in developing the local economy by maintaining a consistently low level of intervention in the local economy throughout its transition. It encouraged local private sector growth and managed to face political pressure from the Central government, eventually succeeding in becoming politically acceptable by virtue of its economic growth. The sections below will outline events in the 3 phases of Wenzhou's economic development.

8.4.1 Phase 1: 1978–1989

Although Wenzhou's unorthodox economy was in operation before the economic reforms of 1978, the reforms allowed the local government greater scope to act to develop its local non-state sector (Liu, 1992a). Thus 1978 serves as a useful landmark year to begin examining the Wenzhou government's role in economic development.

With a weak state sector, the total employment in Wenzhou's SOEs was very low. In 1978, only 167000 were employed by the state sector, which accounts for just over 3% of the total population of 5.6 million. In contrast, at the provincial level, 5.9% of the total population in Zhejiang were employed by state industries, and this compares to a national average of 7.7% in the same year (Wenzhou Statistical Yearbook, 2003, Zhejiang Statistical Yearbook, 2004, China Statistical Yearbook, 2000). The scarcity of farmland in Wenzhou, with 0.025 hectares available per person, meant that resorting to labour intensive agriculture to absorb the unemployed was also impossible. Even by 1999 there was a surplus rural labour force of 1 million people (Forster and Yao, 1999).

The pressure on the local economy prompted two trends. First, the migration of Wenzhouese out to the rest of China eased local over population and unemployment, and also played a key role in providing Wenzhou with human capital and business opportunities later on in its development (interview, 2003, Wenzhou chamber of commerce).

The second trend was the growth of an informal, private market, or the "black economy". By 1978, Wenzhou's economy already had a significant non state and non collective sector, which officially accounted for 9.2% of the total industrial output by value. This compares with Wenzhou's state sector, which accounts for 37.5% of total industrial output. Although illegal, the lack of alternative sources of income has meant that privately owned factories and firms have been operating semi-legally and illegally in Wenzhou's "black economy" since well before 1978 (Parris, 1993, Wenzhou Jingji Luntan, 2001). This was also true in rural areas, where farmers adopted their own system of household responsibility contracting well before

its endorsement by the Central state in 1978 (Johnson, 1982).

China's 1978 economic reforms allowed private firms to exist as a means to "develop production, enliven the market, satisfy the daily needs of the people, and increase employment" (State council, 1981, cited by Young, 1989, p58). In order to address the potential conflict that reviving private enterprise would cause in a socialist economy, private firms were seen as playing a subsidiary role to the state sector. They were to "fill in the gaps" left by the state sector, but their size would be limited to seven employees, their access to capital and technology restricted, and they would be subject to state regulations. Private businesses were never supposed to grow beyond their niche of supporting the state economy, "filling in" for production and employment here and there, without undertaking a massive transformation of the socialist economy, while state owned firms remained the mainstay of the economy (Young, 1989).

However, the initial economic condition in Wenzhou was more suited to a developmentalist approach. The local government lacked the resources to develop the state sector, while the budding private sector showed promise without needing resources from the local government. Thus the local government needed to reconcile the possibility of fostering growth in the private sector with the limitations imposed on private enterprise by state regulations, and the political animosity towards private businesses. As a response to this need, the Wenzhou government created a set of regulations, creating a new form of ownership – share holding collectives (interview 2003, Wenzhou economic reform office). They also consented to illegal or dubious practices – such as the creation of a local credit market – in order to facilitate growth in the private sector.

Thus the role of the local government in this first phase of economic development was to introduce a system of regulations, allowing the local economy to function under a semi-private market system that has not yet received Central government approval. The strength of the local entrepreneurial tradition has proven to be more than sufficient to drive economic growth, and the regulations put in place helped to divert political pressure from the entrepreneurs. When asked by Central government work teams, we explained that the regulations were in line with the Central government policy of introducing competition into the economy, while ownership was collective, rather than being in private hands (interview, 2003, Wenzhou economic reform office).

A popular view of the Wenzhou government in this first phase of development is to describe it as being “inactive”. For example, Forster and Yao (1999) suggest “The early period of reform until 1987 witnessed a period of government inaction, as the Centre and province permitted the development of the private economy in Wenzhou” (p90). However, Parris (1993) and Liu (1992a) argued convincingly that the Wenzhou local government’s role in economic development was quite important. It is pertinent here to introduce a concept that Chinese scholars of the Wenzhou model use to describe the function of the local government. “*WuWei*” (non action) and “*YouWei*” (action) are used by Chinese scholars such as Shi et al (2004), Zhu (2003), Dong and Ma (2003) to describe the attitude of the Wenzhou government towards economic development. The passivity of the Wenzhou government played a key part in allowing the surviving local entrepreneurs to develop the private economy. Its attitude of “*WuWei*” meant that

unlike the “corporatist” mode of behaviour for local governments proposed by Jean Oi (1992, 1995), Wenzhou’s local government was not involved in managing enterprises itself. A local corporatist government will act as an entrepreneur while running its own businesses, directly managing local state enterprises through its subordinate departments, or exercising its authority to select managers to run businesses. It may also take advantage of aspects of its official and bureaucratic authority to secure resources and information, exploiting official channels of communications to give those enterprises under its control a certain competitive advantage over both private businesses (which were still very much stigmatized in the early reform period) and other local state enterprises that did not receive the same amount of attention from their local government.

Although successful, Wenzhou did not develop or rely on a specific industry or activity. Resources were not concentrated in a few select sectors or firms in order to ensure growth. Wenzhou’s development model can be seen as being rather decentralised, relying more on the ingenuity of its entrepreneurs to create economic growth than on local government direction. Thus the development model lacks a definite structure or approach. Unlike the corporatist model of local economic development, the Wenzhou government did not act in the role as an entrepreneur. Indeed, it may appear superficially that the local government has not contributed much to the whole process of development, as Forster and Yao (1999) suggest. The economic growth appears to have been driven almost entirely by the actions of local entrepreneurs. However, this neglects the fact that the local government was under scrutiny during this period by the Central government, and that the operation of a market economy in Wenzhou required the creation of new policies and regulations, and the co-operation of the local government with local private firms. These policies

and regulations would otherwise not have been needed in a local economy dominated by the state sector. Finally, the local government did participate in actively disguising the illegal nature of many de-facto private businesses, by lending them the credibility of more legitimate, collective enterprises.

The Central government's interests in Wenzhou stems from the debate over the future direction of China's economic reforms. Wenzhou was picked out as being representative of growth through reliance on the private sector. However, this contradicted the ideological stance of the CCP at the time, and thus the Central government found itself divided between factions that supported Wenzhou's private enterprises, and factions who saw it as a violation of the country's socialist ideology. Wenzhou's trials and tribulations were taking place in the larger context of the pro and anti-reform debate taking place in the Central government at this time (Levy, 1995). As a result, various work teams were sent to "fix" the "Wenzhou problem", as Deng referred to it (Wenzhou Jingji Luntan, 2001). Wenzhou's leaders were also subject to changes dictated by the Central government. Between, 1981 and 1992, Wenzhou had four changes of leaders. Yuan FangLi in 1981, Dong ChaoCai in 1985, Liu XiRong in 1990, and Zhang YouYu in 1992.

The reason for the rapidity of some of the changes stems from the Centre's desire to force the Wenzhou economy to conform. The appointment of Yuan FangLi in 1981 was aimed at curbing the "chaos" that Wenzhou was suffering at the time. He was specifically charged with the objective to "cut the capitalist tail" off Wenzhou's underground economy and black markets. He was also to deal with the weak government, robbery, corruption and smuggling that was endemic in Wenzhou (Wenzhou Jingji Luntan, 2001). However, when he failed to do so, he was replaced

by Dong ChaoCai in 1985. Dong was also under instruction to curtail the private economy of Wenzhou, and to revive the state sector. He was in turn replaced by Liu XiRong in 1990 when he also failed to eliminate private economic activities. This shows that the Central government was applying considerable pressure on the local government to comply with its ideology, albeit unsuccessfully. The Wenzhou local government, then, was far from “inactive”. Rather, by refusing to follow the Central government’s demands and resisting the pressure to toe the line, it was actively encouraging the growth of the private economy.

As a means of reducing the pressure from the Centre, the Wenzhou local government needed to ameliorate the appearance of the local private sector. According to Parris (1995) and Liu (1992a, 1992b), as well as several people interviewed, this was done through the practice of “*Gua Hu*”, allowing private businesses to borrow the stationary and bank account details of legitimate collective enterprises, thus giving what were privately owned concerns the appearance of being legally operating collective enterprises.

Thus the Wenzhou government passed a number of regulations and policies regarding the operation of these collective–shareholding enterprises, including in 1987 the “Temporary regulations for the management of *GuaHu* enterprises”, “temporary measures for regulating private enterprises in Wenzhou municipality”, “Rules concerning the miscellaneous issues of rural collective enterprises”, and in 1988 “Rules concerning the miscellaneous issues of private and collective–shareholding enterprises”, and in 1989 “Notice concerning the standardisation of policies for collective–shareholding enterprises” and so on (Shi et al, 2004). These regulations set the foundations for Wenzhou’s future economic growth by protecting

the rights of these semi-private enterprises, and giving entrepreneurs a regulated structure in which to operate their businesses.

So this series of policies from the Wenzhou government gave local businesses a degree of political protection. As long as the debate over the “socialist” versus “market” aspects of the Wenzhou model continued to rage, by placing the emphasis on the “collective” nature of these firms, the Wenzhou government was managing to ease the political pressure on these firms.

The “collectivist” nature of the policies also served practical functions, including the protection of the rights of the “collective” shareholders, which were sometimes the workers in the firm, or the village in which the firm was based. They benefited from the guaranteed allocation of a proportion of profits to them (albeit managed by the firm’s managers). Another portion of the profits was directed back into the businesses for investment and expansion. The “collectivist” label meant that local firms had to reserve 25% of profits into a public welfare fund (though the allocation of the funds for worker bonus, welfare, health and so on was at the discretion of the firm’s managers). 50% of profits were to be re-invested into the firm itself, benefiting all shareholders by increasing the value of the firm. This way of allocating funds ensures that there was sufficient justification that these collective-shareholding enterprises did indeed serve the collective good (Wenzhou interview, 2003, Wenzhou economic reform office).

This kind of close, co-operative behaviour begs the question of how and why local officials colluded with firms in carrying out what were illegal activities. The section above on Wenzhou’s historical background explored how local officials were

able to do this. By a series of historical, political, social and geographical accidents, Wenzhou's relative isolation from the Centre meant that enforcement of the Central government's will was sporadic. This view is proposed by Liu (1992b), who calls it "sporadic totalitarianism". In the case of Wenzhou, although the Central government was able to bring pressure to bear on Wenzhou's government and leadership, it was only able to do so intermittently. "Work teams" and officials from outside Wenzhou were sent in to monitor and correct the situation of the revival of local capitalism in Wenzhou. However, they were posted temporarily. The Centre never succeeded in "rooting out" the capitalistic tendencies of the Wenzhou government. Several interviewees in Wenzhou agreed with this sentiment, repeating the oft heard sentiment that at the time "the emperor was far away" (*TienGao HuangDiYuan*). Thus even under a nominally totalitarian and centralised political system, it was difficult for the Central government to bring the region of Wenzhou into line.

There is no convincing evidence to suggest that officials in Wenzhou are any more altruistic than officials in other areas. In interviews with local officials and businessmen, altruism was dismissed as an explanation for the behaviour of local officials. Instead, pragmatism, and a good sense for business (even among cadres), as well as a certain impotence on the part of the local government, was seen as a much more realistic explanation. "*MeiYou BanFa De BanFa*" (interview, 2004, Wenzhou economic reform office) – the choice of having no choice – appeared to be what determine the attitude of the local government towards private businesses. The weak state sector, plus a large population and land shortage, has created a large reserve of unemployed labour. This reserve needed to be employed somehow, even if it were by illegal means. Fortunately, Wenzhou's tradition of small household production and private entrepreneurship managed to survive the difficulties under the centralised

economy, and this provided a basis to create employment in the collective and private sectors (interview, 2004, Wenzhou economic reform office).

By 1985, the composition of Wenzhou's total industrial output by ownership shows that private enterprises accounted for almost the same amount of output (19.1%) as SOEs (19.4%). By the following year, 1986, the industrial output of private enterprises (19.6%) overtook that of SOEs (18.4%), and by 1989, the end of the first phase in Wenzhou's economic development, the proportion of total industrial output by SOEs had declined further still to 17%, compared to 24% accounted for by the private sector.

8.4.2 Phase 2: 1989–1997

In 1989, the Tiananmen Square massacre, coupled with a wide range of economic problems, prompted the Central government to implement a series of measures to slow down economic growth and to recentralise power (Gelber, 1990). This could be seen as the moves of a Central government feeling the need to re-establish its grip on a country that was socially and economically stressed, and in the context of China's recent history, it is the latest in a series of waves of decentralisation and recentralisation. However, the international reaction after the shock of the massacre was one of caution – It was not known whether the Central government and the CCP intended to proceed with further reforms in the future, or to halt and reverse the economic reforms already made (Shambaugh, 1991).

Then, in 1992, DengXiaoPing took his "southern tour", a rare public appearance that garnered much media attention. Zhao (1993) suggests several reasons for Deng's decision to return to the public view after his retirement, the most

pertinent reason to this discussion being the need to defend the economic reforms against attack from more conservative (“leftist”) elements within the CCP. Although presenting no practical solution for China’s overheated economy, Deng’s tour nevertheless showed that achieving economic growth through the market and through what may be seen as “capitalistic” practices is nevertheless valuable and desirable. His tour had a profound effect on supporting the cause of Wenzhou’s private economy. Interviews with a toy manufacturer showed that the tour boosted confidence in Wenzhou:

...[then] in 1992 Deng Xiaoping took his southern tour, to Zuhai and Shenzhen, supporting the private businesses and development of the private economy. To us [in Wenzhou] that was a very important visit, it helped push forward faster reforms in the economy (interview, 2003, Wenzhou toy manufacturer)

The Wenzhou local government recognised that economic success from private development was taxing local infrastructure. The existing transport and communications system was unable to cope with the growing economy, and was proving to be a bottleneck to future growth. This became even more critical as Wenzhou’s advantage of being a “first mover” in adopting free market economy was being challenged by the collectivist mode of development in Sunan. At this time, Sunan was receiving large amounts of support from the provincial and Central governments, while Wenzhou remained reliant on local resources (interview, 2003, Wenzhou economic reform office).

With the developmentalist approach to economic growth, Wenzhou’s local government embarked on a series of large scale infrastructure projects. Two key

projects dealt with the poor transport linkage between Wenzhou and the rest of Zhejiang. In 1990, construction on the Wenzhou International Airport was completed. In 1998 the Jinhua to Wenzhou railway was completed, for the first time linking Wenzhou into the national railway system, allowing trains to run directly from Hangzhou, the provincial capital, to Wenzhou. Other projects included the construction of 220 kilovolt power switching sub stations, bridges over the OuJiang river, expansion of port facilities to handle larger container vessels, and so on (Shi et al, 2004). The construction of these infrastructure facilities allowed Wenzhou products to be exported more easily across the rest of China.

Faced with limited resources and little support from the provincial and Central government, Wenzhou's local government encouraged the participation of local entrepreneurs and the population to fund construction. This approach is distinctively developmentalist, providing local entrepreneurs access to projects that were the purview the local government, and further increasing the participation of the private sector in influencing their own growth.

Shi et al (2004) suggest that the total savings in Wenzhou exceeded 20 billion Yuan, plus the amount available from Wenzhouese all around the country and the diaspora abroad. This provides a rich source of funds for the local government to tap into and raise the capital needed to finance large projects. The local government has also encouraged individuals, firms, conglomerates and collective enterprises to finance small projects on their own, such as small scale hydro-electric power stations and small docks to take advantage of the various waterways criss-crossing Wenzhou (interview, 2004, Wenzhou CCP college)

The sale of land use rights provides one of the main source of income for the Wenzhou government (interview, 2004, Wenzhou CCP college). Rural agricultural land is purchased by officials and the land use rights are transferred to urban developers for a much higher price. According to Zhu KangDui, an economics lecturer and policy researcher at the Wenzhou Party College, the newly constructed local government offices were mostly funded by the proceeds from this kind of land transfer (Zhu KangDui, interview, 2004). Such practices are not without their problems, however. The massive difference in the purchased price and the price at which land is transferred to developers has created some tension between the government and the former rural land users, who are demanding to be compensated. Nevertheless, the local government has benefited far more than from such land transactions than it has cost.

