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***The role of Township and Village Enterprises  
in China's economic reform***

por  
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## **1. Introduction**

This paper examines the origins, development, and prospects of China's township and village enterprises<sup>1</sup> (TVEs) in the context of transition from a centrally planned economy (CPE) to a market economy. China's economic reform is occurring with no major changes in the political system. The Chinese advocate a “socialist market economy,” or “socialism with Chinese characteristics,” implying, among other things, limited private ownership of the means of production.<sup>2</sup> However, in the context of economic reform, China has adopted measures that are irrevocably changing its economy and society. The “household contract responsibility system” and the “open door policy” have led the nation onto a transition path characterized by multiple and complex forms of enterprise ownership. There are *state-owned* enterprises (large, medium, and small units), *collective-owned* enterprises (run by townships and villages, cities, counties, towns and street committees), and *private-owned* enterprises (individually owned, jointly owned, and privately owned cooperation limited). There are also *joint ownership units* (jointly invested by enterprises of different ownership), *share holding economic units* (limited companies and limited liability companies), *foreign-owned economic units* (including joint-ventures, joint cooperation enterprises, and foreign capital-only enterprises), and economic units owned by Overseas Chinese from Hong Kong, Macao and Taiwan.<sup>3</sup>

The creation and proliferation of the so-called township and village enterprises (TVEs), arguably the most distinctive feature of Chinese transition, have been highly instrumental in the success of China's economic reform. Key to their success seems to be the high degree of competition, flexibility, and autonomy, which have occurred without significant privatization. What are TVEs? Why did the TVEs arise? What role are they playing in China's transition process? Why their success? What challenges are they facing? These are the issues examined in this study.

This paper is organized as follows: section 2 introduces some basic views on enterprise reform in the context of transition; section 3 provides an overview of China's enterprise reform; section 4 analyses

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<sup>1</sup>TVEs generally refer to enterprises owned by village and township governments (including those leased to individuals). Because of data restrictions those privately owned are often included.

<sup>2</sup>The concepts of capitalism and socialism are used here in their most common way, i.e. they are defined in terms of private versus nonprivate ownership of the means of production (Hillman et al., 1992)

<sup>3</sup>*China Statistical Yearbook 1995*, p. 53.

the “transitional” role of TVEs, their evolution and contribution to China’s reform; and section 5 elaborates on what may be ahead for the TVEs. Lastly, some concluding remarks are made.

## 2. Enterprise Reform in the Context of Transition

Elements of reform, in the context of transition from a CPE to a market economy would include, in addition to the need for macroeconomic stabilization and control: 1) price and market reform (liberalization of product, labor, and capital markets); 2) enterprise reform (restructuring and privatization); and 3) institutional reform. The pace and sequencing of these various elements are the objects of a great deal of debate. The consensus seems to be that there is no general blueprint given historical, economic, political, legal, and cultural specificity.<sup>4</sup>

Enterprise reform most often applies to state-owned enterprises (SOEs), and usually entails a discussion on restructuring and privatization related issues. As far as restructuring of enterprises, many now believe that restructuring of SOEs should precede privatization (Kaandorp et al., 1993). Recently, the World Bank concluded that “financial discipline spurs restructuring - regardless of ownership” (*World Development Report: 45*).

Nevertheless, privatization is still regarded as the solution to many problems. In particular, as privatization contributes to economic independence it provides financial discipline, enables competition and releases the forces of entrepreneurship and innovation (Aaslund, 1993).<sup>5</sup> The importance of privatization has thus been stressed by many economists, who see well-defined private property rights as a necessary condition for a well-functioning market economy. Some have gone as far as saying that: “Socialism is the abolition of rational economy . . . Exchange relations between production goods can only be established on the basis of private ownership of the means of production” (von Mises, 1972).

Others have tied the importance of property rights to democratic ideals. Olson (1993) has explored how different governments, i.e., dictatorship versus democracy, affects economic development. He suggests that an economy can only fully benefit from all potential gains associated with economic development if two conditions are fulfilled: 1) individual rights to property are preserved and 2) contract rights are impartially enforced. He further proposes that since these are the same very conditions necessary for a lasting democracy, securely democratic societies will naturally experience greater economic development than non-democratic ones. It follows that privatization would be necessary for maximum economic growth:

(...) democracies have the great advantage of preventing significant extraction of social surplus by their leaders. They also have the extraordinary virtue that the same emphasis on individual rights

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<sup>4</sup>for a discussion see for instance Fischer and Gelb (1991).

<sup>5</sup>In the case of eastern Europe, Aaslund lists as particular causes for the urgency of privatization: 1) the need for a "critical mass" of private enterprises to facilitate the functioning of the market; 2) the inability of the state to provide capable and effective management; 3) the potential as a source of state revenues; 4) but most of all privatization is seen as a way of creating healthy enterprises with good management.

that is necessary to lasting democracy is also necessary for secure rights to both property and the enforcement of contracts (Olson, 1993).

