

## Between Plan and Market: The Role of the Local Sector in Post-Mao China

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One of the most notable features of the Chinese economy is its strong regional character, where local governments allocate substantial resources. Planning is done not only at the central government level, but also at various local levels including province, city, county, and even townships.<sup>(1)</sup> Given the multiple levels of decision-making, decentralization is a complex process that can generate a number of possible outcomes, and a reduction in the scope of central planning does not necessarily mean a shift to market allocation.

Defining decentralization as a shift of decision-making power from the top toward the bottom, with "+" indicating gains and "-" indicating losses, we can enumerate five different outcomes in a three-level economy as follows:<sup>(2)</sup>

	1	2	3	4	5
Central units	-	-	-	-	-
Intermediate units (local governments)	-		+	+	+
Primary units (enterprises)	+	+	+		-

These outcomes are arranged in an order of declining "throughness", which is defined according to Chinese reformers' stated objective of transferring decision-making power to enterprises. In the best case (type 1), decision-making power is transferred from both the central and local governments to the enterprises. In the worst case (type 5), "positive intermediation" occurs, where the intermediate units of local governments gain at the expense of both the central government and the enterprises. In-between the best and worst cases are scenarios where "leakage" occurs,

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(1) The multi-level planning system is discussed in a number of recent studies. See Wong(1985, 1986a), Granick(1986) and Tidrick and Chen, forthcoming.

(2) This enumeration draws from Neuberger(1985: 18-26).

with local governments usurping some or all of the decision-making power passed down by the central government (type 3 and 4). The success of market reforms in China obviously depends on the type of outcome that is obtained in the decentralization process, as well as on the behavior of local governments.

Previous decentralizations of the Chinese economy (especially during 1958 and 1970) were of type 4 ("administrative decentralization"). While post-Mao reforms have broken decisively from that tradition by transferring much greater decision-making power to enterprises, there has also been a good deal of "leakage" to the intermediate units. In fact, it will be argued that decentralization through 1983 was closer to type 5 than to type 1. In the more recent period, market pressures have eroded local control in some respects, but much remains to be done to ensure that reforms continue to make progress toward the objective of increasing enterprise autonomy.

This paper looks at the local sector and its role in the reform process. In this paper, "local" will refer to administrative levels below the central government: province, municipality, prefecture, county, township and village.<sup>(3)</sup> Two sets of interrelated questions are explored. The first set concerns the nature of decentralization and the size of the local sector in the reform period. The second set concerns the behavior of the local sector: how is the local sector managed? What is the relationship between local governments and enterprises? And what are the implications of local control of resource allocation?

## I. The Local Sector and the Structure of Chinese Planning

During the 1960s and 1970s, the local sector was a "catch-all" category that absorbed the spillovers from the state (central) sector, when the market sector was virtually nonexistent. Through the successive rounds of decentralization and rapid local industrialization, it grew to rival the state sector in size. By the mid-1970s, it had developed substantial growth momentum based on resources generated within the sector itself. To understand the key role played by the local sector, it is necessary to look at the structure of Chinese planning.

A number of features distinguish the Chinese economy from other

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(3) This is a problematic category because of the great diversity among the units, in terms of size and relationship to the central government. The common bond that allows us to group them together for the purposes of this paper is their competition for resources vis-a-vis the central government.

Table 1. Size Distribution of Industrial Enterprises in Selected Countries  
(percent)

Size of enterprise	China,	United	United	South			Yugo-	
	1982	Kingdom	States	Korea	Japan	India	slavia	Hungary
	1982	1979	1977	1981	1972	1976-77	1981	1981
5-33 employees	59.2	65.2	56.4	70.6	80.2	51.7	6.6	2.2
33-75 employees	19.5	15.7	20.3	14.4	10.7	35.3	15.8	4.8
75-189 employees	12.2	10.8	12.4	9.2	6.1	7.8	32.1	18.7
189-243 employees	8.5	1.4	3.8	1.5	0.8	0.8	12.0	9.2
More than 243 employees	0.6	6.9	7.1	4.3	2.2	4.4	33.5	65.1

Note: Data are percentages of the number of enterprises with five or more employees in the country.