Government departments have employed a variety of methods to raise funds individually, sometimes in conjunction with their official functions. For instance, the department of vehicles and transportation managed to raise 50 million Yuan through the auctioning of motorcycle number plates. New fees have also been applied in some cases to serve specific purposes. For example, the “water and transportation fee” increases the cost of construction by imposing a fee of 5000 – 15000 Yuan per “mu” (approximately 340 square metres) of land in areas served by water utilities and road network (Shi et al, 2004). This passed the cost of construction and infrastructure from the local government to the local population, while introducing the mechanism of demand and supply into the process of infrastructure construction.

Aside from constructing tangible infrastructure, the Wenzhou government also created new regulations to deal with a number of problems threatening the

reputation of its economy. Rapid economic growth both in Wenzhou and China in the early 1990s has given rise to a huge increase in demand, which in turn encouraged the production of counterfeit goods, low quality exports, growing environmental problems and the lack of regulations governing the behaviour of individual firms. It was difficult to impose a uniform level of quality control on the products of Wenzhou's small-scale household producers. Indeed, many of these industries had prospered because they were able to utilise low quality material and low cost labour to produce goods at extremely low costs. This was possible given the shortage of almost all kinds of consumer goods in China's economy at the beginning of the reforms, when the dominant state sector concentrated on producing industrial goods. Consumer demand was high enough that even low grade goods were purchased. However, the problem with such a short term approach to economic growth soon became apparent.

By the mid 1980's and early 90's, Wenzhou successfully sold its products to domestic markets within China. Its private firms were competing successfully with SOEs in other regions and other provinces. However, in 1985 and 1986, newspapers began to report on the low quality of shoes produced in Wenzhou, which were given the nickname of "dawn till dusk shoes", "one day shoes" and so on. Consumers were enraged to find that the shoe soles were glued on and that artificial leather was used. A point of crisis was reached in 1988, when a Wenzhouese shoe market in Nanjing was destroyed by angry customers (Shi et al, 2004).

Other products from Wenzhou also came under pressure. Yueqing, a small township outside of Wenzhou city, was known for manufacturing low voltage electrical switches. Usually silver is used in the manufacturing process, but Wenzhou

did not have silver, and the manufacturers substituted it for copper in the switches. Compounding the situation was the fact that the switches were relatively simple to produce, so even those without much technical understanding started to enter the market, further lowering the quality of the products (Sonobe et al, 2004). This resulted in two undesirable outcomes that are linked. First, illegal manufacturers sprang up in Yueqing, without licensing, registration or regulation. Second, without the necessary regulations, the low quality products were sold throughout China, and Wenzhou soon gained a poor reputation for producing goods that did not last. After a series of investigations and scathing government reports at the national level, a notice was issued jointly by six Central government ministries in 1990 regarding the unlicensed production and sale of low quality products from YueQing. Among the recommendations, it strongly stated that the YueQing local government needed to “observe the rule of law” and to “stop the production and sale of low quality goods from any unlicensed firms, danwei, and individuals” as well as to “stop those goods leaving the factory.” (Office of the State Council, order number 29, 1990).

This presented the Wenzhou local government with a dilemma. The low quality goods sold under the Wenzhou banner was destroying its reputation, inviting criticism from other local governments, the Central government, as well as rousing a violent reaction from the general population. However, shutting down the illegal producers would seriously damage the economy. Instead of choosing either path, the local government ignored the directives issued from the Central government, and instituted a series of policies designed to regulate local firms. Manufacturers were encouraged to improve the quality of their goods. In order to distinguish themselves from low quality counterfeit and anonymous producers, certain manufacturers also began to promote their own brands (Sonobe et al, 2004).

It must be noted that the firms were profiting from the sale of low cost, low quality goods (Sonobe et al, 2004), and two of the entrepreneurs interviewed even suggested that later growth in Wenzhou was financed from the capital accumulated by selling fake, low quality goods (interview, 2003, Wenzhou Chamber of Commerce). Despite this, the local government was well aware of the long term damage that a bad reputation could do to the economy. Indeed, the repercussions are still felt by Wenzhouese businesses now. In a television interview, the CEO of AuKang corporation (a maker of shoes based in YongJia, a Wenzhou township) was asked:

“Your shoes have become very well known in China, and they have received the compliment of being one of the top ten shoe makers in China. Why then are the packaging labelled ‘Zhejiang province, YongJia township’, but does not make clear it is made in Wenzhou? Are you exploiting the fact we don’t know YongJia is part of Wenzhou? If you labelled your shoes ‘Made in Wenzhou’, will you still be able to sell them?” As a representative of Wenzhouese shoe makers, and indeed as representative of all Wenzhou manufacturers, Wong ZhenChao was silent before the questions of the presenter. After a long pause, he replied, “polishing Wenzhou’s name is so hard.” (Jin, 2001, 18)

Between 1990 and 1994, the Wenzhou government concentrated on improving the quality of goods produced in Wenzhou as well as shutting down illegal, unlicensed and unregistered producers. By 1995, 88.9% of all goods produced in Wenzhou passed quality control inspections (1.27% higher than the

provincial average), with 98.93% of export goods passing quality control (Shi et al, 2004).

The improvement in quality illustrates the relationship between Wenzhou's developmentalist government and local private firms. Although the Wenzhou government had no ownership claim over firms, the initiation of the campaign for improving product quality required a close co-operation between government, businesses, and business associations. The informal, social network between government officials, semi-government officials (in Wenzhou's business associations, for instance) and private entrepreneurs proved to be a valuable channel for communication and co-ordinating this effort.

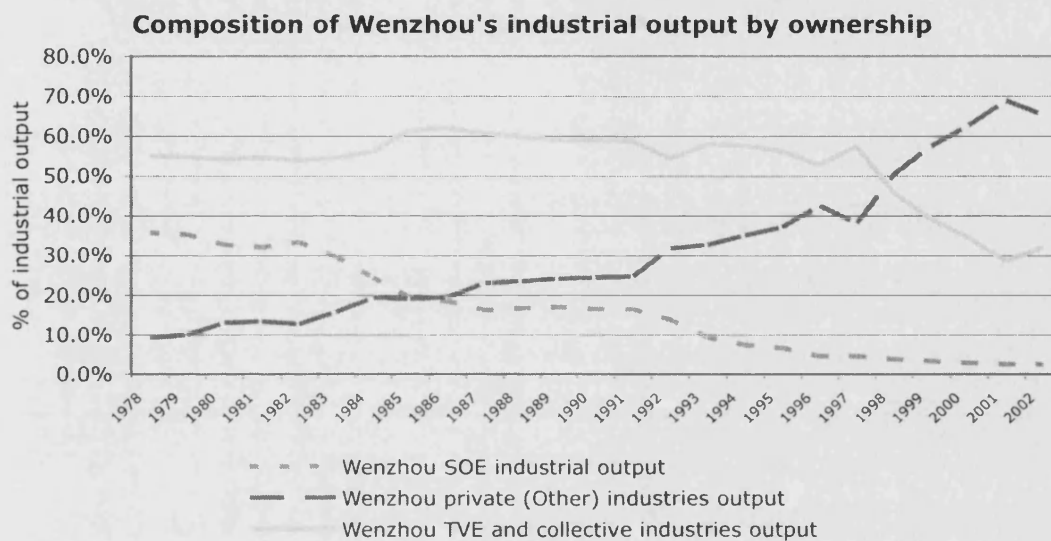
8.4.3 Phase 3: 1997 onwards

The success of Wenzhou's small scale, flexible, labour intensive industries was remarkable. However, with the continuing changes in the Chinese economy, Wenzhou faced challenges from other parts of China adopting similar methods for economic growth. Ironically, the success of the Wenzhou model, the acceptance and adoption of the market model ("market socialism") as the direction for future economic growth in China also increased the competitive pressure faced by Wenzhou's manufacturers. Furthermore, many of Wenzhou's firms faced critical shortages of energy, land, and raw materials, as well as rising labour costs because of its rapid economic growth, which threatened to make Wenzhou less competitive (interview, 2004, Wenzhou Chamber of Commerce).

In response, the Wenzhou government has initiated a number of strategies aimed at upgrading both the industries in Wenzhou, from producing simple goods, to

becoming high tech manufacturers. For instance, Wenzhou's University City was consolidated in 1999, on a joint stock ownership model (People's Daily, 19/11/1999). The consolidated collage was set up on a new university campus, completed in 2004 outside of Wenzhou city, with the aim of increasing the availability of high skilled employees in Wenzhou.

Figure 8.6 Composition of Wenzhou's industrial output by ownership



Source: Wenzhou Statistical Yearbook 2003

Firms in Wenzhou have been fortunate enough to avoid the complex, disruptive process of privatization. Their transition from “state” and “collective” ownership was a matter of removing the status granted to them by the local government for protection, and allowing existing managers to formally take over as private owners of the firms. As China's economic transition progressed and private enterprises became increasingly acceptable and restrictions were removed, most Wenzhou collective firms dropped the label of being “collectives” and became fully fledged private enterprises. This can be seen in Figure 8.6 by the change in the makeup of Wenzhou's total industrial output. In 1997, collective enterprises and

TVEs made up 57.4% of Wenzhou's total industrial output, while private industries made up 38.1% of industrial output. By 2002, the proportion had changed to 32% and 65.5% respectively (Wenzhou Statistical Yearbook, 2003).

However, despite (or because of) Wenzhou's success, firms and individuals from Wenzhou are eagerly looking for investment opportunities elsewhere in China. As was previously mentioned, land suitable for development is scarce in the mountainous terrain of Wenzhou. The shortage of critical resources locally, such as electricity and raw materials, has led to higher input costs. Local labour costs have also risen, with low paid jobs increasingly being taken by migrants from other parts of Jiangsu province. There is also a shortage of human capital, a trait that can be ascribed to Wenzhou's entrepreneurial culture. The founder of a large valve manufacturer in Wenzhou laments that there are not enough managerial level staff available, and he is worried about finding suitable successors. In the mean time, almost all managerial level decision is still being made by him (interview, Wenzhou Chamber of Commerce, 2004). The construction of the new university city is an attempt by the Wenzhou government to solve the shortage of skilled labour by improving higher education.

The increase in input prices has meant that local entrepreneurs invest outside Wenzhou, in Shanghai, Beijing and other large metropolitan areas. Whereas the poor reputation of Wenzhou in the past made investments difficult, Wenzhou's economic wealth means new ventures have sufficient resources to compete in large urban markets.

[A] large venture has recently opened in Shanghai to recycle old car tyres. They used to be based here, but

compared with Wenzhou, there are more old tyres in Shanghai. [They've] moved completely away to set up there (interview, Wenzhou chamber of commerce, 2003)

The strength of firms from Wenzhou has become a double edged sword, allowing Wenzhouese firms to make bold decision to move away from their homes, at the same time depriving the local economy of investment. In terms of development, Wenzhou's economy has reached a level where the local economy can no longer sustain the growth rate it achieved over the past 20 years.

Wenzhou is too small, and it doesn't have the connections with surrounding cities to form a large economic cluster. [It's closest major market] Shanghai is too far away, and there aren't any other large markets that are close enough. I think Wenzhou will remain a medium sized city (interview, Wenzhou CCP college, 2004).

Coupled with the high cost of basic inputs and a shortage of land, Wenzhouese firms are seeking cheaper places to invest in. The lack of investment opportunities within Wenzhou has also created a new phenomenon, that of the "Wenzhou gangs", who speculate on real estate prices.

These groups of well-heeled individuals from Wenzhou, a prosperous city in East China's Zhejiang Province, recently went from city to city buying prime properties with the aim of reselling them for quick profits (China Daily, 2004).

Whatever their real impact on the Chinese property market, their transactions have drawn criticism and have caused sufficient alarm in Wenzhou for the local government to issue restrictions on home purchase loans.

Wenzhou's economic success is undeniable, but the result has been rising costs due to natural constraints. Although the local government has been attempting to compensate by upgrading the workforce, it is impossible to overcome the natural limitations of Wenzhou's terrain. Nevertheless, this can be seen as a natural progress of economic development, where surplus capital and profits from Wenzhou's successful firms are seeking outlets elsewhere. Strict controls on the flow of money, however, remains outside the scope of the Wenzhou government's remit, as financial regulation is dealt with by the Central government.

A number of new initiatives have been launched by the Wenzhou government to counteract the threat of increased economic competition and the effects of local firms moving away from Wenzhou. The new Wenzhou University city was constructed to bring all higher education institutions in Wenzhou onto one modern campus, with shared facilities and more resources available to students. Wenzhou University actively pursues forming academic ties with institutions abroad, and encourages foreign students to attend exchange programs, as well as arranging visits to foreign universities to learn from their teaching experience (interviews, Wenzhou University, 2006). The Wenzhou government has also initiated joint co-operative programs with Taizhou and Luishui to develop a local "economic cluster" that would enable further development to take place, with joint transportation networks and development goals.

8.4 Wenzhou's developmentalist local government

The development of Wenzhou relied on a close co-operation between local government and private entrepreneurs. In the three phases of Wenzhou's development, the local government minimised its attempts to control and manage local firms. The ownership of firms were obfuscated in order to avoid direct conflict with Central government policies, while allowing private entrepreneurship to remain and flourish, but the original managers and owners were allowed to remain and run the firm. The local government also allowed private entrepreneurs to fund local infrastructure, which used to fall under the purview of the local state. Moreover, the regulations of the local economy were developed and changed with the needs of the local economy, while restrictive policies from the Central government were reinterpreted to suit local conditions, or where this was not possible, they were sidestepped. Wenzhou's development relied on the creation of an environment where local private entrepreneurship was allowed to grow and, to a certain extent, determine its own requirements. This enabled development in Wenzhou take place with locally available resources, with lower levels of investment and hard infrastructure, and with a "weak" local state.

Thus the actions of Wenzhou's developmentalist local government divided into two components, one internal and one external. First, the Wenzhou government recognised and developed the potential of the private sector. This included the creation and implementation of regulations for new collective shareholding ownership types, for privately funded infrastructure projects, allowing the creation of a local capital market, and so on. Second, Wenzhou managed its relationship with the Central government, resisting political pressure to cut off its "capitalist tail", and negotiating the interpretation of Central government policies to suit its private sector

ownership and development, whilst pushing the success of its economy in support for more market oriented development in the economy.

A number of anecdotes from interviews conducted in Wenzhou suggested that there was a critical phase at the start of the 1980s when Wenzhou's local economy began its transformation from operating a "black economy" to legitimating its many local private enterprises. In August of 1981, Yuan Fanglie was ordered to go to Wenzhou in order to "fix" its intractable problems of its ineffective government, poverty, and the persistence of private enterprises. Yuan was the deputy governor of Zhejiang province at the time, and he was able to act with extraordinary authority granted by the Zhejiang provincial government (interview, 2003, Wenzhou CCP college). He restructured the local government, unifying the territories and often conflicting bureaucracies of three separate counties in Wenzhou, a procedure that was approved by the provincial government. He also succeeded in restoring order in Wenzhou by eliminating predatory officials from the government. However, he did not manage to terminate the presence of private enterprises in Wenzhou. Instead, Yuan was instrumental in recognising the importance of private businesses to Wenzhou's economic future.

Although Yuan was instructed to clean up the remnants of Wenzhou's private economy, he was unable to do so. First, the state sector was unable to produce the growth in the economy even with additional subsidies from the Central government. Although he succeeded in obtaining additional investment, Yuan was unable to solve the problem of poverty in Wenzhou. Second, the government lack the capacity to curtail private enterprises, which were small scale, and often involved the collusion of the official enforcers. Finally, anecdotal evidence suggests that in 1982 he was

confronted with the evidence that the (albeit illegal) practice of agriculture by individual households produced better results than that of communal farming. He was also shown the operation of small, private underground factories, which yielded much higher returns than state enterprises.

In October of 1982, Yuan instituted a policy of recognising the importance of the “two households” – the “individual household (ge ti hu)” and the “priority households (zhong dian hu)”. A conference was held where the representatives of these private entrepreneurs were told that their activities would be encouraged by the local government. Thus in future, should there be pressure from higher levels of government on these semi-legal enterprises, the local government, and specifically, Yuan Fanglie, would be held accountable.