But how important is privatization in the context of transition from a CPE to a market economy? It is widely accepted that price liberalization and other market liberalization measures are necessary for a well-functioning market system. However, these measures are viewed by many as insufficient. As prices replace state directives as the main mechanism in allocating resources that may not be enough to guarantee efficiency. For instance, Hinds sees privatization as essential in any transition.<sup>6</sup> In his view, privatization is not only necessary for achieving efficiency but also for stabilizing the economy.<sup>7</sup>

“... the main source of the problem is not central planning, but the absence of private ownership of the means of production. Without private ownership, factor markets essential to the functioning of market economies are absent. As a result, the socialist system creates an economic environment in which resources are misallocated and in which there is chronic excess demand, even after central planning is eliminated and prices are liberalized. (...) Privatization is the core policy element of economic reform.” (Hinds, 1992)

On the other hand, should “privatization” be accepted, does private ownership guarantee enterprise autonomy? Not necessarily, insofar as bureaucracies can interfere with privately owned enterprises as easily as with state-owned enterprises (Perkins, 1988). Perkins has suggested that a well-functioning market system does not even require private property of means of production. In his view, the market will function well as long as: 1) goods are available for purchase and sale on the market; 2) managers behave according to the rules of the market; 3) the markets faced by enterprise managers are competitive; and 4) prices reflect long-run relative scarcities. Hence, a market economy would be compatible with social ownership.

China's transition experience has been a fertile ground for all these ongoing debates. Next section provides an overview of China's economic reform, with an emphasis on enterprise reform.

### **3. China's Enterprise Reform: an Overview**

From 1949 to 1958, as China established the foundations for a centrally planned economy, private property was gradually eliminated. The land reform movement followed by rural collectivization, eliminated landlords as a class and organized the peasants, first into producer cooperatives and then into collectives. This process was extended to factories, shops and restaurants, which became state-owned

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<sup>6</sup>This view is the one endorsed by international institutions such as the World Bank:

“For the transformation to be effected swiftly and with minimal meandering, the key institution of a market economy, pervasive private property, must be established. (...) without privatization, without the incentives of the capitalist market economy, economic agents will fail to replicate the behavior of real market participants” (*World Development Report*, 1991)

<sup>7</sup> though stabilization can be achieved in the short term without privatization (Hinds:14)

enterprises (SOEs). Industrial production was collectively organized under brigades and communes, which were responsible for economic, administrative, and political functions. At the end of the 1950s there was practically no private property in China. From 1958 to 1978 China closed onto itself and tried to develop without outside help, with disastrous results (particularly after 1966 with the “Cultural Revolution”). This picture has been fundamentally transformed under the process of economic reform launched in 1978. It was then, that the Third Plenary Session of the 11th CPC Central Committee adopted policies aimed at reforming the domestic economy and opening it to the outside world.<sup>8</sup> Some features are described below.

a) *contract responsibility system*

It is only natural that China's economic reform, like its liberation movement, first succeeded in the countryside,<sup>9</sup> with the “household (contract) responsibility system.” Under this system, farmers were given the right to use the land for a period of 15 years and considerable management autonomy. Once they meet the production targets set by the state, which is sold to the state at fixed prices, they are free to sell the surplus in the open market at market prices (dual-price system). As a result the productivity increased dramatically, particularly during the period 1979-84. The contract system quickly spread to township and village enterprises (mostly small industrial units) and in 1984 was adopted in a variety of forms by state-run enterprises. Essentially, this system does reward economic efficiency with wage bonuses or the retaining of “excess profits.” Under this system there is a separation between ownership and right of use, control and management. There is still state ownership but the enterprises have considerable autonomy in terms of management (price, wages, investment decisions) in exchange for fulfilling output and/or profit obligations on a “contract” basis. The “contractor” can be the manager, “a board of directors,” some or all the employees, even people from outside. The lease system is a variation of the “responsibility system.” A lease requires collateral and entails more risk than a “contract” (Xie, 1992).

b) *ownership structure*

China's reforms are dramatically changing the ownership landscape (table 1). The most striking change is the shrinking share of the state sector, which now accounts for about one third of industry’s “gross output value.”<sup>10</sup> Collective ownership almost doubled from 1978 to 1994, whereas individual ownership and other (such as joint ventures and foreign enterprises) went from zero to 11.5 and 13.6% respectively. They are both increasing very fast.

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<sup>8</sup>see (Perkins, 1988) for a detailed analysis of this process.

<sup>9</sup>Though reform succeeded first in the countryside, it was attempted first in the industrial sector but with no success (Naughton, 1994).

<sup>10</sup> However, in 1994, state units still accounted for three-quarters of investment and 70 percent of bank credit. (*World Development Report*, 1996, p. 46)

**Table 1: Ownership Structure of Industrial Production (%)**

Ownership	1978	1985	1990	1992	1994
State	77.6	64.8	54.6	48.1	34.1
Collectives	22.4	32.1	35.6	38.0	40.9
Individual	0	1.8	5.4	6.8	11.5
Other	0	1.2	4.4	7.1	13.6

Source: *China Statistical Yearbook*, 1995.

