

The role of rural enterprises in China's economic development since 1978

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THE ROLE OF RURAL ENTERPRISES IN CHINA'S ECONOMIC DEVELOPMENT SINCE 1978

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1997

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Abstract

This report is concerned with the role of rural enterprises (or RNA) in China's economic development since 1978: the origins of the rapid growth of rural enterprises and the consequences. It applies the Ranis-Stewart (R-S) model to the post-reform Chinese economy and discusses whether the R-S model can explain what is happening in China. Our analysis shows that while the R-S model can capture some features of rural enterprise growth, it has limitations.

The R-S model is an extension of the Hymer and Resnick model to the post-colonial era. There are four archetypes, depending on alternative colonial situation and differential performance in post-colonial era. In the favourable post-colonial archetype, RNA becomes one of the dynamic elements in industrial development, due to favourable government policies and supply and demand conditions. Its pattern of growth tends to be associated with a high overall rate of growth, a more egalitarian distribution and better regional balance.

The economic reforms since 1978 created an environment in which rural enterprises could flourish, and it is reasonable to place it in the favourable category according to the macro-policy setting and policies toward rural development in the post-reform period. Reforms introduced in the agricultural sector during the earlier period resulted in high growth in agricultural production, more marketable surplus and savings, more equal income distribution and greater incentives to expand RNA. Faced with favourable supply and demand conditions, market-oriented rural enterprises have become the most dynamic elements in

industrial development. The growth of rural enterprises has contributed not only to higher overall growth of the economy, but also to high employment and export growth, structural change, and rural urbanisation, etc.. All these can be explained by the R- S model.

However, contrary to the R-S model, rural enterprise growth has been associated with rising rural income inequality and widening regional imbalances. To sustain its growth, China needs to redress this problem urgently. The long-run solution lies in the national integration of labour and capital markets, and improvements in human and infrastructure development in the poor regions. In the short run, the government is providing helps to the poor regions.

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Chapter 1

Introduction

1.1 The rise of China's economy

China, “the sleeping giant of Asia” as Napoleon referred to it, has achieved remarkable economic growth since economic reforms beginning in 1978. Its success stands in contrast to the failure of the Soviet Union and Eastern Europe. One indicator of the success was the annual 10% (average) growth rate of GDP during 1979-94 (China Statistical Yearbook 1995 p. 21) and the substantial improvement in ordinary people's standard of living. However, China's economic success has not been confined to raw economic growth. With industrial production growing at around 15% annually (Ibid p. 23), rapid structural change has also taken place, although China is still a developing economy. China has managed to move from autarky to being one of the world's major trading powers. Its exports climbed from a mere \$US9.75 billion in 1978 to \$US121 billion in 1994, with an annual growth rate of 17% (Ibid p. 25). Not only did exports rise, but they also become more sophisticated, with manufactured goods accounting for a large share. While accomplishing this export growth, China has recently achieved huge trade surpluses and its foreign exchange reserves exceed \$US100 billion. The growth in foreign investment was even stronger: foreign investment increased from \$US4.65 billion in 1985 to \$US43.2 billion in 1994 (Ibid). “Never before in China's long history has the economy expanded so fast for so long. Never before has it been so

closely linked by trade and financial flows into the life of an international economy outside its borders” (Garnaut et al. 1992 p. 6). Compared with other nations China’s economic growth rate has been very high. In fact, as Overholt points out, “the Chinese takeoff appears to be unique in world history”(1993 p. 2). During the 1980s China was the world’s fastest-growing economy, and has become once again the world’s fastest-growing economy since the early 1990s after a brief period of disinflation in the late 1980s. This kind of performance previously appeared to be confined to relatively small economies (e. g. Hong Kong, Singapore). The largest other developing economy that has grown for several years at a rate close to double digits is South Korea, with a population of 40 million. But China’s population is roughly 30 times as large (Ibid p. xi).

As a result of rapid growth, the China’s economy has increased not only in size, but in its importance on the world stage. In 1987 China’s GDP was the 9th largest in the world (not including the Soviet Union), trailing only the US, Japan, West Germany, France, Italy, Britain, Canada and Brazil (Minami 1994 p. 11). If Summer’s calculation is correct, China’s economy will pass the US economy in sheer size within 11 years (Overholt 1993 p. 21), making it the world’s largest economy. This means that China’s influence over the world economy and world politics in the next century will be significant.

Location in an economically dynamic region - East Asia - has influenced China’s economic growth in one way or the other. As we know, the East Asian economies have achieved sustained, rapid growth in the period since the Second World War.

Japan's unprecedentedly high economic growth in the 1950s and 1960s, and the rise of NIEs (Taiwan, Hong Kong, South Korea and Singapore) in the 1970s were the first two waves of Asian economic growth. The economic takeoff of the four ASEAN nations (Indonesia, Malaysia, the Philippines and Thailand) marks a third wave of Asian economic growth. The "Asian Era" has arrived. If China's economic reforms are successful and the Chinese economy grows steadily, it will lead to the fourth wave of Asian economic development, and the effect of Asia on the world economy is difficult to imagine (Minami 1994 p. 236). And within East Asia, greater China (including Taiwan and Hong Kong) is increasing its influence.

1.2 China's development strategy and the dual economy

Why did China's economic performance differ so much from that of Soviet Union and Eastern Europe? What is the basis of China's success? These questions lead us to exam the development strategy adopted in post-reform China and the distinctive feature of the Chinese economy: the persistence of the dual economy.

Dualism existed in China before 1949. The Stalinist model pursued by China in the pre-reform period did not alleviate but reinforced a dualism in China's economy and society. Rural-urban disparities persisted. On the one hand, with substantial state investment, modern capital-intensive industries, mainly in the producer goods sector, have developed in urban areas. They used advanced technology, and operated under the state plan. On the other hand, with limited state investment and poor access to formal financial institution, agricultural productivity grew slowly and used backward technology. A very high proportion

of China's population lived in rural areas, and rural-urban migration was restricted by the household registration system (*hukou*) implemented since the late 1950s. This Soviet type of development strategy had resulted in a low rate of consumption growth, a high rate of accumulation, mismatch between demand and supply, low economic efficiency, and high level of unemployment and underemployment, and thus had contributed to the failure of the Chinese economy before 1978. Economic reforms were intended to address the problems mentioned above and flaws in the economic system, and transform the centrally planned economy into one in which the market has an increasing role to play.

Since the economic reforms, China's development strategy has been distinctively Asian (Overholt 1993 p. 5). It focused on economic growth. With limited resources available from the government and state-owned enterprises (SOEs) in trouble, firstly, the Chinese government gave priority to industries and sectors where limited government investment would produce rapid growth, and opportunity of expansion to the non-state sector (Ibid p. 6). Unlike the Soviet Union, which neglected agriculture, China's economic reforms had deep roots in peasant society. In fact, economic reforms in China started with the agricultural sector. Due to price increases for agricultural products, introduction of the household responsibility system, and deregulation of rural markets, huge increases in productivity, income, and investable and marketable surpluses were generated with negligible state investment, and these provided the basis for the development of rural nonagricultural activities (RNA) in a favourable policy environment. The

rural industrial and services sectors grew by 16.8% and 19.4% respectively during 1978-91, compared to 8.1% and 7.0% growth of the urban industrial and services sectors, and 5.3% growth of agriculture (Findlay et al. p. 42). The rapid growth of rural enterprises contributed not only to high GDP growth, but also to employment growth, structural change in the rural economy and the national economy. The export earnings of rural enterprises made up one-third of the national total in 1995 (Long 1996 p. 6), and rural enterprises also contributed to agriculture and rural welfare and education. Secondly, China was very encouraging to foreign investment (Overholt 1993 p. 6). Taking the advantage of geographic proximity and similar structural feature with the high-growth East Asian economies, and the unbalanced development strategy adopted by the central government, coastal region has become the nation's most prosperous region, while the interior region is underdeveloped. Table 8 and 9 (Chapter 4) show the rising regional differences in national income per capita and rural net income per capita respectively. From Table 10 (Chapter 4), we can see that the eastern region accounted for a large share (around two-thirds) of rural enterprise gross output value. Analysis shows that the differential rate of growth in rural enterprises contributed to the growing rural inequality and regional income gaps.

In his study, Overholt points out, "the Chinese economic strategy emphasises an explosion of production and jobs outside the state enterprise sector.....This emphasis on construction produces more rapid growth, less inflation and a greater sense of common interest than the Eastern European approach, which gives

priority to destruction of institutions of socialism rather than to construction of a productive market economy”(1993 p. 43). This strategy has undoubtedly served the objective of growth, but it raises new question: whether China can sustain its rapid growth.

According to Meier, “economic development is the *process* whereby the *real per capita income* of a country increases over a *long period* of time—subject to the *stipulations* that the number of people below an ‘absolute poverty line’ does not increase and that the distribution of income does not become more unequal” (1995 p. 7). From the definition we can see that economic development is not just economic growth, it is growth plus change. Improvement in the distribution of income is an integral part of the development problem, and there is a vital distinction between initiating development and the more difficult task of sustaining development over the longer run (Ibid pp. 6-7). Recent studies have shown the relationship between distribution of income and achieving sustainable growth. Therefore, to sustain its growth, China needs to address its problem urgently.

1.3 Purpose and structure of this report

Economic development in China, a country with one-fifth of the world’s population, is interesting. Literature on the Chinese economy has been increasing rapidly since China’s economic reforms. The rapid growth of rural enterprises has attracted world-wide attention. The nature, structure, origins and patterns of growth, and prospects of rural enterprises, the impact on rural income distribution,

and the Chinese government's recent efforts to promote balanced growth and rural enterprises in the interior region have been documented in a number of studies, e. g. Byrd et al. (1990), Khan et al. (1993), Findlay et al. (1994), Rozelle (1994), Chang and Wang (1994), Chen and Fleisher (1996), Yang and Wei (1996), etc.. While all these studies have contributed to increasing our understanding of rural enterprise growth and its consequences, they tend to treat the issues involved separately, thus fail to incorporate them into an appropriate and comprehensive theoretical framework.

This report is intended to fill in this gap by tying those issues together. We apply the Rains-Stewart (R-S) model to the post-reform Chinese economy, and discuss the role of rural enterprises in China's economic development since 1978, the influences of rural enterprise growth have on the future development of the Chinese economy, and some policy options for the Chinese government.

Since China still had the characteristics of a dual economy in the late 1970s when the economic reforms began, and this had impact on the reforms, understanding the problems associated with the economic development of a dual economy is a pre-condition for us to understand China's economic development since 1978. We start with the most celebrated model on dualism – Lewis's dual-sector model, which tells us about the relationship between the traditional agricultural sector and the modern industrial sector. We notice that Lewis's model is based on such implicit assumptions as the existence of an integrated labour market, financial institutions, and capitalist class, which may not be true in many

developing countries. Thus the direct applicability of the model is limited. Other versions of dualism – financial dualism, technological dualism, wage dualism, etc. contribute to our understanding of the features of developing economies and development path. We also discuss issues associated with rural-urban migration, which is central to the above models. Unlike many other developing countries, which suffer from over-urbanisation due to huge inflow of labour from the countryside into the cities, the Chinese government has encouraged the development of RNA since economic reforms. As mentioned before, it is the rural enterprises, which are mainly engaged in RNA, rather than urban SOEs that have expanded most rapidly. Thus we turn to the long-neglected issue – the role of RNA in the development process, paying particular attention to the R-S model, which we think is most relevant to China. The model suggests that under favourable circumstances, RNA (the Z-sector) can become one of the dynamic elements in industrial development, with a high rate of capital accumulation, technology change and employment expansion. It also stimulates further agricultural growth, and this pattern of growth tends to be associated with a high overall rate of growth, a more egalitarian distribution and better regional balance (Ranis and Stewart 1993 pp. 83-84) (Chapter 2).

After looking at China's dual economy in the pre-reform period, we apply the R-S model to the post-reform Chinese economy with some modification of definitions. Since the macroeconomic policy, policies toward rural development, and supply and demand conditions are favourable to the development of RNA, we

place China in the favourable category. We also find that local governments have played an important role in promoting rural enterprises in China, an aspect not captured by the R-S model. Just as the model suggests, rural enterprises have become the driving force behind China's rapid economic growth. They contributed not only to higher overall growth of the economy, but also to high employment and exports growth, structural change and rural development. However, due to its inability to take into account the special characteristics of the Chinese economy, the model cannot explain the rising rural inequality and widening regional imbalances (Chapter 3).

These developments have impact on China's ability to sustain its growth. Recent studies have shown that distribution of income is an important factor in achieving sustainable growth, and evidence from East Asia suggests that low levels of income inequality may have directly stimulated growth. The sharp increase in rural income inequality is associated with low factor mobility, especially labour in China. Widening regional imbalances can be attributed to decentralisation, the government's unbalanced development strategy, and other geographical and historical factors. We conclude that in the long run the solution to reducing income inequality and regional gaps lies in the national integration of labour and capital markets, and improvement in human and infrastructure development in the interior region. In the short run, the central government has decided to adopt a balanced development strategy, and is trying to provide various helps to the central and western regions (Chapter 4).

Chapter 2

A Review of the Literature

Since the emergence of modern development economics in the late 1940s, economists have made great effort to adapt their conventional way of thinking about economic problems to the particular context of developing countries. They have noticed that an outstanding characteristic of many less developed countries (LDCs) is the existence of dual economies: a modern commercialised industrial sector has developed alongside a traditional subsistence agricultural sector (Meier 1995 p. 113). When a dual economy exists, the question for the country's development is how the modern sector can expand while the traditional sector contracts. In other words, there is structural change in the development process: the share of manufacturing in output and employment rises as per capita income increases, while the share of agriculture declines. Although investment is an important source of growth for developing countries (as it is for the developed ones), studies have shown that structural factors can be significant for developing countries (Chenery et al. 1986 p. 14).