This was the first time the Wenzhou local government recognised the private enterprise as a vital component of its economy. Although it did not completely legitimate private enterprises - for the local government had no authority to do so - this was a key step towards strengthening the link between local private businesses and the local government. Most importantly, it allowed the Wenzhou government to formulate policies in aid of the private sector. Interestingly, it also set the precedent for the behaviour of then Wenzhou government’s approach to the private sector. The private sector was given permission by the local government to grow, while the local government was responsible for deflecting the political pressure from the conservative, anti-reform elements within the Central government. Rather than directing or managing the economy, the Wenzhou government has taken on the task of providing the environment in which private enterprises could operate with minimal levels of hindrance.

The local government has sought to protect local entrepreneurs after 1982 to the best of its abilities, as illustrated in the previous sections in this chapter. Moreover, it took drastic action in protecting the reputation of Wenzhou by targeting counterfeit goods. It also helped Wenzhou's development by creating large markets for traders and buyers to meet. By attracting buyers to come to Wenzhou, it increased its profile and served as publicity (interview, Wenzhou trade association, 2004). Although these were not formulated as part of a coherent development strategy, they were effective and appropriate to serve Wenzhou's development.

8.5 Conclusion

The Wenzhou government played a key role in the economic development of its economy. However, its efforts were also helped by fortuitous timing. In the first and second phases, the private sector in Wenzhou was able to take advantage of its relative freedom and flexibility vis-à-vis the state owned and collective enterprises and exploit market opportunities all over China, while the rest of China was undergoing a transformation in their economic structure. While other local governments were engaged in managing their local firms, Wenzhou's government was creating in its economy the conditions and regulations necessary for private enterprises to survive and operate.

The success of Wenzhou's private economy depended on a level of trust between the private businesses and the local government. In part, this trust rests on the knowledge of the local government's partial impotence in local affairs – that it risked crippling its own economy and risking social turbulence if it had to carry out the orders of the Central government. Conversely, this also meant that local

businesses and the local government had many shared interests, especially in the area of sheltering the private sector. Aided by the social network, the wishes of each party can be passed onto the other, without necessarily using official channels of communications, thus bypassing Central government oversight. Wenzhou's developmentalist strategy showed that a weak, non-interventionalist local government can use social ties and distance from Central government control to foster growth in its economy against political opposition.

Chapter 9: The role of Yangzhou's local government in local economic development – Economic transition from collectives to private enterprises

9.1 Introduction

Yangzhou's economy went through a gamut of different economic development modes, from a state economy, through local state and collective ownership, to becoming a privately owned market economy. At each stage, the Yangzhou government has been proactive and involved in directing the local economy. Yangzhou's location in central Jiangsu meant it has been influenced by the "Sunan" model from southern Jiangsu, where local corporatism or entrepreneurial local governments were deeply involved in managing the local economy and firms within the local economy.

However, there is a difference in the case of Yangzhou's economy. A key component for the early success of the Sunan model is the nearness of Shanghai, which proved to be an invaluable market for the products of the collective enterprises (Lin, 1995). Proximity to Shanghai also allowed surrounding regions to gain from the movement of industrial activities out of the city in the early 1990s as Shanghai sought to reorganise itself spatially and emphasise tertiary, service based functions in the city itself (Zhang, 2003). Shanghai's access to foreign markets provided Sunan's collective enterprises with a ready outlet for their products abroad, attracting buyers as well as serving as a shipping point for their goods. This concentration of infrastructure, industry, metropolis and international connections was a potent mix in injecting vitality into Sunan's economic development process (Yehua, 2002).

Yangzhou's distance from Shanghai neutralised this advantage. While

Yangzhou cannot be described as either economically backward or destitute, its economic and industrial development has been mediocre, producing and processing agricultural and food products during the time of Central economic planning. This was due to Yangzhou's historical development of its commercial, rather than industrial, economy. This led to relatively low levels of state investment in the area.

9.2 Background: Economic changes in Yangzhou

Located in the Centre of Jiangsu province, Yangzhou is situated between a prosperous south and a poorer north. Sunan, the southern area of Jiangsu, has cities such as Nanjing, Suzhou and Wuxi, as well as close economic ties with Shanghai. Sunan is a highly urbanised and industrialised area, the origin of the Sunan model, and the base of the "Kunshan miracle" in attracting massive inflows of FDI, while by contrast, Subei, northern Jiangsu, is a predominantly agricultural area without the benefit of economic spill-over from a major metropolitan area such as Shanghai.

Suzhong (central Jiangsu) is demarcated by the Yangtze river. Yangzhou is located roughly 230km upstream from the mouth of the river. Historically, Yangzhou sat at the junction of the Yangtze river and the Grand Canal, a crucial transportation and trading Centre for agricultural goods travelling from the fields of southern China to the political Centres in the north. Consequently, Yangzhou developed as a sophisticated commercial port, culturally enriched by the patronage of traders and salt merchants who congregated within its walls. The surrounding area is flat and fertile, making it an excellent area for agriculture, and small deposits of minerals and fossil fuels have also been found (Yangzhou Nianjian, 2005).

However, industrial production in the area was limited, concerned mainly

with producing agricultural tools, small household crafts items, and food processing. Economic planners in Yangzhou in 1950 were faced with the reality that there were just “one and a half” factories of significant scale in the city - a flour mill, and a small electrical power station (interview, 2005, Yangzhou CCP college).

Compounding this lack of industrial capacity, the importance of Yangzhou as a transport and trading Centre has been in constant decline following the slow collapse and neglect of the Grand Canal and connected water transport systems. Alternative and more modern transportation links to the county were poorly developed. In 1924, when planning began for a railway line to link Yangzhou with the city of Nanjing, local farmers and residents protested against the construction. Deeply traditional, they feared the negative impact that the noise and smoke steam engines would have on the local livestock, and the project was abandoned. In 1930, another construction project, this time for a highway, was partially abandoned because of local protests. This meant that Yangzhou was bypassed by the beginning of the 20th century as a centre of commerce, since modern transportation links to Yangzhou were relatively underdeveloped, especially in terms of linkages to cities in Central Jiangsu (Zhu, 2001).

Politically, Jiangsu’s fragmented administration meant the local governments of Yangzhou and surrounding areas were in competition. Under the centrally planned economy, local governments did not need to develop co-operative ties with their neighbours, nor were they encouraged to do so. Successive political campaigns such as the Great Leap Forward encouraged competition between local governments to achieve the highest output figures, and during the late pre-reform period, local governments competed to obtain the greatest amount of budgetary slack. This has not been improved in the post reform era, where with the high degree of emphasis on

territorially based development strategies, there is a critical lack of co-operation between neighbouring governments at the local level. Even with the county of Taizhou, which was created from part of Yangzhou's territory in 1996, there is competition with Yangzhou (interview, 2005, Taizhou CCP college). This has been somewhat exacerbated by Jiangsu provincial government's proposal in 2000 to "further elevate Sunan development levels, stimulate Suzhong's rapid growth, take advantage of Subei's late development status", which has placed the cities of the Suzhong region in competition with each other to be the economic leader of the region (Yi, 2003).

Thus Yangzhou's post reform economy developed with special emphasis on the importance of local state owned and controlled firms, which were placed in competition with industries from surrounding areas. Local industrial policies, management and institutions were shaped for the purpose of achieving the highest growth rates in the area so as to reach the top of the economic league table.

It's important to be at the top of the economic growth rate table. It's published every year and regions are ranked by the speed of growth. [If you] are at the top of the table it's easier to get noticed and promoted (interview, 2005, Yangzhou Economic Reform Office).

9.3 Yangzhou's statistical data

The ancient administration of the many waterways in Suzhong served as the basis for drawing administrative boundaries, and these have remained mostly intact (interview, Yangzhou 2005). This historical accident, though useful while the waterways served their function as important trade routes, is economically divisive,

as the administrative boundaries were economically arbitrary, and foster little economic co-operation and spill over between the various Suzhong cities, as each city is politically bound to its administrative region.

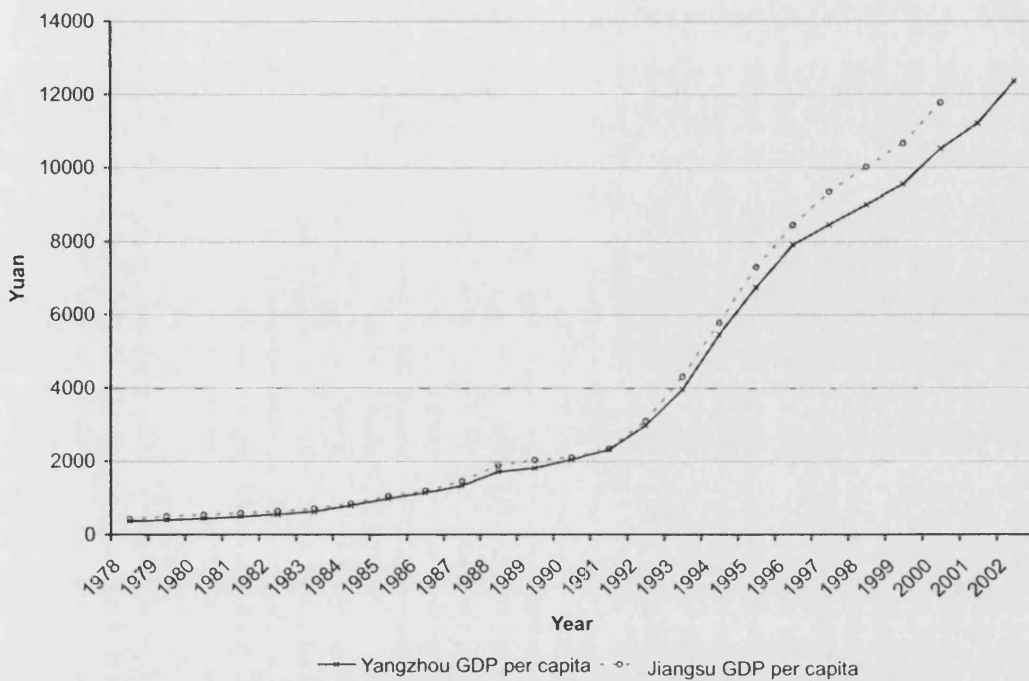
Between 1988–2002, Yangzhou’s GDP growth was one of the slowest in Jiangsu (see figure 9.1). In comparison with other cities in Jiangsu, both GDP and GDP per capita grew slower than other cities. Figure 8.2 shows that Yangzhou’s GDP per capita was roughly equal to the provincial average from 1978 until 1992, when it began to diverge. By 2000, Yangzhou’s GDP per capita (10515 Yuan) was 12% lower than the Jiangsu average (11773 Yuan).

Figure 9.1: Comparison of cities in Jiangsu, ranked by GDP per capita growth 1988–2002

		1988	1994	2002	Growth 88-02
Suzhou	Population (millions)	5.51	5.71	5.84	106%
	GDP (billion yuan)	16.51	72.09	208.04	1260%
	GDP per capita*	2995	12615.687	35733	1193%
	Area (sq. km)		8488		
Nanjing	Population (millions)	4.88	5.18	5.63	115%
	GDP (billion yuan)	13.32	46.69	129.76	974%
	GDP per capita	2728	9007.8973	22858	838%
	Area (sq. km)		6588		
Nantong	Population (millions)	7.62	7.82	7.80	102%
	GDP (billion yuan)	11.13	34.52	88.73	797%
	GDP per capita	1459	4411.5103	11356	778%
	Area (sq. km)		8001		
Xuzhou	Population (millions)	7.44	8.43	9.04	122%
	GDP (billion yuan)	8.46	31.84	79.14	935%
	GDP per capita	1138	3776.0392	8763	770%
	Area (sq. km)		11258		
Yancheng	Population (millions)	7.50	7.81	7.96	106%
	GDP (billion yuan)	8.49	22.96	67.33	793%
	GDP per capita	1132	2940.4629	8464	748%
	Area (sq. km)		14983		
Yangzhou	Population (millions)	9.08	9.36	9.56	105%
	GDP (billion yuan)	13.57	47.04	106.35	784%
	GDP per capita	1718	5021	11122	647%
	Area (sq. km)		12425		

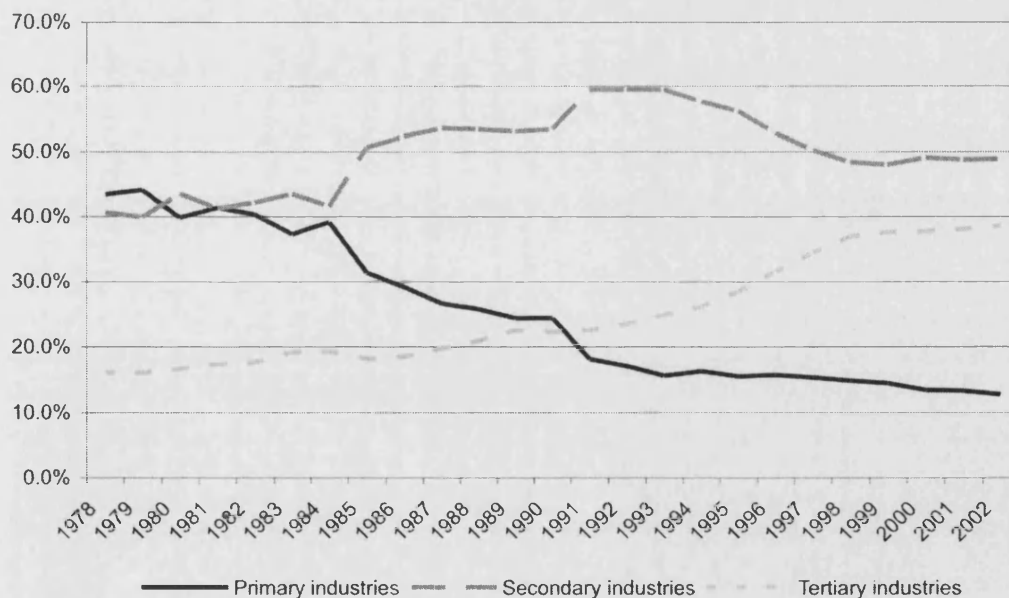
(Source: Jiangsu Statistical Yearbook 2003)

Figure 9.2: Yangzhou GDP per capita, 1978–2002



Source: Yangzhou Statistical Yearbook 2003, China Statistical Yearbook 2000

Figure 9.3 Employment breakdown by sector

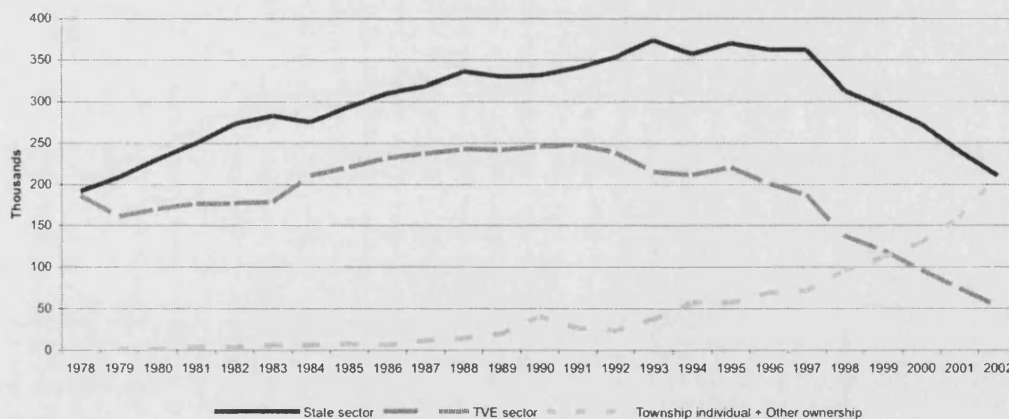


From: Yangzhou Statistical Yearbook 2003

The economic composition of Yangzhou was dominated by its primary sector until the 1980s (see Figure 9.3), with nearly 40% of GDP being accounted for by the primary sector. Although the secondary sector was also responsible for

approximately 40% of total GDP, it was composed mainly of rural industries set up in support of agricultural production, and was closely linked with agricultural activities. Only in 1984 was there a clear trend where the secondary sector overtook the primary sector. During this time, the local government was enthusiastically promoting the process of rural industrialization, and shifting labour and other resources away from the agricultural sector to newly formed rural industries. The transition of Yangzhou's economic structure can be seen in the change of GDP composition in this period, as the importance of the primary industries decline steadily while the proportion of output from secondary industries grew until 1993, then declined. Tertiary sector output has grown steadily from the start of the reforms, but it must be noted that their growth reflects primarily the ease of entry for small and new firms into the tertiary sector, rather than serving as an indicator of Yangzhou undergoing an industrial transition towards a service based economy.