A restructuring of the SOEs was attempted in the beginning stages of the economic reform, with a reallocation of resources into the production of consumer goods. Later in 1984, the introduction of the contract responsibility system and the practice of dual pricing made the SOEs increasingly autonomous and market-oriented. The overall impact of the reforms can be measured in terms of changes in structure (greater autonomy, higher incentives and competition), conduct and performance. The SOEs “intensive” growth was the result of higher productivity instead of larger resource consumption (Jefferson et al., 1994).

Though some economists recognize that SOEs played a positive role in the transition process, they believe time has come for China to privatize the SOE sector (Naughton, 1994). Under China's “share holding” approach, the capital of state-owned enterprises (either the original or the additional capital) would be converted into shares to be sold to the employees or the public. In May 1990, the government decided to continue this practice on a trial basis and subject to serious restrictions. Public ownership must be dominant and share ownership is limited to joint-ventures, township and village enterprises, and to special economic zones and open coastal cities, of which Shenzhen and Shanghai (sites of the two Chinese stock exchanges) have been the most successful. As a result, only a few SOEs have been privatized. A bankruptcy law was passed but only smaller firms have been closed. In November 1993, the Chinese government announced sweeping reforms including a restructuring of the state-owned sector, in fact renouncing one of the “four cardinal principles” -- state ownership (*The Economist*, October 22nd, 1994). The official attitude toward privatization of the SOEs seems to have shifted from a very ebullient position in 1993 to a more conservative approach that reflects a desire to hold on to a large state sector. They currently seem to favor mergers of nonprofitable SOEs with profitable ones rather than sell-offs. The model seems to be Taiwan, and the vast corporate holdings of its ruling party, the Kuomintang.<sup>11</sup>

Collectively owned enterprises include urban as well as rural enterprises.<sup>12</sup> The latter ones are usually termed township and village enterprises. These are not collectives in the ordinary sense but rather community enterprises, encouraged by the existence of surplus labor in the rural communities and the

<sup>11</sup> SOEs are still a major drag in the economy, though their losses as a percentage of GDP has been decreasing. Forty percent of the state-owned firms reported losses in 1994 (*World Development Report 1996*).

<sup>12</sup> Since 1984, collectively as well as privately owned enterprises, located in rural areas, are classified as “rural enterprises” (*Chinese Statistical Yearbook 1989*, p. xxxvi).

lack of mobility among those communities. Many of these enterprises have strong linkages to agriculture, both backward and forward, such as farm machinery, fertilizers, and feed/grain processing. Though they first appeared in 1956, it was with the rural economic reform that they exploded. In 1980 they adopted the contract responsibility system and shared ownership, with employees as shareholders. They typically have more independence and flexibility than SOEs, and face “harder” budget constraints.

The official attitude toward privately owned enterprise has been one of reluctance. It was only after 1984 that private enterprises with more than seven employees were allowed. Privately-owned enterprises can consist of one (self-employed) owner, who may hire up to seven other workers (individual units) or it may take the form of an enterprise that hires more than eight people (private enterprises).<sup>13</sup> From 1978 to 1988, private enterprises grew quite rapidly, but in 1989 they suffered a sharp decline. In 1993, 25% suffered losses, partly due to an austerity program designed to fight inflation. Since then, private enterprises have been growing rapidly.

Other areas of the economy are reflecting these changes. Table 2 indicates the sources of government revenue by ownership. The “state” share has been steadily decreasing whereas the private sector (individual and other) has been steadily increasing accounting for 18.7% of government revenue in 1994. Collectives show a somewhat erratic pattern.

**Table 2: Government Revenue by Ownership (%)**

	state	collective	individual	other
1978	86.9	12.7	0,5	-
1984	78.9	17.2	2.8	1.1
1988	72.2	19.0	5.2	3,7
1990	70.2	17.4	7.4	5.1
1992	66.1	14.6	14.6	4.7
1994	65.7	18.0	11.5	7.2

*Source: China Statistical Yearbook, 1996*

### *c) industrial structure: enterprise groups*

One of the lesser known effects of China's economic reform has been the emergence of a large number of the so-called “enterprise groups.” These enterprise groups have been established through different mechanisms. Some were initiated by regional government authorities, who conveniently converted the former “line bureaus” into enterprise groups, absorbing the enterprises they used to supervise. Some were created by SOEs. With the economic reform, SOEs were forced to replace the former “plan” determined distribution channels with newly established backward and forward “linkages.” These new connections were also dictated by a desire to increase efficiency, develop technical knowledge or invest capital. Yet others, were initiated by individuals with the help of local government authorities, and others were

<sup>13</sup> The difference between the two is ideologically and politically important, while the former are viewed as small proprietors, the later are viewed as capitalists. The number 8 is (wrongly) attributed to Marx (Xie: 458).

created “through nongovernmental channels.”<sup>14</sup> These enterprise groups evolved from “loose structures” in 1980 into formal enterprise groups in 1986. In fact, some of these groups (55 large enterprise groups) are not only officially recognized but also granted special privileges such as the right to set up their own financial companies. Their main activities are in the following sectors: machinery (16), energy (7), defense (6), steel, building materials, chemicals and pharmaceuticals (four in each), banking (3), and forestry, transport and foreign trade (two in each) (Kumar, 1994).