Source: World Bank, China; *Longterm Development Issues and Options*, 1985, Table 1.1.

socialist planned economies. The first is the extremely large number of industrial enterprises. The *Chinese Statistical Yearbook* counts a total of 437,200 enterprises at the end of 1984; with 84,100 in the state sector (SSB, 1985: 305). Even though this number excludes most enterprises in the rural sector, it is extremely large compared to socialist economies in Eastern Europe.<sup>(4)</sup> Moreover, the number has increased by over 25% in the reform period, with the addition of nearly 90,000 enterprises since 1978, almost entirely in the collective sector.

The second feature is the preponderance of small-scale enterprises. By World Bank estimates, only 0.6% of Chinese enterprises have more than 243 workers, compared to 65.1% in Hungary and 33.5% in Yugoslavia (see Table 1). It is difficult to convert Chinese enterprise size categories for cross-country comparisons since they are based on annual output, productive capacity, or fixed assets. However, even if the World Bank numbers underestimate the portion of large-scale Chinese enterprises by as much as 5-10-fold,<sup>(5)</sup> it remains true that the size structure of Chinese industry is very unusual for a socialist planned economy, though not for a developing country. In addition, while the trend has been toward merging enterprises

(4) The number is over 1,000,000 if rural enterprises at all levels are counted. Chinese industrial statistics include only township enterprises, excluding those at the villages and production teams, as well as the considerable number of private and cooperative enterprises set up in recent years.

(5) In 1984 there were 6,400 large and medium enterprises by Chinese definitions (=1.46% total). The average employment in these enterprises far exceeds 143 workers.

into ever-larger units in other socialist countries, in China the share of output from small plants has grown steadily from 45% of Gross Value of Industrial Output in 1970 to about 55% today.

Given the large number and small scale of industrial enterprises, the Chinese planning system has by necessity evolved differently from those in Eastern Europe. Through the mid-1960s and 1970s, when rapid industrialization at the local level was adding large numbers of small enterprises, the impossibility of incorporating them into the planning structure led to the creation of a multi-tiered, regionally based system where much of the responsibility for planning and coordination devolved to local governments. In this system, enterprises were divided by their importance and by ownership. Large-scale, key enterprises remained in the central plan, while non-key enterprises were left to planning and coordination at the provincial, prefectural and county levels.<sup>(6)</sup>

The approximate distribution of enterprises by administrative level is presented in Table 2. At the top are some 2,500 enterprises controlled by the central government and its ministries, which produce 30-40% of total industrial output. In addition to key enterprises in the defense industry, this group comprises the largest producers in important industries. In 1980, for example, they included 84 coal mining administrations (with 553 mines), 20-odd iron and steel enterprises, 53 large and medium cement plants, 50-odd producers of sulfuric acid, 5 producers of soda ash, and 10-plus key forestry regions (*Xiandai Zhongguo Jingli Shidian*: 312-13).

In the second tier are enterprises run by provinces and cities. These include 30-40,000 mostly small and medium enterprises in the state-owned sector, as well as over 100,000 collective enterprises. Collective enterprises in this group range from very small (with a few employees) to very large (with over 1000 employees). Even though the bulk of these collective enterprises belong to vertically-oriented light industrial systems, they are also subject to a high degree of local control.<sup>(7)</sup>

In the third tier are enterprises in the prefectural and county systems. These include perhaps 40-50,000 state-owned enterprises and some 20-25,000 collective enterprises. These enterprises are mostly small-scale, and they operate largely free of state plan control. At the bottom are rural collective enterprises run by townships and villages (formerly communes and brigades). In 1983 the State Statistic Bureau included 186,100 township

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(6) For a history of the evolution of this multi-tiered system, see Wong(1985).

(7) For a detailed description of the collective sector, see Wong (1986a: 582-4).

**Table 2. Estimated Distribution of Industrial Enterprises by Ownership and Administrative Level\***

(1983)		
STATE	COLLECTIVE	
1) 2,500 large enterprises controlled by central government (30-35%)		URBAN (75%)
2a) 30-40,000 small-medium enterprises controlled by province and city governments (25-30%)	2b) 100,000+ "large" and "small" urban collectives (10-12%)	
3a) 40-50,000 county and prefectural en- terprises (13-15%)	3b) 20-25,000 "large" and "small" col- lectives (3-5%)	RURAL (25%)
	4) 186,000 enterprises owned by townships and villages (7%)	
(78%)	(22%)	

\*Figures in parentheses denote shares of gross value of industrial output.

