ONE

Just How Capitalist Is China?

In 2004, Lenovo, a computer maker based in China, acquired the manufacturing division of IBM. This event, coming off the heels of the news that China had contributed more than the United States to global GDP growth, took the world by storm. Richard McGregor (2004), a reporter for the *Financial Times*, captured a widespread sentiment when he wrote that the purchase was "a symbol of a new economic era, of how a fast-rising China had suddenly grown powerful enough to subsume an iconic American brand." Princeton economist and *New York Times* columnist Paul Krugman (2005) had not been alarmed with Japanese acquisitions in the 1990s but he was about Chinese investments. He believed that the Chinese corporate acquisitions posed a great threat to the United States. There are even those who hailed the Lenovo acquisition as heralding a new world order with China at its center (Shenkar 2006).

Business-school academics are particularly enamored with Lenovo. For them, Lenovo is proof positive of China's fertile entrepreneurial environment and rising competitiveness. In his book, *The Chinese Century*, Oded Shenkar, a professor at Ohio State University, rejects the notion that China lacks its own homegrown corporate giants. Lenovo, he argues, is just as homegrown as the best of the Indian corporations, such as Wipro or Infosys (Shenkar 2005). Lenovo is also featured prominently in *Made in China: What Western Managers Can Learn from Trailblazing Chinese Entrepreneurs*, a book by Donald Sull, a business professor at INSEAD (Sull 2005).

There is one problem with these otherwise perceptive books – Lenovo is not a Chinese company. There is no question Lenovo is a huge success story but it succeeded precisely because it was able to operate outside of the Chinese business environment. The Chinese face of the firm is Lenovo China headquartered in Beijing. This is the original firm founded in 1984 under the Chinese Academy of Sciences (CAS). But the real corporate control and equity holdings of the production and technology development of Lenovo actually reside elsewhere – in Hong Kong. Consider Lenovo (Beijing) and Lenovo (Shanghai), the business units of the firm that run manufacturing, R&D, software development, and customer services. Both of these business units are not only foreign-invested enterprises (FIEs); they are, in fact, wholly owned FIEs – that is, they are 100 percent owned by a legal foreign entity, which is Hong Kong Lenovo. They have no direct equity relationship with Lenovo China. As wholly owned FIEs, the Beijing and Shanghai divisions of Lenovo are more foreign than GM's operation in Shanghai, which is a 50–50 equity joint venture. The foreign operations of Lenovo are so substantial that in 2003, seven of Lenovo's Hong Kong subsidiaries were included on a list compiled by the Chinese government as among China's 500 largest FIEs.

This is a book about this and many other phenomena of the Chinese economy. In the first part of this chapter, I provide a detailed account of Lenovo in order to make a larger point – the Chinese economy is so complicated that what appears to be straightforward and obvious on the surface is not at all so once we dig into the details. To get into these details requires going far beyond the normal empirical basis of much of the economic analysis on China (e.g., data on GDP and foreign exchange reserves). In this book, I have examined numerous government documents, including memoranda and instructions issued by officials of the central bank and by senior bank managers and a large quantity of survey data on households and Chinese firms. The conventional economic data, such as GDP, exports, and FDI, serve as motivations for further research rather than as statements about settled conclusions. (I provide more details on the empirical sources of the book later in this chapter.)

The Lenovo example is not just about getting the facts right about the Chinese economy; it is also about drawing the right analytical and policy implications from China's growth experience. This is another theme running throughout the book. Much of the received wisdom in the academic literature states that entrepreneurship, financial liberalization, and private property rights security are not significant components of Chinese economic growth. (Or, at the very least, to the extent that these components are important, they have very different manifestations from those prevailing elsewhere.) The success of the Chinese economy has inspired the idea that economic growth follows from an adept tailoring of economic policies and institutions to their local contexts rather than from an application of universal economic principles. Let me apply this idea to the experience of Lenovo.

A critical detail of the Lenovo story is its foreign registration status. A reader may wonder, “So what?” What is so significant about the fact that Lenovo is registered as a foreign-owned company in China? Furthermore, isn’t it the case that Hong Kong is now a part of China so the designation of Hong Kong Lenovo as a foreign firm is a frivolous legal fiction? The answers to these questions show precisely how important it is to get the details of the Lenovo story right.

Understanding the Hong Kong roots of Lenovo entails significant implications about constructing the right causal attributions. Hong Kong is a laissez-faire economy based on a market-oriented financial system, rule of law, and property rights security. Hong Kong, many would argue, is the closest living case to the textbook version of neoclassical economics in the world. This is why it matters so much to accurately attribute the success of Lenovo. If we believe Lenovo to be a product of China’s business environment, then many of those who argue that China has created a unique, country-specific formula for cautious deregulation, state ownership, and selective government intervention in the economy have a point. If we believe Lenovo to be a product of Hong Kong and Hong Kong institutions, the success of Lenovo then becomes a story of rule of law and market-based finance. It is thus worth going into some details about this matter.

Apart from the initial financing from CAS in 1984, it is the market-oriented and conventionally Western Hong Kong capital market that supplied Lenovo with almost all of its subsequent capital during the critical growth period of the firm.[1] In 1988, Lenovo received HK$900,000 from China Technology, a Hong Kong–based firm, to invest in a joint venture in Hong Kong. This investment thereby established Lenovo’s legal domicile in Hong Kong. (Originally, the firm was known as Legend.) Here, luck and fortuity played a role. The father of Liu Chuanzhi, the main founder of Lenovo, ran China Patent Agent based in Hong Kong. China Patent Agent was a major shareholder of China Technology. Computer manufacturing is capital-intensive and requires substantial investments. It was the capital market in Hong Kong that met this high level of capital requirements of Lenovo. In 1993, Hong Kong Lenovo went public on the Hong Kong Stock Exchange. The initial public offering (IPO) raised US$12 million, which the firm plowed back into its investments in China. Lenovo is a success story of the market-based finance of Hong Kong, not of China’s state-controlled financial system.

Although it is true that the founders of Lenovo all came from CAS, that the firm became a business subsidiary of CAS is a historical artifact. The founding capital was 200,000 yuan, an enormous sum in China in

1984. The money was actually a loan from CAS, not an equity investment. In fact, the arrangement was exceedingly convoluted. According to one account, the 11 founders of Lenovo had secured the money as a bank loan, which they lent to CAS. CAS then turned around and loaned the money back to Lenovo. Under Western law, Lenovo would have been a straightforward private firm with CAS as its creditor, not the equity holder. But the reason why Lenovo incorporated itself this way has nothing to do with the actual share of capital contributions. The reason is that in 1984, there was really no legal vehicle to register an independent private-sector firm of the size of Lenovo and operating in a modern industry such as computer manufacturing. In the 1980s, although private-sector liberalization in rural China went far and deep (a topic I revisit in the next chapter), the urban economy remained almost completely state-controlled. Many of the large-scale otherwise private businesses were incorporated in this way in the 1980s.

Understanding Lenovo's Hong Kong connections also helps us gain the right perspective on the Chinese business environment. The legal status of Lenovo as foreign-owned mattered to Lenovo in a most fundamental way – this was its entry ticket into computer manufacturing in the first place. After its founding, Lenovo was denied a production license in computer manufacturing in China. Instead, the Ministry of Electronics granted a production license to the Great Wall Group, a traditional SOE. Lenovo only began to produce computers in China not as a Chinese company but as an FIE originating in Hong Kong. Every single manufacturing, service, and R&D operation launched by Lenovo in China has followed exactly the same route. They are either wholly owned by Hong Kong Lenovo or they are foreign joint ventures with other Chinese firms. In 1997, Hong Kong Lenovo absorbed the last remaining Chinese operation, its Beijing operation.[2]

As an FIE, Lenovo came under the jurisdiction of the Foreign Equity Joint Venture Law or the Wholly Foreign Equity Law. Chinese laws and regulations provide a more liberal operating space for foreign-registered firms than they do for domestic private firms. In the 1990s, China pursued a highly biased liberalization strategy that conferred substantial tax and policy incentives on FDI while restricting the growth potentials of the indigenous private sector.[3] Until 2005, many of the high-tech and so-called strategic industries were declared off-limits to domestic private entry. Indigenous private entrepreneurs, many highly capable, could grow their businesses only via foreign registration. This is why Lenovo acquired a foreign legal status. As an FIE, Lenovo was able to operate in greater regulatory space and with more autonomy. As an illustration, the firm that bypassed Lenovo and was given the production license in computer manufacturing – the Great Wall Group – operated completely within China's domestic business environment. The firm floundered badly.

Professor Sull chronicles seven other firms in his book: Sina, UTStarcom, AsiaInfo, Haier, Galanz, Wahaha, and Ting Hsin. Every single case Professor Sull discusses is a Lenovo-like story. The firms are all registered as foreign firms in China, or some of their main operations are so registered. Sina, UTStarcom, Ting Hsin, and AsiaInfo are wholly owned FIEs, 100 percent owned by foreign investors, identical to Lenovo (Beijing) and Lenovo (Shanghai). Galanz and Wahaha are joint ventures. (In 2007, Wahaha's founder was involved in a bitter dispute with its foreign business partner, Danone.) Haier itself is not an FIE but its main business and production units are FIEs, including its core areas in refrigerator and washer and dryer production. All of these firms are legally classified as FIEs and they fall under the relatively more liberal purview of China's foreign investment laws and regulations.

It is quite understandable that Sull assumed that all of these firms are Chinese. They are Chinese to the extent that their managers and owners are ethnically Chinese, but their legal status is *foreign*. That corporate success in China requires a combination of Chinese management and foreign legal status is probably the cleanest illustration of the massive distortions in China's business environment – that this is a system that has imposed a straitjacket on the domestic private sector. It is thus not a coincidence that corporate success stories in China all share an underlying commonality with Lenovo and Sina. In 2002, *Forbes* compiled a list of the most dynamic small firms in the world. On that list, four are run by Chinese entrepreneurs and derive most of their revenue from their China operations, but each one of them is actually headquartered in Hong Kong.

The rise of Lenovo has so impressed some foreign analysts that a McKinsey consultant goes so far as to claim that China has the "best of all possible models" (Woetzel 2004). This reasoning holds up the particular policy and institutional path that China has followed as a model for other developing countries. China has inspired Western researchers to argue that microeconomic and macroeconomic successes do not depend on adoption of Western-style financial and legal institutions. This is the argument in an influential finance paper that claims that informal finance is nearly as good as market-based financial institutions in channeling capital to the private sector (Allen, Qian, and Qian 2005).

The story of Lenovo casts doubt on all these postulations. Yes, China lacks efficient legal and financial institutions, *but it has access to them – in*

Hong Kong. Take the view that formal finance does not matter. The management of Lenovo certainly would not agree with this. The firm raised more than US$12 million from its Hong Kong IPO. Formal finance – and the institutions supplying it – is absolutely essential to the success of Lenovo. Informal finance might be sufficient to start small kiosk businesses or simple production, but it is not adequate for firms to acquire modern production facilities and to move up on the technological ladder.

Lenovo is the most prominent product of what is known as "round-trip" FDI – "foreign" capital that is first exported from China and then imported back into China. The key function of Lenovo's Hong Kong operation has nothing to do with technology. In fact, according to one of the best and most-detailed accounts of Lenovo, the managers and scientists at Lenovo had far superior technical expertise than the Hong Kong firm with which it teamed (Lu 2000). The true contribution of China's open-door policy is not just about allowing foreign entry but also about allowing Chinese exit. It enabled some of China's own indigenous entrepreneurs to find an escape valve from a very bad system. To put it another way, China's success has less to do with creating efficient institutions and more to do with permitting access to efficient institutions outside of China.

This – largely unintended and under-appreciated – effect of China's open-door policy should be explicitly recognized, but recognizing this effect is qualitatively different from stating that China does not need efficient market-based institutions. The story of Lenovo is precisely about the importance of efficient market-based institutions. Lenovo was able to tap into these institutions because China is fortunate enough to have the most laissez-faire economic system at its doorstep. Hong Kong is a safe harbor for some of the talented Chinese entrepreneurs and an alternative to China's poorly functioning financial and legal systems. It is only a slight exaggeration to say that Lenovo benefited as much from the British legacy as from the growth opportunities within China itself.

China is unique in that some of its capable entrepreneurs have the option of accessing one of the most efficient financial markets and legal institutions in the world. But here is an important policy implication. It would be futile for other developing countries to emulate China's domestic financial and legal institutions and practices as a way to achieve economic growth. As successful as Lenovo is, the special circumstance of Hong Kong limits the general applicability of this model. In this connection, McKinsey's exhortation that China has "the best possible" business model is equivalent to urging other poor countries to acquire their own Hong Kong, a piece of advice of dubious utility.

Finally, there is the issue of whether or not getting the story right about Lenovo and about China really matters for China. Maybe the lessons of China cannot be readily extended to other countries, but as long as the China model works for China, this is fine. Isn't it the case that many firms like Lenovo are able to tap into Hong Kong's financial market and legal institutions and are able to emerge as competitive giants on the world stage? As long as there are substitute mechanisms, China's growth can continue.

This is a flawed inference from the success of Lenovo and other Chinese companies. Recall the fact that Lenovo was able to tap into the financial market of Hong Kong surreptitiously – Liu Chuanzhi's father was an executive in Hong Kong. Familial connections enabled Lenovo to escape from the clutches of China's poor institutions, but for each Lenova-type success story, there are untold cases of failure of indigenous entrepreneurs for whom access to Hong Kong is not an option. This is true especially of those would-be entrepreneurs located in China's vast rural and interior regions. One can go even a step farther. China's need for an efficient financial system is greater in the interior regions than it is in the coastal provinces precisely because the interior is so short of other conditions for growth.

Bad institutions are especially detrimental to rural entrepreneurship, the type of entrepreneurship that matters far more to the welfare of the vast majority of the Chinese, as compared with urban, high-tech entrepreneurship. Two chapters of this book delve extensively into this issue. Unlike many countries, the most dynamic, risk-taking, and talented entrepreneurs in China reside in the countryside. These rural entrepreneurs created China's true miracle growth in the 1980s, first by dramatically improving agricultural yields and then by starting many small-scale businesses in food processing and construction materials. The open-door policies alone can do very little – and they did very little – to help these entrepreneurs in the interior regions.

To a large extent, the story of Lenovo mirrors the story of China. What appears to be abundantly obvious on the surface is, in fact, not obvious at all. To get the facts right requires a deep digging into many details. A substantial portion of this book illustrates this point. In part, this is a history book – marshaling facts and data about the evolution of the Chinese economic system over the last three decades. But, as my account of Lenovo shows, getting the China story right is also about constructing the correct explanations about China. The explanation I put forward in this book is simple and even bordering on the mundane: China succeeded where and when bottom-up, private entrepreneurship flourished and it stagnated where and when entrepreneurship was suppressed.

In this chapter, I begin with a basic question, "Just how capitalist is the Chinese economy?" This is a legitimate question, considering the following. First, the year 2008 marks the 30th anniversary of China's economic reforms (1978–2008). By 2008, it will have taken China one year longer to reform its socialist economic system than the duration of the pre-reform central planning system itself (1949–1978). (Indeed, by the account of economic historians, a full-fledged central planning system was not established until the mid-1950s.[4]) The question of the pace at which China is transitioning to capitalism is worth considering. Second, some of the most prominent and authoritative China economists have already declared that China's transition to a market economy is now complete.[5] The remaining challenge, they argue, is economic development. It is legitimate to subject this judgment to an empirical test.

One of the most important – if not the most important – hallmarks of a market economy is the role and magnitude of the private sector. However, as in so many other areas of the Chinese economy, there is no straightforward answer to this seemingly direct question about the size of the Chinese private sector. The reason is that the Chinese style of reforms has spawned a large number of firms that have fundamentally confusing and often deliberately vague ownership structures. After sorting through some definitional complications, I show that the size of the Chinese private economy, especially its indigenous component, is quite small. Using fixed-asset investment as a measure of policy, I show that the policy treatment of the indigenous private sector deteriorated substantially in the 1990s as compared with the 1980s. This policy reversal is the most important reason why China's transition to capitalism remains incomplete 30 years after the reforms began.

The second section of this chapter provides a preview of my account of the Chinese reforms during the last 30 years and concludes with a précis of the remaining four chapters of the book. Three issues are highlighted. First, a good account of the Chinese economy should be able to explain both its many well-known weaknesses – the weak financial system, the underdeveloped private sector, and the deterioration of social performance – as well as many of its considerable achievements, such as its rapid growth and its impressive reduction of poverty. The key factor identified in my account is a reversal of economic policies at the end of the 1980s. In the 1980s, the direction of economic policy was progressively liberal, primarily in the rural areas of the country. Access to finance by the private sector improved rapidly and rural entrepreneurship was vibrant. In the 1990s, the direction of economic policy was reversed, with an increasing emphasis on industrial policy and state-led investment drives. Although GDP growth was rapid during both eras, both the drivers and the effects of the growth differed substantially. In the 1980s, the rapid GDP growth was accompanied by fast personal income growth, an improving income distribution, and a steep decline in poverty. Since the early 1990s, and at an accelerating pace since the late 1990s, the welfare implications of the fast GDP growth turned adverse. In other words, many of the best-known achievements of the Chinese economy owe their origins to the policies of the 1980s and many of the deep-seated problems today are an outgrowth of the policies of the 1990s.

The second part of my account emphasizes the importance of the rural sector. The importance of the rural sector derives not just from its sheer weight in the Chinese economy and society – that China has a large rural population – but also from the institutional perspective. In China, the origins of market-based, entrepreneurial capitalism are heavily rural in character. This observation entails some significant auxiliary implications. One is that the fate of rural entrepreneurship has a disproportionate effect on the character of Chinese capitalism. When small-scale, market-oriented, broad-based, and politically independent rural entrepreneurship is accorded greater operating freedom and supported by policies, entrepreneurial capitalism thrives and produces many of its associated virtuous effects. When rural capitalism is restricted in favor of its urban counterpart, Chinese capitalism is less welfare-improving. In essence, this is the tale of the two decades. In the 1980s, the country was moving directionally toward the virtuous kind of capitalism, or what Baumol, Litan, and Shramm (2007) describe as entrepreneurial capitalism. In the 1990s, the country still moved toward capitalism but of a different and less virtuous kind – the state-led brand of capitalism.

The third part of my account has to do with how to interpret China's growth experience. My purpose here is to present the relevant factual details and to develop the right analytical perspective based on them. I argue that China's growth experience is actually very conventional. Private ownership, financial liberalization, property rights security, and even some degree of constraints on the political rulers are as essential to China's economic success as they are to economic successes elsewhere. The success of Lenovo, which "borrowed" the institutional benefits of Hong Kong, illustrates this point. On the other hand, many of China's failings are a direct result of the country's poor and underdeveloped economic and political institutions and, more important, a consequence of the fact that the country reversed its policies and practices from the directional liberalism of the 1980s to the directional illiberalism of the 1990s.

1 Just How Capitalist Is China?

A hallmark of a market economy is the size and the vitality of its private sector. There are two standard perspectives on this question as related to China. One is the view that growth happened in China despite the absence of sizable private ownership. Advocates of this view point to TVEs – the growth engines in the 1980s and the first half of the 1990s – as an illustration. The other standard perspective is that China's private sector was not substantial *ex ante* but became substantial *ex post*. This perspective is rooted in the gradualist framework on the Chinese economy. According to the gradualist perspective, China did not actively privatize its SOEs, but it successfully created a hospitable business environment for the entry and the organic growth of private entrepreneurship. Over time, the private sector grew to overshadow the state sector. Market economy developed by evolution rather than by revolution.

I provide an alternative perspective in this book. Later in this chapter and in Chapter 2, I delve extensively into the TVE phenomenon; the gist of the finding is that TVEs, upon a microscopic examination, were in fact a substantially private phenomenon. In this section, I look into the gradualist perspective on China's private sector. The issue here is not so much whether the gradualist perspective is directionally accurate about the growth of China's private sector. There is little question that the size of China's private sector today is much larger than that in 1978. (In 1978, it was zero.) The issue is just how successful is China's evolution toward a market economy. Scholars schooled in the gradualist perspective declared a huge success. The analysis I present in the following paragraphs reached a far more tempered judgment on this question.

As almost with any other aspects of the Chinese economy, the issue comes down to data as well as perspectives. Let me use the example of Huawei Technology Corporation, one of the largest private-sector firms in China, to illustrate the myriad complexities of the Chinese economy. By most accounts, Huawei, with sales revenue of about US$5.7 billion and operating in more than 90 countries, is China's most successful private-sector firm. But our knowledge of its actual ownership structure is almost non-existent. Huawei is a microcosm of China's private sector – we know that it is there but we do not know its actual size and its boundaries. The convoluted ownership structure of China's private sector – and of Huawei in particular – makes it very difficult to answer the question, "Just how capitalist is China?" Huawei, like Lenovo, is an apt case study of the enormous complexities of the Chinese economy.

We came to know a bit more about Huawei as a result of a lawsuit against the firm in 2002. The lawsuit itself reveals little about the ownership structure of the company, but it reveals some of the reasons why there is so little outside knowledge about it.[6] The case was filed by Mr. Liu Ping, one of the earliest employees of the company. Upon leaving the company, Mr. Liu, who had accumulated substantial shares in the company, was told that Huawei would redeem his shares only at the original 1-to-1 ratio. Mr. Liu contended that this was unfair. The assets of Huawei had increased several-fold since he joined the firm in the early 1990s.

The lawsuit reveals some fascinating details about this otherwise very secretive company. For example, Huawei mandated that all of its employees purchase shares, which suggests that its employees own at least a portion of the firm. But the company has never issued any share certificates explicitly recognizing their ownership. The employees were required to sign share certificates upon purchasing the shares, but Huawei kept all the copies. Because there is no information about how many shares were issued, we do not know whether Huawei is an employee-owned company. Even if we assume this to be the case, there is no paperwork actually documenting it as such. For a firm that even Cisco views as its main technological rival in the 21st century, it has some of the world's most medieval recordkeeping practices.

It is not unreasonable to assume that Huawei has gone out of its way to purposely obfuscate its ownership structure. The reason is not hard to understand. The firm was established in 1988 and, until very recently, the telecommunications sector was declared off-limits to private-sector firms in China. In addition, Chinese financial regulations have stringent restrictions about issuing shares to employees. It is all but certain that Huawei, by virtue of the fact that it is a private-sector firm, is in technical violation of many of these regulations. This hypothesis also dovetails with the widely held knowledge that Huawei has backing from the Chinese military. It is inconceivable that a politically naïve private entrepreneur could have gone as far as this firm has.

The lawsuit also shows that a number of state-owned telecommunication firms in Shenzhen were granted shares by Huawei, although, again, there is no information about the amount of the shares. It is possible that Huawei has some state share capital on its balance sheet, but we can safely rule out the possibility that Huawei is a state-owned firm. One telling clue is that its general manager, Ren Zhenfei, has been in his position since the founding of the firm in 1988. The longevity of the general manager is the most reliable way to distinguish a true private-sector firm from an SOE. The government frequently shuffles the management of SOEs and, therefore, SOE managers typically have very short tenures.