Figure 9.4: Industrial employment by ownership in Yangzhou

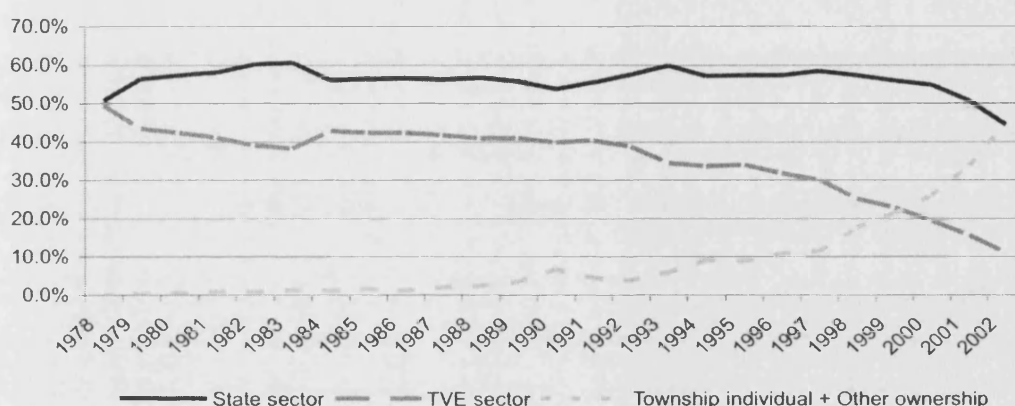


Source: Yangzhou Statistical Yearbook 2003

Examining ownership patterns in Yangzhou, it is possible to see a distinct trend in the growth of employment in both the collective and state sectors after the first phase of agricultural reforms, from 1984 onwards (see figures 9.3 and 9.4). The change in government policies on rural development shifted the emphasis towards

the development of collective enterprises rather than further expanding agriculture, and the amount spent on agricultural support, as a proportion of total government expenditure, fell from more than 25% in 1978 to just 5.2% in 1985. This shift from agriculture to rural industries signaled a period of rapid rural industrialisation, with total employment in TVEs growing from 186 300 in 1978 to 247 500 in 1991, an increase of almost a third.

Figure 9.5: Proportion of employment by ownership type



Source: Yangzhou Statistical Yearbook 2003

However, the growth in TVE employment was overshadowed by the massive growth in the state sector (see Figure 9.5). In 1978, the state sector employed 190 900 workers, over half of the total non agricultural employment in Yangzhou. By 1991, it employed 340 300 workers, accounting for 55% of non agricultural employment. By 1993, 373 500 workers are employed in the state sector, which accounted for almost 60% of non agricultural employment (Yangzhou statistical yearbook, 2003). By the early 1990s, however, there began a rapid decline in the numbers employed by both the state sector and by TVEs. Conversely, in the same period, employment in the private sector (including both private enterprises and “individual” enterprises) began to expand rapidly. From 26 600 in 1991, the private

sector employed 210 200 workers by 2002.

Thus the economy of Yangzhou was dominated by the state sector at the start of economic reforms, and the strategy for developing state enterprises along with collectively owned firms seemed to give the best of both worlds, as the collective firms remained under the influence of the local government, but operated within a free market economy, and state owned enterprises helped create a stable “backbone” of industries for local economic stability. They were less competitive than local collective firms, but under the direction of the local government, the activities of both sectors were co-ordinated in order to avoid direct competition (interview, 2005, Yangzhou Economic Reform Office).

It is interesting to note that analysing the changing economic structure of Yangzhou with employment figures alone is far from satisfactory. There is no reliable way to tell the contribution of the state, collective and private sectors to overall economic growth in Yangzhou. However, without reliable numerical data for industrial output by ownership, it is impossible to demonstrate the changing contribution of firms under different ownership types. Indeed, the lack of such a crucial piece of data is unfortunately not limited to foreign scholars alone. Even staff at the Yangzhou CCP college expressed frustration at the lack of information.

The information is there, but [the Statistics Bureau] won't release it, because they are afraid of being wrong. It also makes writing reports more difficult. If they published the actual numbers, then it's more difficult to generalise and they would have to check their figures before publishing their reports (interview, 2005, Yangzhou CCP college).

9.4 Four phases in Yangzhou's development

Yangzhou's economic development followed the course of China's move from a state economy, through collective ownership, to the creation and growth of a private economy. The Yangzhou economy's government directed development is apparent in all phases of its growth. It can be described as local corporatist state, or entrepreneurial local state. In each phase the government took different actions, creating local state enterprises, consolidating local firms, privatising local firms, and so on, but within these Yangzhou's local government remained closely connected to and in control of firms in the local economy.

9.4.1 1978–1985 Agricultural reforms and the creation of the collective economy

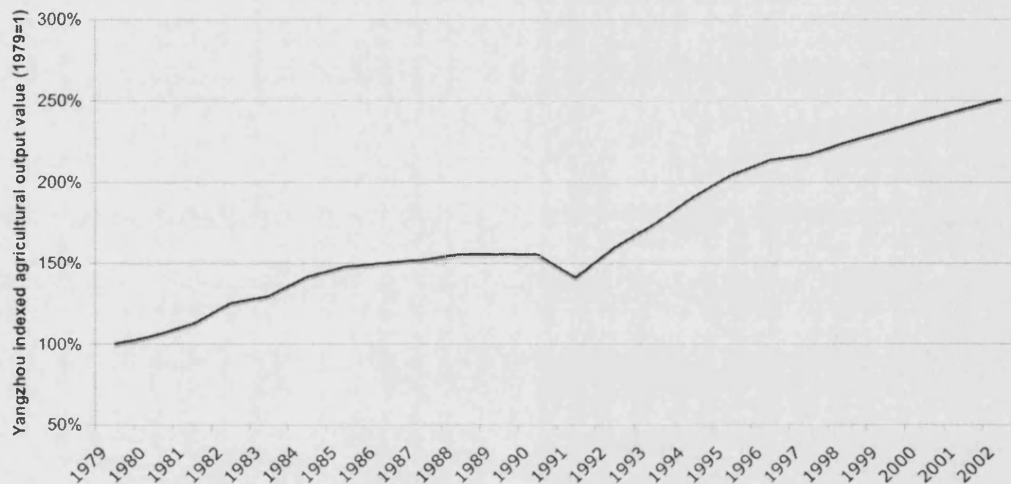
Agricultural production in Yangzhou was mainly concentrated on growing and producing rice, grains, cotton and vegetable oils, as well as specialist products such as silk cocoons. The first phase of reforms involved changes to the agricultural sector of Yangzhou's economy, especially the implementation of the household contract responsibility system. Although explicitly forbidden by the Central government, which considered it anathema to socialist values, the practice was nevertheless widespread. By 1981, when it was officially sanctioned by the Central government, some 45% of agricultural production teams in China were already dismantled and the new responsibility system put in its place (Lin, 1992a, p37).

The adoption of the first phase of agricultural reforms required only a low level of government resources and involvement, as it remained up to each household

to satisfy Central government production quotas. Once the state quota was satisfied, any surplus crops could be sold at the discretion of the farmer at market prices.

Figure 9.6 shows that between 1979 and 1984, the value of Yangzhou's agricultural production grew by 50%, almost twice as fast as the growth from 1975–1979 (26%) (Yangzhou statistical yearbook 2003).

Figure 9.6: Agricultural output value of Yangzhou (1979=1)



Source: Yangzhou Statistical yearbook 2003

The initiation of agricultural reforms must be considered in the context of the legacies left by Central economic planning, with communal farming, small holdings, low levels of mechanisation, and over staffing. Although China's agricultural policies were praised at one stage for having apparently absorbed massive numbers of unemployed through its deliberate labour intensive farming practices (Taylor, 1988), in reality under-employment and very low levels of productivity per worker were prevalent problems. As Taylor (1988) points out, it was unwise politically and economically to have a large number of workers *unemployed* in the countryside, and *underemployment* seemed preferable. Industrial development under Central economic planning depended on the production of agricultural surplus, which was then channelled into the industrial sector. The solution was to increase labour

intensity for crops, both to absorb unemployed workers, and to increase agricultural output.

The primary vehicle for accomplishing this end was to raise the labour intensity of farming by promoting multiple cropping, intercropping, deep ploughing, extensive fertilization, and expanded irrigation. [...] Recently published statistics indicate that the labour intensity of crop production did rise though 1978. [...] [A]verage annual labour days expanded per hectare in growing all major crops rose sharply between 1953 and 1978. For example, from 1953 to 1978 the labour intensity of raising rice, millet and tobacco more than doubled, the labour intensity of growing sorghum, rapeseed, cotton and hemp more than tripled, and the labour intensity of growing wheat, soybeans, peanuts and sesame more than quadrupled. (Taylor, 1988, 740–741)

Furthermore, the fixed plan prices for agricultural products discouraged individuals from increasing their production. The introduction of a system of pay according to “work units” – the amount of time worked rather than actual productivity – distorted individual incentives even further. Workers often put in the time without putting in the effort.

Everyone was paid the same everyday, to do the same work, they did not want to work harder, why should they? So [agricultural production] was very inefficient (interview, 2005, Yangzhou CCP college).

With the introduction of the household responsibility system, individual

farmers were encouraged to produce more. Once their quota for “plan production” was fulfilled, they were allowed to sell their extra produce and keep the profits. This led to increased agricultural production in the early 1980s, and farm income was increased (interview, 2005, Yangzhou CCP college). By the end of 1985, average rural income was 501 Yuan, compared with 762 Yuan in urban areas, leaving only 33% difference between urban and rural areas. The household responsibility system began to impact agricultural production in small scale, informal production.

It could be just a small back garden, a small corner of land where [the farmers] grew some extra vegetables to sell, and they would make extra income for their family. This then gradually expanded to include more land, before it [the household responsibility system] became officially approved (interview, 2005, Yangzhou CCP college).

However, the initial phase of growth in agriculture did not last long. As farmers increased their production over the state quota, their produce flooded the informal market. This resulted in a drop in the price of agricultural goods, slowing the growth of rural productivity and household incomes. By the end of 1991, the gap between rural income (941 yuan) and urban income (1621 yuan) grew to 42% (Yang & Tai, 2005).

The introduction of reforms in the agricultural sectors presented new problems. The incentives provided by the household responsibility system meant labour intensive practices were abandoned in favour of more efficient means or production, leading to underemployment and surplus labour in rural areas once again. Moreover, the surplus of agricultural goods in the local markets had begun to

depress the growth of agricultural income, leading to a slowdown of rural economic growth. This double threat to rural household income and to social stability set the stage for the next step in Yangzhou's economic development, as the local government implemented policies to develop rural industries.

9.4.2 1985–1990 Growth and consolidation of the collective sector

The reforms to agricultural production in Yangzhou had a paradoxical outcomes. On the one hand, its success raised the level of rural household incomes as well as increasing the production of agricultural goods, all with the minimal level of local government involvement. On the other hand, it became a victim of its own success, depressing local agricultural prices (the national market being difficult to access due to poor transport infrastructure) and raising the spectre of mass unemployment in rural areas.

The reduction of rural unemployment has been a long standing issue for the Central government (Talyor, 1988), as massive unemployment poses both economic and political problems for the government. Economic migration to urban areas could occur as a result of increasing income gaps and persistent unemployment in the countryside. In 1980, with 86.8% of Yangzhou's population classified as "agricultural" (Yangzhou Nianjian, 1981), the prospect of massive rural to urban migration was highly unappealing, with the urban areas unable to absorb and cope with such a large influx of rural population. Although the movement of the rural population was restricted by the household registration system, nevertheless, should the difference in living standards between rural and urban areas become sufficiently great, illegal migration could potentially overload the hard and soft infrastructure in urban areas, or else create massive dissatisfaction in rural areas. Thus rural

industrialisation was proposed as the solution so the rural population could "enter the factory without moving into the town" and "leave the soil but not the village" (Lin, 1997, p74) – industry and employment would go to the rural towns and villages.

The pre-existing network of rural industries in Yangzhou, set up under the economic plans to support agricultural production, were set up as the seeds for growing industrial activities in rural areas. The policy of rural self sufficiency under centralised planning meant that rudimentary workshops had already been created to produce basic agricultural tools and machines (interview, 2005, Yangzhou CCP college). The infrastructure was already in place to serve these industries, reducing the cost of setting up new firms. The local government also took it upon itself to play the role of entrepreneur, setting up new enterprises in rural areas, taking advantage of a series of highly favourable policies from the Central government to develop rural areas. These included tax breaks for new rural firms, for those serving the local agricultural industry and the local communities, and for small scale power plants, cement plants, and coal and iron mines. Moreover, the Agricultural Bank of China was instructed to set aside a portion of its loans specifically for rural industries (Wong, 1988, p6–7), so obtaining capital for these new projects was possible.

In the early 1980s, China's consumers still suffered from a lack of consumer goods, offering the opportunity for even relatively inefficient rural industries to profit from producing basic consumer products and selling them at the same price as those produced in more costly urban areas (Young, 2000). Thus it is not surprising that there was a massive expansion of collectively owned rural industries in Yangzhou, driven by the local government, which was in addition able to give these new firms their political support (interview, 2005, Yangzhou CCP college, 2005). Driven by the

need to satisfy the shortage economy, and by “investment hunger” – the perceived need for continuous expansion – local officials continued to borrow massive amounts from banks to fund new enterprises (Shen & Ma, 2005). While there were tax breaks given to new rural enterprises, and no remittance needed to be made to the Central government, it was possible for local government to extract revenue from these firms by imposing impromptu fees.

At the same time, the collective sector was growing rapidly all over China. With the shift in economic policies emphasising the development of light industries, collective enterprises were springing up to fill the massive “shortage economy” of China, especially in the production of consumer goods (Cao, 2000, p13). The Yangzhou local government was thus involved in creating many small scale rural firms, using its influence and connections to ease the bureaucratic process, acquire inputs, and gathering capital. The collective sector, consisting mainly of small scale firms scattered in towns and villages, were easily dominated by the local government’s influence, even though the label of “collective” ownership suggested that it was the local community which owned and operated those firms.

Jin and Qian (1998) suggest that there are three main objectives for local governments developing a strong local collective sector. First, these firms served to increase rural income, which is a key objective that China’s local governments needed to fulfil as the drivers for economic development. Second, local collective firms served to increase employment in rural areas, reabsorbing the surplus labour released by employing more efficient agricultural production methods. Finally, the relationship between local governments and the collective sector is financially rewarding for the local government, providing an additional source of revenue

income. With the tax exemption for newly formed rural firms, remittance to the Central government is decreased, while the local government was able to find various, non tax means to carry out its policy objectives. For instance, the effects of unemployment if one firm collapsed can be mitigated by transferring workers to another collective firm, although this was unpopular and simply spread surplus workers around, creating overemployment in other collective firms.

It was common for them [the Yangzhou local government] to request that we take on workers from other firms in the area. It's bad to have people unemployed, so workers are transferred around. We had to be strict and set the new workers very high targets, and only kept them if these targets were met. Otherwise our own productivity would have fallen (interview, 2005, Yangtze River Pharmaceuticals).

The growth of Yangzhou's collective sector was matched by the growth of the state sector. The creation of new firms were not all limited to the rural collective sector, and local state industries played an important part in Yangzhou's economy at this point. Local state firms, more formally and fully under the control of the local government, were directed to purchase inputs from collective firms. The aim was to allow Yangzhou's small, scattered and unspecialised industrial sector to become larger, more concentrated and specialised by serving the larger state firms (Huang, 1995), so strengthening Yangzhou's industries sufficiently to enter the national market and compete with other domestic Chinese firms.

9.4.3 1990–1998 Reforms to the collective economy

Reforms to the collective sector began soon after the period of economic

retrenchment in 1988–89, in the volatile period before and after the Tiananmen square massacre (Dittmer, 1990). Economically, the Central government was concerned by runaway inflation and an overheating economy, and it moved to severely restrict the granting of new loans by the state owned banks. This had the desired effect of reducing inflation in the Chinese economy, but the sudden lack of credit also impacted the locally based collective economy, which had until this point depended on the easy availability of loans from the Agricultural Bank of China to fund new projects and expand existing productive capacity.