To understand the development process of a dual economy, we must understand the relationship between the modern sector and the traditional sector. Section 1 of this chapter examines the Lewis's dual-sector model, before briefly discussing other versions of dualism and how a dualistic economy can transform into a modern growth regime in Section 2. The central problem of the dualistic model –

rural-urban migration is examined in Section 3, and the role of rural nonagricultural activities in the development process, especially the Ranis-Stewart model is examined in Section 4. Section 5 presents a summary of this chapter.

2.1 Lewis's dual-sector model

According to Meier, Lewis broke the economy into two sectors. The first being the traditional sector which is characterised by noncapitalist institutional arrangements. In this sector, there are no markets or any form of wage labour. Instead people may work for families and get part of their product as wages. Output per head is said to be lower in this sector and given the very primitive production techniques marginal productivity of labour is equal to or near zero. In contrast, the capitalist sector is that part of the economy that produces manufacturing goods with the use of capital and pays capitalist for the use. There is employment of wage labour and output is sold on the basis of profit.

The fundamental relationship between the two sectors is that when the capitalist sector expands, it draws labour from the reservoir in the noncapitalist sector. The argument is that when marginal productivity of labour is near zero, it means that as long as wages are slightly higher than subsistence earnings, you can pull labour out of agriculture with very little change in output. So at the existing capitalist wage, supply of labour is said to be perfectly elastic. The large pool of unskilled labour in the traditional sector enables new industries to be created or old industries to expand in the capitalist sector without encountering any shortage of unskilled labour.

In tracing the process of economic expansion, Lewis emphasises that the key to the process is the use of the capitalist surplus. In other words, the driving force in the system is generated by the reinvestment of the capitalist surplus, which is the only source of savings, in creating new capital.¹ As the capitalist sector expands, labour withdraws into wage employment; the surplus then becomes even larger; there is still more reinvestment of profits; and the process continues progressively.

Within the Lewis model, what happens is that when the capitalist sector expands, it will grow at an accelerating rate, because as it expands, the wage-price ratio remains constant, the share of profits in national income² increases, and therefore savings and investment also increases as a proportion of the national income.

According to Lewis, eventually there is a limit to the development process because the capitalist sector will have grown so much that it will have exhausted all surplus labour, and any further expansion will lead to rise in real wages. This will in turn reduce the rate of profits and the growth rate in the capitalist sector.

Lewis also considers the possibility that the expansion process might be cut short by a rise in real wages and a reduction in profits that halt capital accumulation before the excess labour supply is completely absorbed. To prevent a deterioration in the terms of trade for the industrial sector, it is extremely important to provide an agricultural surplus for consumption in the expanding industrial sector, so agricultural output must expand along with industrial development.

¹Lewis assumes that all wages are consumed and that the profits are the only source of saving.

²It is determined by the share of the capitalist sector in the national output and by the share of profits in the capitalist sector.

In application, we should notice some implicit assumptions of the model.

Firstly, Lewis assumes that there exists an integrated labour market, and labour is perfectly mobile between sectors. Although he recognises that in poor countries skilled labour might be in short supply, he discounts its importance by considering it to be only a temporary bottleneck that can be removed by more training.

Secondly, Lewis assumes that financial institutions exist so that the agricultural surplus can be transferred.

Thirdly, Lewis assumes that a capitalist class already exists. So the model ignores not only capital shortage, but also shortages of capitalists themselves.

Fourthly, Lewis assumes that there is elastic supply of agricultural output with no increase in price.

Finally, Lewis assumes that whatever the capitalist sector produces, it can sell.

These assumptions may restrict the direct applicability of the model. However, as Meier (1995 p. 125) points out, the model retains high analytic value for its insight into the role of capital accumulation in the development process. What is crucial is the way investment becomes a rising proportion of national income and the economy undergoes a structural transformation that involves the reallocation of labour between sectors and can accelerate growth.

2.2 Versions of dualism

While Lewis's two-sector model has a central position in development literature, other versions of dualism which emphasise different types of asymmetries have been presented. They include social dualism, technological dualism, financial

dualism, wage dualism, and organisational dualism. The concept of dualism goes wider than asymmetry between a modern and traditional sector.

2.2.1 Technological dualism (Meier 1995 pp. 129-130)

Benjamin Higgins and several writers have attributed the labour employment problem of a poor country to *technological dualism*, that is, the use of different production functions in the advanced sector and the traditional sector. In their interpretation, dualism is associated with *structural unemployment or technological unemployment* – a situation in which limited productive employment opportunities result from resource and technological restraints in the two sectors.

The characteristics of the traditional rural sector are: it engages in peasant agriculture and handicrafts or very small industries, it has variable technical coefficients of production and its techniques of production are labour intensive. In contrast, the modern sector is composed of plantation, mines, oil fields, or large-scale industry, its production is characterised by fixed technical coefficients and the production processes are relatively capital intensive.

In many developing countries, the advanced sector was initially developed by an inflow of foreign capital. With modern production techniques output in this sector expanded. At the same time, population was growing, in some cases, at a rate higher than the rate at which capital was accumulating in the advanced sector. Since production processes in this sector were capital intensive, the labour force grew faster than the modern sector could absorb, and labour became a redundant

factor in this sector. Entry into the traditional rural sector was the only option for surplus labour. As the labour supply increased in the traditional sector, it may have been possible initially to bring more land under cultivation, but eventually land became relatively scarce and production processes became even more labour intensive, and the marginal productivity of labour fell to low level.

In the long run, technological progress did not ease this situation. For in the modern sector, technological progress favoured more capital-intensive techniques, so that it was more difficult to increase employment opportunities in this sector as investment and output expanded. At the same time, there was no incentive in the rural sector to introduce labour-saving innovation.

2.2.2 Financial dualism (Meier 1995 p. 131)

Dualism may be the characteristic of a fragmented capital market. *Financial dualism* means that capital funds are provided to large firms in the modern sector on easier terms than they are offered to small economic units in the traditional sector.

Firms in the modern sector have access to financial institutions and can borrow at relatively low interest rates from the *organised* market. In contrast, peasant farmers or handicraft workers in the traditional sector must borrow at high interest rates from the *unorganised* capital market. The more underdeveloped the domestic credit market and financial institutions are, the larger the gap in interest rates tends to be. This may cause an allocation of excessive capital to the modern sector relative to the traditional sector.

2.2.3 Wage dualism (Meier 1995 p. 131)

A fragmented labour market may also have the characteristic of dualism. The existence of a higher level of wages in the modern sector than in the traditional sector may discourage the expansion of the modern sector and distort the allocation of resources in the opposite direction from that caused by financial dualism. Besides the economic differences in the two sectors that can explain wage differentials, there may be certain factors that arbitrarily widen the wage differentials between the modern and traditional sectors and distort the allocation of labour between the two. An artificial widening can result from various government regulation on labour and minimum-wage rates or from the action of trade unions in the modern sector.

2.2.4 Organisational dualism (Meier 1995 pp. 132-139)

Hla Myint incorporates these different types of dualism into a general conceptual framework embracing the underdeveloped economy as a whole. He believes that dualism is pre-eminently a phenomenon of an underdeveloped organisational framework, characterised by incomplete development, not only of market but also of the administrative and fiscal system of government. There are four types of dualism: in the goods market, the capital market, the labour market and administrative and fiscal machinery of the government.

According to Hla Myint, the modern sector includes wage households, business firms, financial institutions, and the government, while the traditional sector consists of a large number of peasant farmers and other small-scale units. In many

underdeveloped countries, the organisation of the goods market is incompletely developed. With high transport and marketing costs, the retail-wholesale price differential will be wider than in a developed economy with a more effective market organisation. This may explain the prevalence of subsistence production in the traditional sector in many underdeveloped countries. The high transaction and information costs restrict the flow of funds from financial institution to the traditional sector and cause wide gap in the level of interest rates in the organised and unorganised capital market. This can explain why large business firms with established creditworthiness can borrow money from financial institution at relatively low rates while small borrowers in the traditional sector can only borrow money from the highly fragmented unorganised capital market at high rates. Wage differentials between the modern and the traditional sectors can be explained by the qualitative differences in labour between these sectors. The unskilled labour in the modern sector is not the same as the raw labour from peasant agriculture. In an underdeveloped economy it is difficult to transform the raw labour from the traditional sector into suitable material for a regular wage economy, large elements of labour market dualism would remain even if we could eliminate all the artificial wage distortions. Thus business firms in the modern sector are willing to pay higher wages for the same type of labour to retain a stable force of experienced workers. In an underdeveloped country, the effectiveness of general administration tends to decrease as we move away from the headquarters to the remoter peripheral area. Thus, even if the government were to spend the same

amount per head in providing public services to the rural and urban population, the quality of these services would be poorer in the traditional sector compared with the modern sector. Therefore, dualism in the government's administrative and fiscal machinery must be recognised as an essential element in the total picture of dualism, imposing an organisational constraint on the capacity to implement policy.

2.2.5 Discussion

These various versions of dualism capture particular features of underdeveloped countries and enable us to have more accurate analysis of development path and policy.

Despite some constraints, there is something that the government can do to alleviate dualism. The government can encourage the modern sector to adopt labour-intensive methods of production. By correcting policy-induced distortions in the capital market, for example, stopping subsidising capital and foreign exchange, some of the technological dualism can be alleviated. The government can also provide small producers with economic incentives to adopt more appropriate technology and better access to credit. The government can remove the factors that arbitrarily widen the wage differentials between the modern and the traditional sectors so as to improve the allocation of labour between the two sectors. By providing better infrastructure – roads, telecommunications, etc. in the countryside, the goods market will be more completely developed, and the effectiveness of government administration will be improved.

In dualistic developing countries, initially the agricultural sector is relatively large. We can assume that the savings out of the agricultural surplus serve as the principal fuel for the continued growth of the dualistic economy. It is important for the agricultural sector to yield sufficiently large agricultural surpluses and to preserve a sufficient large part of such surpluses for productive investment in nonagriculture. At the same time, the nonagricultural sector, financed by this agricultural surplus plus the reinvestment of industrial profits, must grow fast enough to absorb the labour force being allocated. Over time if the economy can progress along a balanced growth path at a rate in excess of population growth, it will escape from dualism into a modern growth regime. Once balanced growth has proceeded long enough and fast enough labour shortage will appear in both sectors, so that the marginal productivity calculus of wage determination will take over (Chenery et al. 1988 pp. 79-86). The actual process of transformation from dualism into a modern growth regime depends on the institutional framework of each economy.

2.3 Rural-urban migration

Central to the above models in the development process is the migration of labour to the cities. In the 1950s economists were optimistic about rural-urban migration and city growth. City migration was seen as a favourable process whereby “surplus rural labour was withdrawn from traditional agriculture to provide cheap manpower to fuel a growing modern industrial complex” (Todaro 1980 p. 361 as quoted in Chenery et al. 1988 p. 442). In the dual economy models, urbanisation

augments aggregate output both through short-run efficiency gains and long-run growth effects (Chenery et al. 1988 p. 449). In the short run, labour is shifted from low to high marginal productivity employment. In the long run, accumulation rates are raised since savings are higher in urban sector. Thus city immigration leads to high savings, investment, and output growth.

Things were different in reality. Since the 1960s it appears that the huge flow of migrants from the countryside into the cities was more than the cities could handle. It created great pressure on the cities and government, and led to rising urban unemployment.

Two principal hypotheses were used to explain the rapid city growth and urbanisation: “(1) unusually rapid rates of population growth pressing on limited farm acreage, pushing landless labour into the cities; and (2) economic forces pulling migrants into the cities” (Ibid p. 426). The latter forces include: “domestic policies that distort prices to favour cities (e.g. the domestic terms of trade have been twisted to ‘squeeze’ agriculture); cheap energy prior to the first OPEC shock favouring the growth of energy-intensive urban sectors, thus creating urban jobs; the diffusion of technology from the developed world, which favours modern, large-scale urban industries; foreign capital flows into urban infrastructure, housing, power, transportation, and large-scale manufacturing – further augmenting the growth of cities in the Third World; and the liberalisation of world trade since the late 1950s, which has stimulated demand for manufacturing exports produced in Third World cities”(Ibid).

New urban pessimism slowly replaced the optimism of the 1950s. In 1969 Michael Todaro presented his model of labour migration and urban unemployment. He emphasised a migration function which uses as the relevant urban income, the present value of expected earnings. It is the combination and interaction of these two variables – the urban-rural real income differential and the probability of securing an urban job that determine the rate and magnitude of rural-urban migration. In a distorted labour market, growing urban unemployment is consistent with equilibrium in this model, and rural-urban migration is assumed to occur until there is equality between the actual rural wage and the expected urban wage (Meier 1995 p. 114).

One implication of Todaro model is that we cannot rely on raising urban labour demand to reduce urban unemployment (Ibid), and we need to pay attention to the interaction between rural and urban labour markets. Lewis realised this, and stated in his 1979 paper: “unemployment in the towns cannot be ended by spending more in the towns” (Ibid p. 393). He suggested that “the basic solution is rather to make the countryside economically viable, with a large cultivated area, with rising productivity on the farms, more rural industry, and better social amenities” (Ibid).

2.4 Rural nonagricultural activities (RNA) and rural industrialisation

For a long time economists did not seem to pay enough attention to the role of RNA in the development process. However, evidence from East Asia suggests that

for many developing countries there may be a considerable greater scope for rural industry involving simple technology and the processing of agricultural materials, and the employment potential in rural industrialisation may be greater than that of the modern urban sector.

2.4.1 The Hymer and Resnick model (Ranis and Stewart 1993 p. 76)

A early model on RNA was constructed in 1969 by Hymer and Resnick (H-R) to explain the decline of RNA in the colonial era. They postulate a self-sufficient peasant economy in the pre-colonial era. Peasants use only labour to produce two types of goods, food and some nonagricultural products, to serve their own needs. The RNA – defined as ‘Z-goods’ consist of the household or village production of handcrafts and services. In the colonial era, the rural economy was increasingly linked with the world economy, and two related developments occurred: on the one hand, new export activities such as minerals and cash crops developed, offering an alternative use for rural labour; and on the other hand, consumption of imported manufactured goods, produced in the cities, became possible. These imported products (M) not only offered a wider range of needs than Z-goods, but also were of better quality. Consequently, labour was induced (sometimes forced) to move out of the production of Z-goods and into the production of (non-domestically consumed) cash crops for export (A_E); the foreign exchange so earned was used to import manufactured goods, which replaced Z-goods. Therefore, the result of these developments was that the Z-goods sector declined and both exports and imports expanded.