Obviously, it is impracticable to determine the size of China's private sector by examining the tenure of general management. The information simply is not available. In this section, I present two measurements, each with its advantages and disadvantages. But the common advantage is that they are relatively systematic and they are derived on the basis of explicit assumptions and judgments about the workings of the Chinese economy. They are thus "falsifiable."

We distinguish between two types of measurements – output-based and input-based measures of the size of China's private sector. The output-based measure is often used by academics to gauge both the size of China's private sector and the evolving policy environment for the private sector. I show that this is the correct measure to assess the size of the private sector in China, but it is deeply problematic as a measure of the evolving policy environment. The basic problem is that this measure confounds the effects of two factors – the policy changes and the firm-level efficiency differentials between SOEs and private-sector firms. A rising ratio of private-sector output to the output of the state sector can be a result of policy changes toward the private sector or can be a result of the fact that private-sector firms are simply more efficient than SOEs. We do not know which factor is driving the change in this ratio.

Let me illustrate this point with an extreme example. No one would accuse Leonid Brezhnev for being pro-private sector, but actually under his leadership, private plots contributed to roughly one half of agricultural household income in the Soviet Union (Gregory and Stuart 1981, p. 230). This was so because private farming was so much more efficient than the state farming so its contributions to income were disproportionate to the inputs allocated to it. Private plots only accounted for 1.4 percent of cultivable land in the Soviet Union (Hewett 1988, p. 117).

The minuscule share of private plots in the Soviet Union suggests that a better measure of the changes in the policy environment should be based on an input allocated to private sector rather than its share of the output. The most appropriate input-based measure is the fixed-asset investment capital. Fixed-asset investments are equivalent to purchases of plants, property, and equipment in the Western accounting system. There are two reasons why this is a better measure of policy. One is that fixed-asset investments remain substantially controlled by the state; thus, changes in the patterns of fixed-asset investments are a more accurate reflection of the policy preferences of the Chinese state. The second reason is that in a poor country, capital is scarce relative to labor. So capital allocation is more indicative than labor allocations of the fundamental orientation of the economic system.

In the following sections, I assess these two questions. First, how large is China's private sector? Second, has the policy environment improved over time for China's private entrepreneurs? Unfortunately, these weighty questions do not have straightforward answers. I elaborate on various measures and approaches and on the assumptions and definitions behind them. The treatment is quite detailed (and even tedious), but the only way to get at these issues is to sort out many of the complications in the Chinese data.

1.1 How Large Is the Chinese Private Sector?

Defining China's private sector is fiendishly difficult. Some scholars have used the state and non-state categories of firms as a way to assess private-sector development in China (Bai, Li, and Wang 2003). The state-sector firms are traditional SOEs, whereas the non-state-sector firms encompass a huge variety of firms, including collective enterprises, truly private firms, shareholding enterprises, domestic joint-ownership firms, and FIEs. In some studies, SOEs that have issued shares on the stock exchanges are also counted as part of the non-state sector.

Information on state and non-state firms is easily available but it is not very useful. Depending on the definition that is used, there are vastly different estimates of the size of the non-state sector. Based on one definition, the share of the non-state sector in industrial output value was 68.4 percent in 1997 (Wang 2002).[7] Based on the definition of the National Bureau of Statistics (NBS), the non-state sector accounted for only 21.2 percent of industrial value-added in the same year (NBS 1999a). Equating the non-state sector with the private sector is problematic.[8] Local governments control collective firms to varying degrees.[9] The vast majority of the SOEs that have issued shares on China's stock exchanges are technically classified as non-state firms but they are still tightly controlled by the state.

In the following paragraphs, I present estimates based on a superior approach that gets at the core issue about firm ownership. An accurate definition of a private-sector firm should be based on how its control rights are assigned. Control rights mean the rights to appoint management, dispose of assets, and set the strategic direction of the firm. On this count, SOEs that issued shares on the stock exchanges are not private because they are still tightly controlled by the government. The difficulty, however, is that it is not easy to know whether a firm in China has private or governmental control rights. To arrive at an estimate of the size of China's private sector, an analyst would have to make certain assumptions about which types of firms in China have private control rights.

A study by two Organisation for Economic Co-operation and Development (OECD) economists, Sean Dougherty and Richard Herd (2005), represents the most systematic and comprehensive attempt.[10] Their paper is based on a very unique dataset compiled by the NBS. The dataset covers more than 160,000 industrial firms in China between 1998 and 2003. (The Appendix to this chapter provides further details on this dataset.) I first summarize their findings and then present my own estimates. My own estimates, which reveal a far smaller indigenous private sector as compared with the OECD study, are based on the same methodology as the OECD study but on different assumptions about what types of firms have private control rights.

The advantage of the NBS dataset is that its data are disaggregated at the firm level and cover a wide range of firm activities. One critical piece of information in the dataset is the shareholding structure of the firms. This is a solution to the uncertainty over the ownership boundaries of Chinese firms. The OECD economists use the shareholding structure as the basis for their definition. One caveat, however, is that the NBS dataset is biased toward large firms – defined as those with at least 5 million yuan in sales. So the estimates here reflect the private share of the industrial value-added produced by the largest firms in China, not the private share of the entire industry. (The 2004 economic census has data on private businesses below the 5-million-yuan threshold. However, NBS does not publish the shareholding information.)

The Appendix to this chapter explains their classification methodology in greater detail. The most critical assumption in their methodology is that a category of firms known as legal-person shareholding firms are privately owned. They conclude that the private economy accounted for 52.3 percent of industrial value-added in 2003, compared with 27.9 percent in 1998.

I examined the dataset used by the OECD economists and checked their findings. I used exactly the same ownership classification methodology they used and was able to reproduce findings broadly similar to theirs.[11] I also extended their methodology to the 2005 data. The results are presented in Table 1.1.

Table 1.1. *Estimates of private-sector shares of industrial firms above scale in Chinese industrial value-added/profits, 1998, 2001, and 2005 (%)*

OECD Definition of the Private Sector				Definition of the Private Sector Based on the Guangdong Statistical Manual			
Definition/Year	(1a) 1998	(1b) 2001	(1c) 2005	Definition/Year	(2a) 1998	(2b) 2001	(2c) 2005
Indigenous:	**17.2**	**27.8**	**50.5**	**Indigenous:**	**7.9**	**9.65**	**22.0**
(1) Individual share capital >50.0	5.9	10.6	19.1	(1) Registered	2.4	5.97	16.3
(2) Legal-person share capital >50.0	11.3	17.2	31.4	(2) Individual share capital >50.0	5.5	3.68	5.7
Foreign:	**11.7**	**16.9**	**20.7**	**Foreign:**	**23.9**	**29.1**	**28.8**
(1) Foreign share capital >50.0	11.7	16.9	20.7	(1) Registered	21.8	26.4	28.3
				(2) Foreign share capital >50.0	2.1	2.74	0.48
Sum of indigenous and foreign	**28.9**	**44.7**	**71.2**	**Sum of indigenous and foreign**	**31.8**	**38.8**	**50.8**

Notes: I follow the classification methodology used by Dougherty and Herd (2005). Their methodology involves two steps. First, they divide the firms into state and non-state firms. State firms, in turn, comprise two types of firms: SOEs and collective firms in which the collective share capital exceeds 50 percent. The second step is to classify all those firms in the non-state category as those with more than 50 percent of share capital held by legal persons, individual investors, and foreign firms. The Guangdong definition includes all the firms explicitly registered as private-sector firms (*siyin qiye*) and those non-state firms in which private share capital is substantial. I set the "substantial" threshold at 50 percent. The non-state firms in the Guangdong definition refer to shareholding cooperatives, other alliance firms, and other shareholding firms with limited liabilities.

Source: NBS database of industrial firms above 5 million yuan in sales. See the Appendix to this chapter for an explanation.

I separate data on indigenous and foreign private-sector firms rather than reporting them together. In the OECD definition, indigenous private-sector firms are defined as those firms with substantial individual share capital and legal-person share capital (i.e., exceeding 50 percent of the total share capital). The foreign private-sector firms are those with foreign share capital exceeding 50 percent. By the OECD definition, the sum of the indigenous and foreign private-sector firms in China's industrial profits is 28.9 percent in 1998, 44.7 percent in 2001, and 71.2 percent in 2005, respectively.[12]

The OECD economists assign the entire output by legal-person shareholding firms to the private sector.[13] Is this a reasonable approach? Getting this question right is critical. In 1998, legal-person shareholding firms accounted for 40 percent (11.3/28.9) of the purported private sector. Excluding these firms would reduce the share of the private sector in industrial value-added from 28.9 percent in 1998 to only 17.6 percent (i.e., 28.9 percent minus 11.3 percent). For 2005, the private sector exclusive of legal-person shareholding firms would be 39.8 percent rather than 71.2 percent (i.e., 71.2 percent minus 31.4 percent). This is another illustration of a common refrain in this book – getting the details right matters.

Legal-person shareholding refers to cross-shareholding by firms. Probably because of the connotations of this term, the OECD economists might have assumed that legal-person shareholding implies that China has a *keiretsu* arrangement similar to that in Japan where firms own each others' stocks. The difference with Japan, however, is that in China much of the legal-person share capital originates in the state sector, via SOEs establishing or holding significant equity stakes in other firms. These firms then become affiliates or subsidiaries of the SOEs. The subsidiaries of the SOEs, on account of their final ownership, are still SOEs.

One way to learn more about these legal-person shareholding firms classified by the OECD study as private is to check their names. Even a casual glance at the data reveals that many of these legal-person shareholding firms are among the best-known and quintessential SOEs in China. They include subsidiaries of Daqing and Dagang oilfields, owned and operated by two of China's largest SOEs. Daqing is owned by PetroChina and Dagang is owned by China National Petroleum Corporation (CNPC). The list also includes subsidiaries of NORINCO, a large defense-product firm. PetroChina, CNPC, and NORINCO are not only SOEs; they also are known as central SOEs directly supervised by the State Council. In fact, some of these firms have the word "state-owned" in their names.

Another well-known SOE on the list classified by the OECD study as private is SAIC Motor Corporation Limited (SAIC Motor). In the NBS dataset, the state share of SAIC Motor's share capital structure is 0 percent; it is 70 percent legal-person shareholding and 30 percent individual shareholding. So this firm qualifies as a private firm in the OECD definition. But SAIC Motor is not even remotely a private firm. SAIC Motor was established in 1997; its predecessor was Shanghai Gear Factory. In 1997, 30 percent of the share capital was issued on the Shanghai Stock Exchange and the rest of the share capital was held by Shanghai Automotive Industry Corporation (SAIC), which is 100 percent owned by the Shanghai government. Because the Shanghai government owns SAIC Motor via SAIC – a legal-person shareholder – the state share capital is reduced to zero; however, from a control perspective, there is little question about who controls this firm.[14]

The example of SAIC Motor also illustrates the nature of the SOE reforms in the 1990s. Much of the reform effort had nothing to do with actually changing the owners of the firms but rather it was directed at securitizing the full but previously implicit equity holdings of the state in the SOEs. Although these reform measures copy the superficial forms of a capitalistic market economy, none of them has anything to do with its essence – transferring corporate control from government to private investors.

The high concentration of the ownership structure of the legal-person shareholding firms is another sign that these firms are not private at all. In the NBS dataset, SAIC Motor has the most dispersed shareholding structure among the legal-person shareholding firms because 30 percent of its shares are held by individual shareholders. (This is because the firm is listed.) In contrast, of 16,871 legal-person shareholding firms in the NBS dataset for 1998, 75 percent have zero individual share capital. The average individual share capital is only 3.7 percent. This is entirely expected given the heavily accounting nature of the SOE reforms. As evidence, 7,612 of these so-called legal-person shareholding firms are actually factories – they are simply production subsidiaries of other SOEs. This explains the extraordinary concentration of ownership and control of these firms.

Table 1.1 breaks down the private sector into indigenous and foreign components. There is a substantive reason for doing this. It is well documented by now that in the 1990s the Chinese state systematically favored foreign firms at the expense of indigenous private-sector firms.[15] Although this policy bias can be evaded in various ways (Lenovo being a successful example), it cannot be evaded completely. The brunt of the policy bias is borne by those indigenous private entrepreneurs who do not have the option to convert their businesses into legal foreign firms. These types of firms show up as indigenous private-sector firms in the NBS dataset.

According to the OECD definition, indigenous private-sector firms are those with individual share capital of more than 50 percent. Another definition is suggested by a statistical manual prepared by the Guangdong Bureau of Statistics.[16] The Guangdong definition of indigenous private-sector firms includes registered private-sector firms and non-state firms in which individual share capital is substantial. (The non-state firms in the Guangdong definition refer to shareholding cooperatives, other alliance firms, and other shareholding firms with limited liabilities.) I set that threshold at 50 percent of the private share of the equity. These two definitions lead to similar estimates. Under the OECD definition (excluding the legal-person shareholding firms), indigenous private-sector firms produced 5.9 percent of profits in 1998, 10.6 percent in 2001, and 19.1 percent in 2005.

According to the Guangdong definition, these three figures are 7.9, 9.7, and 22 percent.

It is striking how small the indigenous private-sector firms were as recently as 2001. Let me use the average of the OECD and Guangdong estimates, which comes to 6.9 percent for 1998 and 10.2 percent for 2001. To be sure, because the NBS dataset covers only the largest industrial firms, this finding reflects the position of China's indigenous private sector at the top of the corporate chain, rather than at the bottom. But, we still reach the same inescapable sobering conclusion: At the end of the twentieth century, the size of the indigenous private sector in China was minuscule. By 2005, however, the indigenous private sector did become sizable (at 22 percent of the industrial value-added). The flourishing of the indigenous private-sector firms is a very recent development.

Let us also compare indigenous private-sector firms with FIEs. There are two definitions of FIEs. The OECD study adopts a conservative definition, covering only those firms with foreign share capital exceeding 50 percent. This definition is too narrow because under Chinese law, any firm with 25 percent of foreign share capital is classified as an FIE and an FIE is subject to the regulatory regime of the foreign sector. The prevailing Chinese definition classifies FIEs by their registration status because it is the registration status that determines the basis of their legal and regulatory treatments. I adopt this definition here under columns (2a), (2b), and (2c) of Table 1.1. In addition, I include firms not registered as foreign firms but whose foreign share capital exceeded 50 percent.

Based on the OECD definition, the percentage shares of FIEs were about 1.6 to 2 times the percentage shares of indigenous private-sector firms (excluding the legal-person shareholding firms), although the two came much closer by 2005. Based on the Guangdong definition, the differences are larger. In fact, the data on aggregate size obscure the extent to which indigenous private-sector firms are undersized. This is because there are far more indigenous private-sector firms than there are FIEs. Let me illustrate this point using the OECD definition. The 5.9 percent share of indigenous private-sector firms in 1998 was spread among 19,322 firms, whereas the 11.7 percent share of FIEs was produced by 15,934 FIEs. The aggregate size of the indigenous private-sector firms is less than half the size of the foreign private-sector firms, and their individual sizes are even smaller. Even the latest data for 2005 show a larger foreign sector – at 28.8 percent – than the indigenous private sector at 22 percent.

To the extent that the Chinese economy is capitalistic, it is based on foreign capital, not on indigenous private capital. This is *prima facie* evidence of the severity of the policy biases in China. The system privileges one type of firm – FIEs – at the expense of another type, indigenous private firms. This is not to imply that China has not made progress in its economic transition. It has, but let us keep an appropriate perspective. Between 1978 and 2001, the size of the indigenous and foreign private sector among the largest firms grew from 0 to 38.8 percent. This implies an annual growth rate of the size of the private sector of about 1.7 percent a year. It is commonly alleged that China adopted a gradualist pace of reforms, and here is a concrete illustration of this gradualism. Economist Jagdish Bhagwati once described India's embrace of Fabian socialism under Nehru as a "measured and slowly paced ascent up the Marxist mountain."[17] What happened in China since 1978 can be described as a very measured and slowly paced descent from the same mountain.

1.2 Has the Policy Environment Improved for China's Private Sector?

The industrial value-added is the right measure of the size of the private sector in China today (provided that the assumptions of what constitutes the private sector are correct). However, many economists have used the output-based measure for a different purpose – to show the evolution of China's policy environment over time. This is problematic.

Recall the example of the Soviet agriculture in which private farming contributed substantially to agricultural income despite the massive restrictions placed on the private sector. An output-based measure incorporates two very different effects. One is the "policy effect": the increase in the private-sector share that results from a more favorable policy environment. But this measure also incorporates what might be called an "efficiency effect." The private firms are more efficient than the SOEs and, therefore, even given a very narrow business space, they can out-compete the SOEs. This suggests, at least theoretically, that the ratio of the private to the state sector can rise without any improvement in the policy environment for private-sector firms and with rising inefficiencies of SOEs. Indeed, one can think of a situation in which the private output share rises *because of* policy constraints on the private sector. Credit-constrained private-sector firms have few options to grow other than to increase their efficiency. SOEs, lavished with resources, have no such incentives. Thus, the efficiency differential can be very large precisely because of the policy discrimination.

There is an easy way to expose the flaw with the output-based policy measure. Let us choose a period we know for sure to be adverse for private-sector firms. That way, we cannot attribute any increase in private-sector output during that period to policy improvements. This is the 1989–1990 period when the post-Tiananmen leadership launched a systematic crackdown on the private sector. Private-sector employment fell during this period and many private firms were closed down. Credit was tightened. Yet, despite the adversity in the policy environment, the gross output value of the industrial private sector, as a ratio to the SOEs, increased from 7.6 percent in 1988 to 8.6 percent in 1989 and to 9.9 percent in 1990.[18]

Apart from the empirical inaccuracy of using the output of the private sector as a policy measure, there is also the issue of correctly attributing credit for the growth of the private sector. Treating output increases as a measure of policy implicitly assigns credit to the government. On the other hand, if we view the output increase as an efficiency measure, credit would then go to the Chinese entrepreneurs. The fact that the private sector was still able to grow in an enormously difficult environment after the Tiananmen crackdown is a tribute to the agility and acumen of Chinese entrepreneurs, not to the wisdom of the policy of the Chinese government.

I advocate using a different indicator to measure the policy evolution. This is an input-based measure of policy evolution. The input we focus on is capital allocated for fixed-asset investments (FAIs). There are several advantages to using fixed-asset investment data as a measure of China's evolving policy environment. First, by Chinese standards of statistical reporting, the data are remarkably consistent across different reporting sources. The standard source of data used by scholars is the annual *China Statistical Yearbook* (CSY) published by the NBS. I have cross-checked the CSY with a number of publications specializing in reporting fixed-asset investment data and found few variances among the sources.

Another advantage is that the coverage of the private sector in the area of investment activities goes back to the earliest years of the reforms. This may be because fixed-asset investment activities went through a government scrutiny process that required a bureaucratic paper trail. The third reason we focus on fixed-asset investments is that they are heavily controlled by the government, as compared to other activities in the Chinese economy. (The Appendix to this chapter provides more details related to fixed-asset investment data.) Because this measure directly tracks government policy preferences and practices, it is superior to the output measure. It does not involve the kind of confounding problems of distinguishing between the effect of policy and the effect of firm-level efficiency differentials that cloud the output measures of private-sector development.

Table 1.2 presents a number of private-sector development indicators based on fixed-asset investments. The reform era is broken down into four

Table 1.2. *Fixed-asset investment measures of private-sector development: Period averages (%)*

	1981–1989	1990–1992	1993–2001	2002–2005
Panel (A) Share/ratio indicators: Registered private sector				
1) Private share of total FAI:				
a) All private	21.4	19.8	13.3	14.7
b) Rural private	19.2	17.1	9.5	5.5
2) Private-to-state % ratio of FAI:				
a) All private	34.6	28.8	25.9	39.9
b) Rural private	29.6	25.9	17.8	14.5
3) Rural private/collective % ratio of FAI:	214.3	183.8	80.3	48.7
4) Private share of equipment purchases:				
a) All private	11.3	5.1	4.7	9.3[c]
b) Rural private	11.3	5.1	4.3	5.9[c]
c) Rural private/rural collective ratio	118.5	38.9	28.8	30.8[d]
Panel (B) Share indicators: Alternative definitions of the private sector				
5) Private share of total FAI:				
a) Registered + unclassified[b]	n/a	n/a	14.1	15.6
b) Guangdong definition[a]	n/a	n/a	17.2 (1998)	27.6 (2002) 33.5 (2005)
Panel (C) Share indicators: Indigenous firms only (excluding FIEs from total)				
6) Share of FAIs by indigenous firms:				
a) All private	n/a	n/a	15.1	16.2
b) Rural private	n/a	n/a	10.4	5.8
Panel (D) Real annual growth (deflated to 1978 prices)				
7) FAI:				
a) All private	19.9	2.6	12.4	26.0
b) Rural private	19.1	1.1	7.5	6.8
c) SOEs	8.1	23.8	9.1	13.4
8) Equipment purchases:				
a) Rural private	25.4	1.4	20.8	15.3[c]
b) Rural collective	26.0	42.8	29.6	23.7[c]
9) Nonresidential installations:				
a) Rural private	84.2	19.7	−3.9	−3.1
b) Rural collective	13.9	38.3	12.9	19.7[d]

[a] The Guangdong definition includes registered private-sector firms as well.
[b] Unclassified refers to units outside the state, collective, and private sectors, as well as FIEs and various mixed-ownership firms.
[c] 2002–2003 only.
[d] 2002–2004 only.

Note: FAI stands for fixed-asset investment. In 1996, the government raised the reporting threshold from 50,000 to 500,000 yuan for the state and collective sectors.

Sources: Based on various sources on fixed-asset investments compiled by the NBS. See the Appendix to this chapter for a detailed explanation.

periods in the table: (1) 1981–1989, (2) 1990–1992, (3) 1993–2001, and (4) 2002–2005. This represents a political periodization of the reform era. The 1981–1989 period was the era of Hu Yaobang and Zhao Ziyang. The 1990–1992 period is often described as the "Tiananmen interlude," when central planners exerted control over economic policy after the Tiananmen crackdown. The 1993–2001 period carries the unmistakable policy stamp of Jiang Zemin and Zhu Rongji. During the 2002–2005 period, a new leadership, headed by Hu Jintao and Wen Jiabao, established its rule. It is only natural to ask what the private-sector policies were under these four distinct leadership periods.

Panel (A) of the table presents statistics on fixed-asset investments in the *registered* private sector. The registered private sector includes two types of entities – self-employed household businesses (*getihu*) and what are known as privately run enterprises (*siying qiye*). For both types of entities, the control and revenue rights are unquestionably private. The difference between the two stems from a historical policy of registering small household businesses and large private enterprises separately. The regulatory definition of the former is an entity with seven or fewer employees and the definition of the latter is an entity with more than seven employees. (Throughout this book, unless otherwise noted, "private sector" refers to the indigenous private sector and excludes the FIEs.)