Table 3 displays the composition of industrial output by sectors, for state and collective units.

**Table 3: Composition of State and Collective Industrial Output, 1978 and 1988 (%)**

	Machinery	Apparel & Leather	Chemicals	Building Materials	Textiles	Food Processing	Metallurgy
<i>State</i>							
1978	21.12	1.04	11.81	2.75	13.83	12.44	11.80
1988	27.36	.97	12.38	2.66	13.68	12.99	9.77
<i>Collective</i>							
1978	36.07	11.28	10.94	8.37	7.90	2.96	1.97
1988	33.54	7.89	12.06	7.19	15.70	5.53	3.69

*Source:* (Jefferson et al. 1992)

Machinery, chemicals, and building materials account for respectively 33.54, 12.06, and 7.19%, of collectives industrial output (table 2). Table 2 also reveals “signs of structural convergence” and much greater structural change in the collective sector than the state, implying that collective industry may be less stable (Jefferson et al., 1992).

Collectives include urban as well as rural enterprises. The latter ones are usually termed township and village enterprises. What are TVEs? Why did they arise? What are the causes of their growth? What is ahead for these enterprises? These are the questions addressed next.

#### **4. Township and Village Enterprises: between Private and Public**

These rural enterprises first appeared in the 1950s, but it was only in the Deng era that they mushroomed and became a major economic force. In 1978, there were 1.5 million TVEs in rural China employing 28.2 million workers whereas by 1994, there were 24.9 million enterprises employing 120.2 million workers (table 4).

<sup>14</sup>this subsection draws heavily on Kumar (1994).

**Table 4: Number of TVEs, Employment, and Gross Output**

Year	Enterprises (10,000)	Employment (10,000)	Gross Output (100 000 000 yuan)
1978	152.4	2826.6	493.1
1984	606.5	5208.1	1709.9
1990	1850.4	9264.8	8461.6
1994	2494.5	12018.2	42588.5

*Source: China Statistical Yearbook 1995.*

a) *Why did TVEs arise?*

After reform, commune and brigade owned enterprises were reclassified as township and village enterprises (TVEs), but the development and dramatic growth of the TVEs can only be understood in the context of China's transition strategy. TVEs are viewed as a natural response to a strategy of transition that first liberalized the product markets, which went without liberalization of factor markets (Naughton, 1994). TVEs gave rural communities -- townships and villages the ability to transform control over assets into income in the "absence of asset markets." This could be done without resorting to privatization. And the profits of those enterprises could then be used for the benefit of the entire community. These local government units also helped the channeling of funds (mostly from households) in the absence of a well-functioning banking system. Financial links with the community enabled these enterprises to "correct" the capital market imperfections.

Hence, the proliferation of the TVEs was to a large extent the response to China's own version of transition strategy, but it was only made possible because of the pre-reform existing conditions. These "preconditions" were created by both the decentralized Chinese model of development and the relative inadequacy of central planning. In contrast to the Soviet-type model which favored centralization and specialization at the country level, the Maoist view of local self-sufficiency resulted in substantial decentralization, and specialization at the province and local level. Only six percent of Chinese industrial enterprises could be classified as large or medium scale prior to the market reforms, while seventy eight percent of Chinese enterprises were small scale, labor-intensive collectives controlled by local governments (Nee, 1992). Also, the decision-making process concerning distribution of resources and products were made on a multi-tiered level, with the central government delegating authority to regional and local governments. Moreover, the difficulty in the implementation of central planning in China fostered relationships between township enterprises and SOEs early on, and helped explain the rapid development of township enterprises (Hua, Zhang and Luo, 1993), and the subsequent expansion of subcontracting ties between SOEs and TVEs.

Economic reforms further favored TVEs. State monopoly of several economic sectors (such as manufacturing) was relaxed and barriers to entry removed, enabling TVEs to engage in activities

previously denied to them (Naughton, 1994). Local governments were given greater powers and more incentives to develop local marketized economies based on private or collective ownership. Collectives became the main source of local revenues forging a mutual dependence between local enterprises and local governments. This "partnership" effectively energized and enabled the local firms and collectives to compete against large SOEs for resources and markets. Also, of special significance was the reform of foreign trade and its subsequent decentralization to provincial and local level. This measure led to the "internationalization of the countryside" (Zweig, 1990) and resulted in dramatic increases of TVEs exports (Lardy, 1992).

b) *How did they evolve?*

Because of flexibility and adaptability to the environment, TVEs structures and development patterns, vary from locale to locale throughout China. Though generalizations are difficult and possibly inaccurate, that has not stopped economists from doing just that. Dong (1988) described three dominant models of (rural) economic development: the Wenzhou Model, the Jiangsu Model, and the Mixed Model.