Sources:

Breakdown of collective sector output by urban and rural: SSB (1985: 306, 315).

Estimated breakdown of urban-rural GVIO:

Liu Suinian, "The Issue of Concentration and Dispersal in China's Economic Development", in Liu Guoguang, ed., *Zhongguo Jingji Fazhan Zhanlue Wenti Yanjiu* (Research on the Issues of China's Strategy for Economic Development), Beijing, 1984: 502.

enterprises in its industrial statistics (1985: 313). In addition, there were several hundred thousand enterprises at the village level and below.<sup>(8)</sup> The shares of industrial output by enterprise categories are derived from reported breakdowns of output by sector and urban-rural division.

(8) For 1983, the *Agricultural Yearbook* listed 744,000 rural collective enterprises engaging in industrial production. 43.5 billion yuan of output from village and team enterprises was counted as agricultural output (1984: 71, 79).

In this hierarchical ordering of enterprises, a rough correspondence exists between enterprise size and the degree of incorporation into the central plan. In general, the share of enterprise output included in the central plan declines as we move down the enterprise hierarchy. In 1977-1978, for example, when the central plan included some 50-55% of gross value of industrial output, it accounted for close to 100% of output in centrally administered enterprises, but less than 20% of output in rural collective enterprises.<sup>(9)</sup> Interpolating from these two extremes, we estimate that the central plan accounted for perhaps one-half to two-thirds of the production in provincial and city enterprises, and one-fourth to one-third of the production in provincial and city enterprises, and one-fourth to one-third that in county and prefectural enterprises during the late 1970s.<sup>(10)</sup> By 1984, with the share of gross industrial output included in the central plan declining to 30-40%, there has been a corresponding decline in planned shares of output in all categories, though not necessarily proportionally. With most enterprises and so much of the industrial output outside of direct control by the central government, the success of market reform in the post-Mao period depends critically on whether local governments introduce appropriate change, *pari passu*, at the lower levels.

## II. The Local Sector Post-Mao

In the post-Mao period, there is some uncertainty about the size and behavior of the local sector. On the positive side, the rapid response of local production to market stimuli has greatly improved the supply of many consumer goods as well as producers' goods such as coal and building materials.<sup>(11)</sup> The more rapid growth of the non-state sectors during the reform period is generally attributed to the greater dynamism of the local economies. On the other hand, a good deal of anecdotal evidence indicates that in at least some spheres, local growth has come at the expense of the

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(9) Estimates for the central plan's share of gross value of industrial output and for tier one enterprises are from Wong (1986a: 586-8); rural collective share is from RMRB August 21, 1980.

(10) These estimates are supported by anecdotal accounts. The portion of industrial output under state plans was 70% for Wuxi Municipality, 30% for Wuxi County (Zuo Mu, 1980: 32), and one-third for Guangdong's Nanhai County (*Chinese Association of Material Economics*, 1984, v. 2: 343-4).

(11) For example, during the 1979-84 period, local mines accounted for nearly 80% of the increase in coal production (MTNJ, 1982: 9, 16; 1983: 61; 1985: 50).

state sector and to the detriment of overall economic efficiency. Because of competition from local producers, for example, state procurement plans for a variety of agricultural products are substantially underfulfilled, including tobacco, wool, raw silk, animal skins, and high grades of cotton. As a result, production in large-scale, modern processing plants is being displaced by less efficient production in local small plants (Wu Jinglian, 1986; CASS, 1985). More importantly, the rapid growth in local investment in the 1980s has been squeezing out state investment projects, even in the bottleneck sectors of transportation and energy production.<sup>(12)</sup>

While there is little question of the continuing significance of the local sector, its true size is difficult to ascertain. In 1984, Chinese planners estimated that about 30-40% of total industrial output was included in the central plan. Another 20% was said to be produced "primarily according to market principles."<sup>(13)</sup> This latter figure was also the estimated portion of industrial output traded at market prices.<sup>(14)</sup> The 40-50% of industrial output that falls outside of both the central plan and the market constituted the upper-limit for the size of the local sector, though the actual size of the sector was probably somewhat smaller.<sup>(15)</sup>

A major source of difficulty in estimating the size of the local sector is the paucity of information on the relationship between local governments and their enterprises. During the pre-reform era, when enterprises had virtually no autonomous decision-making authority, whatever was outside of the central government sphere of control could safely be treated as within the local sphere.<sup>(16)</sup> This applied, for example, to the disposal of funds that were nominally retained by enterprises, such as depreciation and technical renovation funds. Through the Cultural Revolution period, these funds were frequently pooled by local governments for use in local investment projects. With the reforms strengthening enterprise autonomy, however, the use of these funds may have slipped out from under local

(12) This has been argued by Naughton (1985), Wong (1985), and others.