This is admittedly a narrow definition of the private sector. In the Appendix to this chapter, I address various definitional and measurement complications that may surround the indicators presented in the table. (These dynamics include the declining importance of agriculture, the existence of hybrid ownership firms, and the effect of including housing investments in the data.) None of these issues detracts from the following central point – the most liberal policy toward the private sector was in the 1980s under the leadership of Hu Yaobang and Zhao Ziyang, not in the 1990s. The primary difference between the two decades is the private-sector policies in rural China: In the 1980s, the policies were liberal, but in the 1990s, they became restrictive. In Chapters 2 and 3, I examine numerous government documents and household survey data to illustrate the specific policy developments that explain this pattern of fixed-asset investments.

Table 1.2 presents two types of indicators – indicators based on percentage shares and indicators based on annual growth statistics. Row (1) presents percentage shares of the registered private sector in China's fixed-asset investments. The private sector claimed the highest share of China's fixed-asset investments at the very start of the reform period; its share then lost to other firms throughout the 1990s and began to recover somewhat only during the 2002–2005 period. During the 1981–1989 period, the share of the private sector was 21.4 percent; during the Tiananmen interlude, the share declined modestly, to 19.8 percent, and then sharply to 13.3 percent during the 1993–2001 period. During the 2002–2005 period, the share rose slightly to 14.7 percent.

The most important development in the 1990s is that the contraction of the rural private investments. What China economists understatedly call a "Tiananmen interlude," in fact, was both severe in its effect and long-lasting in its duration. The growth rates of private investments slowed down dramatically during the 1990–1992 period. The rural private investment rate after the Tiananmen interlude never recovered to the levels prevailing before.

The most revealing effect of the 1989 Tiananmen crackdown is the contrast between the growth rates of the private sector and the growth rates of the state and rural collective sectors. This is shown in Panel (D) of Table 1.2. The growth of the private sector virtually collapsed during the Tiananmen interlude and recovered only during the 2002–2005 period. Row (7a) shows that the annual growth rate was 19.9 percent in the 1980s, 2.6 percent during the 1990–1992 period, 12.4 percent during the 1993–2001 period, and 26 percent during the 2002–2005 period. Rural private sector investments, however, never regained their momentum of the 1980s. The growth rate in this critical sector of the economy in the 1990s and 2000s was a fraction of the growth rate during the 1980s (Row [7b]).

By contrast, the investment growth of the state and collective sectors accelerated sharply in the aftermath of Tiananmen. The growth rate of SOEs during the 1990–1992 period tripled over that in the 1980s. Contrary to the view that the state was divesting from the SOEs in the 1990s, the investment growth rate of the state sector in the 1990s and 2000s accelerated over the growth rate in the 1980s. Row (7c) shows that the growth rate of the state sector averaged 8.1 percent in the 1980s. But, during the 1990–1992 period, growth accelerated to 23.8 percent and then 9.1 percent during the 1993–2001 period and 13.4 percent during the 2002–2005 period. Data on equipment purchases and nonresidential installations in the rural collective sector exhibit exactly the same trends (Rows [8b] and [9b]).

The Appendix illustrates that broadening the definition of the private sector does not change qualitatively the point that the private-sector policy environment became illiberal in the 1990s. (The only revision is that the broadest definition of the private sector does show the policy environment during the 2002–2005 period to be more liberal than that in the 1980s.) We also have some independent verifications that our measure accurately tracks private-sector policies. It is not in dispute that the Chinese government implemented a crackdown against the private sector after the 1989 Tiananmen crackdown. This shows up in our fixed-asset investment measure. All indicators in the table during this period contracted. (It should be noted that a measure based on output would show an *improvement* in the policy environment immediately following Tiananmen.) We also know that since 2002 there have been a number of liberalization measures aimed at the indigenous private sector. There was a more explicit political affirmation of the private sector at the Sixteenth Party Congress in 2002, a constitutional amendment in 2004 aimed at enhancing property rights, and a fairly sweeping sectoral liberalization measure in 2005 (the so-called 22 articles). Our fixed-asset investment measure tracks very well these policy developments during this period.

2 Getting the China Story Right

The previous portrayal of the state of the private sector and the uneven pace of policy evolution is not as positive as much of the received wisdom on the Chinese economy. But, let me state the following point explicitly and strongly: China's economic achievements have been both substantial and real. A good, parsimonious account has to be minimally consistent with and hopefully explanatory of both the real successes of the country as well as its many obvious failings. The key component in the explanation is suggested by the fixed-asset investment data presented previously: Private-sector development in the rural areas was rigorous and broad-based in the 1980s but it languished in the 1990s. In the remainder of this chapter, I provide an outline of my account.

As the Lenovo story shows, getting the details right matters both for analysis and for drawing the right policy implications. But here is the difficulty about researching the Chinese economy: We have abundant data on macroeconomic outcomes, such as statistics on GDP, exports, FDI, and so forth, but there is an acute shortage of data on what I call microeconomic processes – referring to policies, institutions, and the nature, behavior, and conditions of the economic agents. All things considered, it is relatively easy to get the facts right about Lenovo. After all, it is a Hong Kong–incorporated and listed firm and, as such, it is required to disclose a lot of information about its operations. Yet, some still get it wrong. Now try to arrive at an accurate estimate of the size of China's private sector when we do not even have available the basic information that one takes for granted in a market economy – such as who owns what – about the most prominent private-sector firms such as Huawei.

In this section, I first present a number of perspectives on Chinese economic policies and institutions in Western academic literature. In the formulation of their views on the Chinese economy, many of these academics were heavily influenced by observations of the easily available outcome data. They then proceeded to make inferences about Chinese policies and institutions. I call this approach an inference-based approach. Although this approach has some merits, its accuracy critically depends on the accuracy and comprehensiveness of the outcome data. Often, Western academics work with and accept at face value a narrow set of data, such as GDP per capita. In this book, I show that in certain circumstances, there is no guarantee that GDP per capita truthfully reflects the welfare of the average Chinese person.

My own approach is primarily based on making direct observations of Chinese policies and institutions. This approach first formulates a view of these policies and institutions and then renders a judgment on their economic outcomes. A view produced by this approach would argue that the most important factors in China's growth experience are private ownership, security of property rights, financial liberalization, and deregulation. The welfare of the Chinese population improves along with the growth of its GDP when and where these institutional conditions are becoming stronger. The welfare of the Chinese population improves less or even declines when and where these institutional conditions are being attenuated. But, this perspective requires a massive amount of empirical documentation about China's microeconomic processes and practices on the one hand and policy developments on the other. Much of this book focuses on this empirical task.

2.1 Making Inferences vis-à-vis Making Direct Observations about Policies and Institutions

In 2004, the *Wall Street Journal* published an article based on a survey on and subsequent interviews with a number of Nobel laureates in economics (Wessel and Walker 2004). China featured prominently in the Nobelists' views of the world and of the future. Most of the Nobel winners in the survey believed that China will overtake the United States or the European Union in 75 years. When asked which country in the world has the best economic policies, the answers were "a tie between Norway and the United

States – with China the runner-up.” Professor Harry Markowitz of the University of California in San Diego picked the United States as his top choice because it has the most free market. But, in his estimation, China was a close second to the United States. Professor Robert Mundell of Columbia University argued that Deng Xiaoping did more than anyone in the 20th century to improve the living standards of hundreds of millions of people because he “opened the country to foreign investment.” Professor Joseph Stiglitz, also of Columbia University, ranked China very highly in terms of its economic management. The *Wall Street Journal* article describes Professor Kenneth Arrow of Stanford University as having “grudging respect” for China’s performance.

By the OECD’s methodology, the private sector produced 71.2 percent of China’s industrial output as of 2005, the most recent data available. This figure can be considered as the upper-bound estimate of the size of China’s private sector. Irrespective of its many problems, let me take this claim at its face value and compare China with a number of other countries. It turns out that the private sector’s share of industrial output in China in 2005 was broadly similar to that of the India of Indira Gandhi, not that of Manmohan Singh – India during the early 1980s. (Chapter 5 presents more details of the China/India comparison.) It is extremely difficult to reconcile this microeconomic observation with the view that China is a close second to the United States in terms of *market freedoms*. Although Deng Xiaoping probably did contribute more than anyone else in the 20th century to poverty reduction, as Professor Mundell points out, it is questionable to assign the full credit to his FDI policies. The most impressive poverty reduction in China occurred at a time when China had no FDI – in the early 1980s – and, in fact, after China became a member of the World Trade Organization (WTO) in 2001, the emerging evidence is that China’s poverty level increased. (I return to this issue in Chapter 5.)

The most likely reason for the highly laudatory views held by these eminent economists is that their judgment calls were heavily influenced by the easily available and highly visible achievements in terms of GDP growth. Because its GDP performance has been so phenomenal, it must be the case that the country has rational economic policies and institutions. This is one example of the inference-based approach in the study of the Chinese economy. For these eminent economists, the Chinese economy presents no analytical challenges: Excellent economic performance must be the result of excellent economic policies.

In Chapter 5, I show that this single fixation on GDP data is a mistake. My view here is not rooted in the common criticisms of GDP statistics – that GDP data may not sufficiently reflect resource costs, the extent of environmental degradation, or the subjective sense of well-being. I leave aside all these universal complications of GDP data. The argument is that China had rapid GDP growth during both the 1980s and the 1990s but the welfare implications for the Chinese people during these two periods have been very different. During the entrepreneurial decade of the 1980s, fast GDP growth was accompanied by equally fast household income growth. During the state-led 1990s, fast GDP growth diverged from household income growth. In particular, rural income – the best measure of the welfare of the majority of the Chinese population – sharply declined in terms of its growth rates compared with the 1980s. Other indicators such as education and health in the rural areas also showed some significant problems in the 1990s.

A second variant of the inference-based approach reasons that China's economic policies and institutions provide rational and efficient *functions* even though those policies and institutions may appear, at first glance, to be lacking in conventional economic efficiencies. This is a more sophisticated and nuanced approach, and it is more fact-based than the simple declaration that China has good policies. It recognizes a seeming incompatibility – that China has many economic policies and institutions that are overtly inefficient and yet the country has performed well (again in GDP terms). Scholars then propose analytical devices to solve this incompatibility. Although there are different versions of this approach, their commonality is to reason that these manifestly inefficient policies actually have strong underlying efficiency attributes *given* the specific context of China. This is the approach that has traveled very far in mainstream economics, and several papers anchored in this approach have won coveted spots in some of the most prestigious social science journals.

Let me illustrate by a few examples. One of the most profound puzzles in the study of the Chinese economy is the so-called township and village enterprise (TVE) phenomenon. The best articulation of this puzzle – and the broader puzzle about why China grew at all – is by another Nobel laureate, Professor Douglass North. He states (2005):

> This system in turn led to the TVEs and sequential development built on their cultural background. But China still does not have well-specified property rights, town-village enterprises hardly resembled the standard firm of economics, and it remains to this day a communist dictatorship.

A huge amount of analytical energy has been invested in trying to explain the TVEs, a corporate form that seems so different from "the standard firm of economics." The view that has gained the most traction is the one that models the normally inefficient public ownership – associated with TVEs by many analysts – as a transitional institution to overcome governance problems.[19] According to this view, local government ownership of firms is a solution to the problem of a lack of rule of law, in several ways. One is that the absence of rule of law makes it possible for private stealing of assets. Public ownership mitigates against information problems and other problems in a transitional context. Second, the absence of rule of law creates a commitment problem for the public sector as well. The Chinese state, unconstrained by any institutional checks and balances, may expropriate private assets at will. TVEs thus command a substantial advantage in such a hostile political environment. They are owned by the local governments and, because of the incentive alignment between the central government and local governments, they are not subject to the expropriation risks that afflict private entrepreneurs.[20]

Some scholars have inferred efficient functions from even the most manifestly inefficient policies and institutions. For example, the widely acknowledged fact that the private sector in China is credit-constrained is reasoned to be not so inefficient in its effects. The financing repression of the private sector has an underlying stronger economic rationale – financing government deficits in a system that has poorly developed public-finance tools. And, the financing repression in the formal sector does not matter anyway because of the availability of informal finance (Allen, Qian, and Qian 2005). Whereas elsewhere in the world the concern is that an unconstrained government is a grabbing hand undermining economic growth (Frye and Shleifer 1997), local governments in China are viewed as helping hands because they are subject to effective constraints in the form of "federalism, Chinese style" (Montinola, Qian, and Weingast 1995).

The analytical attraction of this approach is easy to see. Take, as an example, the missing-institutions explanation of TVEs. The model has the feature of "killing two birds with one stone." It identifies two attributes of the Chinese economic system otherwise viewed as inefficient when each is analyzed separately – lack of political self-constraints and public ownership. Combining the two, an efficiency function emerges. This approach seems to be well suited to China, a country associated with good growth but also with many manifestations of microeconomic inefficiencies.

This functional-efficiency perspective on China – often formalized with mathematical models and proofs – is extremely influential in economics. Papers advocating this perspective were published in top journals and are widely cited by general economists who otherwise may not have detailed country expertise on China. In this book, I adopt a different approach and it is one based on direct observations of institutions and policies. This approach will lead to a depiction of Chinese reforms considerably at odds with the stylizations summarized previously. Instead of devising elaborate analytical tools to solve the supposed incompatibilities, I ask whether these incompatibilities actually exist in the first place. These are the types of questions this book explores:

- "China has experienced rapid GDP growth since the late 1970s, but has that growth always promoted welfare to the same degree?"
- "Are TVEs really publicly owned?"
- "Did China undertake financial reforms in the 1980s?"
- "Did these reforms continue in the 1990s?"
- "Did the Chinese political system always lack self-constraint?"

The devil is in the empirical details. Constructing direct observations, as opposed to making inferences, about the Chinese economy requires a massive amount of information and data. To that end, I have conducted detailed and wide-ranging archival research on government and bank documents, edicts, and directives. The details and the sources of these documents/data and the citation information are presented in the relevant parts of the book, but let me highlight one source of documentary data to illustrate the depth of this research. To ascertain China's financial policies toward the private sector, I have examined thousands of pages in a 22-volume compilation of internal documents of the central bank, all major state-owned commercial banks, and the rural credit cooperatives (RCCs). These bank documents, issued between 1982 and 2004, range from speeches given by bank presidents to their employees, operating instructions issued from headquarters to regional bank branches, internal regulations governing human resource screening and evaluations, lending criteria and rules, and so forth. Although this compilation of bank documents is accessible at libraries at Harvard University and the Chinese University of Hong Kong, as far as I know they have never been examined by a Western academic.

To ascertain the ownership meaning of TVEs, I have tracked down the original government document that provides a detailed definition of TVEs, as well as many other government documents and regulations bearing on the ownership status of TVEs. I have also resorted to different data series from the familiar GDP and output data. As I have already shown, using fixed-asset investment data series suggests a different dynamic regarding private-sector policy evolution as compared with a dynamic based on output data. Instead of simply relying on the *Chinese Statistical Yearbook*, a standard source of economic data, I have looked at the database on TVEs compiled by the Ministry of Agriculture. The Ministry of Agriculture was in charge of collecting data on TVEs and its database provides a far more detailed breakdown of the ownership categories of TVEs than the *Chinese Statistical Yearbook*.

For this book, China's GDP and output performance are the beginning of the analysis, not its end. I have used extensively the household income surveys conducted by the NBS on urban and rural areas to examine the growth of personal income – a closer measure of economic well-being of the average Chinese person than the crude measure of per capita GDP. In addition, I have looked into several waves of surveys on Chinese private-sector businesses. The totality of this qualitative and quantitative evidence, as I show throughout this book, conveys an alternative picture of the Chinese reforms compared with the familiar stylizations in Western economics research on China.

2.2 Getting the China Story Right

As far as the leadership and cadre systems of our Party and state are concerned, the major problems are bureaucracy, over-concentration of power, patriarchal methods, life tenure in leading posts and privileges of various kinds.

– Deng Xiaoping, August 18, 1980

In this section, I develop and elaborate on the main argument that I put forward in the book. Let me state the central idea of this argument as explicitly and as directly as possible: The successes of the Chinese economy are a function of conventional sources – private-sector development, financial liberalization, and property rights security. In regions and periods when Chinese economic growth has faltered *and/or* Chinese economic growth has failed to improve the welfare of the average Chinese, it has been the result of governmental interventions, illiberal financial policies and practices, and property rights insecurity. A second and related idea in this argument is that Chinese economic success is a result of a movement toward *manifestly and explicitly* efficient policies and institutions, not just a result of *functionally* efficient policies and institutions. This is probably the stronger of the two ideas that run through this book and it is the one I concentrate on developing empirically.

The social science literature against which I benchmark China is that on the connections between institutions and economic development. This book focuses on the institutional sources of economic growth. I mention but do not go into details about the role of education and human capital in the concluding chapter (mainly as a way to differentiate between China and India). I take for granted the assumption that education, especially basic education, contributes substantially to economic growth.

This book is concerned with three economic institutions and their effects in China – the organization of firms (e.g., TVEs), the orientation of providers of finance, and property rights security. By necessity, we cannot study these three institutions in isolation from politics and from China's political system. Political institutions structure, organize, and order economic institutions and, in this respect, China is no exception. The bulk of the empirical coverage in this book concerns the three economic institutions mentioned previously. However, I offer conjectures – plausible postulations – about the workings of Chinese politics to contextualize the economics and policy discussions.

Ownership, Finance, and Property Rights Security in China. It is no exaggeration to say that the importance of private ownership is a fundamental, core principle of neoclassical economics. Private actors, consumers, or firms, acting in their self-interests and maximizing their own payoffs in the ways they understand them, promote both private and social welfare. This is a central tenet of economics, going back to Adam Smith. Although there are circumstances in which private and public welfare may diverge in a privately owned economy, it is safe to say that the majority of economists accept the general claim that private ownership is more efficient on average as compared with state ownership.

It is in this sense that the TVE phenomenon is viewed as a puzzle. TVEs are believed to be owned publicly, although at lower levels of the government, such as townships and villages. Yet, they have performed superbly. I resolve this puzzle in Chapter 2 where I present detailed documentary evidence that shows a huge gap between the Chinese definition of TVEs and the Western understanding of TVEs. The Chinese define TVEs as a *geographic* phenomenon – that TVEs are businesses *located* in rural areas. The Western academic literature has an *ownership* understanding of TVEs – that TVEs are *owned* by townships and villages. How substantial is this gap in these two understandings of TVEs? Data from the Ministry of Agriculture show that as early as 1985, out of 12 million businesses classified as TVEs, more than 10 million were purely private. If we get the facts right, TVEs, as it turns out, are a huge private-sector success story.

In recent years, social scientists, especially economists, have substantially advanced our understanding of the effects of financial and legal institutions on economic growth as well as the specific channels whereby these institutions exert such effects. Much of the work in this area is not only theoretical but also deeply empirical, showing strong empirical correlations between good institutions and economic growth. Another characteristic of this body of work is that it identifies fairly specific mechanisms linking institutional quality with growth. It is not an exaggeration to say that the idea that good institutions – understood in a conventional and straightforward sense – are important for growth is based on a solid empirical foundation.[21]

Against this large and cumulative backdrop of the solid empirical demonstration of the virtuous effects of efficient financial and legal institutions, China appears to be a staggering anomaly, as the previous quote from Douglass North suggests. This book argues that once we look a bit closer, China is not an anomaly. I have already shown that in the case of Lenovo, the microeconomic development of the firm was critically contingent on the presence and operations of conventionally efficient financial and legal institutions – in Hong Kong. Is there any reason to think that the general economic success of China has been a result of institutional forces dramatically different from those that have favored growth elsewhere?

I take on this issue in Chapters 2 and 3. Going through thousands of pages of bank documents, I have uncovered evidence that China implemented financial reforms very early in the reform era – beginning in the early 1980s. These financial reforms encompassed two areas – improving access to finance for the private sector and allowing or even encouraging some private entry into the financial services sector. The documentary evidence also shows, directly and explicitly, that these reforms were initiated at the very top of the Chinese financial system. There were directives and instructions supportive of private-sector lending issued by the governor of the People's Bank of China (PBoC), China's central bank, and presidents of the Bank of China and the Agricultural Bank of China. In the 1980s, China's financial system was moving *directionally* toward liberalism at a time and at a speed that previous scholarship on China may have under-estimated.

There is an important caveat to this interpretation of China's financial development. Almost all financial liberalization took place in the rural part of the country. In the 1980s, urban China was virtually unaffected by the financial reforms. This raises the issue of the relative economic and institutional importance of rural China vis-à-vis that of urban China. This issue, presented in great detail in Chapters 2 and 3, is at the heart of understanding China. The essence of the argument I put forward in these chapters is that rural China matters for the country not just economically but also *institutionally*. The economic importance of rural China derives from the fact that China – even today – is deeply rural. The institutional importance of rural China is that rural China was always more predisposed toward capitalism and entrepreneurship.[22]

Recognizing the extant rural disposition toward capitalism entails important analytical implications. One is that it partially resolves a puzzle why seemingly modest policy changes nevertheless enlisted huge entrepreneurial responses. Economists characterize a critical piece of rural reforms – the dual-track system at which farmers sold their crop at the market prices after they fulfilled their obligations to the state at price points set by the state – as a modest policy departure from the *status quo ante* (Lau, Qian, and Roland 2000; Rodrik 2007). I come back to this issue later and discuss whether this characterization of the dual-track system is accurate, but for now let me take the claim at its face value. The dual-track system was operationally simple and straightforward, but it required economic agents to have a basic concept of residual claims. As of the late 1970s, rural China still retained some rudimentary capitalistic practices that operated on the principle of residual claims.

Even at the height of the commune system, Chinese peasants still possessed what is known as "private plots" – the land that was owned by the collectives but worked by the peasants themselves.[23] The land was not tradable but the revenue rights were private. The production on private plots was not taxed and the returns accrued to the peasants with the assignment rights to the land. Of course, the degree of private appropriability varied substantially in the 1960s and 1970s and depended heavily on the twists and turns of the Chinese politics, which had swung in unpredictable fashions during the Cultural Revolution.

Sachs and Woo (1994) also emphasized the "ruralness" as a determinant in economic transition, similar to the view laid out here. A rural economy, being poorer and simpler, could grow even with partial reforms, they argued. My reasoning, although reaching the same conclusion, postulates an entirely different causal mechanism. It was the pre-existence of entrepreneurship that mattered. "Ruralness" can be thought of as a proxy of entrepreneurship. To illustrate this point, consider a situation in which any residues of entrepreneurship were completely absent. This was in the industrialized Soviet Union. Gorbachev copied the Chinese dual-track system but the experiment failed completely. By contrast, the same reforms produced stunning results in a country similarly rural as China – Vietnam.

The second analytical implication has to do with the effects of *ex ante* rural entrepreneurship. Financial reforms, even though limited to the rural areas, had a disproportionately contributory effect on the overall entrepreneurial and market development because rural China was already predisposed toward capitalism in the first place. This is why the supply response – surging private-sector investments and rural entrepreneurship – was so elastic with respect to seemingly modest policy changes. By the same token, financial under-development and urban biases in economic policies also had a disproportionate effect on the overall entrepreneurial and market development *in the opposite direction.* As I show later in this section and in Chapter 3, in the 1990s China moved away from the policy direction of the 1980s. Many of the productive financial experiments in rural China were reversed and the government favored the cities in its investment allocations. This reversal greatly stunted the development of broad-based, entrepreneurial capitalism in China.