With the proliferation of rural firms and the rapid creation of collective enterprises in the previous 5 years, Yangzhou faced the problem of an over-diversified economy consisting of many small scale, low tech, and inefficient firms. They were set up while the incentives given by the Central government were favourable, and remained profitable as long as China remained a “shortage economy” with economic distortions from the remnants of economic planning (interview, 2005, Yangzhou economic reform office). However, as these distortions were gradually eliminated, and as both foreign investors and private domestic firms became increasingly numerous, the inefficient firms became increasingly unprofitable. An official described the rural economy as being like a “plate of scattered sand” (*yipan sansha*) (interview, 2005, Yangzhou economic reform office). The small rural firms were difficult to manage, and vulnerable to the economic downturn, having little in reserve to endure the harsh anti inflationary measures imposed by the Central government.

In recognising this challenge to the growth of its economy, the Yangzhou government undertook the task of reforming the local collective sector, consolidating

smaller firms into larger conglomerates. It also changed its approach by concentrating its energies on developing fewer “backbone” or “fist” industries that were to carry the local economy forward. Xue (1994) explains the “Yangzhou phenomena” as follows:

The main purpose of the Yangzhou phenomena is to put effort into the nurturing and development of the large scale economics, pushing forward the restructuring of the economic structure to its advantage, to gain the advantages of economies of scale, and to increase the speed [of development] on the basis of improved efficiency (Xue, 1994, p12)

Yangzhou implemented a new development strategy, targeting key industries such as ship building, large vehicle manufacturing, cable manufacturing, textiles, chemical processing, and food processing for development (Ma, 2001). It was reasoned that the concentration of resources in a few industries will allow them to grow faster. These “backbone” industries, were also known as “*quiantou*” (fist) industries, as they were encouraged to “punch” out of the local market to become nationally competitive champions, leading the way for Yangzhou to export its products all over China, and eventually, to other countries.

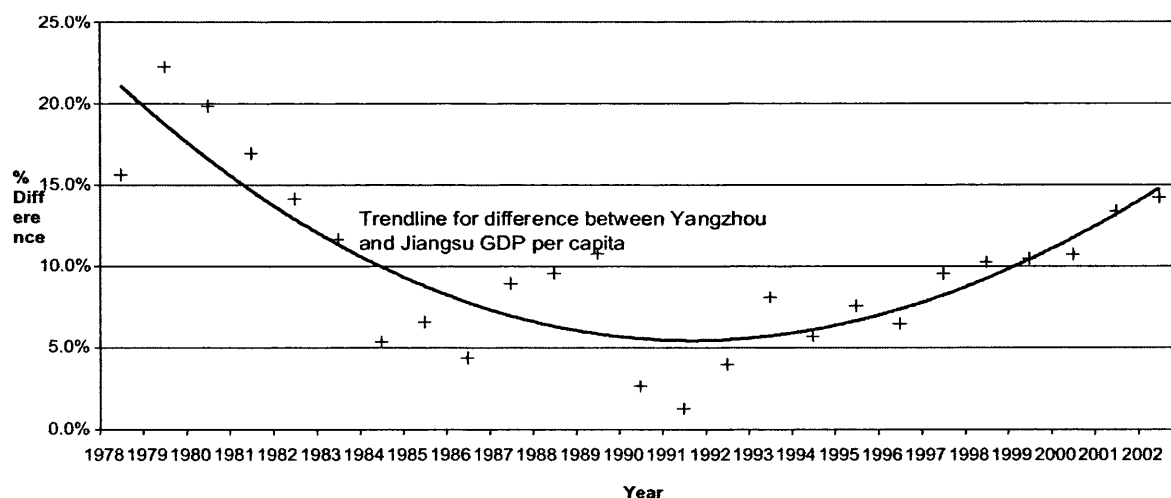
The core of Yangzhou’s economic policies in the mid 1990s was to emphasise the development of economies of scale, and to improve efficiency. This has much to do with the Central government’s retrenchment campaign, which not only denied central bank loans and grants to collective enterprises, but also once again subsumed local government authority to set up new enterprises under the authority of the State Planning Council, the State Economic Commission, and the

People's Bank of China. State owned enterprises, on the other hand, were to receive priority access to loans, raw material, energy, and transportation (Dittmer, 1990). The change in attitude by the Yangzhou government thus reflected the situation, where continuing to expand rural industrialisation and both collective and private firms was impossible, while expanding the state owned sector seemed to be an easier alternative.

9.4.4 1998–present Opening the local economy to investment

The per capita GDP growth rate over the past 5 years, 1994–1998 inclusive, placed Yangzhou just below the Jiangsu provincial average (18.4% versus 18.8%). However, in absolute terms, a gap has been growing between Yangzhou's GDP per capita and the provincial average since 1991 (see Figure 8.6). Thus even though Yangzhou's rate of economic growth matched the provincial average, its absolute GDP per capita was falling behind the rest of Jiangsu.

Figure 9.6: Difference between GDP per capita in Yangzhou and Jiangsu



Source: Yangzhou statistical yearbook 2003, China statistical yearbook 2003

Accordingly, the Yangzhou government began to review the local economy,

and the role of the state and collective firms within it. It was during this period of time that the privatisation process started to take place. At the beginning, the privatisation process was slow. In 1994, the local state sector accounted for 57.1% of all industrial employment, while the collective sector accounted for 33.4% (see figure 8.4). Total private sector employment was only 9.2% of the total. In 1998, private sector employment had grown to 17.6%, while the collective sector shrunk to 25.2%. The local state sector remained the largest employer, however, retaining 57.3% of the industrial workforce. The privatisation process only began to affect the local state sector in 2002, when it shrank to 44.4%, while the private sector increased to 44.6%. Total employment in the collective sector was halved from 25.2% in 1998 to 11% in 2003. However, it is not possible to draw a firm conclusions based on this data, as *total* industrial employment shrank in the same period, and thus the relative growth of employment in the private sector could be an effect of the decline of industrial employment, rather than being the result of privatization or a real growth of private enterprises.

Interviews with local officials revealed that the privatisation process was largely driven by pragmatic and practical considerations, especially in the case of loss making firms.

If a firm was making losses, the government will not support it. Like everyone else, the government wants to make money too. Privatising the firm, retaining “golden shares”, is a good way to make money (interview, 1995, Yangzhou Economic Development Office).

Privatised firms were either sold to management, who took on the firm’s

debts, or the firms were converted into shareholding enterprises, with the local government keeping “golden shares” – non controlling shares – in the firm. This allowed the local government to gain revenue from both taxing the firm as well as from receiving dividends from the shares. Moreover, it was emphasised that such an option was found to be ideologically acceptable, since the government retained nominal “ownership” in those firms. It was hoped that the privatised firms would stop being a drain on local financial resources and become a source of income for the local government (interview, 1995, Yangzhou Economic Development Office).

Between 1994 and 2002, private sector employment grew from 57,300 to 210,200. By 2004, private enterprises in Yangzhou employed a total of 460,000 people (Yangzhou nianjian, 2005). Currently, the local government is also making clear its support for the development of indigenous private enterprises. The document, “Discussion about accelerating ‘total liberalisation, popular entrepreneurship, popular wealth creation, creating a middle class’” was distributed in 2004, and proposed a number of policies to change local rules and regulations in order to encourage the formation of private businesses (interview, 2005, Yangzhou Economic Development Office). The main aim of the policy was to lower the barriers to entry for new entrepreneurs, decreasing fees for registration and streamlining the process for registering new small enterprises, waiving firms registration fees for those who are unemployed, loosening the regulations over household registration, and removing the fees for graduates to register and work in a private enterprise. This reduced the start up costs for small enterprises as well as the cost for private firms to hire new workers, a particularly important fact in view of the potential for the private sector to absorb unemployed workers.

This suggests that the Yangzhou local government aims to create an environment favourable for the small entrepreneur, a strategy targeted specifically at resolving the problem of rural unemployment (Yang & Tai, 2005). Ironically, officials admit that the inspiration for their new development policy was based on the experience of Wenzhou's private economic growth.

Everyone's using the Wenzhou model now. The development strategies [of China's local governments] are all converging to become service governments, serve private businesses. Everyone's going private, it's common (interview, 2005, Yangzhou economic development office)

However, there are many potential barriers to the growth of private enterprises in Yangzhou. The most critical is the lack of capital, which is the result of slower reforms in the Chinese financial sector. It remains difficult for private enterprises to obtain loans from state owned banks without intervention from officials. Loans obtained also tend to be expensive to repay, relatively small, tightly controlled, with short repayment periods (interview, 2005, Wenzhou Business Association in Yangzhou). Although the changes in regulations for new private firms may encourage more entrepreneurs to form their own businesses, there remains the problem of sustaining the growth of a firm when it required additional funding.

There is also an issue with the predominant type of private enterprises in Yangzhou, which tended to rely on the low cost of input factors – cheap land and the availability of low paid workers from neighbouring regions – to remain price competitive. There is only a low level of investment in both marketing and technology, with fewer “nationally renowned” brand names being based in

Yangzhou than in Sunan, Zhejiang and Guangdong (interviews, 2005, Yangzhou Economic Development Office). This can potentially hinder the potential for the future growth of those private enterprises when they face competition from more renowned rivals with better technology. It also raises the issue of “slash and burn” entrepreneurship, where entrepreneurs exploit the incentives given by the local government, the low cost land and labour, then shifting their activities away to another region when these initial advantages disappear (interview, 2005, Wenzhou Business Association in Yangzhou). The presence of labour intensive, low cost, low tech firms may solve the unemployment problem in the short run, but without developing deeper linkages with the local economy, there is the risk that the local economy remains predominantly the low tech, low cost, and thus easily replaced if another source of cheap labour becomes available elsewhere in China.

The issue of creating economic linkages also applies to the most unambiguous change to Yangzhou’s economic development strategy, that of attracting foreign investors. Between 2000 and 2002, the total amount of utilised FDI in Yangzhou grew from US \$92.22 million to \$462.99 million (see figure 9.7) Yangzhou’s share of FDI as a proportion of the provincial total also grew from just 0.6% to 6.3% between 1999 and 2002 (see Figure 9.8).

Figure 9.7: Comparison of FDI in Yangzhou and Jiangsu

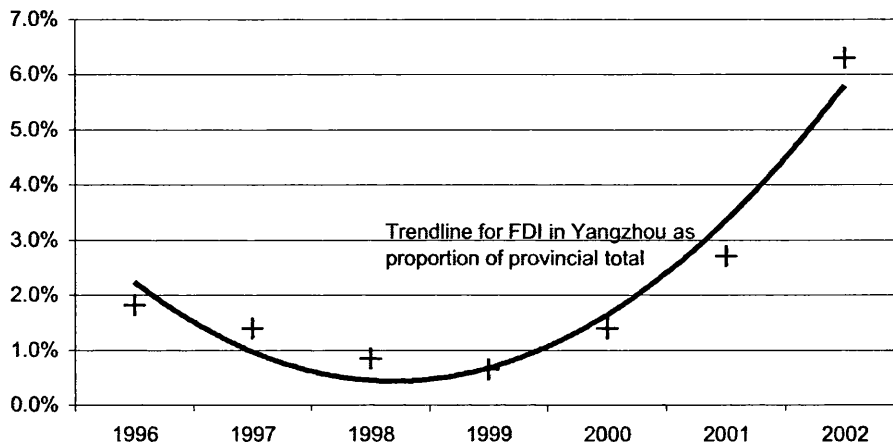
	1996	1997	1998	1999	2000	2001	2002
Jiangsu total FDI (USD millions)	5502.92	5287	6956.62	6640.23	6595.1	6785	7352
Yangzhou FDI	99.85	73.71	58.94	42.48	92.22	183.71	462.99
Yangzhou FDI as proportion of provincial total	1.8%	1.4%	0.8%	0.6%	1.4%	2.7%	6.3%

Source: Yangzhou statistical yearbook 2002, Jiangsu statistical yearbook, 1999, 2000, 2002

The shift in direction – from developing large, indigenous conglomerates, to

attracting outside investors and building development zones – coincides with the transfer of Lee Jianje, the former mayor of Kunshan, to becoming the party secretary in Yangzhou.

Figure 9.8: Yangzhou FDI as proportion of provincial total, 1996–2002



Source: Yangzhou statistical yearbook 2002, Jiangsu statistical yearbook, 1999, 2000, 2002

The extraordinary success of Kunshan’s economic development relied on its ability to attract domestic and foreign investors, many of whom were from Taiwan. Kunshan, located in the Sunan area next to Shanghai, was an economically backward area. Unlike neighbouring regions, Kunshan did not adopt the “Sunan model” of development through promoting TVEs. Its economy was dominated by agriculture at the beginning of China’s reforms, and it did not benefit from the burst of growth experienced by TVEs in the 1980s (Yehua, 2002). However:

In 1984, with the shift of emphasis of the reforms to urban reform and open-door policies, *the new leadership initiated economic and regional planning that set ambitious targets*. [...] A major strategy to reach these objectives was the decision to establish “Kunshan Economic and Technological Development District” [...] in the eastern part of Kunshan Town (Yuhua, 2002, p1731, emphasis mine)

As the change in leadership is decided by higher levels of government, the appointment of new leadership usually signals a change in the attitudes for the local government. The spectacular success of Kunshan, which attracted US\$500 million of investment in 1998 demonstrated that it was possible – indeed, it was critical – for local governments to positively affect the direction of local economic development. The appointment of Lee suggests that the new economic strategy is to concentrate on attracting FDI into Yangzhou.

The critical element in Yangzhou's new development strategy is its openness and outward orientation. Compared with the local corporatist approach to development, shaping Yangzhou as a destination for investment signifies a change in Yangzhou's government, which now emphasises the need to provide service to businesses, rather than maintaining managerial control and ownership over local firms. Moreover, the emphasis has not just been on foreign investors, it includes domestic investors as well. One of the main investment sources in Yangzhou comes from Zhejiang, to the south. The investors are mostly small and medium scale private industries, expanding from Zhejiang's well developed private economy. Among the more prolific entrepreneurs are those from Wenzhou. The interviews in Yangzhou suggested that these entrepreneurs tend to be those who have had trading relationships in Yangzhou in the early 1980s. Specifically, many came over as a result of the textiles and clothing industries in both Wenzhou and Yangzhou (interview, 2005, Wenzhou Traders Association). The evolution of this trading relationship is highly symbolic of the difference in the development of the two cities, with small traders in Wenzhou first arriving in Yangzhou to sell to the local collective firms, then becoming investors themselves and moving their business to

Yangzhou altogether.

Yangzhou provided two main advantages for investors from Wenzhou: lower land cost and cheap labour. Land cost in Yangzhou cost only 1/20th of that in Wenzhou, and rural workers from Northern Jiangsu provide a readily available pool of cheap labour (interview, 2005, Wenzhou Traders Association). Thus many of the workers in the new industries are migrants from the poorer regions of Subei, Anhui and surrounding areas. Local Yangzhouese workers employed in the factories are, by contrast, in the minority, and they demand higher levels of pay than the migrant workers (2005 interview, Wutinglong International Toys Presents City).

Thus the question arises of the potential benefits that accrue to Yangzhou from pursuing outside investors to develop its economy. Yangzhou's 11th five year plan, starting in 2006, emphasises that Yangzhou "take a further step towards openness", and that the use of foreign investment was to be both "deepened and broadened", while more effort is to be concentrated on attracting investors (interview, 2006, Yangzhou development office). It is hoped that the flow of foreign investment would stimulate indigenous firms in the local economy. However, even in describing its plans for developing the private sector, the use of outside investment is highlighted as a critical component.

9.5 The role of Yangzhou's local government in economic development

A cursory examination of Yangzhou's economic history suggests that the local government has adopted a number of development strategies. A summary of the dominant strategy in each of the 4 phases is presented below (figure 9.9).