(13) Briefing given to the American Economists Study Team, December 1984, reported by Naughton (1986: 625).

(14) Estimate made by Zhang Zhuoyuan in a seminar at the University of California, Berkely, October 1984.

(15) If the local sector approached this limit, however, the 20% market portion came entirely out of the central plan's share, since the local sector included 45-50% of industrial output on the eve of reform in the late 1970s.

(16) This also ignores resources under control of state organizations, such as highway departments and the water conservancy bureau. For our purpose of looking at resources available for "empire-building", these organizations probably behave similarly to local governments.

government control. Since over 70% of all extrabudgetary funds are retained by enterprises, the nature of local government-enterprise relations is an important determinant of local sector behavior. Unfortunately, this relationship appears to be a rapidly changing area for which data is difficult to obtain. Moreover, there is undoubtedly a great deal of regional variation in the nature of these relationships. In the absence of definitive information, the charges that local governments are continuing to wield primary control over local resources, use "commandist workstyles" in managing local economies, etc., have to be viewed against reform efforts to reduce their influence.<sup>(17)</sup>

### III. The Nature and Evolution of Local Planning: the Cultural Revolution Legacy<sup>(18)</sup>

As it evolved in the 1960s and 1970s, local planning occupied an intermediate position between central planning and market allocation. Initially, local planning grew out of the need to augment state plans, when decentralization transferred to local governments the responsibility for coordinating production. Although the planned components of production were usually supplied with planned allocations of major inputs, enterprises were expected to find supplementary supplies from local sources. In the absence of goods markets, local planning developed to coordinate supplies of materials allocated under state plans with local resources.

The market-like character of the local sector grew out of the need to obtain resources outside plan channels, as local industries grew beyond local supply capabilities. It was local industrialization that spurred the growth of interregional barter trade during the 1970s, where market-like prices developed. In turn, the availability of an extraplan channel where surpluses could be exchanged for needed resources provided incentives to orient local production along "economic" lines. By its very nature and evolution, local planning extended into the market fringe, both for supplies and for outlets for local production. In the way that local planning formed the bridge between planning and the market, it was a precursor of "guidance" planning, a concept that is much in vogue today.

At the same time, the market-like characteristics of local economies should not be exaggerated. During the Cultural Revolution period, many restrictions limited the scope of extraplan, interregional trade and pre-

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(17) For examples of these changes, see Ding Jiatiao(1985), Zhao Yujiang(1986), and Zhu Xiaowen(1985).

(18) Information for this section draws from Wong (1985).

vented local economies from fully exploiting their comparative advantages. Instead, local planning was conducted along bureaucratic lines, and transactions within the local economy were usually guided by command principles. By all accounts, in the pre-reform period, China operated as a command economy, albeit one that was fragmented into many vertical and horizontal pieces.

Plan-making was a separate and discrete process at each level. This lack of coordination can be illustrated with an example from Shashi, a medium-sized city in Hubei province. In 1977, the city was supplied with 13,408 tons of steel from state allocations. Of this, only 3,100 tons came through block transfers for general allocation of the 267 city-owned enterprises. The other 10,000 tons were directly allocated by central and provincial departments and designated for 3 centrally-owned enterprises. The other 10,000 tons were directly allocated by central and provincial departments and designated for 3 centrally-owned, 10 provincial-owned and 14 city-owned enterprises under *sheng zhigong* (provincial direct supply).<sup>(19)</sup> These latter materials were routed through the prefectural materials bureau, completely bypassing the city's material supply system. In this way, central and provincial plans passed through Shashi without interacting with the city plan (Shashi Materials Bureau, 1984: 166), and the situation was one where enterprises located side by side were separated into discrete planning systems and supply channels, with virtually no interaction among them.