Did China grow without a conventional version of property rights security? This is the subject of Chapter 2. Documentary research uncovers internal as well as public policy deliberations in the early 1980s that explicitly sought to enhance policy and political commitments to reforms and liberalization. In the early 1980s, Chinese leaders chose to word their policy announcements very carefully, with the objective of conveying the stability and predictability of their policy actions. They also took proactive and highly symbolic acts, such as returning assets to former capitalists, direct and public meetings between some of the top leaders of the country and private entrepreneurs, and, in some of the local cases, publicly apologizing to those private entrepreneurs who had been wrongly treated by the government in the past.

Directional Liberalism. But, surely this is not the final story. A deeper question is why these policy promises made by the Chinese leaders, however well intentioned and explicitly worded, should have been viewed as at all credible. The political system, then as now, imposes no institutional constraints on the rulers to renege on their promises. The commitment problem, as political economists know very well, is massive in an unconstrained political system. The fundamental dilemma, as stated by Weingast (1995, p. 1), is as follows: "A government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens." This commitment problem, on top of a holdup problem whereby the political elites confiscate wealth *ex post*, normally would have deterred investments of energy, effort, and capital by would-be entrepreneurs.[24]

One of the deepest puzzles in the history of Chinese economic reforms is why the supply response of rural entrepreneurship was so massive in the early 1980s. The economic policy change is believed to be "modest," for one thing. For the other, millions of rural entrepreneurs took upon themselves considerable risks. They put up a significant amount of capital, as we saw in Table 1.2. They needed to feel reasonably confident about the security and the predictability of the investment and political environments. They needed to trust the Chinese state not to renege on reforms. Keep in mind that China was just four years away from the Cultural Revolution. Up to that point, the record of the Chinese state in keeping its promises and delivering on its commitments was not outstanding, to put it mildly.

The political economy question – how China managed to create a *prima facie* sense of policy credibility and political predictability so soon after the Cultural Revolution – is the crux of the matter. But, arguably, it is the least understood aspect of Chinese economic success. Consider the view that dual-track reforms were a "modest" change. The mechanics of the reforms were simple and straightforward. This is true, but for the system to work as designed, it was critical for the Chinese peasants – numbering in the hundreds of millions – to trust that the grain quotas would not be instantaneously ratcheted up each time they were exceeded. The economics of the dual-track system might be modest; the political economy of it was not.

I offer a conjecture here. It is a conjecture, not a settled claim, because there are simply no data to directly demonstrate my hypothesis. Yet, the question is so monumentally important that any account of the Chinese reforms is incomplete without at least an attempt to explain this question. This conjecture rests on two exercises. The first is trying to come up with a reasonable approximation of the perspective with which a potential Chinese entrepreneur viewed his political milieu. The second exercise is to postulate that a potential Chinese entrepreneur had the ease of knowledge that Chinese politics of the 1980 vintage was objectively different from the Cultural Revolution.

The key to an understanding of the explosive entrepreneurship in the early 1980s is to specify the right baseline benchmark with which the would-be Chinese entrepreneurs viewed their political world of the 1980s. That baseline is not a Westministerian system of checks and balances, which would have shown the Chinese system in a poor light indeed. That baseline is China of the Cultural Revolution from 1966 to 1976, a period during which Chinese politics can be safely described as "nasty, brutish and short" in the Hobbesian sense. The Chinese political system circa 1980, as arbitrary and as absent of self-constraints as it was, marked a substantial *marginal* change from the *status quo ante* of the Cultural Revolution. The incentive effects – that the would-be private entrepreneurs felt increasingly assured of the safety of their assets – came from this dynamic development. This is what I call "directional liberalism."

The next question to consider is whether this marginal change from the *status quo ante* was substantial. There are two ways to think about this question. First, it is important to highlight the extreme ideological antagonism toward capitalism during the Cultural Revolution era. Private businesses were strictly forbidden and in urban China, all vestiges of capitalism were completely eliminated. (There was more leeway in rural China.) Anyone who went into private business faced instantaneous risks of being arrested and of being severely persecuted.

Entrepreneurs in China of the early 1980s no longer faced this imprisonment risk. Imagine the incentive effect changing from an equilibrium in which a would-be entrepreneur faced instantaneous arrest to one in which this was no longer an automatic risk. This gets to the distinction between the security of the proprietor – the person holding the property – and the security of the property itself. The security of the proprietor is the necessary condition for the security of his or her property. China then and now does not have well-specified property rights security. But, China in the early 1980s moved very far and fast toward establishing security of the proprietor. One should never underestimate the incentive effect of not getting arrested.

A second way we consider this issue is that there were objective – and objectively large – differences between China of the 1970s and China of the 1980s. This gets to the question of whether the potential entrepreneurs in the early 1980s viewed the political and policy signals that they would not be imprisoned as credible. This is not an idle question because the standard political indicators do not show any difference between Chinese politics in the 1970s and Chinese politics in the 1980s. The issue is whether the would-be entrepreneurs themselves had a *prima facie* reason to believe that there was a great difference. The surging entrepreneurship in the early 1980s was a function of the incentives and the mindset of those going into entrepreneurship. It was not a function of an exact match or lack thereof between the Chinese political system circa 1980 and the textbook version of good political governance.

Quantitative indicators used by social scientists are unable to show any meaningful differences between China under Mao and China under Deng. One widely used political database is the Polity IV database developed by political scientists at the University of Maryland and other universities. The polity score for China in both 1976 and 1980 was −7, with −10 referring to the most autocratic and 0 most democratic. (In fact, China had a score of −7 throughout the reform era.)[25] This political ranking implies that the nature of Chinese politics under Deng Xiaoping was identical to that during the waning years of Mao Zedong as well as that in the Soviet Union in 1953, the year Stalin died.

If the Chinese peasants had relied on the Polity IV to judge their property rights security, none of them would have gone into entrepreneurship. The political risks would have been prohibitively high. But, equating Deng's China with the Soviet Union under Nikita Khrushchev and with the last year of Mao Zedong would strike anyone with even rudimentary knowledge of China as incredulous. The political science work on China demonstrates clear and sharp differences between China under Mao and China under Deng in terms of the predictability of the political rules of the game and the degree of institutionalization. Mao, as Shirk (1993) notes, launched mass campaigns such as the Great Leap Forward and the Cultural Revolution to stem the trend of institutionalization. From the very beginning of his rule, Deng Xiaoping "proposed a system governed by rules, clear lines of authority, and collective decision-making institutions to replace the over-concentration of power and patriarchal rule that had characterized China under Mao" (Shirk 1993, p. 9).

The quote printed at the beginning of this section from Deng Xiaoping is the single most incisive analysis of the problems of the Chinese political system. Notice the date of the speech: It was given in 1980, at the very beginning of rural reforms. Every single important political reform, as noted by Pei (2006, p. 11), such as the mandatory retirement of government officials, the strengthening of the National People's Congress, legal reforms, experiments in rural self-government, and loosening control of civil society groups, was instituted in the 1980s. The timing here is critical. The institutional literature stresses the institutional conditions as preconditions for and as antecedents of growth. China met this test. China began to implement these political reforms either prior to or concurrently with its economic takeoff. Although these efforts to institutionalize Chinese politics and to implement incremental reforms may not show up in the Polity IV rankings, they might have contributed to the rising and cumulative sense that the reforms were irreversible and that proprietors and property grew more secure. This dynamic story seems to be able to account for the substantial supply of entrepreneurship at a time when a political commitment problem was theoretically present and realistically massive.

However, the relevant question is not whether China specialists know that there is a difference in Chinese politics between the 1970s and the 1980s. The relevant question is whether the would-be rural entrepreneurs in China noticed the directional liberalism being postulated here. In

Chapter 2, I speculate that it is not implausible that the Chinese peasants sensed a change in the political climate in the late 1970s. Admittedly, the evidence I can provide is casual and scant. A stronger statement, however, is that the Chinese rural entrepreneurs had *reasons* to know that the Chinese politics had changed. This is the Deng Xiaoping effect.

The almost instantaneous credibility of the Chinese reforms owes in no small measure to the fact that Deng Xiaoping, not somebody else, presided at the helm of the Chinese politics. It is the conventional wisdom – both among academics and practitioners – that Deng was the architect of Chinese reforms.[26] My account stresses not his reformist inclinations or his political power but rather his credibility vis-à-vis the would-be entrepreneurs. He might have prevailed over his conservative opponents to push forward his reforms, but none of this would have mattered from the point of view of peasants' incentives and their sense of property rights security if he was not viewed credible. The importance of Deng is that he was *observably different* from Mao. (And I am not just talking about their difference in physique.) The key word here is "observable" – Deng had a set of credentials that were not obtuse but commonly known. The ease of knowledge is important. The entrepreneurial response originated not from a select group of urban elites but from hundreds of millions of Chinese peasants scattered in far-flung places. They had to believe that the policy change under Deng was permanent rather than cyclical and that Deng's China was objectively different from Mao's China. Here is why Deng mattered: He was purged *three times* by Mao and one of his sons was crippled by Mao's red guards during the Cultural Revolution. No other Chinese leaders commanded the kind of automatic credibility that he did.[27]

This book ends with a view that many current problems in China are due to the lack of genuine institutional reforms – reforms of the political system itself rather than a simple shift within the system. Is there a contradiction with the notion of directional liberalism proposed here? Not at all. I go into this issue in more detail herein but suffice it to say here that in the 1990s, China reversed much of the directional liberalism of the 1980s. The policy and political reversals weakened the virtuous incentive effects associated with the directional liberalism and may have irrevocably undermined the hard-won credibility that the Communist Party had acquired in the 1980s. Another factor is that directional liberalism works in a time-varying way – the strength of its effect is a diminishing function of time. The reason for this is straightforward: In 2008, the Cultural Revolution does not loom as large as a baseline benchmark as it did in 1978. Marginal changes, however substantial, may no longer be sufficient to establish confidence in and a sense of property rights security. Institutional convergence with democracy, clean government, and quality governance may now be necessary to move the Chinese economy to the next stage because both the private-asset stakes and the value of political predation have increased substantially.

Reversal of Fortunes. The conjectures and some of the factual details presented in the previous sections are descriptively consistent with the story of surging and vibrant entrepreneurial development and the general economic success of the country in the 1980s. However, the empirical account of the Chinese economy as of the first decade of the 21st century has another side – a relatively small indigenous private sector, severe financing constraints, increasingly investment-driven growth, and massive governance problems. A reasonable reader may ask, "How does one account for all these problems as well as China's well-known successes?"

The fixed-asset investment data presented earlier illustrate a phenomenon few China economists seem to have noticed: Private-sector policies, especially in the rural areas most predisposed to capitalism, became illiberal in the 1990s. Chapters 3 and 4 offer empirical support for this view of the Chinese economy on the basis of documentary and survey evidence. The most substantial reversal occurred in the area of rural finance. Private-sector access to capital to engage in nonfarm activities became very difficult in the 1990s. The embryonic rural financial liberalization – decentralization of management of local savings and loans organizations and a permissive stance toward private entry into the financial services sector – was completely stopped. Rural political and fiscal management was centralized. In more recent years, lease holdings of land have become increasingly insecure as local officials have grabbed land on a massive scale. Directional liberalism turned into directional illiberalism. Not a single new political reform initiative was proposed in the 1990s and many of the political reform initiatives of the 1980s were discontinued (Pei 2006, p. 11).

This portrayal of China in the 1990s is at sharp variance with the received wisdom in the economic research on China, much of which argues that China in the 1990s not only continued but also deepened the reform program of the 1980s. Let us put to a plausibility test the idea that the three generations of Chinese leaders since 1978 have continued with and have deepened the same policy programs. The leadership of the 1990s put Zhao Ziyang – premier and Party general secretary in the 1980s – under what amounted to house arrest from 1989 to 2005. (He died in 2005.) The relationship between the current generation of leaders – Hu Jintao and Wen Jiabao – and their predecessors from the 1990s is no more congenial. An article in the Singapore press summarizes the situation in the five years since

Hu Jintao succeeded Jiang Zemin as follows: "[Hu] wrested control of the military from Mr Jiang, co-opted rivals who could be persuaded to switch sides, and ruthlessly sacked those who failed to toe the line, such as former Shanghai party boss Chen Liangyu."[28] The starting presumption – until proven otherwise – ought to be that there were significant policy differences among leaders so at political odds with one another.

The three generations of Chinese leaders do share one thing in common: They do not want to return to central planning. At this level of aggregation, the received wisdom is correct, but this is surely too sweeping a statement to be analytically useful. (It amounts to saying that both Bill Clinton and George W. Bush want to preserve capitalism and, therefore, their economic policies are identical.) We have enough information and data to probe into the specifics of the policies and the policy orientations of the three generations of Chinese leaders. Their rural policies are at the front and center of their policy differences.

Just as rural China illustrates the extent of the directional liberalism in the 1980s, rural China in the 1990s is a case study of policy and political developments in the opposite direction. This is the subject of Chapter 3. (The book focuses on the 1980s and 1990s. In Chapter 5, I take a look at the leadership of Hu Jintao and Wen Jiabao. All indications show that the current leadership is returning to a version of the policy model of the 1980s.) In the 1990s, China did move forward in FDI liberalization and in the area of restructuring urban SOEs. In this book, I assign a greater weight to rural developments than to these other developments in my explanation of the pace and the character of China's transition toward capitalism. The argument is that FDI and SOE reforms are fundamentally urban and, to the extent that entrepreneurial capitalism is rural in origin, rural policies matter more for China's economic transition. One may wish to disagree with how I weight different components of reforms, but it is not the case that I "ignored" FDI liberalization and the SOE restructuring in the 1990s.

What triggered these policy reversals? I leave this issue to future historians, who may have better access to government archives to resolve the issue more definitively. Let me propose a conjecture based on both the timing of the turning points detected in the economic data and the observable characteristics of Chinese leaders in the 1980s and the 1990s.

We have already seen in the data on the fixed-asset investments that the turning point occurred during the 1989–1990 period. Chapter 3 presents data on the growth of rural income and on the changing composition of the sources of rural income. Those data also show that there was a turning point during this period. Documentary research on bank documents shows that the policy reversals became apparent a few years later, during 1993 or 1994.

A reasonable conjecture is that the political and policy turning point was the 1989 Tiananmen turmoil. It is well known that the post-Tiananmen leadership sought to crack down on the private sector, mainly on ideological grounds. The ideological assault was quickly halted, as is well known by China scholars, but a longer-lasting effect of Tiananmen was a substantial change in the composition of the Chinese leadership. Suffice it to mention that the pre-Tiananmen and the post-Tiananmen leaderships differed in one critical aspect – their rural vis-à-vis urban credentials. Before Tiananmen, many of the top Chinese leaders charged with day-to-day economic management – Zhao Ziyang, Wan Li, and Tian Jiyun – hailed from rural provinces that had pioneered in agricultural reforms. They built their economic credentials by having succeeded in the management of agriculture. After Tiananmen, the top Chinese leaders in charge of the economy – Jiang Zemin and Zhu Rongji – came from the most urban and the least reformed region of China – Shanghai. We cannot know for sure whether these observable characteristics of the Chinese leaders explain their policy orientations, but they are not inconsistent with the view that there was a rural policy bias in the 1980s and that there was an urban policy bias in the 1990s.

3 The Outline of the Book

The key to getting the China story right is to understand its rural entrepreneurship. This is why the decade of the 1980s is so important in our efforts to explain China. I devote all of Chapter 2 and a portion of Chapter 3 to this topic. I show that rural entrepreneurship was not only vibrant but also virtuous. Rural entrepreneurs built businesses of a substantial scale in some of China's poorest provinces and, after only a few years into the first decade of the reforms, the private portions of the TVEs were extraordinarily high.

An important theme of this book is that capitalism in rural China is broad-based and vigorously entrepreneurial. Chapter 3 documents the policy reversals that led to financing repression and other restrictions on this virtuous form of capitalism. In the 1990s, China did not revert back to central planning. Far from it. But China began to adopt policies and practices that favored the more state-controlled urban areas. During this period, China made notable progress in reducing the ideological stigma associated with the private sector (much of which was actually revived during the Tiananmen period). But, financial policies became adverse in the rural areas and fiscal and economic affairs in the rural areas were centralized. The power and the reach of the state expanded even when the ownership role of the state declined in the 1990s.

Chapter 4 focuses on a pivotal region of the country – Shanghai. Shanghai is a large economy in its own right but the main reason I focus on Shanghai is political. Shanghai dominated Chinese politics and policy making in the 1990s. In many ways, the Shanghai model is the apex of the development model of the 1990s: The Shanghai leaders designed and presided over this policy model in the late 1980s and in the 1990s expanded this model to the rest of the country in their capacity as national leaders. The Shanghai model possesses the following central elements: an urban bias, heavy-handed interventionism by the state, an investment-intensive growth strategy, and a biased liberalization that privileges FDI over indigenous – especially small-scale – private entrepreneurship.

Chapter 5 takes stock of all these findings and asks the question of whether the policy developments documented in Chapters 2 through 4 really mattered. This is a legitimate question. From the GDP data, one cannot identify a meaningful difference between the 1980s and 1990s. This is why this book treats GDP data as the beginning of the analysis rather than the end. Surveys on household incomes show a dramatic difference between the 1980s and the 1990s. Rural income slowed down considerably in the 1990s. Also, in the 1990s, national income accounting data – that is, GDP data – began to diverge from household income survey data. To put it briefly, household income as a ratio to GDP (all on a per capita basis) declined substantially in the 1990s compared with the 1980s.

In fact, national income accounting data show a substantial difference between the 1980s and the 1990s if one is willing to go one level down in the data disaggregation. In the 1980s, the labor share of GDP was rising and in the 1990s it was declining. In the 1990s, China was producing output at an impressive rate but this output production began to benefit its citizens less and less. This is a cautionary note that we should rely on empirical details other than GDP growth, exports, and FDI to formulate a view of the Chinese economy. Other indicators such as acute income inequalities, social tensions, rising illiteracy, and so forth all show adverse developments in the 1990s. In other words, although GDP growth was fast in the 1980s and the 1990s, the welfare implications were quite different.

A central mechanism of the growth model of the 1990s was to finance state-led, urban China by heavily taxing entrepreneurial rural China. The result was the urban boom – the skyscrapers and urban amenities in Beijing and Shanghai – that many take as a sign of China's economic success.

Very few observers have asked the obvious question, "What financed these expensive projects in a poor country like China?" The second obvious question is, "If China spent precious resources on such projects, what other projects had to be given up to finance these projects?" The first question gets to the actual costs of these projects; the second question gets to the opportunity costs. These are especially pertinent questions because such urban projects are nonproductive and state-led urban China is less efficient.

The answer is that entrepreneurial rural China paid the price. Chapter 5 provides some details. In the 1990s, rural tax burdens were high and increased substantially. In addition, the state increased charges for providing basic services, such as education and health. In some parts of the country, local governments began to charge for administering immunization shots. The number of primary schools, as well as the number of medical facilities, fell in the rural areas.

The magnitude of these costly resource-allocation decisions is only beginning to show up now. A little-known fact is that China experienced a sharp rise in adult illiteracy between 2000 and 2005, all of which took place in the rural areas. According to the official data, there was an increase of 30 million illiterates. In Chapter 5, I look into this development in some detail. The way adult illiteracy is measured in China implies that all the new illiteracy was a product of the basic education in the 1990s. Under some highly realistic assumptions, we can show that an increase of illiteracy by 30 million people suggests that China's basic education failed about 30 percent of the rural school-age children in the second half of the 1990s. This estimate is within a close range of the dropout ratios reported by Chinese analysts based on their field research. The rising illiteracy is probably the most long-lasting and the most damaging legacy of the 1990s. The simple GDP data, upon which Western economists have been fixated, do not capture this development at all.

Chapter 5 also places the state of the private sector in China against a broader perspective. It shows that even as China is about to enter the fourth decade of reforms, the size of its indigenous private sector is conspicuously small. The best way to characterize the Chinese economy today is that it is broadly similar to many of the commanding-heights economies of the 1970s. It is capitalistic to be sure, but it is a version of the state-led capitalism that, as Baumol, Litan, and Shramm (2007) argue, characterized Latin America. Today China has other attributes that also put the country closer to the Latin American end of capitalism rather than to the East Asian end – the rising income disparities and the contraction in social opportunities available to the population to attain education and health.

A country that was habitually written off in comparison with China is showing increasing economic vitality and strength – India. Chapter 5 presents a stylized comparison of the two countries. Understanding the emerging Indian miracle is both analytically meaningful and relevant to policies. As China begins to ponder the question of political reforms, it is worth revisiting the supposed tradeoff between growth and political freedom. Many held the view that such a tradeoff existed when India was growing at 2 to 3 percent a year, but this belief was increasingly untenable when India began to grow at an East Asian level. The rise of India, when explicitly benchmarked against China, also raises questions about the importance of "soft infrastructures" – financial and legal institutions – vis-à-vis the importance of "hard infrastructures," such as bridges and buildings. I delve into some of these issues in Chapter 5.

I conclude the book with some speculative comments about China's prospects in the short to medium run. To get at this issue, one has to start with an assessment of the current leadership of Hu Jintao and Wen Jiabao. At the time of this writing, it is clear that the current leadership is rethinking the policy model of the 1990s and has signaled, if obliquely, an intention to return to the directional liberalism of the 1980s. In the past five years, despite significant political baggage from the 1990s, Chinese leaders have revived the policy emphasis on the rural areas, begun to address the massive problems in the social sector, introduced some financial reforms, and revived at least discussions of political reforms. The policy platform unveiled at the Seventeenth Party Congress in October 2007 is probably the most liberal and progressive one since the Thirteenth Party Congress exactly 20 years earlier. These events bode well for China.

There are, however, monumental odds. The political system today is manifestly and substantially more self-serving than the system in the 1980s. The size of the Chinese bureaucracy has roughly doubled in the last two decades and there are powerful vested interests in the status quo. Corruption has intensified greatly in scope and scale. It is a legitimate question to ask whether the top-down policy adjustments, although raising expectations, can actually deliver the desired results on the ground. There are also significant economic risk factors such as the enormous challenge of managing asset bubbles, rising cost pressures, and stagnant microeconomic performances (e.g., the sharp reduction in productivity growth since the late 1990s).

Although there are no easy choices and there are substantial transitional or transitory risks associated with this strategy, this book ends with a prescriptive note that political reforms – reforms of political governance – will help China return to a sustained and welfare-improving growth trajectory. Directional liberalism worked well in the 1980s because of the special historical and political configurations at the time. This time around, however, a fundamental reorientation toward institutional liberalism is needed.