2.4.2 Extension of the H-R model: the Ranis-Stewart (R-S) model

(Ranis and Stewart 1993 pp. 78-85)

To extend the H-R model to the post-colonial era, Ranis and Stewart had to change some of the assumptions.

1. In contrast to the H-R model, the Z-goods sector is not homogeneous, but covers a wide range of products and activities using different technologies. Ranis and Stewart therefore divide the Z-sector into: Z_T , covering traditional household and village processes and products; and Z_M , covering nontraditional or modernising rural nonagricultural processes and products. The latter are more likely to be located in rural towns, rather than in household or villages. Some Z_M activities may have existed even in the colonial era, but become more important in the post-colonial period.

2. A major development of the post-colonial era has been the emergence of a modern industrial sector, located mainly in the urban areas. This sector, called U-sector, was initially devoted to replacing imports. Instead of being replaced by imports, Z-goods are actually or potentially replaced by U-sector goods. They call this displacement of Z-goods by U-goods, U-displacement. Labour is no longer the only factor of production in nonagriculture, as the U-sector imports capital and other inputs in exchange for the A_E cash crop exports.

3. The agricultural sector (A) is in fact composed of two sub-sectors: the agricultural cash crop export sector (A_E), and a domestically oriented food producing agricultural sector (A_D). They assume that in both periods, especially

the post-colonial era, A_D can have the potential for dynamic growth as it is subject to productivity-raising technology change. This feature, which is not incorporated into the H-R model, has two relevant consequences: first, as fewer resources may be required to feed the total population, land and labour can be released for use in the production of more A_E and Z-goods; second, a dynamic A_D can provide stronger linkage between A_D and RNA. Such linkages run both from A to RNA and from RNA back to A. RNA to A linkages include: more RNA activities which can improve agricultural markets or internal terms of trade; and development of RNA which can provide agriculture with modern inputs; growing availability of consumer goods and opportunities for investment in RNA which provide farmers with greater incentive to raise productivity and accumulate saving.

4. In the post-colonial era, most LDCs have experienced constant or deteriorated terms of trade rather than improved terms of trade as assumed in the H-R model. So they assume constant terms of trade, and notice that Z-goods production tends to increase under this assumption.

Ranis and Stewart think that these departures from the H-R model can shed light on both alternative colonial situation and on differential performance in post-colonial era. They construct four archetypes: the unfavourable and favourable ones in colonial period, and the unfavourable and favourable ones in post-colonial era.

1. The unfavourable colonial archetype: the H-R case

In this case, colonial policies inhibit the development of domestic industry. governments pay more attention to the export of minerals and cash crops than

agriculture for domestic consumption. Concentrated A_E result in unequal distribution of income and weak rural linkages. The Z-goods sector is likely to be dominated by Z_T , and Z_M activity is negligible. In this context Z_T is gradually displaced by imported consumer goods, while domestic agriculture tends to stagnant relatively.

2. The favourable colonial archetype

In this case, the colonial government gives more attention to food producing agriculture for its own reasons. With unimodal agricultural sector (composed of large number of individual small-holders), agricultural income is more equally distributed, and the linkages between agriculture and nonagricultural activity are stronger. The colonial government also permits the development of indigenous industries.

Under these assumptions, as agricultural productivity increases, more labour and land are released, leading to the expansion of the Z-sector, which is increasingly made up of Z_M . As a consequence, the displacement of Z by M may not occur or is weakened, as Z_M are better able to compete with imports.

3. The unfavourable post-colonial archetype

In the post-colonial era, U-sector emerges as a consequence of import substitution policy. In the unfavourable case, urban industry is encouraged, relative to both Z-goods production and domestic agriculture, by government policies affecting the internal terms of trade, the exchange rate, the interest rate, etc.. Large-scale domestic enterprises and multinational corporations (MNCs)

dominate the U-sector. Within agriculture, A_E is usually favoured relative to food crops, land and income are likely to remain unequally distributed, and rural linkages are weak.

In this case, while some Z_T production will continue, the potential development of the Z_M sector is severely affected, as Z-goods are increasingly displaced by U-goods.

4. The favourable post-colonial archetype

In this case, the Z-goods sector represents a dynamic element in interaction with a growing food producing agricultural sector. A more favourable environment contributes to this: (1) the government does not discriminate against domestic agriculture relative to traditional primary export activities. As a result, productivity in the A_D sector increases and resources are released to the rest of the economy; (2) since income generated within A_D is more likely to be equally distributed than within A_E , potential demand for the output of RNA is created with the expansion of A_D sector; (3) the allocation of infrastructure and the macro-economic environment are more even between rural and urban industry, as well as between agriculture and industry.

Under the above conditions, the rural industrial sector faces relatively more favourable conditions, both from the perspective of demand, via linkages with agriculture, and of supply, via the dynamics of investment and the adoption of new technology. The Z-sector will be transformed from a sector largely composed of very small, low productivity, household and village enterprises of the Z_T type to

one increasingly represented by Z_M activities, which composed of small factories using modern technologies and producing products of a more uniform quality than the traditional Z_T goods, selling at favourable prices relative to the output of the U-sector and imports. The modernised Z_M sector may also export. U-displacement is much less evident, as the U-sector is forced to compete and/or is induced to establish complementary relations with the Z-goods sector. At some point the U-sector will begin to supply the Z_M with domestically produced capital goods, while the Z_M supplies the U-sector with partly processed agricultural goods and/or serves as a subcontractor for the production of U-goods.

In this case, the sector actually becomes one of the dynamic elements in industrial development, with a high rate of capital accumulation, technology change and employment expansion. It also stimulates further agricultural growth, through RNA to A linkages. Ranis and Stewart predict that this pattern of growth tends to be associated with a high overall rate of growth, a more egalitarian distribution and better regional balance.

2.5 Conclusion

In this chapter we have reviewed the literature on dual economies and shown the problems associated when an economy transforms from a dual economy into a modern regime. While early models suggest that the expansion of the modern sector in urban areas would inevitably involve rural-urban migration, the role of RNA in the development was neglected. We have discussed this issue, paying

particular attention to the R-S model, which will be applied to the post-reform Chinese economy in the next chapter.

Chapter 3

The Development of Rural Nonagricultural Activities in Post-reform China: Application of the R-S Model

Dualism existed in China before 1949. It still persisted in the late 1970s even after a quarter century of industrialisation, due to the economic development strategy pursued by China since the early 1950s. Not only did rural-urban disparities narrowed very little, but there was also a large surplus agricultural labour force in rural China. This has implication for the economic reforms beginning in 1978. Since it would be difficult for urban industries and the cities to absorb a huge pool of rural migrants within a short period, government policies generally favoured the development of rural nonagricultural activities (RNA) in the post-reform period. The rural nonagricultural economy has become the driving force behind China's rapid economic growth. The growth of rural enterprises (the Z-sector in China) has contributed not only to higher overall growth of the economy, but also to high employment growth, structural change, export growth, rural urbanisation and rural development.

This chapter proceeds as follows. In Section 1 of this chapter, we briefly look at China's dual economy in the pre-reform period and its implications. We apply the R-S model to the post-reform Chinese economy in Section 2, discussing the

macro-policy setting, policies toward rural development, and the role of local governments that have contributed to the rapid development of RNA, the rapid output and employment growth in the Z-sector, the many consequences of this development, and the relevance of the R-S model. A summary of this chapter is presented in Section 3.

While we benefit from using some estimated data obtained from previous studies, e.g. the estimated GDP figures during 1979-91 from Findlay et al. (1994), we suffer from lack of the most recent data, which is most obvious in Table 7 (e. g. we do not have rural Gini ratios after 1986). However, inclusion of more recent data will only improve not alter the conclusions and arguments of this and the following chapter.

3.1 China's dual economy in pre-reform (1949-78) period

In China industrialisation before 1949 was modest in scale, and confined to a few coastal cities, where foreigners concentrated. The modern factory sector was owned half by Chinese and half by others (mainly Japanese). The influence of industrialisation and modern cities was limited by the small size of these cities in relation to the vast population of the rural interior. As late as 1953, only 8% of China's population lived in cities with more than 100,000 people, and many of these cities were still administrative rather than industrial and commercial centers (Perkins et al. 1984 pp. 9-10).

Industrialisation proceeded rapidly after 1949. Industry grew at an average rate of 11% a year and increased nineteenfold. As a result, agriculture's share of national

income fell from 58% in 1952 to 39% in 1979. However, the urban population in 1978 was only 17.9% of the total population (Ibid p. 10). In 1952, 83.5% of China's labour force was engaged in agriculture, and in 1979 the percentage had dropped to 73.8% (Tsueh et al. 1993 p. 179).

Thus industrialisation of a quarter century in China affected only a small minority, and the industry-agriculture and rural-urban dualism persisted. How could this happen?

Table 1
Investment in Basic Construction of Agriculture, Light Industry, Heavy Industry, Energy, and Transportation & Telecommunication Sectors 1953-80 (share of total investment)

| | Agriculture | Light industry | Heavy industry | Energy | Transportation & telecommunications |
|---------|-------------|----------------|----------------|--------|-------------------------------------|
| 1953-57 | 7.1 | 6.4 | 36.1 | 12.4 | 15.3 |
| 1963-65 | 17.7 | 3.9 | 45.9 | 15.1 | 12.7 |
| 1980 | 9.3 | 9.1 | 40.2 | 20.7 | 11.2 |

Source: *China Statistical Yearbook* , 1986.

The relationship between industrialisation and economic dualism stems from China's economic development strategy and resident policy. Since the early 1950s China has followed a Stalinist model. The development of capital-intensive heavy industry was overstressed, and labour-intensive light industry was neglected. As we can see from table 1, the state invested heavily in heavy industry. Industries, especially stated owned enterprises, were concentrated in urban areas. At the same time, the rural economy was oriented toward grain production. The government did not commit economic resources to transforming rural society, and had emphasised rural self-reliance.

Unlike other developing countries where the rural population can escape poverty by moving to the cities and finding a factory job, China has implemented a strict household registration system (*hukou*) since the late 1950s to restrict rural-urban migration. The urban areas did nothing to relieve rural population pressure. Thus, as pointed out in Perkins et al., “Chinese planners in a real sense attempted to isolate the rural from the urban sector, and in so doing created, or at least reinforced a dualism in China’s economy and society that they probably did not intend” (1984 p. 11).

Although there were still some linkages between the urban and rural sectors, they were much weaker than they otherwise would have been. The rising supply of urban-produced consumer and producer goods and the reverse flows of farm products to the urban areas were the main rural-urban links from the 1950s throughout the 1970s. After 1950s agriculture no longer provided a significant share of the capital for industry, and even agriculture’s role as a major provider of foreign exchange declined (Ibid pp. 26-27).

Due to the policy pursued, rural-urban disparities have narrowed little since the 1950s. The ratio of the per capita net income of farmers to average disposal income per worker rose from 31.0% in 1957 to 42.3% in 1978, but the ratio of the per capita consumption of farmers to per capita consumption of non-farmers dropped from 38.8% to 31.0% in 1978 (Hsueh et al. 1993 p. 231).

To sum up, after a quarter century of industrialisation, China still had the characteristics of a dual economy in the late 1970s. On the one hand, with

substantial state investment, modern capital-intensive industries, mainly in the producer goods sector, have developed in urban areas. They used advanced technology, and operated under the state plan. On the other hand, with limited state investment and poor access to formal financial institution, agricultural productivity grew slowly and used backward technology. A very high proportion of China's population lived in the rural areas, thus urbanisation lagged behind industrialisation. What is the implication of this development?

Given that the cultivated land per capita in China has always been low, and declined from 0.18 hectares to 0.1 hectares in 1978 (Garnaut et al. 1992 p. 79), and that agricultural population and labour force has grown rapidly, one would expect a large surplus agricultural labour force in rural areas. Under the prescribed management system and technological level, the productivity and living stand of farmers hardly increased, drawing rural development into a vicious cycle, and also limiting industrial expansion (Hsueh et al. 1993 p. 232). To tackle the problem, much more rapid expansion of nonagricultural activities is required.

In theory, China may develop urban industries and other nonagricultural economic activities on a large scale to absorb rural surplus labour. However, China's urban industries were mainly heavy industries with high capital-labour ratio. Relying on an extensive growth strategy, they suffered from low economic efficiency and capital shortage. Since the urban industrial structure and its management could not be changed within a short period, it had very limited new jobs to offer. In fact, during 1952-78, urban industrial employment rose 37.23

million, while the social labour force surged up 191.27 million, and urban unemployment increased (Ibid). Obviously, the new jobs in urban areas could not fully absorb the newly added rural labour force. Moreover, in cities, the living standard was higher, and the cost of accommodating a person was higher. In the past thirty years or so, most cities have not engaged in large-scale construction works, so the supply of housing and other public utilities was seriously inadequate. Transportation facilities were also inadequate. Thus, it would be difficult for the cities to absorb a huge pool of rural migrants within a short period (Ibid p. 234). Under these circumstances, developing rural nonagricultural economic activities became a feasible solution for China.

3.2 Application of the Ranis-Stewart (R-S) model in post-reform (after 1978) China

3.2.1 Some definitions

Before applying the model, some definitions are required.

1. In history China as a whole had never become a colony, thus the distinction between colonial and post-colonial periods is irrelevant. Since the real take-off of rural enterprises (Z-sector) occurred in the post-reform period, despite its long history, we can distinguish this period from the pre-reform period.
2. In China, there has been no clear separation between the agricultural cash crop export sector (A_E) and the domestically oriented food producing agricultural sector (A_D), although China always exports some agricultural products.