Figure 9.9: Summary of Yangzhou's development experience in 4 phases

		Phase 1, 1978-1985	Phase 2, 1985-1991	Phase 3, 1991-2001	Phase 4, 2001-present
Key development strategy		Agricultural reforms	Creation of strong collective sector with credit from Agriculture bank	Development of scale economy in key industries	Liberalisation of local economy, opening to outside investment
Industrial changes		Introduction of household responsibility system increase agricultural production	Numerous small scale light industrial producers in rural areas	Consolidation of collective sector, start of privatisation process	FDI and domestic investors
Relationship with local firms	State sector	Transfer of ownership to local government	SOE remained strong, especially supported by local collective sector, employing 55-60% of total industrial workforce, until beginning of decline in 1997		Decline in importance + privatisation
	Collective sector	Mainly small scale industries in rural areas	Growth in new collective firms in rural areas	Creation of large conglomerates from mergers	Decline in importance + privatisation
	Private sector	Mainly small <i>getihu</i> firms in service sector (restaurants, hairdressing etc)		Some larger, <i>siying</i> firms emerge from privatisation process	Investors create larger <i>siying</i> firms. Local entrepreneurs remain in <i>getihu</i>
Developmental mode of local government		Transition away from state development policies	Entrepreneurial, driving the creation of new rural firms and industries	Corporatist, managing the collective sector and mergers between firms, balancing profit and loss	Developmental. "Service government" (<i>Fuwu zhengfu</i>) for investors and local businesses

Source: Own elaboration

In each phase, the Yangzhou local government adopted a different development strategy in response to changes in the economy. In phase 1, the agricultural reforms introduced the household responsibility system, allowing farmers to sell surplus crops to the market. At the same time, the relationship between the Yangzhou government and firms in the state, collective and private sectors changed due to economic reforms at the national level. SOEs were transferred to local government control, and their development and consolidation with collective enterprises became the basis for the next phase of Yangzhou's development policy, carried out with the aid of credit from the Agriculture bank.

In phases 1 and 2, the private sector remained small and neglected, until the start of privatisation in phase 3. Nevertheless, Yangzhou's development policies continued to concentrate on developing scale economies in key industries in phase 3. Developing SOE and collective firms continued to be the focus of Yangzhou's

economic policy, until the start of phase 4. By 2001, the focus of the government switched from being intimately involved in the management and direction of the local economy, to one of being a “service” government, ostensibly more concerned with fulfilling the needs of local businesses than in running local state enterprises. This is a radical departure from Yangzhou’s previous approach to economic development, and in exploring the role of Yangzhou’s local government, this serves as a useful marker for the transition of the local government from a corporate mode of development to a more developmental mode.

Through the 4 phases, Yangzhou’s local government slowly shifted its mode of development and focus. Starting with the agricultural reforms, the local government began to implement policies as the planned economy was dismantled. By 1985, the Yangzhou government became increasingly entrepreneurial, developing an economy based on the local state sector and supported by the collective sector. This persisted until 2001, with attempts to create large conglomerates and to balance profitable firms with loss making firms through mergers. However, even before the start of phase 4 in 2001, some privatisation took place, and the private sector, along with outside investment, became increasingly important as the local state and collective sectors declined. At this stage, the local corporatist government became a “service government”, assisting private firms in lieu of managing firms in the local state sector.

9.6 The local government as corporate manager

The role played by Chinese local governments has been compared by Oi to that of the board of directors and managers in a corporation (Oi, 1992, 1995, 1999). The local government, as the highest authority in the local political economic

structure, is placed in the position of being both managers and directors of firms in the local economy. It is possible to frame the four phases of Yangzhou's development in this view, with the local government taking on various roles as the economy evolves, much like a firm growing. Figure 9.10 charts the evolution of Yangzhou's local government in relation to Yangzhou's economy as if it were a corporation. Indeed, the strategy of the local government through the thirty year period seems to reflect the phases of growth of a firm, being set up, consolidated, merged, and then privatized. Thus the strategy of the local government mirrors the linear progression from state to market, from state to collective to a private economy.

Figure 9.10: The changing relationship of Yangzhou's local government and local enterprises

	Phase 1, 1978-1985	Phase 2, 1985-1991	Phase 3, 1991-2001	Phase 4, 2001-present
	<i>Transition</i>	<i>Entrepreneur / Manager</i>	<i>Corporatist "board of directors"</i>	<i>shareholder</i>
Government role	Transfer of ownership and management rights of SOEs to local government, greater scope for development	Government officials directly involved in creation and management of collective firms	Management parcelled out / contracted to managers, local firms merged together to create "scale economies"	Privatisation of firms and distribution of shares, "golden shares" kept by government
Evolution of economy	Agricultural production dominant, with small scale rural industries and few large industries	Many new collective firms created, many in rural areas. Ownership and control of SOEs transferred to local government	Merger of collective firms, creation of "scale economy" with government directed co-operation between state and collective sectors	Decline of state and collective sectors, rise of private firms and foreign investment

Source: Own elaboration

Within this framework, the local government may control the management of local firms in many different ways, through both informal and formal channels, as well as giving rise to the possibility of ambivalent relationships such as clientelism. The local government may also engage in more negative relationship of corruption by either individual officials or by entire government departments:

Local collective enterprises, which in many instances received either part or full initial financing from the local government, often bear the brunt of the [illegal] charges. They have become milk cows for local agencies. Usually, the better the enterprises fare, the more payments are demanded. (Lu, 2000). The private sector is

affected by corruption as well:

To small private businesses heavy charges of all kinds from government agencies have become a major source of discontent [...]. As a result, many have become reluctant to expand their businesses, and some have even folded (Lu, 2000, p286).

In Yangzhou, there seems to be a difference between the role of local state firms, and private enterprises. More resources were allocated for the creation and sustenance of the local state sector than for promoting and facilitating the growth of the private sector. As Lu (2000) suggested, local state enterprises are an important source for local government income, which is kept off official records as extra-budgetary income, and received more political support from the Central government during the economic and political retrenchment of the early 1990s (Dittmer, 1990). Lu's (2000) exploration of organisational corruption in local governments suggests that these activities could be seen as the local state, or departments within the local government, acting as a kind of entrepreneur:

The role of the Chinese state, though sometimes facilitating growth, is not as positive and "developmental" as many have perceived. It may be described as "entrepreneurial," though not in the way some scholars have understood this term. It is entrepreneurial because the state (as in state agencies) is involved in profit-generating activities by seizing opportunities provided by the reform. I prefer to call its "bureau-preneurialism," for it has a predatory dimension involving government bureaus and bureaucrats. (Lu, 2000, p274–275)

Seen from the point of view of the Central government, this “entrepreneurialism” is at odds with the prescribed objective of developing the local economy. This activity adds to the cost of transactions for local firms, engenders mistrust in the local bureaucracy, and also compromises the rule of law. However, it is entirely possible that the local state “entrepreneur” sees it in a different light. Viewing the local government and local economy as a corporation, there is the question of profit distribution. The investment and management of firms generates a very tangible benefit for the local government, and there is thus an incentive to maximise this income. Developing a successful local state run economy is one possible way to achieve this objective. Extra income generated by a growing state sector leads to additional income from taxes and fees.

However, the development and growth of the local economy and the objectives of an “entrepreneurial” local government are only partially aligned. Local economic growth *per se* only benefits the local government (in terms of its revenue) when the local government has the capacity to extract rents from that growth. In the context of the gradual reforms in China, this meant that as parts of the planned economy were phased out, the newly liberalised parts, acting in accordance to their new imperative to maximise profits and income, would seek to exploit the remaining price distortions implicit in the planned system for their own benefit (Young, 2000). There is then the incentive to protect these new sources of rent in order to preserve them, even as the initial cause (remnants of the planned economy) are removed through further reforms, thereby creating a new source of distortions in the local economy.

This is particularly relevant in an area such as Yangzhou, with its dependence on the state economy. The powerful influence of the state economy over local economic activities gave rise to many opportunities for those industries freed from planning constraints to exploit remaining distortions in the economy. The existing political economy means that the rent from this exploitation accrues to the local government, which has an incentive to preserve the status quo in order to continue to benefit from the additional income. This could be detrimental to the local economy in the short term, as resources are allocated to firms that may be inefficient, but are protected against competition by the local government. In the long term, attempts to preserve the distortions may stifle much needed reforms in the local economy, and also may lead to behaviours that are ultimately unsustainable and harmful to the local economy as a whole.

Young (2000) argues that much of the effort expended in the earlier economic reforms simply devolved industrial ownership to the lower tiers of local governments. Although at first this may seem similar to the devolution of the responsibility for promoting economic growth, it has instead had the effect of creating vested interests within the local government at the cost of overall economic benefits to the local economy.

Oi (1992) argues that the extraction of profits from the local state enterprises is a part of the cycle of investment and growth. She argues that to view these as the actions of a predatory state neglects to take into account the way that this income is redistributed, in furthering the growth of local industries through short term and long term loans and investment, made more necessary because of an unreformed fiscal sector and the lack of locally available credit. In short, not only is this behaviour not

predatory, it is a natural and necessary part of the local corporatist system.

Nevertheless, as we examine the case of Yangzhou's economic development, from the initial burst of setting up new collective firms, to the subsequent consolidation of the state and collective sectors, it becomes more difficult to apply Oi's arguments. If predatory behaviour – including the natural revenue extraction that is expected to take place in a local corporatist system – is beneficial to the local economy, then an alternative reason needs to be found to explain Yangzhou's poor economic performance.

It is possible to suggest that Yangzhou's poor economic performance is due to the local government being a poor entrepreneur. Individual local state firms may be under private management, bringing in some of the advantages of the private market, but the ownership and ultimate control over the appointment of managers and the disposal of assets remain firmly in the hands of local governments. Oi (1992) points out what this means:

The contract responsibility system charges factory managers with the burden of running the factory efficiently and profitably – but with only limited control over factors of production. Those who lease collective factories are dependent on higher executive management (that is, the local officials who are sometimes, concurrently, the chairman of the village's largest industrial corporation) to make key decisions. Where the factory manager may make suggestions about personnel, development, investment, and product line, the implementation of these changes and programs require official approval. Factory managers

who make good suggestions or happen to run the factories targeted for development or expansion may receive large bonuses, *but the engine for change and development is local government* (Oi, 1992, p92, emphasis mine).

The extraordinary process of China's economic transition had placed local governments in the position of becoming entrepreneurs in their own right, and Central government policies gave them the necessary incentives to do so. They also enjoyed economic and political advantages in the initial stages of the reform specific to its position as the local government. However, China's local governments were not designed to conduct business. Their obligations extended beyond the need to maximise profits, and thus their decisions in terms of managing individual firms, as well as directing the entire local economic "corporation", might not achieve or aim for profit maximisation. Their policies may easily come into conflict with the interest of the individual firms under their control.

9.7 Conclusion: Yangzhou in transition

Yangzhou's local government was heavily involved in the progress of its economy from a state planned economy toward a more open market economy. Through the ownership and management of local firms, applying industrial policy to develop specific sectors, and finally adopting the privatisation process, Yangzhou's local government played the role of a local corporatist state. Viewing Yangzhou's local government and local economy as a corporation is useful in framing the various phases of its local development. When considering its ability to manage the local economy, however, the critical point to consider is that unlike a corporation, Yangzhou's government had more obligations and conflicting interests than a profit

maximising corporate entity. Its behaviours are also governed by different rules and regulation, as the local government is subject to the dictates of provincial and Central government policies.

In the long run, the continual involvement of the local government proved to be detrimental to the growth of those firms under its control, and to the growth of the local economy as a whole. The targeting of specific industrial sectors for development was due to the government's perception that those sectors made the best "national" and "international" champions, based on the local government's desire to create a "scale economy", where the development of large scale industries would provide the region with access to larger domestic and international markets. However, this concentration of resources and deliberate neglect of the development of other sections of the economy that had possibly greater potential for growth meant that growth in Yangzhou's private sector was stunted. Even in 1998, 20 years after the Central government initiated reforms, Yangzhou had less than 15% of its workforce employed in the private sector (Yangzhou Statistical Yearbook, 2003). The local economy remained dependent on the state owned enterprises for employment and growth, both of which hindered the efficient operation of the firms. The conflicting objectives of the local government – to maximise their own revenue, to maintain the level of employment in the state enterprises, to use the firms in directing the local economy on the one hand, and the desire to promote growth on the other – arguably contributed to a reluctance to reform, and a slowness to reform the local economy.

The effects of continued local government involvement has also stifled the development of local institutions, necessary to allow the local economy to function

with less government involvement. The relationship between internal government departments could be confusing, but legally they exist within the same framework, and disputes and disagreements can be resolved by appeal within the apparatus of the local government (interview, 2005, Yangzhou CCP College). However, with the development of a market economy, communications and disputes between the management of different firms no longer pass through government channels, and there is the need for new institutions in order for them to function. These institutions remain under government control and scrutiny, as business associations are required to have a member of the board appointed by the local government. The local government is also slow to allow new associations to be created. For instance, investors from Zhejiang, one of the largest group of domestic investors in Yangzhou took two years to set up their new local trade association (interview, Yangzhou CCP college, 2005).

Changes in the direction of Yangzhou's development suggests that the local government is moving from local state corporatism towards a more developmentalist strategy, with lower levels of direct involvement in the local economy. The process of privatisation freed local collective and local state firms from the managerial control of the local government, eliminating most of the structure of a local "corporation". This was a parallel process, of the local government moving from corporatism to developmentalism, and of local firms moving from state and collective ownership to private ownership.

Chapter 10: A comparison of the local economic development methodologies in Wenzhou and Yangzhou local governments

10.1 Introduction

A comparison of Wenzhou and Yangzhou's development process reveals two local governments that have adopted very different approaches to local economic development through China's economic transition. These differences have been summarised in table 10.1.

Figure 10.1: Characteristics of Wenzhou and Yangzhou local governments

	Wenzhou	Yangzhou
Developmental typology	Developmental, clientelistic	Entrepreneurial / Corporatist, clientelistic
Development aims	Economic growth imperative	Political development incentive
Political situation	Isolation from Central government Non compliance with Central government ideology	Accessible by Central government Structural compliance with central government policies, adapting new Central policies as they emerge
Development strategy	Passive Bottom up, grass roots Market driven economy Low levels of intervention in activities of firms	Active Top down, industrial policy Policy driven economy Direct management or indirect intervention in management of firms

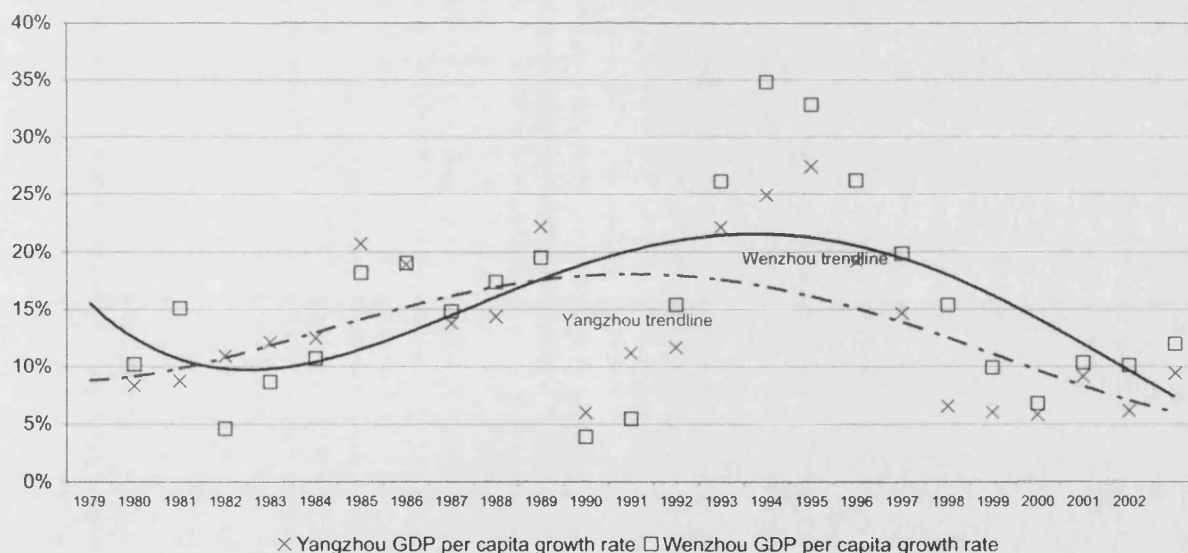
Source: Own elaboration

Figure 10.1 suggests that both politically and economically, the two localities differ from each other. The patterns of development differed in terms of how the local governments were involved in the development of the economy, and it seems to be a simple task to assign each government their mode of development. Wenzhou's passive, *laissez-faire* approach throughout the post reform period indicates that it is a developmental local government, while Yangzhou's involvement in shaping industrial policies and managing local firms shows that it adopted an entrepreneurial

and corporatist approach to development.

Wenzhou and Yangzhou both enjoyed periods of economic growth, and this could be attributed to the different types of economic strategy adopted by their respective local governments. Wenzhou's developmentalism was stigmatised in the early years of China's economic reforms, but became increasingly mainstream as China's economy moved toward a free market. Yangzhou benefited from the advantages of interventions by the local government, which was politically approved, but inefficiencies in its economy were revealed when it came into competition with private sector firms from the rest of China, forcing a change in Yangzhou's development strategy. The pattern of their growth rates can be seen in figure 10.2.