APPENDIX

A.1 NBS Datasets on Industrial Enterprises

Dougherty and Herd (2005) provide detailed information on the NBS datasets. In the NBS industrial dataset, the shareholders are classified in the following categories: (1) state (direct or indirect), (2) collective (i.e., local governments), (3) individuals, (4) domestic legal persons, and (5) foreign companies. The definition of private sector used by the OECD economists includes firms owned by individuals, domestic legal persons, and foreign companies. The NBS datasets cover all industrial enterprises above 5 million yuan in sales. The number of firms range from 160,000 to 180,000 per year. I thank Professor Yifan Zhang at Hong Kong Polytechnic Institute for making the 1998 to 2001 datasets available to me for analysis and Professors Tao Zhigang and Yang Zhi at Hong Kong University for providing the 2005 data.

A.2 China's Fixed-Asset Investments

The Chinese government has published a series of specialized publications on fixed-asset investments. These are NBS (1987), NBS (1991), NBS (1992), NBS (1993a), NBS (1997a), NBS (1998), NBS (1999b), NBS (2002), NBS (2003a), NBS (2004b), and NBS (2005c). The data in the text and in Table 1.2 come from these sources. In addition, the CSY has a section on fixed-asset investments and our data are complemented by these sources. See, for example, NBS (2005b). Data on rural collective installation investments are partially available. For 1981–1983, 1986, 1988, 1989, 1991–1995, and 1999–2001, there are data on the entire collective sector but not on the rural component. For these years, I have estimated the rural installation investments by using the rural shares of collective investments.

Fixed-asset investments are subject to heavy government controls. A telling piece of evidence, as marshaled by Rawski (2001a), is that China's seasonal investment cycles, as recently as during the 1999–2001 period, matched almost perfectly those prevailing during the centrally planned era. Because fixed-asset investment is a large component of China's GDP, fluctuations in investment levels have a substantial impact on GDP. Here, Rawski shows that China's quarterly GDP growth patterns differed substantially from those in South Korea, Taiwan, and Hong Kong, an indication that factors such as weather or traditional Chinese holidays are not the principal determinants of the seasonal rhythm of China's GDP. Rawski quotes a Chinese economist's overall assessment of the Chinese investment process as follows:

> Many basic components of a pure market economy are still in their incipient stage in China, although market-oriented reform started two decades ago. Government-guided investment mechanisms, a state-controlled banking system and dominant state-owned enterprises . . . still run in a framework molded primarily on the previous planned economy.

A.3 Ownership Classifications

In the 1990s, according to Chinese statistics, a new category of firms, the "other" ownership, increased from zero in the second half of the 1980s to 11 percent during the 1991–1995 period and then to 18.7 percent during the 1996–2000 period. To what extent are these "other" ownership forms effectively capturing domestic private investment?

The "other" ownership category consists of four types of firms: (1) joint-ownership firms, (2) shareholding firms, (3) FIEs, and (4) unclassified firms. Shareholding firms and FIEs dominate this category. During the 1996–2000 period, shareholding firms accounted for 42 percent of the fixed-asset investments of firms in the "other" ownership category and FIEs accounted for 53.2 percent. Since then, shareholding firms have become dominant, accounting for 70.1 percent in 2003, whereas FIEs have accounted for about 27 percent.[29]

Some of these shareholding firms are private-sector firms. For example, a category of firms known as "shareholding cooperatives" can be viewed as private-sector firms. Many of them are majority-owned by their employees; however, shareholding cooperatives represent only a small portion of the shareholding firms. As of 2002, shareholding cooperatives accounted for only 2.89 percent of China's industrial output by value, as compared with 11.7 percent for privately run enterprises (*siying qiye*).[30] The majority of the shareholding firms, especially the large ones, are still state-controlled. (I revisit this issue in Chapter 4.) So, excluding the "other" ownership category of firms in our definition is empirically defensible.

A.4 Complications and Definitional Issues in the Fixed-Asset Investment Data

Let me address a number of complications involved in the definitions and measurements used in Table 1.2. One potential concern is that the dynamics of the Chinese economy may have affected our findings. For example, the decline of rural private investments may result from the declining importance of agriculture in the Chinese economy, not the decline of the private sector. Agriculture did decline, from around 30 percent of GDP in the early 1980s to about 12 percent in 2005. (It should be noted that rural employment is still very large even today.) Also in the 1990s, the ownership structure of the Chinese economy proliferated with the entry of foreign firms and the rise of firms with mixed ownership. The private share could be pushed down – mathematically – by the entry of new firms. Let me address these concerns here and show that these complications do not fundamentally alter the qualitative nature of our assessment.

The urbanization hypothesis predicts a decline of the rural private sector, not an across-the-board decline of the private sector in the fixed-asset investment share. It is noteworthy that the rural private share declined in the 1990s *in conjunction with* an overall decline of the private share of fixed-asset investments. If urbanization converted rural capitalists into urban capitalists, then the logical consequence should be a substitution of rural private-sector investments with urban private-sector investments, rather than an across-the-board decrease in the overall private share. This is not what happened. As shown in Table 1.2, the overall private share in the 1990s and 2000s was nowhere near the level prevailing in the 1980s and the rural private share was a fraction of its level in the 1980s. There is no evidence of a rural-to-urban switch.

A more straightforward way to dispel the urbanization hypothesis is to focus only on rural China. In this way, we avoid bundling the two developments together in the data – urbanization and changes in the composition of investment ownership. Row (3) of Table 1.2 presents the percentage ratios of the rural private sector to the rural collective sector. The private sector declined sharply relative to the collective sector in the 1990s. In the 1980s, the rural private sector invested twice as much as the rural collective sector; in the 1990s and 2000s, the rural private sector invested between 50 and 80 percent of what the collective sector invested.

A second potential concern with our findings is our definition of the private sector. Our definition in Panel (A) of Table 1.2 includes only the registered private-sector businesses. This may introduce a downward bias because the decade of the 1990s experienced a proliferation of mixed-ownership firms, such as shareholding firms and FIEs. These new ownership firms are included in the denominator of the ratio calculations but not in the numerator. Is it then possible that the private share was diluted over time by the entry of new types of firms? Let us consider this possibility in a number of ways.[31] There is no evidence that FDI diluted the share of the registered private sector. Panel (C) removes the fixed-asset investments by FIEs from the denominator and presents the private investment shares of only indigenous firms. The private investment share in the 1990s and 2000s is still smaller than that in the 1980s when the FIEs were minuscule (under Rows [1] and [6]).

The rise of mixed-ownership firms also does not affect the substance of our findings, but it is more complicated to explain why. First, it is important to stress that the share of the registered private sector *declined* rather than remaining constant since the early 1990s. Thus, even if it is true that mixed-ownership firms became more important in the 1990s, their rising importance was achieved at the expense of the registered private sector, not at the expense of the state sector. This is a finding worth emphasizing. Many of the reforms touted by economists as ownership reforms have nothing to do with privatization. They are designed as alternative funding devices to supplement a massive investment program organized by the state.

Even if we use a more encompassing definition of the private sector incorporating the mixed-ownership firms, our measure still shows a declining share of the private sector in fixed-asset investments in the 1990s. However, our measure does show some improvement in the 2000s. To illustrate this point, I applied the Guangdong definition to my calculation and included other shareholding firms, domestic joint ventures with non-state firms, and shareholding cooperatives, in addition to the registered private sector. The results are shown in Row (5b). As recently as 1998, based on this broad definition of the private sector, the investment share of the private sector was only 17.2 percent, smaller than that in the 1980s (21.4 percent). Since then, the share went up to 27.6 percent in 2002 and 33.5 percent in 2005. Thus, based on this broad definition of the private sector, all we can claim is that the ownership policies since the late 1990s seem to have become more liberal than those in the 1980s. By the same token, the policy environment during much of the 1990s was more restrictive toward the private sector.

Another way to address the concern of this definitional under-counting of the private sector is to benchmark firms that have clear, straightforward ownership rights at the two extreme ends of the ownership spectrum. This exercise helps us assess two common views in economics research on

China. One is that private-sector policies became more liberal over time; the other is that the Chinese state embarked on an increasingly aggressive privatization program vis-à-vis SOEs. The combination of these two alleged developments would have led to rising private-to-state sector ratios of their respective investment shares. Row (2) presents the private-to-state ratios.

In Row (2a), which includes both urban and rural data, the private-to-state ratio declined sharply during the Tiananmen interlude (28.8 percent) and during the 1993–2001 period (25.9 percent). During the 1980s, the ratio was as high as 34.6 percent. The ratio rose above the level of the 1980s to 39.9 percent only during the most recent period (2002–2005). If we confine ourselves only to the rural private sector, the ratio declined continuously since 1990, including during the most recent period, as shown in Row (2b). This is *prima facie* evidence that the policy treatment of the explicit private sector did not improve relative to the policy treatment of the explicit state sector. In fact, our evidence points to a substantial deterioration of the relative policy treatment of these two types of firms in the 1990s.

Another definitional concern has to do with the inclusion of households in the definition of the private sector. As mentioned earlier, the concept of the individual economy includes household businesses. Households may invest in machines or equipment to run businesses, but they may also invest in housing. The fixed-asset investments recorded under the private sector in Table 1.2 incorporate both types of investments. The issue here is whether if we strip the data of their housing component, we still will see the same declining share of the private sector over the course of the 1990s.

The answer is an unambiguous yes. Rows (8) and (9) of Table 1.2 include only the nonhousing components of the fixed-asset investments. One component is equipment purchases; the other is expenses for nonresidential installations (e.g., factory buildings). The figures in these two rows show the real annual growth rates (deflated to 1978 prices) averaged over the years during the different periods. In both categories of nonhousing fixed-asset investments, the growth rates of the rural private sector are the fastest during the 1981–1989 period, with the growth rates moderating substantially in the later periods. Interestingly, the rural collective sector exhibits the opposite pattern: Its growth rates accelerated by a huge margin in the 1990s. These trends are entirely consistent with the other indicators on fixed-asset investments.

TWO

The Entrepreneurial Decade

In 1982, there was a commercial sensation in Shanghai – sunflower seeds. Sunflower seeds, stir-fried and salted, are one of the most popular snack foods in China. People munch on them when watching TV or playing cards, not unlike the way potato chips are consumed in the United States. But this sensation in Shanghai had a distinct flavor as well as a distinct brand-name – Idiot's Seeds. Idiot's Seeds was the invention of Nian Guangjiu, a farmer in the agricultural and impoverished province of Anhui. Nian held a rather low opinion of himself. He thought that he was good at nothing but making sunflower seeds, hence the brand-name.[1]

Nian's sunflower seeds caught on, not just in Shanghai but also nationwide. This is a fascinating story about how a humble rural entrepreneur succeeded within a few years of the reforms. First, Mr. Nian came up with a brand-name. Whether conscious or not, he introduced the most rudimentary idea of marketing to China. Until Mr. Nian, sunflower seeds had been viewed as an undifferentiated product. The labeling in Chinese stores was by product – sunflower seeds, peanuts, walnuts, and so forth. There was no recognition that the same products might have been made differently. (Nian's brand-name was not always helpful. In 1987, he was considering setting up a scholarship fund at a local school. The teachers balked at the idea of awarding students with an "Idiot's scholarship.")

Second, Mr. Nian was a poor farmer in what was a poor province at the time. Anhui province in 1980 had a per capita GDP of 291 yuan, ranking 27th in the country out of 29 provinces. The province was heavily agricultural, and 88 percent of its population resided in the rural areas.[2] Yet, with a good product, Mr. Nian was able to access the state-controlled distribution system. His Idiot's Seeds were sold in many major cities, including Beijing, Shanghai, and Dalian.

Third, the scale of Mr. Nian's operations was phenomenal. He hired hundreds of workers at a time when private-sector employment was supposedly capped at seven workers per firm. In 1981, he started with four employees and in 1983 he had 103. By 1986, his business was netting 1 million yuan in profits. To put this number in perspective, in 1985, the average profit per SOE – the largest of the businesses in the country at the time – was only 1.1 million yuan.[3] There is another way to illustrate just how substantial Mr. Nian's operations were in 1986: 1 million yuan in 1986 is roughly equivalent to 3.14 million yuan in 2003. We have profit data on about 3,000 large private-sector firms as of 2003 from a private-sector survey conducted in 2004. (The survey is hereafter referred to as PSS2004. The Appendix to this chapter contains more details about PSS2004.) With 3.14 million yuan in profit, Mr. Nian's business would have been considered a corporate giant in 2003 and it would have been larger than 90 percent of the firms covered in the survey. (In PSS2004, a firm in the 90th percentile had a profit of 2.45 million yuan.) Considering that 1986 was only a few years into the reform decade and that China in 1986 was much poorer than China in 2003, this is a remarkable achievement indeed.

Mr. Nian was not alone. The idea of this chapter is to present a perspective on the China of the 1980s that is largely missing in economic research on China. China in the 1980s witnessed an explosion of indigenous, completely private entrepreneurship, but almost all of this entrepreneurship occurred in the rural areas of the country (which might explain its relative obscurity in scholarly research). Although it was a largely rural phenomenon, entrepreneurship in the 1980s was not an agricultural phenomenon. This is an important insight. As the case of Mr. Nian shows, the entrepreneurs were rural residents but they engaged in industrial production and service provision activities. This has important implications for how China managed to rapidly reduce poverty and how the country achieved a virtuous cycle between economic growth and social performance in the 1980s.

The decade of the 1980s deserves far more analytical attention than it has received. Economic research on China is heavily colored by the developments in the 1990s. This is because the Chinese economy became sufficiently important in the 1990s to attract considerable analytical attention. Conducting in-depth economic research was feasible in the 1990s. With better and more data, we know vastly more about China in the 1990s than we do about China in the 1980s. Furthermore, our views of the 1980s are often based on inferences rather than on direct empirical observations. Here, the gradualist framework – that China moved to a market economy progressively and steadily over time – exerted a powerful influence on how scholars framed the issue. Whatever progress China was supposed to have made during the reform era, there are still substantial distortions in the economy today. If so, it must be the case, as the gradualist reasoning would suggest, that the distortions in the 1980s were more severe.

In this chapter and the following chapter, I offer a direct and detailed account of one of the most remarkable phenomena in Chinese economic history – the rapid rise of rural entrepreneurship in the 1980s. In the 1980s, small and impoverished rural entrepreneurs such as Mr. Nian started businesses easily, operated their stalls in urban areas with freedom, accessed bank credits, and had growing confidence in the security of their assets. There was also financial liberalization and even some privatization. I return to this issue in greater detail in the next chapter, but suffice it to say here that some of the rural reforms in the 1980s were quite far-reaching and that in the 1990s there was a reversal of some of the key elements of the reforms that had allowed for a flourishing of rural entrepreneurship in the 1980s.

Another aspect of China of the 1980s is worth mentioning. Private entrepreneurship was developing most vibrantly in the poorest and the most agricultural regions of the country. Yes, the entrepreneurship of the 1980s was exclusively a rural phenomenon, but keep in mind that China in the 1980s was a predominantly rural society, with 80 percent of the population living in the rural areas. Thus, private entrepreneurship had a huge impact on the largest segment and the poorest of the population.

Although the agricultural success is widely believed to have been the result of private-sector development, such as the household contract responsibility system, the consensus among academics is that township and village governments spearheaded China's massive rural industrialization. This is the famous TVE phenomenon. I would argue that this is an incomplete perspective. I show in this chapter that purely private entrepreneurship contributed substantially to the *nonagricultural* success of rural China in the 1980s. One indication of this is the increasing importance of nonagricultural business income for Chinese rural households. Business income refers to the profits derived from owning and operating a business. It corresponds roughly to the returns from entrepreneurship. In the 1980s, business income was the fastest growing segment of rural household income. As a share of total rural household income, business income rose from 8.1 percent in 1983 to 14.9 percent in 1988, a level that was exceeded only in 1998 and 2000. Rural entrepreneurship thus played an enormous role in contributing to the rapid income gains during the 1980s.

There are two important analytical reasons for why we should get the story right about the 1980s. One is that the gradualist view of the Chinese reforms leads to the logical conclusion that the reforms in the 1990s were more radical. This assumption tilts research attention to those policy developments that were the hallmarks of the 1990s. In the 1990s, China experienced a rapid growth in FDI and international trade. In part because globalization fits well with mainstream economics, many came to view globalization as a critical factor in China's broad economic success. World Bank economists are the most vocal in touting the benefits of globalization. David Dollar, the director of development policy for the World Bank, has referred to China as a hugely successful globalization story. The World Bank cited from official Chinese sources that the number of rural poor in China fell from 250 million in 1978 to 34 million in 1999.[4]

As in all aspects of the Chinese economy, details matter. The two data points cited by the Bank convey the impression that poverty reduction was a smooth, continuous process between 1978 and 1999. Nothing is further from the truth. Let's look at the same official data used by David Dollar.[5] In 1978, the number of rural poor stood at 250 million (as defined by the Chinese poverty line) but, in the first 10 years of reforms, this number already declined to 96 million in 1988. The poverty headcount declined by 154 million. In the next 10 years of reforms from 1989 to 1999, the poverty headcount declined by only 62 million. This was a fraction of what China achieved in the 1980s.

One may argue that poverty reduction in the 1980s was faster because it was easier. It was a case of "picking the lowest-hanging fruits," one may say. In the 1990s, by contrast, the residual poverty was entrenched and permanent. A standard explanation is that the currently poor people are ethnic minorities living in mountainous regions. The poverty in China now is structural and therefore persistent. It is very resistant to the effects of policies and of economic growth.

There is some truth to this structural explanation but it cannot be the entire truth. One indication is that the Chinese poverty figures are highly sensitive to the definition of poverty line. At the poverty line of US$1 per day, in 2002, 7 percent of the Chinese population lived in absolute poverty, but when the poverty line was redrawn at US$2 a day, this fraction increased to 45 percent (World Bank 2003). The ethnic and geographic explanation is unable to explain this high level and wide spread of poverty incidence. Also, the structural explanation oddly assumes that it was easier to tackle poverty in the 1980s than in the 1990s. In the 1990s, the Chinese government commanded substantially more resources than in the 1980s.

I return to this question in more detail in Chapters 3 and 5 but suffice it to mention here that the policy model of the 1990s may have contributed to the persistent poverty in rural China. The essence of the policy model of the 1990s was to tax the poorer rural China to benefit the richer urban China and to restrict rather than expand the opportunities for small-scale and humble entrepreneurs like Mr. Nian. There is another facet about the poverty reduction record of the 1990s – it was partially a result of statistical manipulations. In 1998, 1999, and again in 2002, the Chinese authorities *lowered* the official poverty line, making it easier for a *statistical* reduction of poverty. In 1997, the rural poverty line was drawn at 640 yuan per person; by 2002, it was 627 yuan per person (NBS 2007b). (I return to this issue in Chapter 5 but let me note here that during the same period, the Chinese state increased the salaries of its civil servants five times, each time by a double-digit rate.)

The record of FDI and globalization in poverty reduction does not even come close to matching the record of rural reforms.[6] This is not a criticism of globalization but rather a matter of framing the issue with the right perspective. Globalization is the story of the 1990s, not of the 1980s. In the 1980s, FDI and international trade were minuscule. In 1988, China received just 3 billion dollars in FDI, half of what India – widely viewed as an FDI laggard – receives today. And yet, China's record in poverty reduction in the 1980s is substantially more impressive than its record in the 1990s. Other social indicators, such as literacy performance, also show the 1990s in a poor light. By loosely referring to China's poverty reduction during the entire reform era, the World Bank economists vastly understate the achievements of the 1980s and overstate the achievements of the 1990s by the same margin. They also exaggerate the effects of FDI and trade on poverty reduction and completely neglect the role of indigenous private entrepreneurship.

The second analytical reason to get the story right about the 1980s is to resolve what can be described as the "China puzzle." The "China puzzle" is that China's economic development does not seem to fit with a standard economic framework. Qian (1999) succinctly summarizes the sense of this puzzle: "[T]he Chinese path of reform and its associated rapid growth seemed to defy the necessity part of the conventional wisdom: Although China has adopted many of the policies advocated by economists, such as being open to trade and foreign investment and macroeconomic stability, violations of the standard policy prescriptions are also striking." The World Bank's 1996 annual report – devoted to economic transition – proposes a number of analytical categories, such as economic liberalization, private-sector development, and political transition, for all transition economies.

Unable to categorize China, the report placed China in a geographic grouping. China was a part of the "East Asian group" along with Vietnam, and the report made no attempt to explicitly benchmark China against the various liberalization measures.[7]

There is no China puzzle at all. The true China miracle is a classic and conventional one – the country grew because of private-sector dynamism, a relatively supporting financial environment, and increasing property rights security. These are the three institutional conditions that mainstream economists hold to be critical to economic growth, as summarized in Chapter 1. (The present chapter focuses on private ownership and security of property rights. I take on the third institution – finance – in the next chapter.) In the 1980s, directional liberalism reached far and wide. I formulated this view of the 1980s based on direct, empirical, and – as much as possible – systematic observations of the 1980s.

This chapter begins with an account of what I call the true China miracle – the vibrant rural entrepreneurship and its virtuous effect in the 1980s. In the second section, I analyze an institution that has fascinated and puzzled many Western social scientists – the township and village enterprises (TVEs). TVEs are widely believed to be a public-sector institution. Not so. On the basis of detailed archival research of government documents and contemporaneous accounts, I show that the vast majority of TVEs in the 1980s were completely private. I close with a concluding section on a few broad implications of this new perspective on the 1980s.

1 The True China Miracle

> As is clear to everyone, the spontaneous forces of capitalism have been steadily growing in the countryside in recent years, with new rich peasants springing up everywhere and many well-to-do middle class peasants striving to become rich peasants.
>
> – Mao Zedong, 1955

> The countryside has a vast number of skillful craftsmen and capable producers, educated youth and retired soldiers. Their expertise should be put to full use and [we] should support their efforts to establish technical-service organizations and allow any rural economic organizations to recruit them into their workforce. . . .
>
> – Central Committee of the Chinese Communist Party
> – (Central Committee 1992 <1983>, p. 176)

Mao Zedong and the leadership of the 1980s had something in common: They both recognized the huge entrepreneurial potential of China's rural residents. Mao went to great lengths – through the commune system and the

Great Leap Forward – to destroy those potentials because he understood the political ramifications of unleashing them. In 1955, as quoted previously, Mao recognized two fundamental attributes of the Chinese peasantry. One is that Chinese peasants are very entrepreneurial – "spontaneous" – and that they stand ready to be providers of capital and business capabilities as business owners and operators. The second attribute is that Chinese peasants are very motivated – "many well-to-do middle class peasants striving to become rich peasants."

In a political system laden with urban biases, the Chinese reformers in the 1980s recognized these same potentials and created a policy environment to permit and to encourage their realization. The result was that the 1980s was a decade of vibrant, grassroots, bottom-up entrepreneurship in China's massive countryside.

The speed of entrepreneurial development was breathtaking. Because the Chinese statistical system in the early 1980s was not well equipped to track the output production in the private sector, we instead use tax data as an indicator. According to the Ministry of Finance (1989, pp. 23–24), the tax receipts from self-employment businesses – most of which were rural – increased from 884 million yuan in 1981 to 3.5 billion yuan in 1982, a more than fourfold increase in just one year.