3. Imported products (M) have always been dominated by equipment and manufactured products (e.g. the value of these products accounted for 65% of the total value of imports in 1980 and 85.8% in 1994) (derived from China Statistical Yearbook 1995 p. 539), most of which are capital goods. Imported consumer goods are limited. Given China's large population size and limited foreign exchange, it is impossible to fulfil the demand for consumer goods by imports.
4. As mentioned in the previous section, until the late 1970s, China's modern industrial sector (U) had no foreign capital, and mainly consisted of the state owned enterprises (SOEs) in urban areas. Foreign investment and foreign enterprises have been increasing rapidly since the 1980s.
5. China's rural enterprises (Z-sector since reform) are defined as "economic entities established by various levels of local government in the countryside or by the peasants themselves" (Findlay et al. 1994 p. 8). They may be run by towns (*zhen*), townships (*xiang*), districts (*qu*), and villages (*cun*), or by peasants either as individuals, as partnerships, or in cooperation with the village. Their undertakings encompass all types of economic activity, mainly industry, construction, transport, commerce and services. Nevertheless, investment is biased toward industry. In 1990, 74.1% of total output value of all rural enterprises came from industrial activities (Ibid p. 12). Most of the rural enterprises locate in rural areas, while some of them operate in or close to urban areas. Rural enterprises are usually much smaller than their urban counterparts, especially in the initial stage.

One difficulty in applying the R-S model is that it is hard for us to distinguish Z_M from Z_T . The range of China's rural nonagricultural activities had always been very wide. Textile industries, which included cotton ginning, silk reeling, cotton making, food processing, which included rice cleaning, flour milling, oil pressing, tea, fruit and vegetable preparation, and chemical industries, which included paper, pottery, fireworks, oil, etc. existed for centuries, so that perhaps we can regard them as Z_T . Some of the industries, for example, cotton spinning, silk reeling and tea preparation declined after the western incursions, but others continued to fare well (Chuta et al. 1984 p. 123). After 1949 the state government emphasised the establishment of the "five small industries": cement, chemical fertilisers, farm machinery, hydroelectricity, and iron and steel in rural areas and they played an important role in supplying agricultural materials, although using less advanced technology (Ibid p. 126). Perhaps these can also be regarded as Z_T .

Since the late 1970s, the Z-sector has experienced rapid growth and technological change. Thus it is no longer purely Z_T and some has at least partially been transformed into Z_M . It has become more diversified, and the goods it produces now are of higher quality as compared to goods produced earlier. The Z_M sector mainly includes metals industry, textiles and clothing industry, light manufactures, building materials, chemicals, food, and mining industries (Findlay et al. 1994 p. 58).

It can be noticed from the previous discussion that the geographic division of the Chinese economy tends to correspond to the concentration of firms of different

types of ownership. The rural economy is primarily collective or private, and the urban economy is primarily state run. Although this transformation of firms classified by ownership is not perfect, it is close enough to facilitate the analysis (Garnaut et al. 1992 p. 67) .

3.2.2 Causes of rapid rural enterprise (Z-sector) growth in the post-reform (after 1978) period: macro-policy setting and policies toward rural development

As suggested by the R-S model, macro-policy setting and policies toward rural development have great influence on the development of Z-sector in post-reform China, and it is reasonable to place it in the favourable category.

Before proceeding further, we should note that China's economic development strategy has changed significantly since the late 1970s. Stalinist model adopted in the pre-reform period resulted in a low rate of consumption growth, a high rate of accumulation, and low economic efficiency (Hsueh et al. 1993 p. 369). Under the central planning system, enterprises were not independent economic entities. They operated under bureaucratic administrative guidance rather than under the market mechanism. They used an extensive growth strategy, which tried to maximise output even at the expense of using huge inputs of labour, capital, energy and raw materials. In order to avoid interruption in production, they also tried to become "large and complete" and "small and complete", producing a wide range of products. This led to the problem of investment hunger and the appearance of bottleneck sectors (such as transportation, energy, etc.), which further led to low

efficiency in the national economy (Ibid). In addition, there was over-production in the heavy industrial sector and shortage in consumer goods. In the rural sector, agricultural production grew slowly under the commune system due to inadequate investment, very slow improvement in terms of trade for agricultural products, and lack of individual incentive (Griffin 1984 p. 267). Its annual growth rate was only 2.9% during 1952-78, as compared to 7.7% during 1978-84 (McKinley 1996 p. 8). Emphasis on self-sufficiency had limited the scope for specialisation. Market activities were restricted and farmers did not have the freedom to market their own products. These two factors had contributed to the slow productivity growth in agricultural production and the narrow range of agricultural products supplied by the rural sector. Moreover, unemployment and underemployment of labour had reached a high level, and it seemed that the structure of the economy had to be modified to cope with these problems (Griffin 1984 p. 253).

Since the Third Plenary Session of the 11th Central Committee of the Chinese Communist Party (held in December 1978), which marked the beginning of economic reforms in China, the central government found it necessary to address the above problems and flaws in the economic system, thus a change in development strategy was unavoidable. It was expected that the centrally planned economy would move to one in which the market has an increasing role to play. The institutional reforms adopted since then aimed at decentralising power to lower levels of government to enhance economic efficiency (Hsueh et al. 1993 p. 254). It was recognised that more efforts should be made to raise the living

standard of the Chinese people, and reduce the rate of accumulation. In particular, production of food and light industrial goods would need to be stepped up. Thus agricultural output would need to grow at a faster rate than before (Griffin 1984 p. 254). Moreover, rural policy should have a wider perspective in order to deal with the unemployment and underemployment problem.

In accordance with decentralisation, economic reform in China was a “bottom-up” process. “Some policy changes were sanctioned at national level, but the changes were managed at local levels” (Findlay et al. 1994 p. 190). The spectacular growth of rural enterprises since the mid-1980s came at first as a surprise to the central government, it also stimulated change in the state sector.

Macro-policy setting and macroeconomic policy

The role of rural nonagricultural activities was never underestimated by the Chinese government. Before 1978, the development of rural enterprises had passed three main stages. In the first stage (the years immediately after 1949), the government encouraged the development of rural sidelines, and such enterprises were mainly engaged in handicraft production and the primary processing of agricultural products. In the second stage (1958 to the 1960s), the government called for the large-scale development of rural industries, and the industrial nature of the sidelines and their production of inputs for agriculture was stressed. Then in the 1970s, to speed up agricultural mechanisation, the government encouraged the development of agricultural machinery workshops and farm machinery manufacturing and repair plants. However, these enterprises were still not oriented

toward the market or consumer products (Findlay et al. 1994 pp. 5-6). They were confined to using local labour and materials and to meet local needs. By the late 1970s many of them had become subordinate to urban industries, acting as sub-contractors and first-stage processors (Ibid p. 70).

Since 1978 the government's main contribution to the development of rural enterprises was the positive environment it encouraged. It provided little in the way of direct investment (Ibid p. 114). By increasing the prices for agricultural products, it improved the terms of trade for the agricultural sector. Since 1978 state procurement prices for agricultural products have increased sharply. For example, the purchase prices for the principal agricultural products rose by 50-100% during 1978-82 (Byrd et al. 1990 p. 51). This rise in procurement prices stimulated a strong production response: agricultural production grew at an annual rate of 7.7% during 1978-84 (McKinley 1996 p. 8). It enabled the farmers to reap more income, and as a result, the ratio of deposits to per capita incomes rose from 5% in 1978 to more than 30% in 1990 (Findlay et al. 1994 p. 94). These savings, which were relatively equally distributed among the rural households, provided an important source of funds that could be invested in nonagricultural undertakings.

In the partially reformed Chinese economy, macroeconomic policies had an extremely significant influence on capital formation in rural enterprises. Initially, the expansion of rural enterprise capital mainly depended on the internal accumulation of profits. To accelerate rural enterprise development, the government liberated credit policy in 1984 and expanded credit availability. As a

result, rural enterprises developed a high reliance on loans as a source of capital. In 1987, 48% of the fixed asset investment in township and village enterprises were bank loans, the ratio declined to 39% in 1991, but was still high compared to 24% in state-owned enterprises (Ibid p. 99). However, the availability of credit was not determined by market forces. The government attempted to control credit allocation, using both credit rationing and an artificial interest rate system. When it adopted an expansionary credit policy (e.g. in 1984), the rate of capital formation in rural enterprises increased, and, when it tightened credit policy (e.g. in 1985 and 1988-9), capital formation was constrained.

Policies toward rural development

Since 1978 a series of economic reforms, designed to reduce central planning and increase individual incentives and economic efficiency, have been adopted in China. Agriculture was one of the first sectors to which the new policy reforms were applied. The government recognised that rural policy should have a wider perspective than its previous concentration on crop farming, and stressed that the new rural development strategy relied on the comprehensive development of agriculture, industry and commerce (Findlay et al. 1994 p. 6). Besides raising agricultural product purchasing prices, the government introduced the household responsibility system in agricultural production, deregulated the rural markets and permitted the development of nonagricultural undertakings in the countryside to accelerate the growth of rural economy and tackle the problem of unemployment and underemployment (Ibid p. 94).

After the land reform, which was completed in 1952, the government had promoted collective agriculture production, mainly through the commune system. Although it had been successful in distributing wealth and income equally, it undermined the incentives to raise productivity, as work effort was delinked from any direct material reward (McKinley 1996 pp. 5-8). Since the early 1980s, agriculture production has been decollectivised through the introduction of the household responsibility system. The reintroduction of household farming liberalised controls over the use of land and labour. The effect was to precipitate the surplus labour that had previously been hidden within the commune system, and labour became available for other employment. As mentioned before, the price increases for agricultural products meant that more capital became available for investment. The liberalisation of the market system enabled farmers to specialise in production for the market and to develop activities that maximised their returns. They had a market both for the raw materials needed to develop the enterprises and for their output. They became very conscious of the opportunities they faced and quickly diverted resources to nonagricultural activities that generated much higher returns than farming. The interaction of the above factors thus provided the basis for the boom in rural enterprises (Findlay et al. 1994 p. 7).

A change in policy in 1984 played an important role in accelerating the development of rural enterprises. The “Report on Creating a New Situation in Commune and Brigade-run Enterprises”, which was approved by the Central Committee and the State Council in March 1984, pointed out that rural enterprises

run by township and village, as well as individuals would become the focus of a new phase in integrated rural development. These enterprises were responsible for their own profits and losses, but their development should be supported and encouraged by government at all levels. They provided inputs for agriculture, absorbed rural labour, helped to raise rural incomes, and produced for the market (Ibid).

Local governments in rural enterprise development

One aspect of China's rural enterprise development, which is not captured in the R-S model, is the role of local governments. In China local governments had strong incentives to promote rural enterprises. This arose from a new set of fiscal arrangements between the central and local governments. The set of fiscal arrangements is called fiscal contracting, and it shaped the financial relations between different levels of government. "The centralised system whereby all revenue was handed upwards and all expenditure was allocated from above was replaced by a system whereby each level of government makes an agreement with the next level up to meet certain income and expenditure targets" (Findlay et al. 1994 p. 14). If an administrative level is able to generate additional revenue, it is shared with its next superior level according to an agreed ratio set out in the fiscal contract. That contract also stipulates any expenditure subsidy to be provided to the lower level, regardless of changes in its revenue during the contract period. The surplus income retained at the lower level can be used to cover new investment or other expenditure at its own discretion. One major aim of this

change was to provide lower levels of government with the incentive to increase revenue and to improve their financial efficiency (Ibid).

With these changes, local economic interests are clearly defined. The township and village governments, who have no established budgets, and are primarily dependent on the income they receive from the local community and from the remnants of the collective economy that they have inherited, thus have strong incentives to develop and protect their local rural enterprises.

Local government decisions can affect the macroeconomic environment. On the one hand, by providing local support and loans, they tend to soften the central government's drives to restrict credit to stimulate rural enterprise growth. On the other hand, as administrator and manager of the township and village enterprises, they tended to take away significant amount of profits for public expenditure (Ibid p. 115). The different strategies adopted by local governments and their different timing have contributed to the great regional imbalances in the development of rural enterprises and the resulting increasing inter-regional disparities in rural China.

3.2.3 Supply and demand conditions facing rural enterprises and the relationship between rural enterprises and urban industries

The R-S model suggests that favourable supply and demand conditions are important for the expansion of the rural industrial sector. The Chinese experience illustrates this. In contrast to U-displacement, it is the rural industrial sector that

meets the rising demand as China moves from a centrally-planned economy toward a market economy.

Supply and demand conditions facing rural enterprises

Unlike urban state-owned enterprises, rural enterprises operate outside the state plan, and thus do not have any guaranteed budget income from above. They buy inputs and sell outputs in free markets, without having to fulfil plan obligation to the state (Findlay et al. 1994 p. 10). So they are oriented toward the market. Although some impediments still inhibit the free flow of factors and products, the supply and demand conditions they have faced since economic reform are relatively favourable for their expansion.

On the supply side, rural reforms have made capital, land, labour, equipment and materials, and technology available for nonagricultural activities.

1. Capital

As mentioned before, the growth of agricultural incomes and savings played an important role in promoting rural enterprises, especially in the initial stage. Since 1978, agricultural savings have been increasing rapidly. For example, it rose from 13.64 billion yuan in 1978 to 61.78 billion yuan in 1986 (a rise of 453%). Only a small portion of the savings was invested in fixed assets in agriculture (around 3-4 billion yuan), while most were diverted to industries either through bank savings or farmers' collective funds (Hsueh et al. 1993 pp. 212-213). Moreover, since credit policy was liberalised in 1984, more credit became available for rural

enterprises, and their expansion no longer depended on the internal accumulation of profits. Rural enterprises showed stronger growth thereafter.

2. Land

Incomes from land vary substantially from different activities. For example, in Wuxi county income per mu from industry was 63,359.5 yuan, while only 286.7 yuan from agriculture. In Jieshou county, it was 42,711.4 yuan and 149.7 yuan respectively.³ Since industrial income from a plot of land is much higher than the value of its agricultural output, land was increasingly shifted to industrial uses. Arable land was reduced and most of it was taken by rural enterprises. To facilitate the distribution of land resources, primitive land markets was also developed in many places ((Byrd et al. 1990 pp. 52-53).