From the perspective of central planners, local activities were considered "extra-plan" and lumped together with market activities. Local production was not incorporated into national plans except for the portions under compulsory procurement by state agencies. From the local perspective, local plans encompassed central plans and added on to them the quantities needed to ensure supplies for fulfilling central plans as well as meeting local needs. Because of this multi-level planning, production in industrial enterprises was often divided into three pieces: one under central plans, one under local plans, and a third, unplanned portion.

While local planning facilitated the mobilization of local resources and provided some flexibility to an otherwise quite rigid and ineffectual system, it also led to a compartmentalization of resources that greatly exacerbated the tendency of bureaucratic systems toward autarkic development. In terms of the local sector's role in the reform process, the most harmful

(19) "Direct supply" or *zhigong* enterprises are keypoint enterprises that receive higher level support. For a detailed discussion of the complex ownership and control structure in Chinese industry, see Wong (1986a).

legacy of local planning is the behavioral pattern local governments developed during the Cultural Revolution period. Having gained control over large amounts of resources, local governments are in many places actively resisting reform efforts to turn over resource allocation to market forces and to transfer decision-making authority to enterprises.

#### IV. Mechanisms of Local Control in the Reform Period

In the pre-reform period, local governments could directly control production, supply and sales in local enterprises through the allocation of material supplies. The pooling of enterprise profits and depreciation allowances also enabled them to allocate investment funds. In the reform period, while compulsory and guidance plans are still formulated by local governments, these direct control mechanisms have declined in importance, since the development of goods markets have allowed enterprises to be less dependent on administrative allocations. A 1984 survey of 429 enterprises found, for example, that although local levels accounted for nearly half of the compulsory plans assigned to enterprises, compulsory planning accounted for an average of only 24% of total production in these enterprises (CRSRI, 1986: 53). Instead, with the decline in the use of direct mechanisms, there has been a shift to informal mechanisms of control, which have been left largely untouched by market reforms.

The most important informal mechanisms available to local governments are their control over factor resources. The allocation of workers and appointment of managers gives local officials substantial leverage for influencing enterprise behavior. In the absence of national capital markets, there is widespread consensus that local governments continue to exercise significant control over the allocation of investment finance. In spite of the near-universal introduction of enterprise profit-retention schemes, a good deal of evidence indicates that local enterprises, especially at lower administrative levels, enjoy less financial autonomy than enterprises at higher administrative levels. The 1984 survey mentioned above found a profit-retention rate of only 21.6% among small-scale enterprises, compared with an average of 57% for large and medium sized enterprises in the sample. Given that these small enterprises had an average of only 100,000 yuan for production development funds from retained profits, they were left highly dependent on external finance. (CESRI, 1986: 171)

Aside from the growing funds collected from enterprise profits and taxes which fiscal decentralization has transferred to local coffers (see below), local officials continue to exert substantial influence over bank lending, since the regional structure of the banking system places bank

officials at the mercy of local officials for a variety of supporting facilities including housing for the bank staff (Zhou Xiaochuan and Zhi Li, 1987). In addition, other studies found that profit-retention contracts are often violated, with local officials arbitrarily requisitioning enterprise funds for investment in local infrastructural facilities, development of new products, or to support local welfare expenditures (Zhao Yujiang, 1986; Ding Jiatiao, 1985). In a report reminiscent of complaints of the Cultural Revolution period, one writer told of officials in Sichuan province issuing quotas for local development projects in limitation of "advanced experiences" elsewhere. In order to fulfill these quotas, local units were forced to "blindly" start projects that were inappropriate to local conditions, and banks were coerced into granting loans in support of these investments (Zhu Xiaowen, 1985).

With local governments continuing to exercise control through these informal mechanisms, market reforms in the post-Mao period have left enterprises with a "dual dependence."<sup>(20)</sup> Not only are enterprises forced to be more responsive to market pressures, they also remain highly dependent on the administrative bureaucracy to provide vital support. With the economy moving away from the use of physical allocations to emphasizing financial indicators, enterprise dependence on the bureaucracy has similarly shifted from plan bargaining to the financial sphere, in bargaining over profit quotas, subsidies, investment funds, etc.