In the 1980s, Chinese peasants experienced the most rapid income gains in history. Per capita rural income between 1978 and 1981 grew at a real rate of 11.4 percent; the urban/rural ratio of the purchase of consumer goods fell from 10 to 1 in 1978 to 6 to 1 in 1981. According to a rural survey, rural per capita income more than doubled between 1978 and 1984, and real rural per capita consumption increased by 51 percent between 1978 and 1983 (Riskin 1987, p. 292). Rural poverty also declined dramatically in the 1980s, as indicated before.

China scholars have researched this phenomenon extensively. The consensus view is that the rural reforms accounted for the largest segment of the income gains. Administrative measures, such as price increases, played a smaller role. According to one analysis, one-fifth of the increase was due to price increases; the rest, by implication, came from improving allocative efficiencies (Riskin 1987, p. 293). These include improving labor productivities, as evidenced by the fast growth of per capita production of food grains and edible oil, and income diversification opportunities to become involved in nonagricultural activities. Let me add another factor – the flourishing of rural entrepreneurship.

Chinese capitalism is heavily rural in origin. The reasons are complex but one hypothesis is that central planning was always weaker in the countryside than it was in the cities. As I show in this section, even at the height of the Cultural Revolution, rural residents engaged in private commerce and industry in ways that would have been unimaginable in the cities. This may explain the explosion of rural entrepreneurship just a few years into the reform era as the policy and business environment became more permissive. Rural entrepreneurship was also virtuous because it emerged first and developed fastest in the poorer regions of China.

1.1 The Rural Origins of Chinese Capitalism

Today, we can still observe one lasting legacy of the rural origins of Chinese capitalism: Many of the largest manufacturing private-sector firms hail from the backward, predominantly agricultural provinces of China. This is a striking empirical regularity. Kelon Group, until 2005 China's largest refrigerator maker, was founded by Wang Guoduan, an entrepreneur in rural Shunde county in southern Guangdong province. Huanyuan, China's largest air-conditioner maker, is based in the agricultural province of Hunan. China's first automobile exports will not come from Shanghai but more likely from the agricultural hinterland of Anhui province where Chery is located. The Hope Group is even more interesting. The four brothers who started a business in quail eggs abandoned their urban residency and founded their company in a rural part of Sichuan province. Today, it is China's largest agribusiness firm.

Very few of China's successful corporate giants in the competitive manufacturing industries are based in the metropolitan, industrial centers such as Beijing, Shanghai, and Tianjin. (Firms in politically connected sectors such as real estate are another story altogether.) This is puzzling. One would have thought that these urban centers possessed ample and propitious conditions for the growth and development of businesses. They have human capital, agglomeration economics, export market linkages, and high incomes. But none comes close to producing the microeconomic success stories that have come out of some of the initially poorer agricultural provinces. The reason is that the economic policies in rural China were far more liberal than those in urban China.

Zhejiang province is widely acknowledged to be a huge economic success. The province, located south of Shanghai, is home to half of China's largest private-sector firms. It is also rich, especially as measured in asset terms. In 2004, an average urban Zhejiang resident earned an income from owning stocks and bank deposits that was multiples of what an average Shanghai resident earned. But what is often lost in the Zhejiang story is that the province was poor and deeply agrarian in the 1970s. It was ranked No. 13 in per capita GDP in the late 1970s. In 1978, 32.2 million out of a population of 37.5 million resided in the rural areas.

Wenzhou region of Zhejiang province is typical of the province. Today, Wenzhou is the bastion of Chinese capitalism. Its businesses dominate European markets in garments, shirts, and cigarette lighters and the region has begun to venture into electronics and petrochemical products. Wealthy individuals from Wenzhou export a massive amount of capital to the rest of the country, making or breaking real estate markets in Shanghai, Beijing, and Guangzhou. In the entire country, only in Wenzhou have the highways and airports been financed by private capital. All of this private wealth was built on a rural foundation. Of 5.6 million Wenzhou residents, only 550,980 had an urban registration in 1978, just below 10 percent. The region was poor and inconvenienced by high mountains on three sides and ocean on the fourth. For years, Wenzhou lacked basic transportation infrastructures such as a seaport, an airport, and highways to nearby locations.

A universally accepted definition of entrepreneurship is self-employment business. Self-employment businesses are single proprietorships, and in China they are formally known as individual businesses (*geti hu*) or individual economy entities (*geti jingji*) in the Chinese statistical reporting system. By this measure, rural China in the 1980s was extraordinarily entrepreneurial.

We go first to the business registration data maintained by the Bureau of Industry and Commerce Administration (BICA). We then go to two large-scale surveys on private businesses conducted in the early 1990s. The first is a self-employment business survey conducted in 1991 (SEBS1991). Although it was conducted in 1991, it was sufficiently close to the decade of the 1980s to reflect the dynamics of that era. Also, the survey includes retrospective questions about the 1980s. Altogether, 13,259 self-employment business people participated in SEBS1991. It is the only large-scale survey that I know of that was conducted on these self-employment businesses.

We then supplement our findings from a private-sector survey conducted in 1993 (PSS1993). This survey was administered on the larger and more established private-sector firms. These are known formally as the private-run firms in the Chinese system (*siying qiye*). The formal difference between the self-employment businesses and the private-run firms is that the former employ seven or fewer than seven workers, whereas the latter employ more than seven. PSS1993 sampled 1,421 private-sector firms. Like SEBS1991, PSS1993 also contains retrospective questions about the 1980s. We use these questions to gauge the situation prevailing in the 1980s. The Appendix to this chapter contains more details on these two surveys.

According to the BICA registration data, in 1981 there were comparable numbers of registered rural and urban self-employment establishments: 868,000 in the urban areas and 961,000 in the rural areas.[8] Thereafter, the rural number increased rapidly. By 1986, there were 9.2 million registered rural self-employment businesses as compared with 2.9 million urban ones, a rural/urban ratio of 3.2. By 1988, the rural self-employment businesses numbered 10.7 million compared with 3.8 million in the urban areas (a ratio of 2.8). In terms of employment size, the ratios were even more skewed in favor of the rural areas. The rural-to-urban employment ratios for these self-employment businesses were 3.6 in 1986 and 4.5 in 1988.

But is this surprising? After all, China was predominantly rural in the 1980s and there should have been more rural entrepreneurs. However, a more meaningful fact is that the rural entrepreneurs in the 1980s no longer operated in the agricultural sector, not that the absolute number of rural entrepreneurs was large. In the BICA registration data for 1988, commerce claimed the largest share, about 50 percent, followed by industry (13 percent). Altogether, 17 million people were engaged in these nonagricultural activities. This is not a trivial number; it is about 5 percent of China's very large agricultural workforce. There is nothing automatic or natural about such an arrangement. Rural residents did not have an automatic advantage over urban residents in terms of expertise or market access in these nonagricultural activities.

SEBS1991 and PSS1993 also confirm the heavily rural origins of Chinese capitalism. One advantage of these two surveys over the BICA registration data is that we have information about whether the rural entrepreneurs operated in cities or in rural areas. The BICA data tell us only where the business was registered, not the location of its operations. Arguably, it is more meaningful to know that many rural entrepreneurs operated in the cities as opposed to the fact that there were more registered rural entrepreneurs. Here, SEBS1991 and PSS1993 are especially helpful because they targeted private businesses located in the cities.

Both SEBS1991 and PSS1993 contain questions about the prior residential status of the respondents. I thus classify those entrepreneurs who had a rural residential status as rural entrepreneurs. Both surveys give the years in which the business was founded. For those businesses founded between 1979 and 1990, in SEBS1991, 59 percent were rural entrepreneurs. Certain years had an extraordinarily high rural entry; for example, 1980 (63.6 percent), 1984 (65.5 percent), and 1986 (63.9 percent). The figures in PSS1993 are lower. Of those surveyed firms founded before 1990 in PSS1993, 30 percent were run by rural entrepreneurs. It should be emphasized that this finding means that 30 percent of the private-sector firms *based in the urban areas* were run by rural entrepreneurs, not that only 30 percent of the private entrepreneurs in China were rural. In fact, based on the registration data, a Ministry of Agriculture report estimates that private-run firms in the rural areas accounted for 81 percent in terms of establishments, 83 percent in terms of employment, and 84 percent in terms of registered capital (Editorial Committee of TVE Yearbook 1989a, p. 138). At both the small and large ends of the spectrum, capitalism was an overwhelmingly rural phenomenon.

PSS1993 reveals another intriguing finding. Those private-sector firms run by rural entrepreneurs were substantially larger than those run by urban entrepreneurs. For example, their average employment per firm in the first year of business was 22, as compared with 17 for firms run by urban entrepreneurs. (All the data here refer to those firms founded before 1990.) They also had more investors per firm (2.4 compared with 1.8). In the first year of operations, they had more registered capital (208,900 yuan per firm compared with 120,500 yuan per firm) and larger fixed assets (133,800 yuan compared with 87,330 yuan). These figures may be a result of a survivor-of-the-fittest dynamic. The urban areas must have been a tougher environment for rural entrepreneurs and, thus, only the best of the rural entrepreneurs were able to maintain operations there.

Readers may wonder why capitalism in China was rooted in the rural areas. There is a demand-side dynamic – rapid income growth in rural China creating the derived demand for more consumer goods and services (Naughton 2007). The more interesting explanation is on the supply side – why rural entrepreneurs were able to respond to the market changes so quickly and on such a massive scale. One important reason is the radical and market-conforming nature of the reforms initiated by the Chinese leadership in the 1980s. I go into more detail about this later in this chapter. Let me offer two other postulations here. Economic research on entrepreneurship consistently shows that education is a key factor in explaining who becomes an entrepreneur. In this respect, rural China was well positioned in the early 1980s. For whatever its faults, the Maoist leadership invested heavily in the health and educational sectors of rural China. Here, a comparison with India is illustrative. As early as the mid-1960s, China led India across a host of social indicators, including life expectancy, school enrollment, and literacy.[9] The greatest contrast with India is that in China, rural entrepreneurship was able to grow out of the traditional agricultural sector on a massive scale. The rural Indians, in contrast, hampered by a poor endowment of human capital, were not able to start entrepreneurial ventures remotely on the scale of the Chinese. (I revisit this theme in Chapter 5.)

Micro data show that the first generation of Chinese rural entrepreneurs was very well educated. In SEBS1991, few of the rural entrepreneurs – 8 percent – said that they were illiterate; 85 percent of them reported having finished at least middle school (and 14 percent of them finished high school.) Interestingly, there is not much difference in the educational levels of the rural and urban entrepreneurs in SEBS1991. Because educational attainments were higher in the cities than in the countryside, this finding suggests that the rural entrepreneurs came from a better-educated group in their own cohort.

The second reason is that even at the height of the Cultural Revolution, there was still some residual capitalism in rural China. This is, in part, due to a structural factor – agriculture is much harder for the government to plan as compared with industry. Soil conditions vary substantially, even within the same geographic region, and weather changes can be very unpredictable. For this reason, the agricultural sector in some of the centrally planned economies (e.g., Poland and Hungary) was only partially nationalized and limited private plots were allowed in the Soviet Union.

There was also a political factor. The Cultural Revolution, however sweeping and penetrating, was largely an urban affair and it may have undermined the urban political control of the countryside. In a planned economy, the urban centers are always more state-owned than the rural areas and thus a diminution of urban control would inadvertently allow for some breathing ground for capitalism. The Cultural Revolution also inflicted a severe political shock on China's urban economy, seriously constraining the supply side of the economy. The massive supply constraints, in turn, created shortages that the rural entrepreneurs rose to fulfill. Thus, ironically, the Cultural Revolution, however disruptive to the Chinese economy as a whole, might have laid the foundation for the post-reform takeoff of rural entrepreneurship. This dynamic explains an otherwise puzzling phenomenon noted by a number of scholars – even at the height of the Cultural Revolution, some rural residents were engaged in fairly large-scale private-sector activities.

By its very nature, we do not have systematic evidence of the aggregate scale of the private economy during the Cultural Revolution period.[10]

However, Chinese academics have assembled some very interesting accounts of the informal economy in the 1960s and 1970s. In one notorious case, Shishi (Stone Lion) township of Fujian province boasted a vibrant private market consisting of more than 600 merchants during the most feverish years of the Cultural Revolution – the second half of the 1960s. The market was closed down in 1971. The authorities discovered that one entrepreneur, Wu Xiayun, was making an income of 7,000 yuan a year, an enormous amount of money at that time. Another entrepreneur in the same township had raised 6,000 yuan from 36 investors and had started 30 small factories producing Mao Zedong pins (for which a market of considerable size existed during the Cultural Revolution).[11]

Another famous case concerns a village leader of Huaxi village in Jiangsu province. The village leader, while featured in a 1975 article in the *People's Daily* as a model, revolutionary Dachai-type cadre,[12] operated a clandestine hardware-tool factory. He pooled 20 investors and ran a highly profitable business. By 1978, Huaxi village had accumulated fixed assets worth some 1 million yuan and another 1 million yuan in bank deposits. The agricultural output of the entire village was only 240,000 yuan.[13]

1.2 The Scale of Rural Entrepreneurship

We know from the previous section that entrepreneurship in the 1980s was heavily rural in nature. But how substantial was the rural entrepreneurship phenomenon? And how large were the household businesses as individual units? A common measure in economics literature of the size of individual business units is employment. This is an appropriate measure here. We want to know whether the rural entrepreneurial businesses were mainly single proprietorships without any hired labor or whether they were of a size sufficient to have recruited and hired outside employees.

This is an important question from both a political and an economic perspective. Politically, it is widely believed that China in the 1980s imposed employment restrictions on private businesses. This is the so-called seven-employee rule.[14] We want to know how exacting and binding these restrictions were. From an economic perspective, it is important to know how substantial the rural entrepreneurship was in terms of creating employment opportunities outside of agriculture. As agricultural productivity improved, there was a greater pool of rural labor available for nonagricultural activities. From a welfare point of view, it is important to know whether rural businesses generated employment opportunities in nonagricultural sectors for the rural surplus labor.

We have several sources of information that indicate the substantial scale of rural entrepreneurial businesses only a few years into the 1980s. I first provide the findings based on government reports. Apart from the insight and data that we get from them, the very fact that they were recorded in the government reports means that the Chinese government was fully aware of the scale of such entrepreneurial ventures. In other words, these were not back-alley businesses operating in the shadow of an informal sector.

Despite the nominal restrictions of seven persons employed per firm, some of the rural businesses – such as that operated by Mr. Nian – were very large in scale. According to official sources, which might very well have under-counted them, some of the largest rural household businesses in the mid-1980s employed more than 1,000 workers each (State Council 1986, p. 6). The Jiangsu Statistical Bureau has compiled data on the largest private operations in the province. In 1986, for example, the largest employer was Mr. Qian Taiping, who hired 210 workers and earned an income of 600,000 yuan. (Mr. Qian apparently was not the richest person in Jiangsu; that title went to Chen Yubing, who operated a paint business. His income for 1986 was 1.3 million yuan.) In 1987, the largest employer in the province was Chen Tongyin, who employed 270 workers and earned an income of 2.75 million yuan.[15]

These anecdotal stories show that the ceiling effect of the employment restrictions was not as stringent as the seven-employee rule suggests. There were numerous cases of private businesses employing far more than seven persons.[16] An entrepreneur in Shaanxi, Chen Changshi ("a man who can make everything except babies") started a construction-material business in 1986 by employing 50 workers. Song Taiping of Hubei province started a bra production line in the early 1980s. He lined up a sales contract worth some 200,000 yuan in 1983 (an enormous amount of money at the time) and was able to sell in the Shanghai market, as well as landing an export license to sell to the European market. In 1983, he hired 50 workers, but by 1988, his workforce had increased to 700 workers. In addition, he outsourced work to 300 additional workers.

More systematic data based on PSS1993 confirm that rural China had some very large private employers. PSS1993 provides data on the number of investors and workers in the founding year of the business; we use these data to assess the size of rural private-sector firms in the 1980s. Of all firms founded between 1980 and 1990 by rural entrepreneurs, only one year, 1980, had an average size of private-sector firms close to the seven-employee rule. In that year, the average number of employees was 8.89. The largest average employment was 37 persons in 1983, and it was 30 persons in 1985.

Another way to illustrate the large employment size of rural private businesses is to look at those firms in the top tier. After all, if the seven-employee rule was truly binding, it should have been most binding on the largest firms. Again, the year 1983 had the largest firms. The firm at the top 10th percentile employed 106 persons in that year. The fewest employees were in 1981 when the firm at the top 10th percentile had only 21 workers. In most other years, the number ranges from 50 to 100 persons. These findings are not meant to suggest that there were no ceiling effects as a result of the seven-employee rule. Without the seven-employee rule, China doubtlessly would have had private firms employing thousands of employees in the 1980s. So, the ceiling effect was there but its restrictiveness was not nearly as crippling as the letter of the rule suggests.

The aggregate size of rural private entrepreneurship was also substantial. This is our second measure of the scale of rural entrepreneurship. Chapter 1 shows that the private share of fixed-asset investments was already more than 20 percent in the first few years of the 1980s. There is other supporting evidence as well. A carefully designed study based on surveys on 37,422 rural households (supplemented by interviews) shows that those rural households primarily engaged in nonagricultural activities comprised 11 percent of the total rural households as of the mid-1980s.[17] This translates into 21 million rural households nationwide. The entire number of urban households at that time was 50 million. This thus gives an idea of the magnitude of rural entrepreneurship only five years into the reform decade.

1.3 Rural but not Agricultural

Rural entrepreneurship was a method of choice on the part of rural residents to transition out of agriculture in the 1980s. (I show in the next chapter that paid employment at decreasing returns became a dominant option in the 1990s.) We saw in the BICA registration data more than 50 percent of the rural self-employment businesses were engaged in commerce. In SEBS1991, 72 percent of the surveyed entrepreneurs with a rural background were in manufacturing. In the construction business, for example, rural construction firms – not just rural construction workers – began to bid successfully for some large projects in the major cities. In Beijing, the International Hotel and the Bank of China buildings were awarded to a rural construction company based in Henan province (Zhang Houyi and Ming Lizhi 1999, pp. 180–181). As early as 1986, private entrepreneurship had already gained a substantial foothold in the transport sector. Outside the traditional state sector, in 1986, private businesses accounted for 67.6 percent of shipments and 77.6 percent of sales (Editorial Committee of TVE Yearbook 1989b, p. 84).[18] Rural entrepreneurs from Evergreen township in Beijing even began a direct flight from Beijing to Shantou of Guangdong province (Editorial Committee of TVE Yearbook 1989b, p. 84).

All of these developments reveal an important dynamic of the era – there was a great deal of arbitrage activities intermediated by the rural entrepreneurs. One indication is that many of the rural entrepreneurs operated a business in the urban areas. The SEBS1991 asked respondents whether they operated in the urban areas. Of those who answered in the affirmative, 55 percent came from a rural background. Also, many of the rural entrepreneurs with an urban operation appeared to have established a permanent base there. When asked whether or not they "owned" their facilities, 41 percent of the rural entrepreneurs with an urban establishment said yes.

The SEBS1991 data suggest that barriers to rural/urban mobility may have come down in the 1980s, earlier than many Western academics have assumed. Based on SEBS1991, the earlier years of the 1980s had a surprisingly higher rural entry in urban areas than the later years of the 1980s. In 1980, for example, of those entrepreneurs operating in urban areas, 55.6 percent were rural. However, the reason that Western academics assume that rural/urban mobility was greater in the 1990s than in the 1980s is that there were more labor migrants from the rural areas in the 1990s. But here is a critical difference between the two decades. In the 1980s, as SEBS1991 shows, it was the rural entrepreneurs who came to the cities and established operations there. In the 1990s, it was mainly the rural laborers who flooded the cities in search of jobs. Both were engaged in arbitraging activity between the rural and urban areas, but the underlying activities were very different. In the 1980s, the rural entrepreneurs were engaged in arbitraging the rural/urban differences in the returns to their investments, whereas the rural laborers of the 1990s were arbitraging the rural/urban differences in the returns to their labor.

1.4 Rags-to-Riches Entrepreneurship

We saw earlier that the rural income gains were substantial following the reforms and that there was a reduction in rural/urban income inequalities during the first half of the 1980s. Did rural entrepreneurship play a role in the huge poverty reduction of the 1980s?[19] A particularly virtuous aspect of the rural entrepreneurship in the 1980s is that it occurred among the low socioeconomic groups of the society. SEBS1991 shows that only 12.3 percent of the rural respondents had held a prior village or enterprise leadership position before becoming an entrepreneur. SEBS1991 asked about motivations for going into entrepreneurship. In response to this question, 62 percent of the rural entrepreneurs cited "to make a living" as their motivation for going into business, compared with 19.8 percent who answered "to make additional money." Thus, their entrepreneurial motivations were grounded on subsistence needs.

In the 1980s, there were two cross-cutting dynamics in the income distribution trends. One was a rise of within-rural inequality; the other was a decrease in rural/urban inequality.[20] The case of Mr. Nian of Idiot's Seeds illustrates why this was happening. Nian came from a very poor region and yet he was able to develop a sizeable business by the mid-1980s. Relative to others in his village, his income gains were substantial, but relative to urban residents, Mr. Nian brought down the income gap. In the 1980s, especially in the first half of the decade, the overall income disparity lessened because the improvement of rural/urban income distribution sufficiently offset the deterioration in the rural income distribution.

This is a little-known fact but one with monumental significance: In the 1980s, private-sector development and entrepreneurship were growing fastest and most vibrantly in the poorest parts of the country. Entrepreneurship was a poor man's affair. Let me use Guizhou, China's land-locked and poorest province with a large rural population, as an example. We go to SEBS1991 for a more detailed look. We use the amount of registered capital as a measure of the size of the entrepreneurial ventures. Surprisingly, the size of the entrepreneurial ventures in Guizhou was very large compared with those in the more developed regions of the country. During the 1979–1983 period, the average amount of registered capital of self-employment businesses was 1,717 yuan in Guizhou, compared with 2,145 yuan in the city of Shanghai and 1,813 yuan in the city of Chengdu. Guizhou had exactly the same median registered capital as these two much richer cities (500 yuan).

Given how poor Guizhou was, the scale of private businesses in Guizhou was considerable. We can demonstrate this point by calculating the ratio of the registered capital of these entrepreneurial ventures to the per capita GDP of the region. This is a proxy for the state of private-sector development in a province relative to the general level of economic development. By this measure, the private sector in Guizhou was "over-developed." We compare the average value of the registered capital for the 1984–1989 period with the per capita GDP for 1988. In 1988, Shanghai's per capita GDP was 3,471 yuan, the highest in the country. Guizhou's 406 yuan per capita GDP was the lowest in the country. The ratio of the average registered capital to the per capita GDP was 8.31 for Guizhou and only 1.27 for Shanghai. Interestingly, Guizhou's ratio was quite similar to that of Guangdong (8.55), a province that is widely acknowledged to be a pioneer of the reforms in China (Vogel 1989).