3. Labour

Surplus labour in rural China provided abundant supply of labour for the expansion of rural enterprises. Rural enterprises now employ more than 120 million workers,⁴ and this means that they have absorbed half of the rural surplus labour. Causes of labour transfer include: unemployment in the rural areas, income disparity between agricultural activity and nonagricultural activities, and difference in education standards.

4. Equipment and materials

³ Wuxi is a county in Jiangsu Province with an extremely high level of industrialisation, and Jieshou is a county in Anhui Province with a more or less average level of rural enterprise development.

⁴ See Table 2 in Section 3.2.4.

More agricultural raw materials has become available for rural enterprises due to the decline in planned procurement of agricultural products. Rural enterprises that used agricultural raw materials grew rapidly after 1978, and so did rural enterprises that produced energy and raw materials. Rural enterprises can also receive some materials subject to monopoly distribution under the state plan (Byrd et al. 1990 pp. 53-54).

Rural enterprises get their equipment from many sources, mainly state enterprises and rural enterprises in more developed regions. Some rural enterprises use shortages of agricultural and sideline products to establish cooperation with their urban counterparts, getting equipment and technology from them. As rural enterprises in the coastal areas become more developed, they need advanced and up to date equipment, and are able to transfer their old equipment to underdeveloped central and western regions (Ibid pp. 54-55).

5. Technology

Acquisition of technology is important for rural enterprises. Before economic reform, China had already built a large and diversified state-owned industrial sector with strong technical capacity. However, technical manpower was underemployed in many state-owned enterprises. In the early 1980s, lack of protection of intellectual property rights and the eagerness of many individual staff members of the state enterprises for extra income created a favourable environment for rural enterprises to acquire technology at well-below market

prices. Various methods including copying know-how, stealing, etc., were used (Lu 1996 p. 77).

On the demand side, the demand for consumer goods has been strong. Due to the development strategy and central planning adopted previously, China suffered from sectoral imbalances during pre-reform period: heavy industry grew much faster than light industry (annual growth rate of 11.0% as compared to 8.2%) (Nolan et al. 1990 p. 17). Many consumer goods were in shortage and characterised by a seller's market. A number of modern industrial products such as colour TV, household refrigerators were not available. Thus the state sector left many gaps where demand was not filled. Moreover, the sharp rise in rural and urban personal incomes starting in the late 1970s also created new demand. Since state enterprises were not oriented toward the market, and had state plans to fulfil, they could hardly capture this opportunity at that time. This gave rural enterprises great advantages in meeting the rising demand and expanding their markets. It should be pointed out that rural demand played a critical role in the expansion of rural enterprises. Initially it stimulated the growth of rural enterprises that produce consumer goods, thus creating a new source of income for rural households and further spurring their demand for consumer goods. Production increases in rural enterprises that produce consumer goods stimulated the development of the firms that produce investment goods and further increased rural income. Therefore, the rural enterprises are building a ever wider market for themselves, and the chain

effects described above have become more and more conspicuous since 1984 (Byrd et al. 1990 p. 60).

However, as rural enterprises expanded and structural reform in state enterprises began, market competition became heated.

Rural enterprises are highly competitive, and can often sell at favourable prices relative to the output of the urban industries and imports. This is because first, they are oriented to the market, thus they can price their products competitively, design products that meet demand and put more emphasis on marketing; and second, they are more labour intensive and their labour costs are lower. The strategic focus that rural enterprises put on marketing differentiated them significantly from their urban counterparts. Various methods have been used to improve supply and sales work : (1) widespread participation by enterprise staff in obtaining supplies and promoting sales; (2) large bonuses for supply and sales personnel; (3) ample funds used as operational fees and funds to gain access to supply and sales links; and (4) nonprice competition such as giving sales commissions, paying sales agents, and making blank invoices (Ibid pp. 54-55).

The relationship between rural and state-owned enterprises

The relationship between rural and state-owned enterprises is competitive as well as cooperative.

Since the industrial and product structures of rural and state-owned enterprises are to some extent similar, they have to compete in the market. They also compete for energy and raw materials. There has also been considerable cooperation

between them, especially in the initial stages of rural enterprise development. Some rural enterprises retained the subordinate relationship with state enterprises developed previously, production of parts, assembly work, and the like are often subcontracted to them by state enterprises. The latter may simply market rural enterprises' products under their own brand names. The state enterprises can use the cooperation to gain access to certain factors of production that they cannot obtain otherwise or dump their old equipment (Byrd et al. 1990 p. 97). In more advanced areas, rural enterprises have moved away from heavy reliance on subcontracting for urban state enterprises, and more and more of these enterprises have developed close relationship with foreign enterprises. By the end of 1992 there were about 15,000 joint ventures involving rural enterprises (Gao 1994 p. 20). Evidence shows that rural enterprises have become important destination for foreign capital.

3.2.4 Growth of rural enterprises

The total number of rural enterprises increased to near 25 million in 1994, more than a sixteenfold increase from 1978, and fourfold from 1984. Their labour by 1994 was over 120 million, exceeding total employment in state enterprises. Growth has not been even. The period 1984-88 was one of rapid expansion. The restrictions associated with the deflationary policies of 1988-90 led to a phase of uncertainty and slow-down. By late 1991, however, a new stage of accelerated growth had begun.

Table 2
Rural enterprises: numbers and workers, 1978-94 (millions)

| Year | Number of enterprises | Number of workers |
|------|-----------------------|-------------------|
| 1978 | 1.52 | 28.27 |
| 1980 | 1.42 | 30.00 |
| 1984 | 6.07 | 52.08 |
| 1985 | 12.22 | 69.79 |
| 1986 | 15.15 | 79.37 |
| 1987 | 17.50 | 88.05 |
| 1988 | 18.88 | 95.46 |
| 1989 | 18.69 | 93.67 |
| 1990 | 18.50 | 92.65 |
| 1991 | 19.08 | 96.09 |
| 1992 | 20.79 | 105.81 |
| 1993 | 24.53 | 123.45 |
| 1994 | 24.95 | 120.18 |

Source: *China Statistical Yearbook*, 1995.

Table 3
Rural enterprises in the national economy (billion yuan)

| Year | GOV of rural enterprises (a) | GOV of rural society (b) | GOV of national society (c) | (a)/(b) (%) | (a)/(c) (%) |
|------|---------------------------------------|--------------------------------|--------------------------------------|----------------|----------------|
| 1978 | 49.31 | - | - | - | - |
| 1980 | 65.69 | - | - | - | - |
| 1984 | 170.99 | 503.38 | 1313.10 | 33.97 | 13.02 |
| 1985 | 272.84 | 634.00 | 1658.80 | 43.03 | 16.45 |
| 1986 | 354.09 | 755.42 | 1904.50 | 46.87 | 18.59 |
| 1987 | 476.43 | 943.16 | 2303.34 | 50.29 | 20.59 |
| 1988 | 649.57 | 1253.47 | 2980.70 | 51.82 | 21.79 |
| 1989 | 742.84 | 1448.02 | 3451.90 | 51.30 | 21.52 |
| 1990 | 846.16 | 1661.92 | 3803.50 | 57.65 | 25.19 |
| 1991 | 1162.17 | 1900.41 | 4414.20 | 61.15 | 26.33 |
| 1992 | 1797.54 | 2538.63 | 5482.50 | 69.67 | 32.26 |
| 1993 | 3154.07 | - | - | - | - |
| 1994 | 4258.85 | - | - | - | - |

Note: GOV: gross output value.

Sources: *China Statistical Yearbook*, 1995; Findlay et al. 1994 Table 1.2 p. 11.

An indicator of the growth in output of rural enterprises is reported in Table 3. The gross output value of rural enterprises has increased more than twenty-three fold since 1984. Their share in rural output value and national output value rose from 34% and 13% in 1984 to over 75% and 38% respectively in 1994 (Qu 1995 p. 51). Even by 1987, rural enterprises were more important in the rural economy than was agriculture.

Among rural enterprises, the most dynamic growth has taken place in individually owned enterprises. At the end of 1991, these made up 92% of the total number of rural enterprises, employed more than 50% of the total work force, and produced 33% of the gross output value (Findlay et al. 1994 pp. 12-13).

3.2.5 Consequences of rural enterprise development

The R-S model says that the Z-sector can become one of the dynamic elements in industrial development, with a high rate of capital accumulation, technological change and employment expansion. It also predicts that rapid Z-sector growth tends to be associated with a high overall rate of growth, a more egalitarian income distribution and better regional balance. The Chinese experience shows that the Z-sector is the driving force behind China's spectacular economic growth. It has contributed to higher growth of the economy, high employment and export growth, structural change, rural urbanisation and rural development. However, income distribution in rural China has become more unequal and regional imbalances have widened.

Contribution to economic growth

Since the economic reforms began in 1978 till 1994, the Chinese economy has become one of the world's fastest growing economies. The driving force of this growth, however, was not the urban economy dominated by state-owned enterprises, but the rural nonagricultural economy – that is, the rural enterprises.

Research shows that while the total GDP grew by 8.6% per annum during 1978-91, the rural industrial and services sectors grew by 16.8% and 19.4% respectively, compared to 8.1% and 7.0% growth of the urban industrial and services sectors, and 5.3% growth of agriculture (Findlay et al. 1994 p. 42). Thus, rapid growth of rural enterprises contributed to high GDP growth.

Using the estimated manufacturing GDP, the state and the rural enterprise contribution to the growth of manufacturing GDP can be compared. From Table 4, we can see that the rural enterprises' contribution increased significantly, while the contribution made by state-owned sector declined.

As mentioned before, in pre-reform period China adopted Stalinist model which emphasised heavy industrialisation. While the industrial share in total GDP increased from about 11% in 1952 to about 47% in 1978, the proportion of heavy industry in total industrial output grew from 35% to 57% and the proportion of light industry dropped from 65% to 43% (Ibid p. 55). Since heavy industrialisation requires massive capital injection, such a strategy limited the development of rural industry and favoured urban state-owned enterprises, who received capital injection from the central government. As a result, urban state-owned enterprises contributed a significant share of GDP, and the rural economy was dominated by

agriculture: agricultural output accounted for 80% of the total rural GDP in 1978 (Ibid).

Table 4
Share of manufacturing GDP (%)

| Period | State-owned sector | Rural enterprises | Other sectors |
|---------|--------------------|-------------------|---------------|
| 1979-83 | 61.2 | 19 | 19.8 |
| 1984-88 | 37.7 | 42.5 | 19.8 |
| 1989-91 | 35 | 57.6 | 7.4 |

Note: The “other sectors” here refer to the “residual” after the state and rural enterprises. It includes urban collectives and all types of joint ventures. The decrease in foreign investment in the wake of Tiananmen crack-down and economic austerity was largely responsible for the decline during 1989-91. With the increase in foreign investment in recent years, we would expect this sector to be much larger now.

Source: Findlay et al. 1994 pp. 50-51.

We have discussed before that the economic reforms since 1978 created a favourable environment for the development of rural enterprises. The industrial development in post-reform period has been market driven. Although some rural enterprises are engaged in heavy industries, capital constraints they face and abundant supply of rural surplus labour make labour-intensive industries more attractive and feasible to them. In addition, there was shortage and unfulfilled demand in the consumer goods sector when the reforms began. Rural enterprises captured these opportunities and expanded rapidly. In the meantime, their urban counterparts were having difficulty restructuring themselves and orienting toward the market, many of them incurred heavy debt after the drop in government funding. In contrast to the rapid expansion of rural enterprises and the resulting

increased contribution of GDP, the contribution of state-owned enterprises declined.

Contribution to employment

Table 5
Employment growth, total and by sector (%)

| Period | Total economy | Agriculture | Rural industry | Urban industry | Rural service | Urban service |
|---------|---------------|-------------|----------------|----------------|---------------|---------------|
| 1979-83 | 3.0 | 1.9 | 6.4 | 3.8 | 6.9 | 6.0 |
| 1984-88 | 3.2 | 0.7 | 13.7 | 3.6 | 16.4 | 5.0 |
| 1989-91 | 2.4 | 2.7 | 0.4 | 1.0 | 2.3 | 4.2 |
| 1979-91 | 2.9 | 1.6 | 7.7 | 3.1 | 9.3 | 5.2 |

Source: Findlay et al. 1994 Table 3.2 p. 46.

With rapid economic growth in general and rapid rural industrialisation in particular, employment in rural industrial and services sectors grew more rapidly than employment growth in agriculture and urban industrial and services sectors. This is summarised in Table 5. Wu also estimates that in 1979-91, the contribution to growth in industrial employment of the rural industrial sector was 55.7%, while the urban industrial sector contributed 44.3%. The rural service sector contributed 46.2% of the growth in service employment, while the urban sector contributed 53.8% (Findlay et al. 1994 p. 52). Thus, rural enterprises have become the most important absorber of rural surplus labour.

As pointed out before, rural enterprises are more labour intensive or tend to adopt more labour-intensive methods of production as compared to urban state-owned enterprises. Therefore, with rapid expansion, they have greater scope for employment growth than their urban counterparts, which have already suffered

from overstaff. Further analysis shows that due to the differences in urban and rural labour employment system, the growth in rural enterprises fluctuated with macroeconomic policy changes. From Table 5 we can see that employment in rural industry and service grew most rapidly during 1984-88 period when policies were most favourable to rural enterprises; and employment growth slowed down (to a level which was below the growth rate of urban industry and service) during 1989-91 period when there were obvious policy biases against the rural enterprises due to economic austerity policies aimed at fighting inflation. Urban enterprises did not reduce workers to survive the recession, since they relied on production plans rather than market conditions. By contrast, since they had to compete in the market to survive, some rural enterprises had to close down, some had to dismiss workers, and some had to reduce their labour recruitment rate in 1989-91, and some worker returned to farming (Ibid pp. 47-48).

Contribution to structural change

The growth of rural enterprises has not only promoted GDP and employment growth, but also brought about profound changes in the structure of the Chinese economy. The Chinese economy is becoming more market-oriented, more industry- and service-oriented, and the mixture of state and non-state sectors is becoming more balanced.