The Wenzhou Model is named after the city of Wenzhou in southern Zhejiang Province. Villages which have embraced this model are located in relative isolation from large cities and receive little assistance from urban industrial centers. The principal initiators of nonfarm industries are individual farmers who set up one of two types of rural enterprise: the household enterprise by farm families or joint-capital enterprises by joint investment from farm families. These TVEs enjoy greater independence and autonomy than other types of TVEs. Because they must be more competitive, they typically achieve a higher level of efficiency. They tend to be small and use backward technologies but require little capital investment.

The Southern Jiangsu Model, in contrast, has the local government as the main initiator and organizer of nonfarm industries. These rural enterprises typically locate close to big cities, operate at a larger scale, and often cooperate with urban enterprises through investments, technology, or technical assistance.

Thirdly, the Mixed Model combines the two above-mentioned models. In some areas of Jinhua City, Zhejiang Province, enterprises with combinations of household- and government- initiated ownership structures have been developed. The Wenzhou and Jiangsu Models have both worked in coastal provinces where a legacy of commerce has been maintained. In other areas, different mixed ownership models, have been used (Dong 1988).

Dong's typology illustrates the variety of situations that can fall under the TVE umbrella. In many TVEs ownership can be characterized as "fuzzy." According to Weitzman and Xu (1994) a TVE is "best described as a vaguely defined cooperative, meaning an essentially communal organization quite far removed from having a well-defined ownership structure," with "a deep involvement of the community government." Nevertheless, it should be noted that in most TVEs the township and village officials possess all the key components of property rights namely control of residual income, the right to dispose

of assets, and the right to appoint and dismiss managers and assume direct control if necessary. Though property rights for TVEs may be not precisely defined in a legal framework, in practice they are fairly clearly specified (Naughton, 1994).

“The surprising thing about TVEs is not that they function without clearly defined property rights, but rather the fact that local government ownership turns out to be a fairly robust ownership form even though it is dependent on delegation of authority from higher levels of government, and even though it must engage in increasing market competition with private firms.” (Naughton, 1994, p. 268)

c) *Why are TVEs so successful?*

Whatever their institutional organization/ownership structure they have been extraordinarily successful. Their success can be best measured of creating employment.

The number of jobs created by TVEs has increased dramatically since 1978. They employed in 1994 more than 120 million workers, roughly 20% of the labor force, up from 28 million (7%) in 1978. The state sector has sort of “stabilized” at about 8% of employment. “Other urban” (i.e. collective-owned, joint owned, share holding, foreign, overseas Chinese, private, individual and other units) has also been increasing, accounting for 9.1% of total employment in 1994.

**Table 5: Composition of Employment (10000 persons and %)**

	urban state sector		other urban		TVEs		other rural	
1978	7,451	18.6%	2,063	5.1%	2,827	7.0%	27,811	69.3%
1986	9,333	18.2%	3,960	7.7%	7,937	15.5%	30,053	58.6%
1994	11,214	18.2%	5,602	9.1%	12,017	19.5%	32,637	53.1%

Source: *China Statistical Yearbook, 1996*

Most studies have concluded that the TVE sector is more efficient than the SOE sector (Woo et al., 1994; Chen et. al, 1992; Svejnar, 1990). Using data for the 1979-91 period, Weitzman and Xu (1984) found that TVEs total factor productivity grew three times as fast as the corresponding SOEs. The following, in addition to higher flexibility and autonomy, have been identified as advantages of the TVEs: shorter information channels between principals and agents, greater focus on financial objectives (lower costs), harder budget constraints, and special ties with the state sector (Jefferson and Rawski, 1994).

Some attribute the economic success of the TVEs to advantages that stem from their peculiar “internal institutional form,” which are seen to facilitate cooperation through *implicit contracts* among community members locked into an ongoing relationship (Weitzman and Xu, 1994; Nee, 1992). It has been suggested that it is the interaction of these enterprises with the whole community through a “set of interlocking financial, administrative, personnel, and other ties” (Byrd, 1990), the existence of a strong “cooperative culture” (Weitzman and Xu, 1994) that is behind their success.

Undoubtedly, local government-sponsorship brings certain advantages such as: privileged access to capital, and coordination with urban firms. On the other hand, these special ties between government, community, and TVEs usually result in a “redistribution of income.” Table 6 shows where the profits of the TVEs go to. About 35%-40% of TVEs' profits after taxes are remitted to local governments.

**Table 6: Distribution of Profits of TVEs (Unit: yuan billion)**

	1985		1990		1985-1990
	all	industrial	all	industrial	all (% growth)
<i>Profits and tax</i>	27.97	21.73	54.05	42.99	93
1 state tax	10.84	9.06	27.40	23.27	153
2 social expenditure	---	---	3.38	2.80	---
3 net profits	17.13	12.67	23.27	16.92	36
<i>In net profits:</i>					
1 sent to community gov'ts	6.77	4.79	8.71	6.56	
2 retained by enterprises	8.67	5.98	14.81	11.09	
3 unspecified (residuals)	1.69	1.90	-0.25	-0.73	

*Source:* Department of Township Enterprise (1991)

Others (Naughton, 1994) instead emphasize the external conditions to which TVEs are an effective adaptation. Zhang et al. (1994) attribute the “rural enterprise boom”<sup>15</sup>, of which TVEs are a major part, to the existence of barriers to factor mobility, price distortions and the abundant labor in the rural areas. Their study shows how exports contributed to rural enterprises growth. The rural share of national exports increased from 5% to 16%. In addition, the composition of rural enterprise exports reflects the difference in comparative advantage between urban and rural areas. Only 60-65% of all national exports are labor intensive as opposed to about 80% of the exports by rural enterprises. The dramatic rise of rural industrial exports, the result of an export-led growth strategy, was a major contributor to the growth of the TVE sector (Zweig, 1990).