## V. The Impact of Reforms: The First Phase (1979-1983)

Through their formal and informal control over the three principal sources of extrabudgetary funds (enterprise funds, bank loans, and local government revenues), local governments greatly expanded their allocative powers when reforms spurred the growth of extrabudgetary funds from 36.1 billion yuan to 89.1 billion yuan from 1978 to 1983 (JJNJ, 1981: III-90; 1984: IV-43). In this section it is argued that decentralization during the first phase of reform resulted in an outcome that was somewhere between type 4 and type 5, not only with local governments gaining substantial resources, but also with some "positive intermediation," since enterprises became even more dependent on local officials.

Under the profit-based bonus schemes in use during 1979-1984, profit-retention rates were set at low levels of the bureaucracy, and the rates were subject to negotiation between enterprises and their supervisory

(20) This is a term used by Kornai (1986) to describe the condition of firms in the reformed Hungarian economy.

agencies.<sup>(21)</sup> Under this system, the welfare of workers and managers became very much dependent on the goodwill of local officials, who held the authority to set profit-retention rates for the enterprises. Beyond setting the retention rates, local officials had a good deal of control over the level of after-tax profits through their price — and tax-setting authority. For any given level of output and X-efficiency, the level of after-tax profits is directly related to the level of prices and taxes.

The ability of local governments to set prices is a legacy of Cultural Revolution policies. In order to allow small-scale, local enterprises to cover costs, local governments were allowed to set higher “temporary” prices for local products. In the reform period, this price-setting authority has been formalized under the principle of *gaojin gaochu*, whereby enterprises can charge high (market) prices for their output if inputs were procured at high (market) prices. Since much of local production is based on market-allocated inputs, local outputs are not constrained to state prices.

For any local administrative unit, this price-setting authority is dependent upon: 1) the amount of resources available for allocation at below-market prices, 2) its ability to procure output at below-market prices, which is linked to the first; and 3) the gap between state and market prices. For both inputs and outputs, as long as a divergence exists between the market price and the state allocation price, local governments can set the average price level in one of two ways. They can set the mix of the two prices, by stipulating the portions to be sold at each price for outputs, and by setting the portions allocated at each price for inputs. Or more commonly, they can set *local* prices at some intermediate level.

Market liberalization during the first phase of reform greatly increased the price-setting authority of local governments, since the growing gap between market and state prices provided them with a growing margin for changing prices. Obviously, this price-setting authority varies with the administrative level. At the provincial level, where the pool of materials that can be allocated is large relative to total demand, officials have substantial price-setting authority. At the township level, this authority may well be negligible. In 1982, allocations accounted for 70-80% of total materials supplied at the provincial level, and 60-70% at the prefectural and municipal level, and less than 50% at the county level. (Li Kaixin, 1983: 1).

While the rates for both income and industrial-commercial taxes were standardized nationwide, local governments in fact had substantial power

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(21) For discussions of the problems of these profit-sharing schemes, see Naughton(1985) and Wong(1986b).

to change them. When an enterprise ran into financial difficulties, it could turn to tax authorities for help, by asking for temporary tax reductions or exemptions. In spite of numerous attempts to recentralize this tax-relief granting authority, it rested at levels as low as the county. Efforts to make tax offices independent of local governments appeared to have been quite unsuccessful, with tax officials frequently taking the view that it was their duty to aid development of the local economy.<sup>(22)</sup> Interestingly, the "harder" prices faced by enterprises at the lower levels (where officials have less price-setting authority) were often partially offset by the "softer" taxes, with closer working relationships between the tax bureau and the economic planning agencies at the lower levels.

Through this period of reform, all the changes transferred more resources to local control, without any countervailing pressures to force local governments to behave in more economically efficient ways. Indeed, with fiscal reforms transferring the bulk of local enterprise profits and taxes to local revenue incomes, local governments had improved incentives to expand the local economic base. Not surprisingly, these changes brought an explosive growth in investment in revenue-generating activities, accompanied by an outburst of local protectionism. Protectionistic tactics ranged from excluding outside products from local markets, to threatening local enterprises with cutoffs of funds and bank loans, supplies of fuel, etc., should they dare to buy the products of competitors (Li Yue, 1982: 12).