Figure 10.2: Wenzhou and Yangzhou GDP per capita growth rate



Source: Wenzhou Statistical Yearbook 2003, Yangzhou Statistical Yearbook, 2003

Yangzhou had a higher GDP per capita (363 Yuan) than Wenzhou (238 Yuan) in 1978 (Wenzhou Statistical Yearbook 2003, Yangzhou Statistical Yearbook, 2003). Plotting a trend line through Wenzhou and Yangzhou's GDP per capita growth rate (figure 10.2), it can be seen that Yangzhou also enjoyed a faster growing economy than Wenzhou for the first ten years after reforms began. However,

Wenzhou's growth rate overtook Yangzhou in the early 1990s, by 1997 Wenzhou's GDP per capita (8553 Yuan) overtook that of Yangzhou (8455 Yuan).

10.2 Political incentives versus economic necessity

The fiscal incentive given by the Central government to encourage local economic development (see chapter 4) was one of the key motivators for local governments to concentrate their efforts on their local economies. By forcing local governments to utilise their own resources and allowing them to keep the rewards, areas where the potential for economic growth was stifled by Central economic planning were freed from the tether. The difference in the speed of development was recognised as China was divided into three belts (east, central and west), allowing each belt to specialise and also allowing the “ladder step” effect to take place – as the eastern region grew, it would spread its wealth to the central and western regions (Fan, 1995). However, the incitement to grow economically sometimes resulted in economically harmful activities, such as local protectionism, the creation of over capacity in a single industry, lack of economic specialisation, and so on (see chapter 1).

Nevertheless, the drive to achieving economic growth was strengthened by the prospect of promotion for successful officials, as well as through the use of “league tables” to compare the performance of different regions. Officials in each region would strive to be at the top of the performance league, thus introducing a strong element of competition between different regions.

For the Yangzhou government, this type of official competition is very much in evidence. In an informal interview with local government officials, when asked

about the economic performance of the local government, it was admitted that the economic performance as recorded in statistics were “full of water” (ie, they were inflated) – this was considered to be common practice. Indeed, one official said the current policy in evaluating local economic performance was to use the local government’s own revenue and budget figures instead of the measurements of GDP because GDP figures were known to be unreliable. It was explained that the pressure for promotion was the main cause for “adding water” to statistical indicators (interview, 2005, Yangzhou CCP College).

The political aspect to Yangzhou’s economic development can be seen in how cautious it was in creating, maintaining and reforming its local state sectors. By avoiding changing its local economic structure, Yangzhou’s local government avoided the potential short term costs (including unemployment) that would have resulted from privatisation and closure of its more inefficient local enterprises. This also meant that the local government could continue to extract its revenue from the local state sector. However, the inefficiencies in this system became more and more apparent as China’s national economy shifted towards a free market approach to growth, while shedding the last vestiges of the planned economy, which the collective sector exploited for their profit. Nevertheless, the political incentive of maintaining economic growth (or at least avoiding economic pain) meant that no major changes were made to the Yangzhou economy.

Indeed, Yangzhou’s real economic transformation, in the last phase of its development from the late 1990s came as the result of political change. The appointment of Li Jinji to the local government was followed by a period of reforms to the entire local economy. The local state and collective sectors were rapidly

privatised, and Yangzhou began to attract investors domestically and internationally. Moreover, growth in the private sector was encouraged, boosted by the privatised state and collective enterprises. It can be argued that this shift in leadership gave sufficient impetus for Yangzhou's local government to shift its development approach, rather than continuing on developing the flagging local state economy.

Aside from the political competition for promotion, a more pragmatic reason for local governments to strive for rapid economic growth is the growth in their local budget revenues. With China's fiscal reforms (beginning in 1980), the revenue and expenditure of local government budgets were decentralised and became increasingly dependent on the ability of local governments to collect taxes from the local economy, giving local governments an incentive for achieving rapid economic growth rates in order to increase the potential amount of taxation, and hence the amount available to the budget. There was, however, also a perverse incentive to concentrate on the development the most taxable sectors and the firms from which it is easiest to extract rents for the local budget. Moreover, both legal and illegal means were used to extract rent from the local economy. The involvement of the local government as an entrepreneur in the local economy seems to be a logical extension of this, since this then lends more legitimacy to the local government to extract its revenue from the firms under its control. Yangzhou's entrepreneurial government was thus politically expedient, and also made fiscal sense.

Wenzhou differs from Yangzhou in that it was politically isolated from the Central government. The area is linguistically distinct, historically independent, and has a strong local cultural identity, insulating Wenzhou from Central government authority (Parris, 1993), while poor access due to primitive transportation links to

and from the region until relatively recent times meant monitoring and controlling the area was particularly difficult.

This isolation gave Wenzhou a greater amount of flexibility to implement development policies, which may be deviant from what the Central government would otherwise allow. However, the political flexibility must be seen also in terms of its economic impact. Wenzhou's location on the coast was also considered to be "vulnerable to attack", and thus major industrial projects were not planned in the area. Government investment in infrastructure was equally sparse, resulting in a weak industrial structure in Wenzhou.

Thus the ability of the Wenzhou government to implement the Centre's policies was curtailed by the lack of Central government support, politically and economically, leaving the local government isolated in dealing with the issues of local economic development. Without a firm industrial foundation on which to base its development, Wenzhou also resorted to agricultural reforms, albeit prior to 1978, when China's national economic reforms began. One local government official lamented that Wenzhou's (covert) implementation of the household responsibility system pre-dates those in Anhui, even though the latter is often trumpeted as the first official example of agricultural reforms in China (interview, 2004, Wenzhou economic reform office).

The economic weakness of Wenzhou plus its political isolation created massive pressure on the local economy, creating a black economy that was seen as problematic by the Central government. Ironically, this capitalist tail was not removed, but encouraged to flourish by local officials, who, being unable to give

material support, instead lent their political support to the businesses. The Wenzhou local government's contribution to the development of its local economy was to provide it with a political shield with which to defend against the predominant ideology of socialist economic development. The opposition from the Central government was such that local government officials, including (or especially) those appointed by the Central government, faced demotion and transfers for supporting so controversial a method of development as using the private sector. Ownership through shareholding, creating networks of private money lenders, and so on were all critical components in Wenzhou's development. Thus in contrast with the political *incentives* for economic development in Yangzhou, Wenzhou's local government faced a political *disincentive* for developing their economy in the way they did. In allowing the local entrepreneurs to pursue their business, Wenzhou became a developmental government, formulating the environment in which the private sector would grow, rather than managing the firms or setting particular industrial policies.

However, it is then necessary to consider why this course of action was pursued despite the political risks it entailed. With few options for local economic development, and with private development so heavily discouraged, it was entirely possible for Wenzhou to become a failed local state. Indeed, in terms of its actions, it could be considered at least a *dysfunctional* local state, from the point of view of the Central government, as it failed time and time again to heed the demands of the Central government to desist its pursuit of private economic development. Nor was the altruism of local officials a sufficiently strong explanation for the actions of the local government, otherwise the development of private enterprises would only take place where local officials were altruistic. To assume that officials in Wenzhou are all equally altruistic seems unrealistic, and raises the question of why Wenzhou's

officials happen to possess high levels altruism.

This frames the economic imperative of the local government, which is proposed here as the reason for Wenzhou's economic development path. The economic reasons for developing private enterprises are clear: failed local state enterprises, with low levels of resources available to develop them or the local infrastructure, means that the local government did not possess sufficient resources on its own to bolster the state sector. Despite political incentives for local government officials to conform to national guidelines on developing a socialist economy, and the threat of political punishments for adopting non-conformist policies, the local government simply had no choice other than to allow the growth of the local private economy, or else it would preside over economic stagnation in its jurisdiction. Somewhat ironically, this would then fail both the political and economic imperatives, since an undeveloped economy is unlikely to improve the chances of promotion, regardless of the degree of compliance with Central government directives. Becoming a developmental local government was both low cost – thus avoiding for the local government the problem of where to find additional resources for developing the local economy – and a good use of the human capital that Wenzhou managed to accumulate through its large, mobile population. Wenzhou was already in possession of a functional black market. Once regulated, this would provide the local government with a source of revenue that was previous denied it due to the “illegal” and thus unrecorded nature of private transactions. Legalising these transactions is thus a highly effective way to tap into an economic potential.

It is also necessary to consider the close social network and ties between Wenzhou's officials and the local population. Here the issues of clientelistic

behaviour and corruption are encountered, one being an almost essential component in the private sector–local government partnership, the other being far less desirable, but nevertheless an almost inevitable result of the close and informal nature of government – business relationships.

The culturally isolated nature of Wenzhou has also given rise to the development of very dense social networks within the area, between individual and families and especially between Wenzhou and its diaspora. The desperate economic conditions and over population drove the migration of many Wenzhouese to elsewhere in China and all over the world, but these foreign communities have maintained close links with home. The development of trust, between individuals and groups of individuals, is important, for local traders depend on each other to maintain their informal, verbal contracts to fulfil their obligations. The presence of this dense, informal, trust based network extends into the local government, where a relationships with a government official was particularly valuable. In turn, the officials gain personally out of the relationship, making the process reciprocal. Thus Wenzhou's developmental approach to fostering economic growth benefits the government at two levels – through increased revenues on the organisational (local government) level, and through social networking at the individual level (for individual officials).

The differences in the development path taken by Wenzhou and Yangzhou can be explained in light of the differences based on the local economic and political imperatives. Yangzhou's entrepreneurial approach to managing the economy stems from its politically structured incentives to pursue economic growth in competition with surrounding neighbours, and like an entrepreneur, it was encouraged to

implement actions with short term gains, or to minimise short term losses. Wenzhou, on the other hand, engaged the Central government on political terms to develop its local private economy, for economic reasons. The political structure acted as a disincentive for local officials to toe the Central line. Thus its behaviour was mainly political, in aiding the local private sector, although its motivation stems from chiefly the economic pressure to develop and grow the local economy.

This brings up the fascinating dynamic of the relationship between local governments and local firms. Each relies on the other to fulfil essential functions. In turn local firms and local government develop relationships, particularly in the absence of formal frameworks and regulations in the aftermath of economic reforms. These informal relationships, it will be argued next, are also essential in shaping the development strategies of the Wenzhou and Yangzhou local governments, even though each government had a different relationship with local firms.

10.3 Informal relationships with local firms

The relationship between firms and local governments was outlined in chapter 4. Firms could fall under direct control of the local government (as in Yangzhou's entrepreneurial, corporatist approach), or they created informal links with the local government through social networks and unofficial channels. The constant changes in economic reforms means that in order to find a degree of stability in the midst of shifting regulations, firms found it useful to form informal relationships with the local government, or with individual local officials (Wank, 1996). The relationship with local officials could determine the success or failure of a firm, as the manager of the Yangzejiang Pharmaceutical company points out:

[Our chairman] took this company and expanded it into the largest pharmaceuticals firm in Jiangsu. It became larger than Jiangsu Pharmaceutical [a rival, state supported firm], but he was removed from office because he disagreed with local officials and would not do as he was told. That was in 1991. By 1993, profits from Yangzejiang had declined to one tenth of their former level, but the officials refused to reappoint [the chairman] until 1997 (interview, 2005 Yangzejiang Pharmaceuticals)

Yangzhou's collective sector, developed during the second phase between 1984 and 1991, fell under the control of the local government, directly and indirectly, through ownership or through management, with Yangzhou's government retaining the right to appoint managers. As can be seen in the example above, a bad relationship could result in managers being removed, despite having achieved good growth rates. Aside from being critical in appointing managers and acting as the "board" for local firms, the local collective sector also depends on the co-operation of the local government to obtain access to information, bureaucratic support and so on, while the local government benefits from being able to use the local collective sector to fulfil its policy objectives.

Unlike the "hands on" approach taken in Yangzhou's development, Wenzhou's economic growth depended entirely on the local government protecting local firms from the political pressure of the Central government. Without this protection they would not have been able to operate. Moreover, the local government's introduction of innovative forms of ownership – the "rural co-operative shareholding ownership" in 1987 and the "private shareholding co-operatives" in 1988 (Ma, 1998), for example – were attempts to both disguise the

“private ownership” content of local firms, and also to enable private entrepreneurs to have a “legal” and local government approved framework in which to develop and operate. Thus not only was the Wenzhou local government protecting the private economy, it tried to legitimise it.

Yangzhou’s informal relationship with local firms was different, in that it part controlled and part aided in their development. Local officials were involved in obtaining loans and setting up firms, some government departments outright owned local firms. Even individual departments not involved directly with economic production – for instance, the buildings / hospitality department – were involved in running businesses – in this case a hotel where official hospitality and events were held (interview, 2005, Yangzhou CCP college, Yangzhou economic development office). These firms could be seen as an unofficial part of the local government, able to exploit the advantages offered by having a close link with local officials, yet compliant to the demands of local government policies. The Yangzhou government’s entrepreneurial development strategy brought the firms much closer to the local government, and their success was a function of the economic acumen of the local bureaucratic entrepreneurship.

This relationship reveals what lies at the root of local development in Wenzhou and Yangzhou. In terms of its economic imperative, Wenzhou was able to allow the local private sector to develop because it was the only sector that was growing. The state sector was a failure, and the local government did not have the resources to control the private sector. The relatively benevolent informal government–firm relationship in Wenzhou could thus be seen as the result of a fair balance of power – political power, on the one hand, held by the local government

(ability to protect firms from political reprisals), and economic power, on the other hand, held by firms (the private sector was what kept the economy growing).

In contrast, firms and local government in Yangzhou shared an unbalanced relationship. Yangzhou's local government had political power through which it held economic influence – the ability to obtain grants, the ownership of the local state enterprises, and so on. It was thus the political incentive – to keep growing, and conversely, to prevent economic pain, which dictated the relationship between local firms and local government. Local firms were either under Yangzhou governmental control, or – in the case of private firms – were too weak and neglected to be noticed by the Yangzhou government until the late 1990s.

10.4 Bottom up versus top down – grass roots and bureaucratic entrepreneurs

Yangzhou's development depended on the local government imposing its economic development strategies as a matter of course. The economic reforms that took place were to allow local firms to remain in collective or government hands, while operating in a “market environment”. The management of larger collective firms and local state enterprises were contracted out, but the appointment of managers was ultimately in the hands of local officials.

The system of contracting out managerial positions stems from the Central government's principle in 1987 of the “state regulating the market and market conducting enterprises”, allowing state owned enterprises to gain autonomy while remaining under state ownership (Wu, 1997, p1239). By separating ownership and management, the objective was to allow competitive and rent seeking behaviour to

take place, which would not happen under a planned economic system as the government departments and officials receive no incentive to improve the performance of the SOE. In contrast, a contracted manager would be given the incentive of increased payments with increasing performance of the firm (and conversely, the disincentive of decreased payments with bad performance). This type of management, although not the same as private ownership, allows the firm to operate as if under private ownership, in theory giving manager the same set of incentives, although it limits the ability of managers to sell and transfer assets. Ownership is retained by the local government.

However, although this division of ownership and management is able to reproduce some of the incentive structures of private ownership, it has its problems, such as encouraging short term profit seeking. Most importantly, the ownership retained by the local government still gives the local government substantial influence over the operation of the company, through the appointment of compliant managers. Putting aside the limitations on the powers of the manager to run the firm (which is included in the management contract, and differs from firm to firm), intervention by the local government in the running of these firms could come when there is a conflict of political objectives with the economic imperatives of running a profitable firm. Thus the efficiency of this peculiar hybrid ownership-management is curtailed by political considerations of the local government. Within the boundaries of local political considerations, firms may become relatively more efficient than they were operating without any incentives under the planned economy, but gains in their efficiency would not be allowed to come at the cost of local political objectives.

In the case of Yangzhou's state sector, this appears to have been a severe

constraint on achieving economic efficiency for local state and collective firms. For instance, the Yangzejiang Pharmaceuticals firm was successfully grown from a rural collective firm to being one of the largest pharmaceutical producers in the country. However, prior to its privatisation, while it was under the ownership of the local government, the management was requested to take on workers from another, failed pharmaceutical firm, although there was no requirement for additional workers at the time (interview, 2005, Yangzejiang Pharmaceuticals). In terms of running the firm efficiently, such a request would seem absurd, even though it allows the local government to reduce the negative impact of unemployment from firm closures. Overall, if this type of transfer was widespread throughout Yangzhou's local state economy, it would reduce the efficiency of firms asked to take on extra, unneeded workers, but such actions may also discourage managers, regardless of their economic incentives, as they would effectively have to shoulder the burden of local government policies while also managing the firm. It is not known how widespread this practice was, but the interviewee did not seem to regard it as abnormal behaviour.