## 5. What is ahead for China's TVEs?

Can TVEs continue to work effectively in the gray area between private and public? Most TVEs are non-state enterprises owned collectively by townships or villages. Since collective ownership does not have a precise legal definition it may lead to some uncertainty about ultimate property rights (Naughton, 1994). Some believe the importance of well-defined property rights depends on the “cooperating capabilities among people,” thus varying from society to society (Weitzman and Xu, 1994). Others, (Chen et al., 1992) point out that private ownership and a code of property rights are absolutely necessary to limit the ad hoc intervention of the Chinese bureaucracy. The halfway measures such as the contract responsibility

<sup>15</sup>Rural enterprises include not only TVEs but also private enterprises.

system and dual pricing, though allowing for increases in productivity, have reached their limitations. They conclude that “extensive privatization and more complete marketization will eventually be required, if China is to acquire the capacity to develop new products and technologies and to export at competitive prices”.

a) *trend towards privatization*

Two forms of privatization seem to be currently at work. On one hand, there are indications that significant “privatization” of community-owned enterprises is already occurring in China in a variety of ways, such as “leasing” or “contracting”, sale or transfer of enterprises to individuals, or establishment of joint-ventures (Byrd, 1990). Thousands of collectives (and some SOEs) have been transformed into locally-held joint-stock companies<sup>16</sup> (Jefferson and Rawski, 1994). A study by Smith (1995) of eight TVEs in Zhejiang Province revealed that five of them were share holding cooperatives, one regarded itself as a private enterprise and the other two were more traditional township and village enterprises. The latter two combined the public ownership with some formal employee ownership and one of them even had outside shareholders.

On the other hand, new private firms (urban and rural) are being established at a very fast rate. Rural enterprises formerly identified with TVEs, are not so anymore, as its private component is increasing rapidly. In fact, private enterprises grew at an average rate of 84.3% in the 1984-87 period. Their share tends to be higher in provinces with lower rural incomes and industrialization, and poorer TVE sector performance (Byrd, 1990). Though at least one study has shown no difference in terms of relative efficiency between the two components of rural enterprises (Svejnar, 1990) others have indicate that private enterprises are far more efficient than TVEs in comparable industries (Lin, 1990).

Table 7 reveals that “other rural enterprises” now account for 51% of all workers employed in rural enterprises, whereas “pure” TVEs employment share has decreased from 77% in 1984 to 49% in 1994. This trend is likely to continue as the stigma associated with “capitalistic” ownership is reduced. The privately owned sector is likely to continue to increase in importance both in absolute and relative terms.

**Table 7: Rural enterprises - changes in the number of enterprises, workers and output**

	Township&Village level			Other rural enterprises*		
	1984	1990	1994	1984	1990	1994
enterprises	186 (.31)	145 (.08)	165 (.07)	420 (.69)	1705 (.92)	2329 (.93)
workers	3982 (.77)	4592 (.50)	5899 (.49)	1226 (.23)	4672 (.50)	6119 (.51)
gross output	1466 (.86)	5429 (.64)	28866 (.68)	244 (.14)	3032 (.36)	13723 (.32)

\* other comprise community enterprises below township and village level, private and individual enterprises  
*Source: China Statistical Yearbook, 1995*

<sup>16</sup>Weitzman and Xu (1994) argue that this does not represent a clear movement to privatization, because "the bulk of shares is held collectively" (pg. 135)

Table 7 also reveals an interesting phenomenon. “TVE level” enterprises, though only 7% of total rural enterprises account for 68% of gross output, whereas “other rural enterprises” account for 93% of all enterprises but only 32% of gross output.

**Table 8: Sectoral Distribution of *all* TVEs**

	Agriculture	Industry	Construction	Transportation	Commerce
1978	32	52	3	4	8
1980	27	53	4	6	10
1984	4	79	1	2	13
1986	2	42	6	17	33
1990	1	39	5	21	34
1994	1	28	3	15	53

*Source: China Statistical Yearbook, 1995.*

Further insight is given when we consider the sectoral distribution in table 8. More than 50% of all enterprises are in Commerce and Food Service, followed by Industry and Transportation, with 28% and 15% respectively. Most new enterprises seem to be in the service sector.

The TVEs, though still likely to play an important role, are likely to lose ground to the private sector. Furthermore, changes in industrial structure, namely the expansion of mergers and enterprise groups is likely to intensify this trend, as it exerts greater pressure for better defined property rights.