The agricultural share in total GDP decreased from 32% in 1979-83 to 23% in 1989-91, whereas the rural industrial and service share increased from 11% to 25%. Meanwhile, the urban industrial and service share in total GDP decreased

from 57% to 52%. Thus, about one-third of China's nonagricultural economy has become rural and non-state (Findlay et al. 1994 pp. 55-56). Moreover, within the rural economy, nonagricultural activities have become more important than agriculture.

Similar to the change in production structure, employment structure has also changed. The agricultural share of China's rural employment decreased from 89.1% in 1978-83 to 79.5% in 1989-91, while the industrial and service share increased from 11% to 20.5%. Even after rapid rural industrialisation, agricultural employment still accounted for about 80% of China's rural employment, or about 60% of China's total employment (Ibid p. 59). It is estimated that the total labour force in rural areas is 450 million, agriculture only needs 200 million. Although rural enterprises have provided jobs for over 120 million people, there are still over 120 million people in the countryside waiting for jobs elsewhere (Wan 1996 p. 4). So the pressure to shift labour from agriculture will remain very high in the future.

Contribution to exports

Rural enterprises are export-oriented and they now account for a significant share of national exports. It was reported that on average their exports grew at 50% annually during 1991-95, and in 1995 their export earnings made up one-third of the national total (Long 1996 p. 6). However, there are large regional disparities, and the eastern region accounts for a much higher share of exports than the other parts of the country. Since rural enterprises are more labour intensive than urban

state-owned industry, growth in their exports thus also contributed to the change in composition of China's exports toward the labour-intensive category (Findlay et al. 1994 p. 20). Rural enterprises have become an important destination of foreign capital, and the growth in the activities such as processing of semi-finished goods and compensation trade accounted for 17% of the exports of manufactures by rural enterprises in 1991 (Ibid p. 22). Thus foreign investors have contributed to their export performance.

Contribution to urbanisation

We have mentioned before that despite rapid industrialisation, the urban population in 1978 was only 17.9% of the total Chinese population. The development strategy and household registration system had prevented China from getting into the trouble of over-urbanisation, which occurred in many other developing countries. However, urbanisation had lagged far behind industrialisation. China's urban structure at that time was undesirable with large and extra-large cities accounting for a huge percentage and small and medium-size cities accounting for only 32% (Byrd et al. 1990 p. 120).

The rapid growth of rural enterprises has changed this. It has improved the rural economy and accelerated rural urbanisation. The expansion of rural enterprises and the subsequent development of commerce, services, architecture, communication and transportation has led to the mushrooming of small towns of different types. There are over 50,000 small towns in China now, and 40,000 of them were set up in recent years. Infrastructure in these small towns has improved

significantly. They have become the political, economical and cultural centers in the countryside, and serve as bridges linking urban and rural markets. They have provided jobs for 120 million people between 1985-94 (Zhang 1996 p. 4). As a result of these changes and reclassification, the proportion of population classified as urban jumped to 47% in 1987 (Findlay et al. 1994 p. 14).

In fact the development of rural enterprises and the construction of small towns is a very efficient and practical way to absorb the rural surplus labour. Studies have shown that to create one job in a state enterprise, 15,000 yuan would be needed for investment in fixed assets, operating funds and investment in public facilities. In contrast, to employ in rural labourer in a rural enterprise, only 2,000 to 7,000 yuan investment is required, and on the other hand, 2,000 yuan of net value could be achieved by transferring a rural surplus labourer (Longworth 1989 p. 222).

Contribution to agriculture and rural development

Contribution of rural enterprises to agriculture, rural welfare and education can not be neglected.

Rural enterprises have provided large amount of subsidy to agriculture. During the period of 1979-89, the total subsidy was 78 billion yuan. The subsidy in 1992 reached 10.5 billion yuan (Zhu 1995 p. 111).

During 1978-92, the fund that rural enterprises contributed to rural welfare grew at 18.9% annually on average. The amount was 4.5 billion in 1992 (Li 1993 p. 160). During 1985-92, the fund that rural enterprises contributed to rural

education grew at 27.5% annually on average. The amount reached 3.3 billion in 1992 (Ibid).

Impact on income distribution and regional balance

1. Income distribution

On the one hand, rural reform and rural enterprise growth has been successful in raising overall rural income levels and reducing poverty.

Table 6
Rural households per capita income (yuan) (in current prices)

| | | | | | | |
|------|------|------|------|------|------|------|
| 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
| 134 | 160 | 191 | 223 | 270 | 310 | 355 |
| 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | |
| 398 | 424 | 463 | 545 | 602 | 630 | |

Source: Findlay et al. 1994 Table 5.1 p. 95.

Table 6 shows the growth of rural household income per capita, and we can see that nominal rural household income per capita increased more than four times during the 1978-90 period. Research suggests that half of the increase in rural per capita income came from rural enterprises during 1986-90, and the development of nonagricultural activities has become the main channel through which the farmers can increase their incomes (Zhu 1995 p. 112). The dynamism of the rural economy increased the funds available to assist poor areas, as a result of which both the absolute numbers and the proportion of the rural population in poverty fell sharply after 1978. The World Bank states: “(using) a poverty line based on food intake requirement of 2185 Kilocalories per day, it is estimated that the proportion of the rural population in poverty declined from 31% in 1979 to 13% in

1982” , and “the speed and scale of the improvement is probably unprecedented in human history” (1986 p. 31 as quoted in Nolan 1990 p. 27).

On the other hand, researches suggest that rural enterprise growth has been associated with rising rural inequality since the early or mid-1980s.

In the pre-reform period, rural income inequality was low. The Gini coefficient within rural areas, based on national rural household surveys, fell from 0.35 in the 1930s to 0.22 in the 1950s. It remained low during the 1960s and 1970s (Rozelle 1994 p. 364). Emphasis on agricultural production and self-sufficiency, and the government’s redistribution policies might have contributed to this result.

Table 7
World Bank Estimates of Rural Gini Ratio for China

| 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|------|------|------|------|------|------|------|------|------|
| 0.32 | 0.28 | 0.26 | 0.23 | 0.22 | 0.25 | 0.27 | 0.30 | 0.31 |

Source: Khan et al. 1993 Table 5 p. 29.

The results of some early studies on income distribution in post-reform China have been inconclusive. Recent studies, e.g. Khan et al. (1993) and Rozelle (1994), suggest that the Gini coefficient in rural China has increased since the early or mid-1980s. The trend is captured in Table 7: the Gini ratio for rural China declined steadily between 1978 and 1982, and increased steadily thereafter.

Using a 1988 survey of 10, 258 rural households, Khan et al. (1993) also estimate that the Gini ratio is 0.338 for rural China in 1988, which is higher than the World Bank’s estimate for 1986. They decompose the sources of the rural income inequality and find that the most disequalising component is wages from

different types of enterprises. Most of this type of income accrues to the richer households: 62% of income from this source is received by the richest 10% of individuals, while the poorest 20% of the population receive only 1% of their income from this source (p. 24).

According to Rozelle's calculation, rural Gini ratio continued to rise in the early 1990s and reached 0.42 in 1992. "The increases in inequality can be attributed instead almost entirely to the rapid expansion of the industrial sector and its ever-growing importance as a share of total output in the rural economy"(1996 pp. 83-84). So the changing patterns of inequality were closely associated with the changes in the structure of the rural economy. This may mean that the pro-agricultural policies of the early reform period made income more equally distributed while the pro-rural industrial policies that were adopted in the later period may be contributing to increased inequality (Rozelle 1994 p. 365).

2. Regional balance

Widening rural income disparities are associated with the increasing regional imbalances between the more prosperous coastal region and the interior regions, which result from economic decentralisation, the restoration of economic incentives, the government's unbalanced regional development strategy (Yang and Wei 1996 p. 72) as well as historical, geographical factors. As shown in Table 8 and 9, both the per capita income gap and per capita rural net income gap between eastern region and central and western regions have increased since 1978.

Table 8
The Gap of National Income Per Capita Between Coastal and Interior Regions
(yuan, %)

| Year | Coast (a) | Interior (b) | Regional Gap (c) |
|------|-----------|--------------|------------------|
| 1978 | 404 | 251 | 37.9 |
| 1980 | 497 | 310 | 37.6 |
| 1985 | 897 | 552 | 38.5 |
| 1988 | 1429 | 850 | 40.5 |
| 1990 | 1650 | 1016 | 38.4 |
| 1991 | 1848 | 1079 | 41.6 |
| 1992 | 2322 | 1268 | 45.4 |

Notes: Regional Gap (c) = $100 \times (a-b)/a$.

Coastal region includes Beijing, Tianjin, Hebei, Liaoning, Shaighai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, Guangxi and Hainan provinces; and other provincial units belong to the interior region.

Source: Yang and Wei 1996 Table 1 p. 73.

Table 9
Regional Differences in Rural Net Income Per Capita (yuan, %)

| Year | East region (a) | Central region (b) | West region (c) | East-Central Gap (d) | East-West Gap (e) |
|------|-----------------|--------------------|-----------------|----------------------|-------------------|
| 1978 | 141 | 121 | 106 | 14.2 | 24.8 |
| 1980 | 220 | 183 | 162 | 16.8 | 26.4 |
| 1985 | 464 | 357 | 316 | 23.1 | 31.9 |
| 1990 | 867 | 601 | 553 | 30.7 | 36.2 |
| 1991 | 928 | 596 | 567 | 35.8 | 38.9 |
| 1992 | 1031 | 661 | 629 | 35.9 | 39.0 |
| 1993 | 1261 | 729 | 722 | 42.2 | 42.7 |

Note: $d=100 \times (a-b)/a$, $e=100 \times (a-c)/a$.

Source: Yang and Wei 1996 Table 6 p. 88.

The differential rate of growth in rural enterprises contributed to the growing income gap between coastal and interior regions. While the interior regions (the central and western regions) had close to two-thirds of China's rural population, their combined share of rural enterprise gross output was just above one-third of the total (see Table 10).

| Table 10 Regional Share of Rural Enterprise Gross Output Value | | | | | |
|---|-------|---------|---------|---------|------------------|
| Year | Total | Eastern | Central | Western | Cent. & West. |
| 1980 | 100 | 65.0 | 30.2 | 4.8 | 35.0 |
| 1985 | 100 | 63.2 | 31.9 | 4.9 | 36.8 |
| 1990 | 100 | 64.9 | 30.7 | 4.4 | 35.1 |
| 1991 | 100 | 65.7 | 30.1 | 4.2 | 34.3 |
| 1992 | 100 | 66.4 | 29.2 | 4.4 | 33.6 |
| 1993 | 100 | 64.2 | 30.6 | 5.2 | 35.8 |

Source: Yang and Wei 1996 Table 2 p. 75.

3.2.6 Relevance of the R-S model

In this section we consider the application of the R-S model to the post-reform Chinese economy. Can it explain the development and consequences of rural enterprises in post-reform China as discussed above? Our analysis has shown that while the R-S model can capture some features of rural enterprise growth in post-reform China, however, it has limitations.

The R-S model is intended to extend the Hymer-Resnick (H-R) model to post-colonial era. It modifies some of the assumptions of the H-R model, and distinguishes unfavourable and favourable types in both colonial and post-colonial periods. It also implicitly assumes that markets for goods and factors of production have been well developed in a market economy during post-colonial period.

We have modified some definitions of the R-S model so that we can apply it to post-reform China, and pointed out that it is reasonable to place it in the

favourable category according to the macro-policy setting and policies toward rural development in post-reform period.

The economic reforms since 1978 created an environment in which rural enterprises (Z-sector) could flourish. Reforms introduced in the agricultural sector during the earlier period, including the introduction of the household responsibility system in agricultural production, increases of the prices of agricultural products, deregulation of rural markets and promotion of nonagricultural undertakings resulted in high growth in agricultural production, more marketable surplus and savings, more equal income distribution and greater incentives to expand rural nonagricultural activities. Faced with favourable supply and demand conditions, market-oriented rural enterprises (Z-sector) have expanded at a much higher rate than any other sectors in the Chinese economy, thus has become the most dynamic element in industrial development. With rapid expansion, some technological change has occurred in the Z-sector. It has become more diversified, and the goods it produces now are of higher quality. It has become less dependent on the urban enterprises (U-sector). Far from U-displacement, the Z-sector has forced the U-sector to improve its performance as they compete with each other on the market and stimulated changes in the latter. It also accounts for a significant share of national exports now. Thus the growth of the Z-sector contributed not only to higher overall growth of the economy, but also to high employment growth, structural change, export growth,

rural urbanisation and rural development in post-reform China. All these can be explained by the R- S model.

The R- S model predicts that high Z-sector growth tends to be associated with more egalitarian income distribution and better regional balance. However, the Chinese experience does not seem to support this. The limitation of the R-S model lies in its inability to take into account the special characteristics of the Chinese economy in both pre-reform and post-reform periods.

The economic reforms since 1978 are intended to transform China from a central planning system into a socialist market economy step by step. The strong growth of the Z-sector occurred in this transition process, where markets for goods and factors of production were undeveloped, rather than in a well-developed market economy. In contrast to the R-S model, serious impediments inhibit the free flow of factors of production and products. Lack of factor mobility, especially labour, has prevented income from equalising.

China is a large country, and its regions vary greatly in population, geography, natural resources, human resources, material capital, infrastructure and level of economic development. Since the beginning of the economic reforms the central government adopted a unbalanced development strategy and preferential policies were given to coastal regions. As a result, coastal provinces have become the nation's most prosperous region, while other provinces are underdeveloped. As we have seen before, the development of rural enterprises has been uneven, and is characterised by great regional imbalances. Thus the benefit of the high Z-sector

growth has not been distributed equally. Rural inequality has increased, and regional imbalances have widened.

As the economic reforms since 1978 started with decentralisation, the role of local governments has become increasingly important in regional development. We have mentioned before that this aspect is not captured in the R-S model. Due to fiscal reforms, the central government's ability to redistribute revenues and adjust uneven growth among regions has been greatly reduced. This factor has also contributed to rising income inequality and regional imbalances.