Even though fiscal reforms that made local governments more revenue-oriented should have reduced their willingness to subsidize loss-making enterprises, several factors militate against the beneficial impact this was intended to have in forcing enterprises to adjust to market pressure. One was the fact that local governments try to maximize net revenues, which consist of profits and taxes paid by the firm. They would be willing to allow the survival of money-losing firms as long as sufficient tax revenues were generated to offset the losses. Since taxes were wholly unrelated to enterprise efficiency, this thwarted the reform's intent. In addition, local governments were often under heavy pressure to preserve or create local jobs and to respond to social and political concerns, and cost-cutting seemed less pressing in an era of growing revenues. Through the first phase of reform, some local governments took extraordinary measures to protect high-cost enterprises from bankruptcy, in clear violation of the attempt to shut down inefficient enterprises.<sup>(23)</sup>

(22) Fieldwork information, June 1982. Also, numerous articles in *CZ* and *CMJJ* corroborate the pervasiveness of these attitudes.

(23) For example, in one rural county in Guangdong, money-losing fertilizer

## VI. The Second Phases: 1984 —

In recognition of the problematic role played by local governments, the second phase of reform introduced two measures to reduce local government control and break down administrative barriers to resource flows. The first was the measure to promote the "economic role" of cities. The other was the reform to "substitute taxes for profits". Neither has succeeded to date in fundamentally altering the administrative set-up.

The movement to promote the economic role of cities was intended to utilize the natural coordinating functions of cities to break down the rigidities and irrationalities of the hierarchical system. Under this measure, some central and provincial enterprises have been transferred to city management. In some provinces the administrative level of prefecture has been abolished, and counties have been reassigned to supervision by cities. Some improvements have been reported under this measure, most notably in eliminating some of the circuitous shipment of goods caused by routing shipments along administrative lines (State Materials Bureau, 1984, *passim*.) In other areas, transferring enterprises to city management has improved the horizontal coordination of enterprises formerly belonging to different planning systems. However, progress toward reducing regionalism and "departmentalism" has not been universal, since cities are themselves "local" units, and the change has sometimes merely substituted one administrative unit for another, with little change in work-style.

A more concerted assault on local control came in the tax-for-profit reform that was introduced in 1983-1984. The main part of the reform shifted state-owned enterprises at all administrative levels from the system of remitting profits to paying a series of taxes.<sup>(24)</sup> The objective was to formalize the financial interaction between enterprises and their supervisory agencies and end the era of profit negotiation under previous enterprise incentive schemes. Aside from "hardening" enterprise budget constraints, this measure would have the effect of stripping local governments of an important source of control.

The reform would also reduce the financial incentives for local expan-

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plants were helped to set up breweries and cement workshops to improve their overall profitability. Fieldwork information, June 1982. These and other examples are reported in greater detail in Wong (1986a).

(24) This discussion draws heavily from Wong (1986b). Details of the tax-for-profit system are also provided in Naughton (1986).

sion. By pooling all enterprise income tax revenues and apportioning them among the different levels of government regardless of enterprise ownership, it would separate local government revenues from the ownership and profitability of enterprises.

Finally, the reform was to reduce the scope of local government intervention in enterprise operations by mandating that many small-scale enterprises be contracted out to private or collective management. Accompanying the tax-for-profit reform was the announcement that over a three year period beginning in 1985, all small-scale, state-owned enterprises with fixed assets of less than 1.5 million yuan and annual profits of 200,000 yuan or less would be contracted out to individuals or groups (Zhao, 1984). If fully implemented, this measure would turn over to private or collective management as much as half of the 81,000 state-owned enterprises classified as "small-scale".<sup>(25)</sup>

Not surprisingly, due to its potentially significant impact in redistributing income and resources across administrative units, the tax-for-profit program has run into much opposition. Through 1985, implementation was slow, and its objectives remained largely unfulfilled.

## VII. Conclusion

The existence of local governments with substantial allocative power has been detrimental to economic efficiency for 3 reasons. First, the fragmentation of control under local governments continues to impede resource flows. The slowness of the development of capital markets may be partly attributable to local opposition. Despite a promising start, investment trust companies have not developed into serious competitors to state-owned banks as financial intermediaries, perhaps because of their inability to cross over administrative barriers in their investment activities.<sup>(26)</sup> Reports of interregional investments seem to be confined to "interregional cooperation" projects undertaken by local governments to secure raw material and energy supplies.