#### b) *changes in industrial structure*

Before reform, decentralization resulted in specialization at the provincial and local levels. It also led to a multiplication of industrial structures. Not surprisingly, Kumar (1994) found that "concentration, in the sense of size or geography does not appear to have been a serious issue". However, he suggests that there are currently two processes at work that could accelerate industrial concentration: the growth of firms by merger and acquisition and the growth of associations between firms, in the form of enterprise groups.

It was not until February 1989 that merger guidelines were issued by Beijing. By the end of 1989, 17 regional authorities had established specific provisions for mergers, and twenty five enterprise property rights markets had been set up (Kumar, 1994). Evidence suggests that most mergers so far reflect more the need to salvage money-losing enterprises than the need for higher efficiency or the desire for market power. However, the number of voluntary mergers, cross-industry and cross-regional mergers appears to have increased somewhat since 1989 (Kumar, 1994). Many observers expect the number of such mergers to keep increasing as some obstacles decline.

What impact, will these two trends have on TVEs? It was shown in section 3c) that collectives operate in some of the same sectors as state-owned enterprises (and enterprise groups), namely in machinery, which accounts for one third of its output. These trends will pose two kinds of challenges:

increase in competition, possibly leading to restructuring of industry, and greater need to clarify property rights.

*c) cooperation or competition with the urban sector<sup>17</sup>?*

There are some differences between rural and urban manufacturing sectors, in the sense that the latter is relatively more capital intensive (across the board) and may be subject to softer budget constraints. Through subcontracting there has been a great deal of cooperation between rural enterprises (namely TVEs) and urban enterprises (namely SOEs). TVEs are also competing with the urban firms for product markets and markets for raw materials (there seems to be also some competition for labor). What are the future prospects for this relationship?

The increasing interaction between the rural and urban sector is likely to exert downward pressure on the barriers to factor movement, and increase competition. Zhang et. al (1994), however, believe that “complementarities between rural and urban enterprises” are likely to predominate and lead to cooperation and further growth in the rural enterprise sector.

Rural enterprises, along with all other Chinese enterprises are likely to face a more hostile external environment and a more uncertain internal environment. The implications for the TVEs are the object of the next two sections, which are of a somewhat speculative nature.

*d) a more hostile external environment?*

As noted before, exports have been a major source of growth for TVEs. However, as TVEs evolve, they are likely to face a more restricted access to the world markets, namely the U.S. market, whose importance can hardly be overestimated. There are plenty of sources of irritation between the U.S. and China, from economic issues such as the (large) size of the trade surplus and violations of intellectual property rights, to political issues like human rights and Taiwan.

They also face a more competitive world as other countries around the globe turn increasingly outward. They will have to face increasing competition not only for trade but possibly also for capital as other countries in ASEAN, Indochina, South Asia, and Eastern Europe, become equally or more desirable locations for foreign direct investment. The strongest competition is likely to come from ASEAN, as they exhibit the same comparative advantage as well as geographic and cultural proximity. In addition, there will be more competition from world imports as China's trade barriers are brought down as part of China's bid to join the WTO.<sup>18</sup> As many TVEs, often deal with obsolete technology, shortages of raw materials and capital, inadequate information (Nan, 1986) and operate at a small scale, they are likely to be more vulnerable.

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<sup>17</sup>Though TVEs are associated with rural industry, some are located in urban areas. They are still called TVEs if they are supervised by rural township or village governments and the majority of workers are rural workers.

<sup>18</sup>China has recently removed import controls on 176 items and pledged easing of controls on other goods (*China News*, January 1996).

e) *a more uncertain internal environment?*

One of the most remarkable "side-effects" of the economic reform, has been the significant power shift from Beijing's central government to the province and local governments. Along with the enterprise reform came the reform of wages and taxes. Before 1979, the state enterprises remitted all their surplus to the central government that would then make all the relevant decisions. Under the responsibility system, enterprises became responsible for everyday management and investment decisions, and that led to profit taxation rather than remittance. Indirect taxes are also borne (in their entirety) by the enterprises because of price controls. Also, because there is no central collection of taxes the central government must rely on lower level governments for tax revenues.<sup>19</sup> As most state enterprises remained inefficient, and as local governments kept a larger share of the revenues, the central government revenues have fallen from about 36% to 18% of the GDP in the last 15 years. This decentralization more than anything else has weakened the central government and its grip on macroeconomic policy (probably making the economic reform irreversible). It has also created serious regional income disparities,<sup>20</sup> which have resulted in a massive exodus from the interior provinces to the coastal belt (Guangdong, a province of 65 million has a floating population of at least 5 million), contributing to social problems and popular resentment. Regional inequalities may have been exacerbated by the internationalization of the rural economy as increases in rivalry between provinces, has led them to behave like countries, erecting trade and other barriers. TVEs face ever-increasing competition and economic challenges, and China faces ever-increasing social challenges.