3.3 Conclusion

In this chapter we have shown that China still had the characteristics of a dual economy in the late 1970s. After applying the R-S model to the post-reform Chinese economy, we find out that while the R-S model can capture some features of rural enterprise growth in China, it has limitations. Due to the economic conditions in the post-reform period, government policies generally favoured the development of RNA. Several factors have contributed to this: macro-policy setting, policies toward rural development, local governments, and favourable supply and demand conditions. As a result, the rural nonagricultural economy has become not only the driving force behind China's rapid economic growth, but also contributed to higher overall growth of the economy, high employment and export growth, structural change, and rural urbanisation. However, rural enterprise growth is also associated with rising rural income inequality and greater regional

imbalances in China, which will have far-reaching implications for China's future economic development, and will be discussed in Chapter 4.

Chapter 4

Policies

In the previous chapter, we have applied the R-S model to the post-reform Chinese economy and seen that although the R-S model can explain the rapid rural enterprise growth and the resulting high overall growth of the economy, rapid employment and export growth, structural change, rural urbanisation and rural development, it fails to explain the increase in rural income inequality and regional imbalances, which can be attributed to several factors: lack of factor mobility, the Chinese government's unbalanced development strategy and preferential policies, and decentralisation. This implies not only that the R-S model has its limitations, but also that these developments in China's rural enterprises have far-reaching policy implications for China's future economic development.

In Section 1 of this chapter, we look at the importance of income distribution in achieving sustainable growth and policy options for China to redress its problems, both in the long run and the short run. Then we exam the relationship between factor mobility and inequality, factor mobility in China, and how to improve factor mobility in China in Section 2. Finally, we look at various government measures aimed at reducing income inequality and regional imbalances in Section 3. A summary of this chapter is presented in Section 4.

4.1 Income distribution and sustainable growth

Changes in rural income distribution and regional balance in China have implications for China's future development. Since the alleviation of poverty and the diminution of economic inequality is an integral part of economic development, these changes are of concern for several reasons. To some people inequality itself is an undesirable characteristic, and they would be willing to forego growth for greater equality. Recent studies have shown that distribution of income is an important factor in achieving sustainable growth. According to Murphy et al. (1989), "in a poor country, income distribution could be responsible for the lack of industrialisation, even when the income to start it is available. Extreme equality could mean equal distribution of misery, as no sectors industrialise for lack of demand. Similarly, oligarchical income distributions could pose problems for industrialisation, as the small number of property owners demand goods whose production could not possibly be profitably industrialised. While the rich are served by the labour-intensive backstop sector (or imports), industry does not develop for lack of demand" (p. 554). In their research on Taiwan's structural transformation, Park and Johnston have stressed the importance of spillover effects due to demand-side linkages and human capital development in Taiwan's sustainable industrial success. They point out that "two notable stylised facts characterise Taiwan's development experience: rapid rural income growth - farm and nonfarm - with equitable income distribution; and the dominance of SMEs (small- and medium-scale enterprises) in industrial

development” (1995 p. 182). Rural income grew rapidly in the 1960s and 1970s, and the Gini ratio for the distribution of farm family incomes in Taiwan fell from a low 0.34 in 1964 to an even lower 0.30 in 1975 (Ibid p. 185). Broadly based rural income maximises consumption demand for inexpensive and divisible farm inputs and simple consumer goods that are labour intensive and tailor-made for small-scale enterprises. Thus rising rural consumption demand provides an important stimulus for the growth of SMEs. Evidence from East Asia suggest that low levels of income inequality may have directly stimulated economic growth. China is a large country, it is important for us to recognise the importance of domestic demand expansion as an engine of growth. To sustain its growth, China needs to redress these problems urgently and bring the system back into balance.

As mentioned before, rural enterprise growth has great impact on the changing patterns of rural inequality and regional imbalances. Therefore, the solutions must have something to do with rural enterprises. Limiting the expansion of rural enterprises will have an adverse impact on the growth of the economy as a whole, and hence is not feasible. Moreover, even though stimulating agricultural growth would lead to lower levels of inequality, the growth potential in the agricultural sector is limited compared to that in the industrial sector (Rozelle 1994 p. 386). If we accept that the changing patterns of inequality and regional imbalances in recent years is associated with the remaining barriers in China’s rural economy, then we should find ways to break down whatever barriers are keeping large sections of rural society from enjoying the benefits of the success in the rapidly

growing areas. Achieving this objective takes time and faces constraints, so it can only be a long-run solution. In the short run, the central government needs to provide some help to the central and western regions. This is what the government has been trying to do since 1993. The State Council decision of 1993 made rural enterprise development the strategic focus of the interior's economic development program. The Law on Township Enterprises, which took effect on January 1, 1997, embodies the central government's determination to fully support future growth of rural firms. It also provides special support for the development of township enterprises in poor and ethnic minority regions.⁵ Besides signalling to domestic and foreign capital that investment in interior regions was an option for serious consideration, the central government also adopted a number of measures, i.e. increases in the amount of credit allocations, tax incentives, and a project to promote interregional cooperation, to promote implementation of its program (Yang and Wei 1996 p. 78). In addition, promoting and strengthening agricultural growth can also contribute to more equal income distribution in the rural areas.

4.2 Increasing factor mobility

4.2.1 Factor mobility and inequality

Free flow of the factors of production is the prerequisite for raising the overall efficiency of an economic system and achieving inter-regional equality in per capita incomes (Byrd et al. 1990 p. 270). An important objective of China's economic reforms has been to break down the barriers of administrative

⁵See *Beijing Review* Vol. 39, No. 47 (1996) p. 4.

jurisdictions and expand market mechanisms. Spatial flows of the factors of production have increased, but barriers of various kind still exist.

Table 11
Rural Income Ginis in Taiwan

| | |
|------|------|
| 1964 | 0.31 |
| 1968 | 0.28 |
| 1972 | 0.28 |

Source: Ranis and Stewart 1993 Table 11 p. 96.

The sharp increase in inequality and regional imbalances may be associated with the remaining barriers in China's rural economy, and this hypothesis is supported by a comparison with Taiwan's development effort (Rozelle 1994 p. 381). The Taiwan rural economy experienced growth with equity during its take-off period (see Table 11). Due to the existence of open markets, factors of production, including labour and capital, could move to locations where there were opportunities for higher wages and jobs. Poorer agricultural households were able to move into areas with rising wages and employment opportunities, and these movements led to more equitable income distribution (Ibid p. 382). In contrast, serious impediments still inhibit the free flow of factors and products in rural China in the post-reform period. Rural land, labour, and credit markets remain undeveloped. As we can see from the experience of Taiwan, the free flow of unskilled workers can make a great contribution to mitigating inequality. However, the highest barriers exist in the markets for unskilled workers (Ibid p. 367). The local-orientation of rural enterprises distort factor markets since they have to serve multiple social and economic goals, i.e. not only to develop firms

but also to increase local employment, local residents' incomes, and the local government's revenues. Usually, the local governments restrain the inflow of labour from other areas, and the rural enterprises are required to hire locals and use local raw materials, even when local wages and input prices are high (Ibid). For local governments, the purposes for promoting rural enterprises vary in different periods of economic development. When large surplus labour exists in the local community, the goal is to maximise employment. When all local surplus labour has been absorbed, the goal becomes to increase per capita incomes. Under both circumstances, inflow of labour from other areas would have adverse effect on the local community since in the former case it would reduce employment opportunities for local community members, and in the latter it would reduce the average per capita income of the community (Byrd et al. 1990 p. 306). In recent years, on the one hand, some advanced areas have already seen a sharp rise in labour costs because of the shortage of labour (even though most other rural areas still have plenty of surplus labour). Rural enterprises in these areas have to switch to more capital-intensive industries to counteract the rise in labour costs caused by immobility of labour (Ibid p. 318). On the other hand, surplus labourers in less advanced areas still have great difficulty in finding employment opportunities. If labour were mobile, the flow of labour from underdeveloped to advanced areas would curb the rise of labour costs in the latter, and income distribution would become more equal.

From the contrasting experience of Taiwan and China we can see the importance of free flow of factors of production, especially labour, in mitigating inequality. Although the R-S model does not make the assumption of factor mobility, it seems that this needs to be satisfied for the basic predictions of the model to be fulfilled.

4.2.2 Factor mobility in China

Labor

To facilitate the market-oriented economic reforms, the Chinese government has removed some restrictions on labour mobility (Findlay et al. 1994 p. 53). As mentioned above, two-thirds of China's rural population live in the interior regions, and the labour force is growing at a rate that is nearly 20% greater than that of the coastal region (Chen and Fleisher 1996 p. 156). In addition, the majority of China's 80 million poor people live in the central and west regions, where one out of five persons is poverty-stricken (people who subsist on less than 530 yuan a year) (Shang 1996 p. 4). Due to poor infrastructure and lack of capital, the opportunities of getting rich are limited. To some people migration offered a better road to riches than shifting into nonagricultural activities at home. With the relaxation of administrative controls over migration and job allocation, rural labourers could leave their homes and migrate to any cities and work there, even though they could not change their *hukou* or residential status. In the past few years, millions of migrant rural labourer from the interior regions have travelled to urban areas and the coast in search of employment. Estimates suggest an annual

migrant labour flow of around 50-60 million people, although only 10-15 million have settled permanently in cities (Wu and Zhou 1996 p. 54). These migrant workers are very aware of the labour market conditions, and are engaged in a wide variety of activities: industry (28%), construction (23%), transport (5%), agriculture (5%), commerce (8%), food services (15%) and other (16%) (Gilley 1996 p.19).

The flow of rural labour from areas with less opportunity to the more developed coastal regions not only helps to relieve employment pressures in the interior areas, but also provides a bridge between the rich cities and poor areas. The migrant workers' remittances allow their families to improve their standard of living. Moreover, since the *hukou* system discourages migrant labourers from investing in cities, many migrants are taking their savings back home to set up small businesses, bringing techniques and skills to rural enterprises and creating much-needed jobs in the villages (Ibid p. 18). The urban economy has also benefited from immigration. Lower labour cost has made the economy grow faster, which has stimulated demand for goods and services (Wu and Zhou 1996 p. 63). Needless to say, the increase of transient workers is also associated with all sorts of economic and social problems. Since the migrants who can not find a job in the cities are reluctant to return home, they live in urban slums, where living conditions are worse than in the countryside. Lack of income of these migrants tends to be associated with rising incidence of crime. Some people even fear that

large-scale migration will lead to social strain or even political unrest (Gilley 1996 p.19).

Despite the improvement, legal and social restrictions hinder both rural-urban and rural-rural flows of labour. The household registration system still exists, and migrants are often treated as second-class citizens in the cities, so rural-urban migration is limited. Obstructions to the free flow of labour among rural areas are rooted in farmers' dependence on land (Byrd et al. 1990 p. 271). Statistics show that in the past few years intra-regional migration was more common than inter-regional migration: 42% of the migration occurred in the home county, 28% occurred outside the home county but within the home province, and only 30% of the migrant workers went to other provinces (Gilley 1996 p. 19). Moreover, industrialisation-driven migration is highly selective: those who are younger and better educated than average member of the rural labour force are more likely to migrate (Wu and Zhou 1996 p. 57), thus having a negative impact on the regions they are leaving. Therefore, for the poor regions factor mobility may be a mixed blessing.

Capital

Due to financial reforms, banks in China have become more and more aware of the economic returns on their loans. Since the returns in the coastal regions are generally higher, the Agricultural Bank and credit coops thus target their funds (about 70%) to rural enterprises in the eastern coast (Yang and Wei 1996 p. 83), and are reluctant to provide funds to the interior areas, where capital is scarce and

in great demand, but economic returns are lower. In some interior regions the specially earmarked rural enterprise development funds were not fully disbursed, and the amount of loans to rural enterprises even decreased. For example, in Guangxi, the Agricultural Bank's loan quota was reduced from 1.9 billion yuan in 1992 to 1.3 billion yuan in 1993; ordinary loans to rural enterprises fell from 200 million in 1992 to 66 million in 1993. The special loans for rural enterprises in central and western regions from the Agricultural Bank have been subject to certain conditions since 1991: the ratio of overdue loans was not to exceed 10%, and the ratio of non-performing loans was not to exceed 5% (Ibid).

Because of poor infrastructure and lack of business acumen in its management personnel, the central and western regions also have difficulty in attracting foreign capital. Since 1979, 18 inland provinces have received \$13 billion in foreign direct investment. That is only a tenth of the national total (Wong 1996 p. 42).

4.2.3 Increasing factor mobility

Labour

If we accept that free flow of factors of production plays an important role in reducing inequality and regional imbalance, then efforts should be directed toward breaking down the remaining barriers, especially the factors that prevent the free migration of labour, thus increasing factor mobility.

Efficiency and equity were not considered when the policy of separating the urban and rural population was formulated. Reformers in government are calling for a quick end to the household registration system which keeps rural migrants

from settling down near their new jobs. (Over 40 Chinese cities of more than a million people deny migrant workers the right to permanent residency) (Gilley 1996 p. 18). However, in practice, there are constraints. Migration of hundreds of millions rural surplus labourers to the coastal provinces, particularly to urban locations, will overwhelm the capacity of all types of infrastructure, especially sanitation and transportation facilities (Chen and Fleisher 1996 p. 157). It may also increase the incidence of crime, since not every migrant can find a job and support himself in the city. Therefore, free rural-urban migration might not be a viable policy in the short run. In fact, according to the recent policy of China's Labour Ministry, rural surplus labourers will be encouraged to stay where they are so that the number of migrants into urban areas can be held at around 30 million in 1996, and 40 million by the year 2000. In particular, rural labourers will be restricted from flowing into those major cities where the jobless problem is more serious.⁶

Since the income gap among regions is large, people in low-income rural areas have a strong desire to move to high-income areas if they can abandon the traditional conception of "never leaving one's native land unless it is absolutely necessary", reduce their dependence on land, and are accepted by the people in high-income rural areas (Byrd et al. 1990 p. 271). The movement of rural labour has now become a common phenomenon, and is likely to increase. Labour from the poor regions can be employed in the activities such as agriculture and heavy

⁶See *Beijing Review* Vol. 39, No. 19 (1996) p. 6.

work that locals in the rich areas might not be willing to do, or used as contract labour on construction projects (Findlay et al. 1994 p. 91). Since the basic purpose of private rural enterprises is to maximise profits on capital, it requires the free spatial flow of factors of production (Byrd et al. 1990 p. 272). Encouraging, protecting and promoting the development of private enterprises thus can contribute to reducing income inequality and regional imbalances.