Second, when local governments are making the bulk of investment decisions, resource allocation is not following "market regulation", since local government maximands are net revenues rather than profits. Even

(25) This is estimated on the basis of the 1983 profile of these enterprises: they had annual output of 3.1 million yuan and fixed assets of 2 million yuan, and they remitted taxes and profits of 430,000 yuan (SSB, 1984; BR, 1985: 9, 10)

(26) For a brief account of the development of investment trust companies, see Naughton (1986: 615-18).

with market reforms incrementally improving the information carried by prices, tax signals continue to be problematic guides for investment. In addition, local governments make investment choices based on administrative considerations rather than purely economic ones. In many areas the pressure to create jobs remains strong. And as the earlier example from Sichuan demonstrated, local officials are often susceptible to "emulation drives" and model-building practices that run counter to economic rationality.

Third, local governments reduce competition by shielding enterprises from market pressure and by intervening in interregional trade. In addition, they slow down market adjustments by helping to perpetuate sellers' markets in a variety of producer and investment goods through their vigorous investment activities. These investment projects may in the long-run make prices downwardly sticky: the development of buyers' markets may spur new attempts at regional protectionism rather than price-cutting, as local governments try to protect their newly created productive assets. They may even reach oligopolistic compromises that divide markets geographically to avoid competition. For all of these reasons, it is necessary to curb local control in order to achieve reform objectives.

To date, attempts at curbing local control through administrative restructuring have been largely ineffective. It is probably in the realm of price-setting authority that market forces have had the greatest impact in eroding local control, by reducing the amount of resources that local governments can allocate administratively, at below-market prices, and by reducing the gap between plan and market prices for many goods. Since local governments derive substantial leverage through their ability to set prices, these changes have reduced their maneuverability. However, market forces alone cannot close the price gaps, which can be closed only through a combination of raising state prices to realistic levels (where average costs are covered), and eliminating sellers' markets. Numerous adjustments in state prices since 1982-1983 have helped to close the gap for many products, especially consumer goods, where buyers' markets had developed.

Furthermore, market forces cannot always be expected to turn sellers' markets into buyers' markets even with improved resource mobility. Too many factors persist in the economy to fuel excessive investment, including soft budget constraints at the enterprise and local government levels. In the reform period, sellers' markets have persisted for many producer and investment goods, where price gaps remain large. For rolled steel, for example, the market price continues to be 2-3 times the state price.

Price reform is therefore necessary to realize prices to cover average

production costs and to eliminate the gaps between state and market prices. A price reform that reunifies the price structure will substantially limit the bargaining power of local governments over their enterprises and go a long way toward "hardening" the enterprise budget constraint.

Given the importance of taxes in conferring bargaining power on local governments, tax reform is also necessary. The "softness" of the present system must be eliminated by introducing standardized taxes. The authority to grant tax relief must also be recentralized to higher levels to reduce the incidence of abuse. Under the present revenue-sharing system, local officials can often afford to be generous in granting tax reductions or exemptions because the loss of revenue is shared with higher levels, where local officials see this as an opportunity to "rob" the state treasury by reducing total tax payments. To really wrest control of tax rates from local control, then, a new system must be set up to separate local taxes from state taxes, with separate agencies for collections.

Even though these changes are necessary to reduce local influence, they will not be sufficient. The greatest mechanisms of control available to local governments are their control over factor resources, whose geographical immobility confers tremendous power on local governments. Until market reforms extend into the development of factor markets, local governments will continue to wield substantial control in the Chinese economy.

## LIST OF ABBREVIATIONS

- BR *Beijing Review*  
 CASS Chinese Academy of Social Sciences  
 CESRI Chinese Economic System Reform Institute  
 CMJJ *Caimao Jingji* (Finance and Trade Economics)  
 CZ *Caizheng* (Finance)  
 JJGL *Jingji Guanli* (Economic Management)  
 JJNJ *Zhongguo Jingji Nianjian* (Economic Yearbook of China)  
 JJYJ *Jingji Yanjiu* (Economic Research)  
 MTNJ *Meitan Nianjian* (Coal Yearbook)  
 RMRB *Renmin Ribao* (People's Daily)  
 SSB State Statistical Bureau

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