This is another lesser known story: Some of the poorest provinces in China undertook far-reaching reforms in the 1980s.[21] In Guizhou, agricultural household contracting was adopted at a faster pace than in the country as a whole. According to one source, by the end of 1981, 98.2 percent of households were already operating on a contracting system. (China as a whole reached this ratio by 1984.) Guizhou had a very liberal private-sector policy. In Guizhou, almost the entire TVE sector was private. In 1987, there were more than 405,000 TVEs in the province, of which 395,000 were completely private. These were labeled as "household" TVEs and, as of 1987, the household TVEs in Guizhou accounted for more than 97 percent of the total number of TVEs, 77.4 percent of the TVE employment, and 66.2 percent of the output value. The few remaining collective firms were put on performance contracts and, in effect, were rendered private in terms of their control rights. As of 1988, according to a survey of seven regions in Guizhou, 1,033 out of 1,516 collective TVEs were leased to either managers or outsiders. The provincial government openly sanctioned the conversion of the "official sponsorship" of firms to "civilian sponsorship" (Editorial Committee of Ten Years of Reforms in Guizhou 1989, p. 262). This was a code word for privatization.

The liberal policy enabled private businesses in the province to scale up their operations. By the mid-1980s, private TVEs had already developed to a level whereby they began to source capital and technology from other regions. In 1984 and 1985, Guizhou's TVEs imported 100 million yuan, entered into 300 technology licensing agreements, and recruited 3,000 technicians and managers from other provinces (Editorial Committee of Contemporary China Series 1989, p. 206). According to a detailed province-by-province study, some of the rural businesses in Guizhou reached a substantial scale.[22] One family founded an agricultural service business and contracted with the local government to run an agricultural machinery station. From that base, the family branched out into manufacturing and established seven factories, producing everything from alcohol to vinegar. The family business employed some 342 workers and realized sales of 51,000 yuan in 1984. It accumulated 200,000 yuan in fixed assets.

What is interesting is that this business was located in the poorer part of Guizhou – in Zunyi county. Zunyi county's per capita annual income was even smaller than that in Guizhou as a whole, about 200 yuan. To appreciate how substantial fixed assets valued at 200,000 yuan were, let me point out that in 1984, the entire fixed-asset investment credit line of Zunyi's banking system was slightly more than 3 million yuan.[23] It is quite impressive that this one household was able to accumulate such a large quantity of capital equipment so soon after the reforms began and this household was not alone. Some rural entrepreneurs, even in this most impoverished province, had already begun to venture into capital-intensive businesses. An entrepreneur in Zunyi county ran a trucking operation. His long-distance trade netted some 20,000 yuan per year, a huge sum of money in a province where the average rural income was 260 yuan (NBS 1986). Another rural entrepreneur operated a flour mill and earned an annual income of 10,000 yuan.

In this poor province, the purchase of capital equipment, such as a milling machine or a long-haul truck, necessarily required external financing. This gets to one of the least known stories about rural China in the 1980s – private-sector financing from the Chinese banks was sizeable. (I provide more details on this issue in the next chapter.) In Zunyi county, the rural credit cooperatives (RCCs) – a critical financing vehicle for private-sector development in the 1980s – increased their lending by 65 times in just three years between 1979 and 1982. In 1979, lending to rural households was 4.53 percent of that to collectives. In 1982, the lending to rural households was 3.5 times of that to collectives. Between 1982 and 1988, lending to households rose sharply, from 14.6 million yuan to 22.8 million yuan, while lending to collectives – including collectively run firms – remained roughly constant during this period.

There was also some nascent financial liberalization. The provincial branch of the People's Bank of China – an institution that in the 1990s would crack down harshly on informal rural finance – described an increasingly diverse financial scene in Guizhou in very positive terms: "A large number of shareholding and collectively owned financial institutions emerged, while informal finance and individual borrowing and lending developed rapidly."[24] The rapid rise and the scaling up of the private economy in Guizhou provide one answer to the question of why rural poverty declined so rapidly and so substantially in the first five years of the 1980s – this was not just an agricultural success but also a broad veritable entrepreneurial revolution.

2 What Exactly Is a TVE?

Nobel laureate in economics, Joseph E. Stiglitz, an eminent professor at Columbia University and a former chief economist of the World Bank, is probably one of the most prominent proponents of China's development strategy. In particular, Professor Stiglitz is enamored with the corporate organization known as township and village enterprises. TVEs, he argues, are a unique form of public enterprise that can solve what he views as an extremely serious problem afflicting transitional economies – the stealing of assets by private investors. Monitoring institutions are under-developed, he goes on, and therefore public ownership is needed to minimize stealing. TVEs seem to have the best of two worlds – they prevent asset stripping and they mimic the efficiency of private enterprise.[25]

Professor Stiglitz apparently formed this impression of TVEs during a field trip to Guangdong in 1992. In Shunde county of Guangdong province, Stiglitz – accompanied by Yingyi Qian, then a professor at Stanford – visited what was described to him as a TVE – the Pearl River Refrigerator Factory. He was deeply impressed by this firm. According to Stiglitz, this TVE had only 2 percent of the market share in 1985 but it was able to capture 10 percent in 1991, becoming the largest refrigerator maker in China (Qian and Stiglitz 1996). For Stiglitz, this TVE represented the virtues of local government ownership in a transitional context.

Just as in the case of Lenovo in the last chapter, the devil is in the details. The details about the Pearl River Refrigerator Factory, better known as the Kelon Group in China, directly contradict the postulations by Stiglitz. Exactly contrary to the idea that TVEs prevented asset stripping, as a collective TVE, Kelon actually represented a massive expropriation of what would have been straightforward private assets in any market economy. Kelon performed well as long as the township treated the firm as *de facto* private. It collapsed immediately after the township began to exercise its control rights.

First, Kelon was not started by the township government of Rongqi (where Kelon was based).[26] The idea of going into refrigerator production came from a rural entrepreneur by the name of Wang Guoduan. Wang was running a transistor radio factory at the time. Pushed by the competition, he began to look for other products to produce. He observed many Hong Kong people carrying refrigerators to their relatives across the border. This gave him the idea to go into refrigerator production. He asked his Hong Kong relatives to bring him two refrigerators from which he built a prototype.

The start-up equity capital did not come directly from the government. As was common among the large entrepreneurial businesses in the 1980s, financing by the government took the form of a loan. The Rongqi township provided Mr. Wang with a 90,000-yuan technical assistance loan and arranged for a credit line of 4 million yuan for his firm. In return, the township took over nominal control of the firm and assigned an official, Pan Ning, to be the general manager. The loan was quickly repaid to the township, but the firm remained registered as a collective TVE.

The point of the story is that Kelon would have been registered as a straightforward private business in any market economy. But China at that time did not have a legal framework to accommodate a private enterprise the size of Kelon and a firm operating in what was viewed then as a modern industry.[27] Township and village governments assumed controls of these firms as a matter of political prerogative rather than on the basis of their share of capital contributions. The logic of township control had nothing to do with economics; it was deeply political.

Stiglitz was correct that Kelon performed impressively. The firm won market shares not only from state-owned refrigerator producers (e.g., Snowflakes in Beijing) but also held its own against Whirlpool, the huge US home appliance company. In 1997, Whirlpool announced that it would exit the China market after having lost some 100 million dollars there.[28] The reason for Kelon's success is precisely because Rongqi township understood the private origins of this firm and for a long period of time it entrusted the control rights of the firm to its private founders. The first group of employees of this firm was later given the title of founders and they stayed on as top managers from 1984 to 2000, an usually long tenure in a country where the average tenure at a SOE was 5.5 years.[29] As an implicit acknowledgment of the private origins of this firm, the Rongqi township yielded 20 percent of the shares of the firm to the founders and employees in 1992.

But, the entire arrangement that gave rise to the private control rights of Kelon was completely tacit and without any legal foundation. Kelon prospered as long as Rongqi township was benevolent, but this benevolence was not to last forever. In December 1998, Rongqi township, without any advance warning, announced the resignation of Pan Ning. In effect, Rongqi chose to exercise its legal control right over Kelon and abruptly dismissed the entrepreneur who had single-handedly created the Kelon miracle. The background to this decision remains murky to this day. But, apparently, Pan had resisted an order by Rongqi to take over a loss-making air-conditioner firm, Huabao, and might have provoked the township that was eager to shed a poorly performing asset.[30]

The exercise of legal control rights by Rongqi was the beginning of the rapid demise of Kelon. In 2000, Rongqi township replaced all the founding members of the firm. The head of Rongqi township was dispatched to run the firm and he promptly implemented strategic changes that proved to be destructive. Kelon departed from its previous core competence of producing energy-efficient refrigerators and embarked on fanciful and ultimately unfruitful ventures, such as home appliances with artificial intelligence, driverless vehicles, home security, and educational software for online research. None of these turned into anything useful (Huang and Lane 2002).

Even more troubling is that there might have been a massive plundering of Kelon's assets by the state-owned holding company under Rongqi. Kelon, which issued shares on the Hong Kong Stock Exchange and the Shenzhen Stock Exchange, was itself majority controlled by a state-owned holding company 100 percent owned by Rongqi township. Between 1984 and 1998, Pan Ning had built up a formidable Kelon brand and, by the late 1990s, Kelon controlled 25 percent of the world's second-largest refrigerator market. One estimate put the worth of the Kelon brand at 5.5 billion yuan (Leung 1999). But neither Pan nor Kelon itself owned the Kelon brand. The Kelon brand was registered with Kelon's state-owned holding company. That all the business value was located in Kelon but all the corporate control was located in the state-owned holding company created an opportunity to expropriate Kelon's assets. As soon as Pan Ning exited the scene, Kelon suddenly began to record massive payables to its holding company (most likely due to engaging in overpriced related transactions). Net cash flows plunged from a positive 804 million yuan in 1998 to a negative 545 million yuan in 1999. In an interview years later, a former consultant working at Kelon during this period made an oblique reference, "I could turn a bad thing such as losses into a good thing and I could turn a bad thing such as frequent management changes into a good thing. But I was not able to turn a bad thing such as the stealing of money into a good thing" (quoted in Wu Xiaobo 2007, p. 43).

The bleeding continued until 2002 when a little-known Hong Kong–listed firm, Greencool, acquired Kelon. This transaction would begin another tangled saga for the firm. Amid charges of plundering state-owned assets, the head of Greencool, Gu Chujun, was arrested in 2005. In his prison cell, Gu signed the paperwork transferring Kelon to a firm based in Qingdao. In 2006, it was determined that Kelon had incurred losses of 3.7 billion yuan in 2005, it had −1.09 billion yuan in net assets, and there were 93 pending lawsuits against the firm (Wu Xiaobo 2007, pp. 56–58). An excellent business, built by Pan Ning from scrap metals into a 5.6 billion yuan refrigerator empire, was completely destroyed.

Just as in the examples of Lenovo and Huawei, it is hazardous to form a view of this firm without detailed factual knowledge. Kelon was financed by private share capital and built by smart entrepreneurs such as Pan Ning and Wang Guoduan. It succeeded as a *de facto* private firm and it collapsed almost immediately after the township decided to exercise its control right. The story of Kelon turns on its head the theory that TVEs prevented private plundering of public assets. Exactly the opposite was the case. Through the TVE mechanism, Rongqi township or its subsidiary tunneled the assets out of Kelon and robbed what ought to have belonged to Pan Ning and the other founders. (After he left Kelon, Pan, who now lives in Canada, would visit Rongqi only once every year to sweep his ancestors' tomb. He has never visited or talked about Kelon.) Stiglitz's high praise of the township government is miles away from Pan Ning's own view. In a private conversation with a Peking University professor, Pan Ning remarked that he never had to cultivate ties with government officials in Hong Kong so he devoted 100 percent of his time to marketing and management. In China, he was resigned to an untold amount of obligatory time with the government (Wu Xiaobo 2007, p. 58).

The story of Kelon suggests that we need to examine the entire TVE phenomenon carefully rather than accepting the received wisdom among Western economists. Because the TVEs drove much of China's economic dynamism in the 1980s and the early 1990s, an understanding of the true ownership nature of the TVEs entails important analytical implications for how we interpret the role of the private sector in China's growth experience. Many have hailed the TVEs as a tremendous public-sector success story.[31] I show in this chapter that this is far from the case. The TVE story can plausibly be shown to be a substantial private-sector success story.

Understanding the real ownership nature of the TVEs also helps us interpret the policy developments in the 1990s. In the 1990s, the TVEs began to fail. Conventional wisdom holds that the TVEs failed because their public-sector ownership became a liability in the more competitive environment of the 1990s. Thus, their failure in the 1990s was taken as a sign that the Chinese reforms were working. I again disagree. Chapter 3 details the facts and the argument, but suffice it to mention here that in the 1990s the TVEs were almost completely private. The very reason for their failure is that the business environment for rural entrepreneurship turned dramatically adverse in the 1990s. The successes of the TVEs in the 1980s and their failures in the 1990s reflect not firm characteristics but rather policy differences between the two decades. This is the tale of the two decades.

As Professor Stiglitz's writings and views on TVEs show, the TVE phenomenon has powerfully shaped Western economists' interpretation of China's growth experience. In the following paragraphs, let me first summarize how TVEs are commonly portrayed by Western economists. I then present documentary evidence – based on a close reading of numerous government reports and data going back to the early 1980s – that shows that this view of TVEs bears very little resemblance to the real TVE phenomenon.

2.1 What Is a TVE?

Many China economists and other social scientists believe that TVEs have a distinct ownership structure. This consensus view is summarized by Naughton (2007, p. 271) in his textbook on Chinese economy: "TVEs had a special distinction during this period [1978–1996] because of their unusual ownership and corporate governance setup. Originating under the rural communes, most TVEs were collectively-owned. . . . " This view is widely accepted by other scholars.[32]

This special feature of TVEs, according to Roland (2000), poses a challenge to researchers because, given their public ownership, they are not supposed to perform well. The strong theoretical priors of mainstream economists are that private ownership rights motivate entrepreneurs to invest and to take risks. The lack of this incentive device as embedded in a public ownership structure is why the TVE phenomenon was so puzzling.

Elaborate theories – some backed up by mathematically derived formal proofs – have been proposed to explain the performance of TVEs as public-sector businesses. One prominent theoretical strand models TVEs as an efficient substitute in a weak environment.[33] In particular, the public ownership of TVEs is supposed to perform two economically useful functions. One is that it aligns the interests of the central government with those of the local governments.[34] The second function of TVEs, supposedly, is that they are an effective mechanism to prevent private stealing of public assets (Stiglitz 2006). Roland (2000, p. 282) hails this explanation of TVEs as an important application of the path-breaking work in economics on the incomplete contracting framework. This is high praise indeed. The TVE research not only enhances our understanding of China, but it may also represent an advance in economic theory.

All of these theoretical conceptualizations about TVEs are predicated on one empirical detail – that TVEs are public. Let me step back and ask a question that economists should have asked before they began to model: Are the TVEs really public?

The TVE label owes its origins to the commune and brigade enterprises created during the Great Leap Forward. In part because of this lineage, some Western scholars came to believe that the Great Leap Forward laid the foundation for the TVEs in the 1980s.[35] This is not really the case. In 1978, there were only about 1.5 million commune and brigade enterprises (Zhang Yi 1990, p. 25), but by 1985, there were already 12 million businesses labeled as TVEs (Ministry of Agriculture 2003). Clearly, the vast majority of TVEs had nothing to do with the Great Leap Forward. As a product of the reforms, they were completely new entrants during the first half of the 1980s. This is an important observation because the supposed Great Leap Forward lineage of the TVEs implicitly reinforced the view that the TVEs were a collective institution.

The term *TVE* first appeared in a policy document issued by the State Council on March 1, 1984. (There is a semantic issue involving the term. The details need not detain us here except to note that the English usage of the term is actually quite different from its Chinese usage. The English term lumps together two very different types of rural firm. I provide an explanation of this issue in the Appendix.) The full title of this document is "Report on creating a new situation for commune and brigade enterprises." The document coined the term *TVE*. This coinage was to replace the previous term, "commune and brigade enterprise." The new term was necessary, as this historic document pointed out, because many new forms of rural businesses had arisen in the first half of the 1980s. This was not just a semantic change. The label, "commune and brigade enterprise," was used to refer to the collective rural firms from the Great Leap Forward era. But, only a few years into the reform era, a large number of private businesses entered into China's rural corporate landscape. This raised two complications. First, the TVEs began to compete with SOEs on the product and factor markets, which created a sense of unease on the part of planning bureaucrats. The 1984 document was to affirm the high-level political support for the new entrants.

The second complication is that the old label was no longer accurate. So, the 1984 document dropped the old label of commune and brigade enterprises and provided a concise working definition of TVEs. The second paragraph of the document – known famously in China as document No. 4 – defined TVEs as follows (Ministry of Agriculture 1985, p. 450): "TVEs include enterprises sponsored by townships and villages, the alliance enterprises formed by peasants, other alliance enterprises and individual enterprises."[36]

Enterprises sponsored by townships and villages are the collective TVEs, the kind the Western economists assume to represent the entire TVE sector. The rest of the firms under the TVE label are all private businesses or entities. Individual enterprises refer to household businesses that typically have fewer than seven employees. The alliance enterprises – in Chinese, *lianying* – are a 1980s euphemism referring to larger private-sector enterprises. These are private-sector firms with multiple investors and with more than seven employees. In the official documents adopted in the late 1980s, references to alliance enterprises were gradually replaced by the term *private-run enterprises*, *siying qiye*, after a major 1987 Politburo document began to explicitly use the term *private-sector firms* (Editorial Committee of TVE Yearbook 1989a, p. 138). (*Siying qiye* is the standard term for large private-sector firms employing seven or more employees.)

Let me stress that the private TVEs discussed here are not "red-hat" firms. Red-hat firms are typically those very large private-sector firms that are registered falsely as collective firms. Kelon is a classic example. When it began operations, it recruited 4,000 workers. Even though there was more employment flexibility than suggested by the seven-employee rule, in the 1980s it would have been difficult to register a firm with thousands of workers explicitly as a private-sector firm. The private TVEs were fully private and their private ownership identity was fully known to the government. The issue here is one of definition: The official definition and the official data include both TVEs controlled by townships and villages and TVEs controlled by private entrepreneurs.

Let me quote from Chinese officials, policy documents, and references to show that the official definition of TVEs has been remarkably consistent in its inclusion of private businesses. The following excerpts are extensive and detailed because I want to illustrate just how consistent this definition is across different and multiple sources and to underscore the authenticity of the TVE definition inclusive of rural private-sector businesses. Excerpts follow:

- Wan Li, the reformist vice premier in charge of agriculture in the 1980s, criticized those officials whom he said had "an incomplete understanding of TVEs." Following is an excerpt from a speech he gave in 1984: "[Some officials] only include the original collectively-owned enterprises of townships and villages started by the masses as TVEs, but do not include those businesses later established by peasants on their own or those alliance enterprises financed from pooled capital as TVEs. [They] even discriminate against them. This is not correct."[37]
- An official from the Ministry of Agriculture provides the following assessment, "In the 1980s, Chinese peasants finally broke free from the long-standing straitjacket that restricted enterprise sponsorship at two levels (township and village).... Their own alliance enterprises and household businesses sprung up like mushrooms and they became an important part of the TVEs" (Editorial Committee of TVE Yearbook 1989b, p. 29).
- A manual prepared by the Shanxi TVE Management Bureau (1985, p. 1) defines a TVE as follows, "[A TVE] belongs to collective ownership *or* individual ownership" (italics added by the author for emphasis).

- A 1989 Ministry of Agriculture report to the State Council summarizing the state of TVE development: "Nowadays a large portion of TVEs comprises individual businesses and alliance enterprises. . . . Currently, individual businesses and alliance enterprises account for a large share of the TVEs in the northwest, southwest, and other economically backward regions" (Editorial Committee of TVE Yearbook 1990, p. 4).
- A 1987 document by the Agricultural Bank of China instructing its regional branches not only to lend to enterprises at the township and village level but also to pay attention to alliance enterprises and household businesses in their TVE loan programs (Editorial Committee of TVE Yearbook 1989b, p. 524).
- The following is from a report by the Ministry of Agriculture: "In 1996, the total profits of TVEs amounted to 388.6 billion yuan, an increase of 63.5 billion from the year before and a growth rate of 19.53 percent. Of this amount, 173.1 billion yuan was in the collective *xiangcun* [township and village] enterprises" (Ministry of Agriculture 1997, p. 3).
- This is how an analysis in the *China TVE Yearbook (1978–1987)* portrays the TVEs: "Compared with an SOE, a TVE has the following characteristics. First, it is a collective-ownership and individual-ownership enterprise with a lot of autonomy and able to make decisions concerning its own fate" (Editorial Committee of TVE Yearbook 1989b, p. 3).

Because the default definition of TVEs automatically covers rural private businesses as well as collective TVEs and because there are policies that treat collective and private firms differently, some of the official documents and regulations always delineate their applicable scope. This is another way to illustrate the same point – that the Chinese TVE definition and, therefore, the TVE data incorporate private-sector activities in rural China. Consider the following examples:

- Compare the 1990 "PRC Township and Village Collective Enterprise Regulation" with the 1997 "PRC Township and Village Enterprise Law."[38] Provision 2 of the 1990 law, which specifically covers collective TVEs, states that the law only applies to "rural enterprises sponsored by townships and villages." However, the 1997 law, which is meant for all TVEs, defines its applicable scope as "rural collective enterprises or enterprises with the main investments by peasants located in townships and villages."

- In 1986, the Ministry of Finance and Ministry of Agriculture promulgated a "TVE Accounting Regulation." It was designed only for collective TVEs, not for private TVEs. Thus, Provision 2 of the regulation states that regulations for rural alliance enterprises and household businesses "will be promulgated separately" (Editorial Committee of TVE Yearbook 1989b, p. 513).
- As a way of contrast with the previous, the TVE labor and TVE health regulations cover both collective and private TVEs. Provision 2 of each of these two regulations stipulates its applicable scope as "all" TVEs (Editorial Committee of TVE Yearbook 1989b, pp. 530–532).
- Mindful of the ownership differences between collective and private TVEs, the Chinese state adopted different profit-retention regulations for these two types of TVEs. For collective TVEs, the regulations are quite specific and stringent. For example, 60 percent of the after-tax profits of the collective TVEs cannot be distributed as dividends and must be retained by the enterprise (Editorial Committee of TVE Yearbook 1990, p. 12). In comparison, a 1988 policy document on private TVEs does not specify a profit-retention target even though it states a preference for profit reinvestments by these firms (Editorial Committee of TVE Yearbook 1989a, p. 139).

2.2 How Large Were Private TVEs?

TVEs, as used by the Chinese, are a *locational* concept – enterprises *located* in the townships and villages. Western economists, on the other hand, understand the term from an ownership perspective – that they are *owned* by townships and villages. This huge gulf between the two understandings of TVEs has contributed to massive confusion in writings about TVEs.