Capital

To increase the migration of capital to the interior, emphasis should be put on the productivity of investment in the interior and the development of human capital and infrastructure. In fact, the central government has invested heavily in the region's infrastructure in recent years, including 2.7 billion yuan for energy development and 8 billion yuan for railways (Shang 1996 p. 4). Enterprises in coastal regions now suffer from rising labour and land costs, shortage of energy and raw materials, and environmental degradation, and thus have become less suited to labour-intensive and resource-intensive processing industries. In the meantime, labour- and resource-intensive processing industries are more appropriate for the less developed interior (Yang and Wei 1996 p. 77). The development of the interior human capital and infrastructure would not only raise the incentive for coastal businesses, including those funded by foreign investors, to expand to the interior but also facilitate the transfer of labour- and resource-intensive processing industries and technology to the interior, thus helping to

enhance economic growth in the interior, and move toward regional income equality in China (Chen and Fleisher 1996 p. 157).

To sum up, the key to reduce income inequality and regional imbalances lies in the national integration of labour and capital markets. For the reasons discussed before, the national integration of labour markets is likely to occur more slowly than that of capital markets.

While the previous discussion concentrates on the role of factor mobility in reducing inequality, it is also important to note the importance of improvement in the access to education, health care and in infrastructure in the interior region. Despite their complex relationship, there is some correlation between education, health achievements and economic growth. Expenditures on education, training and improvement of health contribute to productivity by raising the quality of the work force, and yield a continuing return in the future. The World Bank's *Education Sector Policy Paper* (1980) concludes that "studies have shown that economic returns on investment in education seem, in most instances, to exceed returns on alternative kinds of investment, and that developing countries obtain higher returns than the developed ones" (as quoted in Meier 1995 p. 320). In fact, heavy investment in education, abundance of human resources rather than natural resources is the base of the East Asian success. Emphasis on high-quality basic education and augmenting labour demand helps to reduce poverty and income inequality, which in turn stimulates growth (Nancy et al. 1995). Since human development in the interior region lags behind that of the coastal region due to

lack of financial resources and poor infrastructure, to close the virtuous circle, more emphasis should be put on improvement in health, education and infrastructure.

4.3 Government measures

The central government has decided to adopt a balanced development strategy in the near future to narrow regional disparity. At present, it is trying to provide some help to the central and western regions. The State council decision of 1993 made rural enterprise development the strategic focus of the interior's economic development program, and the central government also adopted a number of measures to promote it.

4.3.1 Credit policy

In 1992, the People's Bank of China authorised 2 billion yuan in bank loans and 3 billion yuan in rural credit cooperative loans for the purpose of supporting rural enterprise development in central and western regions. It also decided in November 1992 to provide 5 billion yuan a year from 1993 to 2000 in special loans to support rural enterprises in interior regions. The funds would be disbursed through the Agricultural Bank of China. In September 1993, it announced that the State Council would authorise a further 5 billion yuan a year between 1994 and 2000 in special loans to support rural enterprises in interior regions. In addition, at the end of 1992, the Agricultural Bank of China set up a 100 million yuan special discount loan program for rural enterprises located in ethnic minority areas (Yang and Wei 1996 pp. 78-79).

4.3.2 Fiscal policies

Tax incentives

Rural enterprises of central and western regions were also given various tax incentives. All newly established rural enterprises in old revolutionary base areas, minority nationality regions, border regions, and poor areas were to be exempted from income tax for three years. Provincial-level governments in Inner Mongolia, Xinjiang, Ningxia, Tibet, Guangxi, Yunnan, and Qinghai were also authorised to make special policies for rural enterprises in light of local situations. In addition, rural enterprises in the interior were exempted from the fixed capital investment orientation adjustment tax (Yang and Wei 1996 p. 79).

Transfer payments

In its ninth Five-Year Plan, the central government states that it will increase its fiscal support to the central and western regions through transfer payments.⁷ It is evident that the fiscal reforms adopted in the previous period, which tie expenditures to locally generated revenues, has greatly reduced the central government's ability to redistribute revenues among regions. This is another factor that has contributed to rising regional imbalances.

4.3.3 Fight poverty

Since the majority of China's 80 million poor people live in the central and western regions, the central government put a lot of effort on poverty relief projects. China now spends 10.8 billion yuan annually on poverty relief, and will

⁷See *Chengdu Daily* March 20, 1996.

spend a total of 100 billion yuan in eliminating poverty and narrowing the gap between the rich and poor by the year 2000. The central government will urge provincial governments to allocate a sum equal to 30-50% of the central government's contribution to local anti-poverty campaigns. To make poverty-relief efforts more efficient, the money will be employed to benefit poor households at the village level rather than county level.⁸ The World Bank made the first major effort to provide direct assistance to China's poverty-stricken citizens in 1995 through the Southwest China Poverty Relief Program. This effort represented the largest project of its kind supported by an international organisation (Wu 1996 p. 17).

4.3.4 International aid

Despite the official commitment to rural enterprise development in the interior regions, local governments have found it difficult to channel the requisite funds to rural enterprises. The central government has started to steer more international aid into interior regions. In its ninth Five-Year Plan, the central government states that 60% of the loans from international financial institutions and foreign governments will be allocated to the central and western regions.⁹ Japan announced at the end of 1994 that it would shift the focus of its soft government loan program in China from coastal infrastructural development to other areas. A

⁸See *Beijing Review* Vol. 39, No. 40 (1996) p. 4.

⁹See *Chengdu Daily* March 20, 1996.

principal aim of Japanese assistance over the 1996-2000 will be to help China reduce its regional prosperity gap (Yang and Wei 1996 p. 84).

4.3.5 Interregional cooperation

In principle, the State Council also supported the effort of the East-West Enterprise Cooperation and Demonstration Project proposed by the Rural Enterprise Bureau of the Ministry of Agriculture (Yang and Wei 1996 p. 79).

This interregional cooperation program seeks to set up 100 east-west cooperation and demonstration zones, each with a one billion yuan gross output value. By the year 2000, it will select 1,000 industrial demonstration projects in central and western regions. The Ministry of Agriculture will also help 100 pairs of cities and counties establish bilateral cooperation in rural enterprise development, and together with the State Science and Technology commission, help train 10,000 technicians and factory managers over six years. With little choice for the Ministry of Agriculture, the project is designed to generate a significant effect with a small amount of money (Ibid pp. 84-85).

Although the Cooperation and Demonstration Project is still in its infancy, its initiation has prompted local government and enterprises in the coastal region to think seriously about heading west, or accelerating their pace for doing so. Approximately 200 enterprises from Shangdong Province and 400 from Zhejiang Province have established operating units in the central and western regions (Shang 1996 p. 4). The Wanxiang Group, based in Zhejiang province, announced a "Going West Scheme" to develop central and western parts of China. By

October 1994, the group has elicited 1,092 domestic and foreign business inquiries, and was visited by dozens of delegations, including several from interior governments interested in cooperation. The Group has plans to invest 100 million yuan in interior regions in order to reduce production costs and gain better access to raw materials and potential markets. Concerns about rising production costs and access to raw materials and markets have resulted in a rapid rise in the amount of foreign investment directed at interior regions, although starting from a low base (Yang and Wei 1996 pp. 85-86).

4.3.6 Agricultural development

As mentioned in the previous chapter, rural reform and the resulting rapid growth in agricultural production has contributed significantly to reducing rural poverty and improving income distribution. However, agricultural production slowed down in the second half of the 1980s after the spectacular growth in 1978-84 period. Despite the promise to support agriculture, state investment in this sector declined: agriculture's share of state investment in capital construction was 10.5% during 1976-80, it fell to 3.1% during 1986-89 (the lowest level since 1949). Rural infrastructure improved little: highway development lagged behind, water conservancy and irrigation investments were curtailed, and there was only modest progress in the provision of electricity in rural China. Extension of land-use contracts for rural households from 2-3 years to 15 years did not stimulate peasants' investment in land improvement (McKinley 1996 pp. 8-9).

China is unique in its population size, and cannot rely on importation of food. Thus agriculture should always be regarded as the foundation of the national economy. In recent years, the central government has realised that “agriculture was still the weakest link in the national economy. Agricultural production still fell short of the requirements of the development of the national economy as a whole and the constantly improving living standards of the people” (Chen 1996 p. 18) and re-emphasised the importance of agricultural production. In its ninth Five-Year Plan it states that: (1) central government and local governments at all levels should increase their investment in agriculture, and investment from foreign investors, rural enterprises and peasants should also be encouraged. Investment from the central government should mainly be used to harness big rivers and lakes, support seed improvement projects and water conservation and irrigation demonstration projects; (2) to increase productivity and facilitate large-scale farming, the transfer of use-rights of land will be encourage. Arable land should be protected in accordance with the law, and strict limits must be imposed on the spread of city areas and on the use of land by small cities and towns and for nonagricultural purposes such as construction of industrial projects; (3) growth in agricultural production should rely on intensive measures – the promotion of high-yielding and good-quality products (Ibid p. 19).

Hopefully, agricultural production will pick up with these efforts. It will contribute not only to self-sufficiency in food production and sustainable growth, but also to more equal income distribution and regional development.

4.4 Conclusion

In this chapter we have discussed the importance of income distribution in achieving sustainable growth. Since rural enterprise growth has great impact on the changing patterns of rural inequality and regional imbalances, the solution must have something to do with rural enterprises when China redresses this problem. We conclude that in the long run the solution lies in the national integration of labour and capital markets, and improvements in human and infrastructure development in the poor regions, while in the short run, the government can provide help to the poor regions. We have also looked at various government measures aimed at reducing income inequality and regional imbalances at present.

Chapter 5

Conclusion

China has achieved remarkable economic success since the economic reforms beginning in 1978. During 1979-94 its GDP grew at 10% annually on average, and industrial production grew at around 15% annually. Its exports climbed from \$US9.75 billion in 1978 to \$US121 billion in 1994, its foreign investment increased from \$US4.65 billion in 1985 to \$US43.2 billion in 1994, and its foreign exchange reserves have exceeded \$US100 billion recently. Not only was such rapid growth unprecedented in China's long history, it was also high compared with other nations. The rapid growth has enabled China to become the world's fastest-growing economy, and increase its importance over the world economy and world politics. Location in an economically dynamic region - East Asia - has influenced China's economic growth one way or the other. The "Asian Era" has arrived. If China's economic reforms are successful and the Chinese economy grows steadily, the effect of Asia on the world economy will be difficult to imagine. And within East Asia, greater China (including Taiwan and Hong Kong) is increasing its influence.

China still had the characteristics of a dual economy in the late 1970s when the economic reforms began, and this had impact on the reforms. It would be impossible for us to understand China's economic development since 1978 without understanding the problems associated with this dualism in the economy

and society. The Stalinist model pursued in the pre-reform period did not alleviate but reinforced the problems. When a dual economy exists, the question for the country's development is how the modern industrial sector can expand while the traditional agricultural sector contracts. This can be achieved either through the development of urban industries and rural-urban migration or through the development of rural nonagricultural activities (RNA). Under the economic conditions in China in the late 1970s, the second option was more feasible. Development strategy in post-reform China focused on economic growth. With limited resources available from the government and state-owned enterprises (SOEs) in trouble, the Chinese government gave priority to industries and sectors where limited government investment would produce rapid growth, and opportunity of expansion to the non-state sector. Unlike the Soviet Union, which neglected agriculture, China's economic reforms had deep roots in peasant society. In fact, economic reforms in China started with the agricultural sector. Due to price increases for agricultural products, introduction of the household responsibility system, and deregulation of rural markets, huge increases in productivity, income, and investable and marketable surpluses were generated with negligible state investment, and these provided the basis for the development RNA in a favourable policy environment. The rural industrial and services sectors grew by 16.8% and 19.4% respectively during 1978-91, compared to 8.1% and 7.0% growth of the urban industrial and services sectors, and 5.3% growth of agriculture.

The role of RNA in the development process is captured in the Ranis and Stewart (R-S) model, and we apply it to the post-reform Chinese economy with some modification of definitions. Since the macroeconomic policy, policies toward rural development, and supply and demand conditions are favourable to the development of RNA, we place China in the favourable category. We also find that local governments have played an important role in promoting rural enterprises in China, an aspect not captured by the R-S model. Just as the model suggests, rural enterprises have become the driving force behind China's rapid economic growth. They contributed not only to higher overall growth of the economy, but also to high employment and exports growth, structural change and rural development. However, due to its inability to take into account the special characteristics of the Chinese economy, the model cannot explain the rising rural inequality and widening regional imbalances. Therefore, the growth-oriented development strategy has raised new question, i. e., whether China can sustain its rapid growth in the future.

Improvement in the distribution of income is an integral part of economic problem, and sustaining development in the longer run is more difficult than initiating development. Recent studies have shown that distribution of income is an important factor in achieving sustainable growth, and evidence from East Asia suggests that low levels of income inequality may have directly stimulated growth. To sustain its growth, China needs to address its problem urgently. The sharp increase in rural income inequality is associated with low factor mobility,

especially labour in China. Widening regional imbalances can be attributed to decentralisation, the government's unbalanced development strategy, and other geographical and historical factors. Therefore, we conclude that in the long run the solution to reducing income inequality and regional gaps lies in the national integration of labour and capital markets, and improvements in human and infrastructure development in the interior region. In the short run, the central government has decided to adopt a balanced development strategy, and is trying to provide various helps to the central and western regions, including credit policy, fiscal policies, international aid, inter-regional cooperation, and agricultural development, etc..

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