However, China's biggest challenge may be at the political level. Will the Chinese government reform?<sup>21</sup> Can democracy emerge out of China's system of government? How will TVEs respond to political change? Vanhanen (1989) suggests that "the emergence of democracy is due to historical conditions and dispersions of resources that make it impossible for one leader or group to assume all power." Furthermore, democracy is said to emerge spontaneously if "the commonplace conditions that generate autocracy" are absent (Olson, 1993). Are these conditions absent in China? In my view, the decentralization of power due to the economic measures adopted by the Chinese government is (unintentionally) creating, the "historical conditions" and the "dispersion of resources" favorable to a less autocratic system of government. The lack of clear succession for China's paramount leader Deng Xiaoping, and the division of the "domain" into "miniautocracies" (provincial governments) generated by the economic reform is likely to result in some power sharing scheme among China's polity.

And quietly enough, some democratic changes, albeit small, are already taking place. There has been an important change in the way China's one million villages are being run. All across China elections are being held at the village level. Apparently, "the government is promoting this grassroots

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<sup>19</sup>Beijing eventually called for tax reform. The tax reform entails a tax sharing scheme that will eventually give Beijing 50% of the provinces revenues.

<sup>20</sup>Guangdong averaged a 22% growth rate for the past two years and by some accounts has now an income per capita of over \$1,250 compared to China's \$370 (*The Economist*, 1994).

<sup>21</sup>The ongoing political changes in Taiwan makes this issue less speculative.

democracy as a way of finding fresh talent, preventing unrest and improving the government's links to the country's vast rural majority" (*China News*, December 25, 1995).

Since by definition TVEs have a strong linkage to local governments, changes in local government are very likely to affect them. Many TVEs are established at the village level. Democratically elected village officials are likely to introduce more "accountability" in the "system" and increase the drive for higher efficiency. These democratic changes will not directly affect the enterprises at and above the township level, but it may affect them indirectly as village level enterprises become more competitive.

## 6. Concluding remarks

An early large scale privatization for China would have been totally unthinkable for obvious political, ideological and economic reasons and a large-scale privatization in China right now may still be ill-advised. The experiences of the eastern European countries suggest that privatization is not the panacea that many believed it to be. Privatization turned out to be the most complex part of the change of economic system for these countries politically, practically, and legally (Aalsund, 1992). There seems to be strong evidence, based on the experiences of the eastern European countries that it may very well be in the best interest of China to wait before engaging in a large scale privatization scheme (DaCosta, 1995). There are sound economic reasons why it may still be too soon for a large scale privatization to take place: 1) mass privatization will result in massive layoffs; 2) underdevelopment of capital markets would make privatization unwise; 3) lack of domestic capital<sup>22</sup>; 4) ideological and institutional obstacles. However, China's unique transition strategy engendered innovative alternatives to privatization.<sup>23</sup> China, arguably less the government than its people found ways of dealing effectively with the limitations, and within the constraints, set by China's own transition policies.

The "contract responsibility system," by effectively separating ownership and control, is an innovative alternative to individual privatization. It has been described as "a halfway house to privatization" (Fischer, 1991).<sup>24</sup> And the TVEs were China's (rather effective) alternative to early privatization. In fact, the TVEs fall between private and public. They arose because of China's own strategy and because the Chinese development model prior to the reform created conditions favorable to their establishment. They prospered, to the point of being referred to as the major engine of China's success, because of considerable autonomy, flexibility, competition (at all levels) and special ties to the government and community. And maybe more importantly, since they do not operate under a "soft constraint" like SOEs, they must thrive for efficiency in order to survive. However, as transition progresses, and China's economy and society change, they too are changing. In fact, insofar as TVEs can

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<sup>22</sup>China is now relatively prosperous. In 1978 1 out of every 4 Chinese lived in absolute poverty. In 1995 only 1 out of 12 lives in absolute poverty. Workers' real incomes have doubled and tripled (*The Economist*, March 18th 1995). But it still has a long way to go. Time will allow the establishment of a middle class with the necessary purchasing power.

<sup>23</sup>Some refer to China's transition strategy as *Chinese Model* as opposed to the *Standard Model* which would apply to the Eastern European transition (Weitzman and Xu, 1994).

<sup>24</sup>in agriculture there is a *de facto* privatization in the sense that leases are now for up to 15 years and they can be transferred or sold. There is no sale of property rights but there is sale of user rights.

use local governments to behave like countries and erect all sorts of barriers to trade and factor flows, they may be regarded as an hindrance to the establishment of a single market. China, far from being an integrated internal market, has yet to reap the benefits of economies of scale and the benefits derived from industrial “clusters” (World Bank, 1994).

It is possibly too soon to know how the TVEs will further evolve as the reform advances. Nevertheless, evidence suggests that they are facing real challenges, economic as well as organizational, namely an increasing trend towards “privatization tendencies”, changes in industrial structure, increasing competition from other enterprises -- urban collectives, private enterprises, and SOEs -- as well as foreign imports, a more hostile external environment, and a more uncertain internal environment. Their economic importance is likely to decline in favor of the “private and other” components of national output. In terms of organization, as they accommodate to all these changes, they are likely to move closer to “being more private than public.” One may even conclude, albeit prematurely, that the TVEs have already seen their finest hour.

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