Thus it could be argued that overall economic efficiency is not the priority for local government officials. Although financial incentives improved the efficiency of these firms, they remained shackled to policy and political concerns rather than being truly free to pursue economic objectives. Indeed, they could be seen as an extension of the local government's policy tools, which would also make the local government very unwilling to lose the use of such a powerful tool. Privatisation was slowly introduced but became increasingly acceptable in Yangzhou because it was no longer possible for the local government to provide continuous support to local state and collective firms – many of which fell into debt despite the restructuring and reforms

in the mid 90s, relying on the local government to transfer funds from elsewhere to subsidise their operations –and only then was the process of selling off firms and shares begun. “It was costing us too much,” was the pragmatic answer given by a Yangzhou economic planner when asked about the timing of the privatisation process (interview, 2006, Yangzhou CCP college). Through privatisation, the local government gained the financial benefit from the sales, and maintained its status as a shareholder in order to receive dividends from the more successful firms. However, its influence over the management of firms was finally diminished.

By exerting its influence over local firms, the Yangzhou local government aimed to serve both its economic and political objectives, but the conflict between the two convinced it to retain just the potential economic gains from a shareholding type ownership. Wenzhou’s economic growth, by contrast, did not involve the local government in the same type of relationship with local firms. The majority of firms in Wenzhou were small and privately owned and operated, albeit under various guises of collective ownership. They were set up without government intervention and largely without government aid, thriving initially in the illegal black markets before becoming increasingly co-opted and regulated by the local government. Their management remained in private hands, the result of entrepreneurs setting up small ventures in household handicraft production, or of families in villages setting up co-operative ventures. The chief distinguishing feature of the Wenzhou economy is the social network holding it together, allowing individuals to raise capital from friends and relatives, bypassing – or at least minimising – the involvement of the local government. The Wenzhou government thus had little influence over the management of the firms, and in terms of directing their activities.

The production chain of private firms in Wenzhou is another unique feature of Wenzhou's economy that depended on the strong social network to function. Here individuals and households are in direct communication with each other through their own contacts to help set up the production chains of more complex products, allowing each individual to concentrate and specialise on the production of a single component or on assembling the product. This also increased the flexibility of the production, since each household or individual "link" in the chain can more easily swap out their production equipment as needed using relatively small amounts of capital. Again, in this process the involvement of the local government is avoided or minimised.

In the creation and the running of firms, Wenzhou's local government exerted little influence. The decisions are made by those who own and operate the production chains, who in turn make their decisions based on market information collected through their social networks and through the spread of Wenzhou's diaspora throughout China. Their response to the market was based on both the desire to maximise their profits and on a hard budget constraint that had no recourse to transfers and subsidies. As much as possible, Wenzhou's private entrepreneurs operated completely in response to the market signals they received, rather than basing their decisions on the development policies of the local government. It was grass roots growth at the smallest scale of the individual, with very low levels of government regulation or supervision to hinder its development and growth.

The progress of the local private economy succeeded in correcting Wenzhou's dysfunctional economy, but the entrepreneurs cannot claim all the credit. The grass roots growth was aided by the local government's political non-action, as

well as by the creation of local trading and exchange markets. It also began to regulate the private economy, “making the black grey, and the grey, white,” said one official, describing the process of making private firms more legitimate (interview, 2004, Wenzhou Economic Reform Office). The regulation of the private economy is perhaps the most important step, for it heralded the start of the acceptance of private economic development as a legitimate strategy in China. As well as being aware of Wenzhou’s “capitalist tail”, the Central government’s experimental approach to economic reform suggests that it is plausible Wenzhou’s progress was being carefully monitored as a potential model for economic development. The accidental – or rather, pragmatic – developmental strategy of Wenzhou’s local government has influenced not only its own development, but also economic policies all over China.

In Yangzhou’s state owned and managed firms, the entrepreneurial and managerial functions were embodied simultaneously by the local government, which also held the ownership rights to some firms, while exerting influence – albeit informally – in others. The operation of the firms suffered from direct intervention in the case of fulfilling local government obligations as, although they operated with “market style” transactions – the prices of their inputs and outputs were ostensibly set through market mechanisms – and a certain degree of economic incentives were in operation regarding their management, there was little scope for firms to pursue opportunities if the government perceived them to be contradictory to its aims and objectives. This being the case for individual firms, the development of the economy as a whole was also directed by the local government, which set clear guidelines for the development of a “scale economy”, concentrating on the production of a few, specialised products. This was not a response to the market, but was specifically chosen as a means for the local economy as a whole to respond to the competition it

faced from other regions. The direction of the development for these “backbone” products was a political decision rather than a natural economic adaptation to the circumstances. Although circumstantial, the evidence is that almost all these firms were privatised, or failed to survive. Directions for managers were issued from the local government, rather than being the cumulative effect of firms responding to the changing circumstances, and remains reminiscent of a planned economy, writ small at the local level.

In contrast to the top down development strategy of Yangzhou, Wenzhou’s socially distributed economy has been allowed to grow from the bottom up, as individuals and households respond to the needs of the market and to their motive of profit maximisation. The lack of involvement from the local government, in setting up, managing and maintaining the local firms almost backfired as Wenzhou faced economic pressure over the unregulated proliferation of low quality goods, and political pressure over its illegal economic practices. Its response to these pressures, to increase regulation over local firms, still allowed the firms to operate and manage their own production, rather than creating a bias for some sectors and against others. The decisions necessary to adapt to changing demands and market conditions were taken at the lowest levels, without the need for the local government to intervene.

10.5 Conclusion

The involvement of the Wenzhou and Yangzhou local governments in the development of their economies has been shaped by their relationship with the Central government and Central government incentives, the structure of local firms and local firm ownership patterns, and by their assessment of the costs and risks of their development strategies. These combined to determine what mode of behaviour

the local government adopts, whether corporatist, developmental, clientelistic, predatory, or a combination of these.

Ultimately the Central government provides the incentives and the institutional structure within which local governments are allowed to operate. These may be negated or reinterpreted, but they form the same structure within which all Chinese local governments operate. The degree to which these policies can be modified to suit local conditions depends on the Central–local relationship, and the control over the local government the Central government can exert through political and economic pressure. For Yangzhou, this control was relatively greater than that of Wenzhou, and therefore Yangzhou’s development adhered more to what was acceptable to the Central government, through developing state and collectively owned firms, neglecting private ownership, creating a structure where the Yangzhou government and local firms were closely interlinked. Wenzhou’s political isolation weakened Central government control, and also forced the Wenzhou government to protect its budding private economy, which provided the only means for its economic development. Moreover, its local culture encouraged private entrepreneurialism, regardless of whether it was acceptable to the Central government.

The structure of the local economy, in particular, the ownership and control over local firms, was key in determining the speed and depth of local economic reforms. This is partially explained by the potential benefits that can accrue to the local government through local firms. Control and ownership over local firms gave Yangzhou’s local government scope to manipulate the local economy and achieve its policy objectives. Reforms and changes to this situation – for instance, through the introduction of policies favouring the private sector – were therefore not attractive,

and there was little incentive to pursue them. However, Wenzhou's local government faced a situation where the greatest good lay in pushing reforms as far as was possible to support its private economy, as it did not have the benefits of owning or controlling a sustainable state or collective sector. Moreover, its relationship with local entrepreneurs allowed its economic reforms to be tailored to the needs of local firms. This in turn further facilitated local economic growth, to the advantage of the Wenzhou government.

Finally, the assessment of the cost and risk of development to the Wenzhou and Yangzhou local government is apparent at each stage in their development, and this influenced their behaviour. The relative benefits of developing a local state corporation, versus the cost of supporting a weak private sector, meant that at each stage in Yangzhou's development, the local government chose to pursue local state corporatism, until this strategy became unsustainable. Conversely, the Wenzhou government committed to pursuing the relatively uncertain development of its private economy rather than the relative certainty of continuing to suffer a weak state economy. The cost of following Central government policies appeared to be greater than the cost of insidious disobedience, and given its special situation, the Wenzhou local government was able to weather the political pressure brought to bear on it. Thus at each stage, Wenzhou's government continued to stand by its private entrepreneurs.

The role of China's local governments in economic development was, and continues to be determined by the Central government. To encourage and foster local economic growth is the ostensible goal of all local governments. However, the role played by local governments in each specific region varies with their own set of

relationships and circumstances. The comparison of Yangzhou and Wenzhou shows that even with similar backgrounds and the operating with the same Central government policies, the two governments took different paths for economic development and obtained different results.

Nevertheless, by combining the influences of the Central government, the local economic structure, and the relative costs and benefits of different policies for the local government, it was possible to provide both a typology for local government behaviour, and to account for their choice of actions. It also suggests that a proper understanding of incentives and their interaction with local circumstances is necessary to determine the outcome of local economic development in China. This provides a flexible lens through which to examine the behaviour of other Chinese local governments in future studies. A more detailed comparison of other Chinese local governments would be useful for creating a more nuanced understanding of China's economic transition, and the direction it is likely to take in the future.

Chapter 11: Conclusion – the role of the local government in China’s economic transition process

This study set out to create a framework for understanding the role of China’s local governments in the process of local economic development. As China’s economic transition has progressed through the past 30 years, local governments were given increasing responsibilities for economic development. Their actions and the environment within which they operate have also changed significantly as China’s economic reforms continued to reshape the political economy within which local governments operate.

In this attempt to define their role, this study has sought to use a holistic approach, considering the local governments as an actor operating within a network of relationships. The relationships define the boundaries and possibilities for local government behaviour, though their effects can sometimes be counter intuitive. A “positive” relationship might not necessarily lead to a positive outcome, as in the case of Yangzhou’s relatively closer ties with the Central government during the reform period. Wenzhou’s weak relationship with the Central government, on the other hand, served to give the local government more freedom to encourage local entrepreneurs to grow.

Similarly, relationships within the local area also play an important role, though again the qualitative difference between Wenzhou and Yangzhou’s relationship with local firms is crucial. Although Yangzhou’s government had extremely close ties with local firms, exerting considerable influence over their management, it was ultimately unsuccessful in maintaining economic development

through the local state sector. Wenzhou's government, which did not enjoy the same degree of control or influence over local entrepreneurs despite having close ties with them, was successful in sustaining economic development.

This brings up the question of whether the comparison is fair. It is possible to argue that the Yangzhou's slower economic growth, and Wenzhou's rapid development, was due more to the characteristics, virtues, and shortcomings of the local state and private sectors respectively, than it was to the actions of the local governments. Local state firms suffer from several disadvantages compared with firms operating under private ownership, and are less efficient in the long run. However, there was considerable uncertainty in the early part of China's reforms over the relative efficiency of collective firms versus private firms for local economic development, partially due to ongoing political and ideological debate, and partially due to the uncertainty of where China's economic reforms were ultimately headed. While Yangzhou decided to pursue its advantage in developing an economy dominated by the local state and collective sector, Wenzhou chose to nurture its private sector. As China's reforms proceeded, it became clearer that the local corporatist model for economic development would be supplanted by private economic development, Yangzhou chose to continue its efforts in the local state sector. Since a local state sector could not have existed without local government involvement, it was the choice of the Yangzhou government to continue pursuing local state sector development resulting in Yangzhou's slow economic growth as China's economy became increasingly privatized and market oriented. The inefficiencies of the local state sector is inextricably linked with the actions of the local state. Thus regardless of the relative efficiencies of the local state sector and private enterprises, the decision of local governments remain the key variable in

influencing the speed of local economic growth.

Having taken into consideration the relationships within which local governments operate, their modes of development determine the actions and policies adopted for the development process. As was discussed in chapter 5, the categories used to categorize local government types – local corporatist, developmentalist, clientelistic, and predatory – can be used in a more flexible way. As this study has argued, local governments tended to behave in many different ways, and their behaviour could not be neatly compartmentalized into any one of the categories. They are not mutually exclusive behaviours, and although engaging in behaviours described by two or more of the categories may be contradictory or counterproductive, local governments have done so. Yangzhou's attempts at developing a local state sector involved local corporatist behaviours as well as clientelistic behaviours, and its outlook (in terms of extracting benefits for the local government from local state firms) can arguably be classified as being predatory. Similarly, the development of Wenzhou's private sector relied heavily on clientelistic relationships between the local government and firms to establish a channel of communications that would otherwise have been impossible through existing, official channels.

This more flexible view of the developmental mode of local governments, coupled with the recognition of the importance of local government relationships with the Central government and local firms, shows that local governments are highly dynamic and adaptable to the challenges throughout the 30 year period of China's economic transition. The view of local governments developing their economies according to set economic "models" lacks this flexibility, and places local governments at odds with each other. Fundamentally, the same influences pervaded

the decision making process of China's local governments, and these influences affected the actions of local governments. Due to China's gradual approach to economic development, it was impossible for local governments to formulate and pursue a long term development plan, and thus the formation – or rather, *evolution* – of their development policies came from the pressures and opportunities of their existing situations. Attempts to capture and frame this fluid, dynamic and ever shifting process into a model can only be the first step toward understanding the behaviour of local governments, providing the necessary snapshots and observations that then needs to be developed.

However, what this brings up is the question of how effective of efficient local governments are at developing their local economies. The activity and dynamism of local governments do not necessarily correlate to their degree of success in achieving economic growth. Yangzhou's entrepreneurial approach to economic development is arguably more active and dynamic than Wenzhou's protective attitude towards local firms. However, while Yangzhou suffered from its inability or unwillingness to abandon the development of its local state sector, the Wenzhou government less interventionalist attitude allowed its local private entrepreneurs to flourish. In this case, Wenzhou was arguably more *flexible* than Yangzhou, since it too entered – out of necessity – a phase of promoting its (albeit semi-fictional) “collective” sector. When there was no longer any need, this was dropped and the private sector was allowed to grow openly. For all its dynamism and entrepreneurship, Yangzhou's local state sector continued to be developed until it was no longer viable, and then the Yangzhou government entered a phase of privatization. Yangzhou was not able to recognize the coming necessity to develop its private sector and its capacity to facilitate the operation of a private economy.

Thus this study suggests that, viewed as entities within a network of relationships, the success or failure of China's local governments do not depend on the quality of those relationships. Having positive support does not necessarily create the necessary conditions for success, just as negative or ambivalent relationships do not necessarily lead to failure. The dynamism and activity of local governments also does not necessarily bring success. This is not to say they are irrelevant, but rather, they can – and have – produce counter-intuitive outcomes. It would seem that it is the local government's attitude – its ability to be flexible and adaptable through time – which shows success. Wenzhou's pragmatic approach helped it to maximize economic growth, even though it faced some difficult challenges. Yangzhou's active pursuit of a development model seems to have cost it the ability to “sail with the wind” until it became inevitable that the local state sector was to be privatized.

This clearly requires much more research to form a testable hypothesis, for it would appear that rather than studying the policies, actions and behaviours of China's local governments, the objective is to try and determine the degree of adaptability and flexibility shown by the local governments. The actions and behaviours are the results of this deeper characteristic, and the local–Central relationships and local conditions serve as the backdrop, the circumstances which reflect the consequences of these actions. Rather than seeing local development policies as an end result in their own right, this study suggests that instead, they serve as pointers, examples to a set of deeper characteristics within a local government that is more likely to lead to success. Thus it is dubious whether Wenzhou's development policies would have worked as well in Yangzhou, for they are the results from Wenzhou's specific backdrop. However, the sheer pragmatism and dedication of

Wenzhou's government to its entrepreneurs indicates a level of commitment that brought forth the policies and process that took place during Wenzhou's development.

More case studies need to be carried out to see if the conclusions of this study holds true for other Chinese local governments. The specific circumstances of each local government will prove to be different, but to find the underlying factor common between all local governments avoids the superficial differences and apparent contradictions that make comparisons difficult. Future studies may also be able to better refine the characteristics that determine the "flexibility" of a local government, its ability to be pragmatic, which seems to emerge from a historical perspective, for flexibility is necessarily a function of changes over time, and studying a single time period – a snapshot – by its nature will freeze and render this flexibility invisible. Future studies must take into account the historical variable of local government behaviour.

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