There is confusion even about some basic facts; for example, how many TVEs there were. Brandt, Li, and Roberts (2005, p. 524) remark that by the early 1990s, "there were more than 1.25 million of these local government-owned and run enterprises, employing 135.1 million individuals. . . . " The data the three economists refer to are for 1996. In that year, there were actually 23.4 million TVEs, of which 1.5 million were collective. (The 1.25 million figure cited by the three economists apparently refers to collective TVEs at the village level only.) It was the *entire* TVE sector of 23.4 million firms that employed 135.1 million individuals. The collective TVEs employed only 59.5 million individuals.[39]

In terms of establishments, the overwhelming majority of TVEs, even at the early stage of the reforms, were actually private TVEs. In 1985, according to Ministry of Agriculture data, there were more than 12 million TVEs, of which 10.5 million were private. (A careful and well-versed reader may point out that the data from the Ministry of Agriculture reported here seem to be different from the data reported by the NBS. There is no inconsistency, but the two data series are organized differently. I explain this in the Appendix.) In addition, a huge portion of the collective TVEs were concentrated in a few rich, coastal provinces. In many other provinces, the private TVEs completely dominated the TVE pool.[40]

In this section, I present the data on TVEs according to the Chinese definition. One effect of the No. 4 document is that it changed the statistical reporting procedure by the Ministry of Agriculture,[41] the agency in charge of collecting and reporting on TVE data. The Ministry of Agriculture began to consolidate all the rural firms under the category of TVEs in its statistical reporting starting in 1985. The Ministry of Agriculture data provide detailed ownership breakdowns of the TVEs: (1) collective TVEs, (2) privately run TVEs, and (3) self-employment household businesses. The data on the ownership composition of TVEs in terms of establishments and employment from 1985 to 2002 are presented in Table 2.1.

Even a casual glance at Table 2.1 reveals that private TVEs absolutely dominated the total pool of TVEs. The highest number of collective TVEs in 1986 is 1.73 million. In contrast, the lowest number of household TVEs in 1985 is 10.1 million. It is true that before the mid-1990s, there were more collective TVEs than private-run TVEs. In the four years between 1985 and 1988, the number of private-run TVEs more than doubled, from 530,000 in 1985 to 1.2 million in 1988, whereas there was almost no change in the number of collective TVEs (from 1.57 million in 1985 to 1.59 million in 1988). In 1988, the collective TVEs outnumbered the private-run TVEs by only 300,000. In subsequent years, the number of private-run TVEs would decline, due to the Tiananmen effect. Without the 1989 Tiananmen interlude, the private-run TVEs would have surpassed the collective TVEs within three to four years.

Stiglitz (2006), for example, believes that the rise of TVEs challenges the standard claims of economics. He explains: "Many of the new enterprises were created in the 1980s and early 1990s by township and village enterprises (TVEs). These were public enterprises and the standard ideology would have said that you cannot succeed with public enterprises; but they were enormously successful." His assessment is not even remotely close to reality. In 1985, there were 1.57 million collective TVEs; by 1996, as pointed out before, the number of collective TVEs was still 1.5 million. But, during this period, the total number of TVEs increased from 12 million in 1985 to

Table 2.1. *Ownership composition of TVEs, 1985–2002*

	Number of TVEs, Million Units				Employment in TVEs, Million Persons			
			Private TVEs				Private TVEs	
Year	Total	Collective TVEs	Private-run	Household Businesses	Total	Collective TVEs	Private-run	Household Businesses
1985	12.2	1.57	0.53	10.1	69.8	41.5	4.75	23.5
1986	15.2	1.73	1.09	12.3	79.4	45.4	8.34	25.6
1987	17.5	1.58	1.19	14.7	88.1	47.2	9.23	31.6
1988	18.9	1.59	1.20	16.1	95.5	48.9	9.77	36.8
1989	18.7	1.53	1.07	16.1	93.7	47.2	8.84	37.6
1990	18.7	1.45	0.98	16.3	92.7	45.9	8.14	38.6
1991	19.1	1.44	0.85	16.8	96.1	47.7	7.27	41.2
1992	20.9	1.53	0.90	18.5	106.3	51.8	7.71	46.8
1993	24.5	1.69	1.04	21.8	123.5	57.7	9.14	56.6
1994	24.9	1.64	0.79	22.5	120.2	58.9	7.3	53.9
1995	22.0	1.62	0.96	19.4	128.6	60.6	8.74	59.3
1996	23.4	1.55	2.26	19.6	135.1	59.5	24.6	50.9
1997	20.1	1.29	2.33	16.5	130.5	53.2	26.3	51.0
1998	20.0	1.07	2.22	16.8	125.4	48.3	26.2	50.9
1999	20.7	0.94	2.08	17.7	127.1	43.7	28.5	54.8
2000	20.9	0.8	2.06	18.0	128.2	38.3	32.5	57.3
2001	21.2	0.67	2.01	18.5	130.9	33.7	36.9	60.2
2002	21.3	0.73	2.3	18.3	132.9	38.0	35.0	59.8

Source: Data are from the Ministry of Agriculture (2003).

23.4 million in 1996. Assuming that the entry and exit rates of collective and private TVEs were similar, *every single new entrant during the reform era was a private firm.*

However, as both Oi (1999) and Naughton (2007) stress, the private TVEs were individually smaller than the collective TVEs so their employment and output shares were smaller as well. Household businesses are single proprietorships, with a very small number of employees. Although some private-run TVEs were large, they were fewer in number. Table 2.1 illustrates this point. Employment in the collective TVEs was larger than employment in the private TVEs. In 1985, the collective TVEs employed 41.5 million people as compared with 4.75 million in the private-run TVEs and 23.5 million in household businesses.

There is nothing surprising or unusual about the statically large collective sector. Collective TVEs were founded in the late 1950s and had more than 20 years of development. Private TVEs were a result of rural reforms and began only in the early 1980s. Despite their statically small size, the dynamism was on their side, not on the side of the collective TVEs. Private TVEs were growing rapidly to claim an ever larger share of employment. In 1989, private TVEs accounted for 49 percent of employment, and in 1990, they accounted for 50 percent. In 1989, the private TVEs claimed 58 percent of the after-tax profits and 45 percent of the total wage bill of all TVEs. By the end of the 1980s and just within a single decade of reform, the private TVEs were on the verge of overtaking the collective TVEs across a number of dimensions. The static advantage of the collective TVEs quickly eroded as private TVEs accumulated growth momentum. From a dynamic perspective, the TVE miracle took place *entirely* in the private sector, not in the collective sector.

Some scholars cite the smaller share of private TVEs in industrial output value to support their view that the main source of growth came from collective TVEs. Apart from the static and dynamic stories, there is an inherent data bias in this view. As mentioned before, in the 1980s, private businesses first ventured into the service sector rather than into industry. By definition, the industry data will understate the importance of the private TVEs. By 1987, private TVEs already accounted for 32.1 percent of the gross output value in the entire TVE sector, compared with 23 percent of the industrial output value.[42] Private TVEs were still smaller than collective TVEs by the output measure, but their share was by no means insignificant as of the mid-1980s.

In fact, even the 32 percent of the output value by private TVEs understates the economic importance of private TVEs. The 32 percent is the average of the private shares of TVEs in all provinces implicitly weighted by the economic size of the provinces. This introduces a subtle bias. Private entrepreneurship and private TVEs first started in the poorer provinces, an issue I go into in greater detail next. Poorer provinces have a smaller GDP and, therefore, their economic weight is small in the calculation of the national means. The weighted average shares of private TVEs in the output value reflect the size of the private TVEs but also reflect the size of the provincial economies. Private TVEs would necessarily thus appear small simply because they were clustered in the poorer provinces.

The weighted average figure is the correct statistical measure of private TVEs, but it may not be the correct economic measure. Private TVEs were sizeable in the poor provinces and, if so, we need to know how big they were in those provinces. Because the poor provinces lacked many alternatives as compared with the rich provinces, it is important to examine the role of private TVEs in those provinces. The unweighted average of the private

TVEs' share of gross output value in 1987 is 40 percent, 8 percent higher than the weighted average. This is because the poorer and smaller provinces in the 1980s had a larger private sector.

Table 2.2 presents the percentage of private TVEs in the gross output value of the entire TVE sector across all 29 provinces in China. In addition, the table presents provincial data on per capita GDP, provincial shares of China's GDP, and percentage shares of agricultural population in the provincial population. The data refer to 1987. The table arrays the provinces from high to low according to their shares of private TVEs in the provincial gross output value. The highest share is Hebei, at 70.4 percent; the lowest share is Shanghai, at 6 percent. This is an extraordinary range. At the bottom of the private TVE output shares, three out of the five provinces are cities – Shanghai, Beijing, and Tianjin. The other side of the argument that capitalism is rural in origin is that socialism is urban in China. Another interesting finding is that the province that became a private-sector success story in the 1990s, Zhejiang, in fact had a fairly small private TVE sector in 1987. Its output share of private TVEs was only a bit larger than that of Jiangsu: 16.3 percent in Zhejiang compared with 10.7 percent in Jiangsu. The basic difference between Zhejiang and Jiangsu is that Zhejiang continued with the 1980s' model of incremental and spontaneous private-sector development in the rural areas, whereas in the 1990s, Jiangsu adopted the urban-centric development model.

As of 1987, private TVEs already contributed more than 50 percent of the TVE output in eight provinces. In another 15 provinces, private TVEs accounted for between 30 and 50 percent of the output value. Although we do not have data, in the late 1970s, the private share would have been close to zero. This is indicative of the rapid private-sector development in the 1980s. Within only eight years of the reform era, private TVEs already produced the majority of the rural output in one third of the Chinese provinces and accounted for a sizeable share of the rural output in another half of the Chinese provinces. It is difficult to reconcile this finding with the view that the TVE miracle occurred exclusively in the public-sector domain.

2.3 Virtuous Capitalism

Although it is seldom cited by academic economists writing about TVEs, by far the best study of TVEs in the English language is *China's Rural Industry*, a collaborative research project between World Bank economists and Chinese researchers from the Chinese Academy of Social Sciences (referred to

Table 2.2. *Geographic and economic distributions of private TVEs, 1987*

Province	% of Private TVEs in Gross Output Value	Per Capita GDP (Yuan)	Provincial Share of China's GDP	% of Agricultural Population
Hebei	70.4	921	4.56	85.8
Guizhou	63.9	546	1.45	87.8
Henan	61.3	755.8	5.32	88.2
Guangxi	57.7	607	2.11	87.3
Ningxia	56.3	922	0.35	77.7
Neimenggu	55.9	1025	1.85	70.5
Jilin	52.8	1269	2.60	62.2
Anhui	51.9	842	3.86	85.2
Shaanxi	49.3	796	2.09	81.9
Xizang	48.0	863	0.15	86.1
Heilongjiang	47.3	1335	3.97	58.6
Qinghai	46.9	1018	0.38	70.9
Xinjiang	45.1	1053	1.30	55.2
Sichuan	43.0	721	6.52	85.5
Fujian	41.5	1004	2.44	83.3
Gansu	41.4	764	1.39	84.0
Jiangxi	40.7	729	2.30	81.9
Shanxi	37.8	962	2.25	78.7
Hunan	36.2	818	4.10	85.4
Liaoning	36.0	1917	6.28	58.9
Hubei	34.0	1031	4.52	78.0
Guangdong	33.0	1383	7.05	77.5
Yunnan	31.1	653	2.00	88.1
Shandong	23.2	1131	7.79	86.0
Zhejiang	16.3	1470	5.27	83.8
Tianjin	12.2	2682	1.92	45.1
Beijing	10.9	3338	2.85	39.2
Jiangsu	10.7	1462	8.05	81.5
Shanghai	6.0	4396	4.76	34.2
Average of all provinces	40.0	1256	3.4	74.8
Average of top 10	56.8	855	2.4	81.3
Average of bottom 10	21.4	1946	5.1	67.2
Two-way correlation with private TVE shares	n/a	−0.71	−0.39	0.49

Source: The calculation is based on the data provided by the Ministry of Agriculture (2003).

hereafter as the World Bank TVE study).[43] A key insight from the World Bank TVE study is that collective ownership of TVEs prevailed in a few rich regions of the country whereas private TVEs tended to be dominant in the poorer regions.

This is in part because the poor regions lacked a viable collective alternative and in part because the poorer regions by definition were also more rural. Herein is the connection with the rural origins of Chinese capitalism: More rural regions had a stronger version of residual capitalism. For example, in Jieshou, one of the poorer research sites in the World Bank TVE study, 73 percent of the TVEs were private, despite their TVE designation (Luo 1990, p. 147). As was true elsewhere in the country, private TVEs were individually smaller so their employment share was smaller, at 49.4 percent of the TVE workforce, but still a substantial size.

The aggregate data presented in Table 2.2 corroborate exactly the findings in the World Bank TVE study. The bottom rows of Table 2.2 present summary statistics. The average of the 10 provinces with the largest shares of private TVEs is 56.8 percent, compared with 21.4 percent for the bottom 10 provinces. The 10 provinces with the largest shares of private TVE output were substantially poorer and much more agricultural as compared with those 10 provinces with the smallest shares of private TVE output. The average per capita GDP among the top 10 provinces was 855 yuan in 1987, compared with 1,946 yuan among the bottom 10 provinces.

The provinces in the top 10 also had a smaller GDP, less than half of those of the bottom 10 provinces. They were far more agricultural. The agricultural population accounted for 81.3 percent among the top 10 provinces but only 67.2 percent among the bottom 10 provinces. The last row of the table presents simple two-way correlation statistics between the percentage shares of private TVEs and the various other indicators. The private TVEs are negatively correlated with per capita GDP and with the provincial shares of Chinese GDP and positively correlated with the agricultural share of the population.

These are specific illustrations of a central point in this book – Chinese capitalism is an overwhelmingly rural affair. A related point is that Chinese capitalism – *in the 1980s* – was also a poor man's affair. As the case of Mr. Nian shows, poor people and poor provinces went into the rural entrepreneurship in the 1980s. This is one of the most remarkable and under-rated attributes of rural entrepreneurship in the 1980s. Capitalism in the 1980s was not only vibrant, it was also virtuous. Rural entrepreneurship was one of the few feasible mechanisms to transition out of low value-added agriculture and to move beyond the abject poverty. In this sense, it is much more meaningful to study the development of private TVEs in poor regions of China than to study the development of collective TVEs in the rich regions of the country heavily researched by Western academics, such as Jiangsu and Shandong. The policy implications are far more significant.

Private TVEs also affected a large number of Chinese people. As mentioned before, in 1987 there were nine provinces in which private TVEs accounted for more than 50 percent of output in the TVE sector and another 15 provinces in which they accounted for between 30 and 50 percent of TVE output. Those nine provinces were home to 260.2 million rural Chinese (30 percent of China's rural population); the additional 15 provinces accounted for another 427.8 million rural Chinese and 49.7 percent of the rural population.

This book examines Guizhou at close range. Completely land-locked Guizhou is China's poorest province. Yet, it had many private TVEs. Table 2.2 shows that Guizhou had the second highest private TVE output share in the country, at 63.9 percent in 1987. Guizhou managed to have doubled this share in just three years. In 1984, the private TVEs accounted for 31 percent of the output value in the TVE sector in Guizhou. (In the 1990s, as I show in the next chapter, the private TVEs in Guizhou, relative to the collective TVEs, stagnated.)

By contrast, the richer provinces had far smaller private TVEs. In 1984, Jiangsu, a rich, coastal province, had only 4 percent of the private TVE output value (Zhang Yi 1990, p. 192 and p. 200) and in 1987, the share was 10.7 percent (see Table 2.2). The per capita GDP in Jiangsu was 1,462 yuan in 1987, almost three times that of Guizhou (546 yuan). Another example can be found in Shandong province, also a coastal and relatively well-off province (per capita GDP in 1987 was 1,131 yuan). Shandong also had a much smaller private TVE sector. As shown in Table 2.2, Shandong's private TVEs contributed to 23.2 percent of TVE output value. According to a survey of 84 villages in Shandong, in 1988, township-level enterprises dominated the pool of TVEs across the board – in terms of number of business establishments, employment, size, and so on. There were 350 TVEs among these villages, 283 of which were at the township level. These township-level firms accounted for the vast majority of employment and the stock of fixed assets.[44]

This contrast between Guizhou on the one hand and Jiangsu and Shandong on the other is deeply meaningful. In general, the developed parts of China – such as its urban centers and industrialized provinces – were more state-owned. The under-developed and agricultural parts of the country were more privately owned. If we accept the premise that welfare gains of GDP growth are greater in poor regions than in rich regions, then it is not so much the aggregate size of private TVEs at the national level that is of first-order importance. Rather, it is the size of private TVEs in poor provinces to which we should pay special attention. Private TVEs, more than collective

TVEs, contributed to Guizhou's fast growth in the 1980s. Between 1981 and 1984, Guizhou's per capita GDP grew at a real double-digit rate. In other years of the 1980s, the per capita annual GDP growth was consistently around 7 or 8 percent (NBS 1996, p. 731). This is the true China miracle.

3 "Nothing but Revolutionary Reforms"

I remember that it was in 1978. There was an article in People's Daily about raising cows. I got so excited upon reading it. During the Cultural Revolution, every newspaper article was about revolution and class struggle, non-stop, only editorials. At that time, raising chickens or growing vegetables were viewed as capitalist tails to be cut. Now the People's Daily has an article about raising cows. Things have definitely changed.

– Liu Chuanzhi, founder of Lenovo, in 1998[45]

Recall the puzzle I posed in Chapter 1 – how the pronouncement by a completely unconstrained state to honor its commitments to reforms could have been viewed as credible. The quote from Liu Chuanzhi, the founder of Lenovo, provides a clue. His statement helps establish the appropriate baseline benchmark against which we should assess the policy changes in the 1980s. What would strike anyone in the West as utterly mundane and inconsequential – raising cows – was a signal of deep significance to Mr. Liu. The baseline benchmark in Mr. Liu's mind was "revolution and class struggle." Against this benchmark, publicity about raising cows in the *People's Daily* signaled a monumental change in policy. Deng Xiaoping would agree with Mr. Liu. The title of this section is a quote from a speech by Deng Xiaoping in 1984, "The rural reforms that were carried out in the past few years are nothing but revolutionary reforms."[46]

Chinese economic policies – and its politics – in the early 1980s were a world apart from the standard prescriptions of neoclassical economics. Land was not private, prices were controlled, and the state chose not to privatize SOEs. In a famous paper, Hausmann, Pritchett, and Rodrik (2004) put forward the thesis that the initial triggers of growth can often be "humble" in nature. These reforms amount to nothing more than some relaxation of existing constraints on the private sector. No fundamental institutional reforms – those aiming at property rights protection, for example – are needed. Deng's agricultural reforms, according to these authors, fit with this model.

The Chinese themselves – including Deng and Liu – did not see the agricultural reforms as "humble" at all. The reason for the different perspectives is simple: The baselines are different. To Hausmann, Pritchett, and Rodrik, the baseline is the "Washington Consensus" – the famous template of the necessary conditions for economic growth, ranging from macroeconomic stability to private ownership. China in the 1980s – or China now – looks quite different from the Washington Consensus. But to Deng and Liu, the baseline is China of the 1970s during the radical leftist period of the Cultural Revolution. Relative to the Cultural Revolution, the bubbling rural entrepreneurship, the crowded rural market fairs, and the demise of the commune system represented a remarkable departure from the *status quo ante*. This is the essence of directional liberalism.

It is extremely important to make explicit this huge difference in perspectives for it helps us to identify the sources of Chinese incentives. One reason why standard economic analysis emphasizes the importance of the sanctity of property rights for economic growth has to do with incentives. Economic agents need to be confident that their future gains will be safe in order for them to be motivated to expend efforts and capital today. The security of property rights is an incentive device. It is here that the standard economic analysis finds China puzzling. This is a country without the conventional sources of property rights security, such as a constrained government, an independent judiciary, free media, and political power for the propertied class. Where, then, is the incentive for economic growth in this system?

Deng's perspective provides the answer. Property rights protection in China, now or in the 1980s, is very poor, but *relative to the Cultural Revolution period*, the marginal improvement was huge. Directional liberalism, not an exact match with the Washington Consensus, was the relevant modus operandi and was the source of Chinese incentive to go into entrepreneurship. To illustrate the size of the marginal change from the pre-reform order, keep in mind that an average commune – the decision maker before reforms – was 5,000 households (World Bank 1983, p. 30).[47] Within just a few years after the reforms, it was replaced by a system based on household production. It is difficult to exaggerate both the incentive and economic effects of such a change.

The rapidity with which the household responsibility system (HRS) was adopted illustrates Deng's perspective on rural reforms. In September 1980, only three provincial Party secretaries supported the HRS (Rural Economy Research Team 1998). On the basis of this rather fragile political support, the HRS spread extremely rapidly. According to Naughton (1996, p. 141), at the end of 1979, only 1 percent of rural households had adopted the HRS; by the end of 1982, the percentage had increased to 80 percent. In another two years, in 1984, the percentage share of participating households reached 99 percent.

More recent Chinese estimates provide an even faster rate of adoption: 90 percent by early 1982, according to the Rural Economy Research Team (1998). Rural households claimed a rapidly rising share of production assets. By 1983, just four years after the reforms, 53 percent of plowing equipment and animals and 58 percent of vehicles were privately owned. In 1982, the private purchase of tractors reached 1 million units, equivalent to one third of the existing stock of tractors at that time.[48] It was this type of changes that convinced entrepreneurs such as Lenovo's Liu Chuanzhi to leave the comfort of this job as a scientist and to venture into entrepreneurship. The incentive effect came from how far China departed from the Cultural Revolution of the 1970s, not from the proximity of China to the textbook version of Western economic and political institutions.

Recall from Chapter 1 that private fixed-asset investments (FAIs) grew rapidly in the 1980s. In this section, I provide a direct description of the policy developments that matched the fixed-asset investment data. If directional liberalism is the mechanism that motivated Chinese entrepreneurs, then asking whether China fits with the Washington Consensus is the wrong framing. The right framing is to ask whether China was moving in the right direction and, if so, by how much. Even more precisely, the right way to frame the discussion is to ask how far and at which speed China was moving from the rigid central planning – or a sort of Moscow Consensus, if you will. Within only a few years into the reform era, personal security was enhanced, microeconomic flexibility was increased, and individual incentives were augmented. Furthermore, these achievements were a result of a consistent, deliberate, and progressively liberal policy framework.

3.1 Moving Away from the Status Quo Ante

The reforms in China are often described as having occurred during the post-Mao era. Strictly speaking, this is incorrect. The reforms occurred in post-Hua China. Hua Guofeng was a faithful Maoist and he relinquished his power only in 1978. The reformist leadership established full control of the economic agenda at the historic Third Plenum of the Eleventh Party Congress concluded on December 22, 1978. The two strongest advocates of the rural reforms, Zhao Ziyang and Wan Li, were appointed premier and vice premier, respectively, in 1980. (Sichuan and Anhui, led by Zhao and Wan, respectively, had led the country in the pioneering agricultural reforms in the late 1970s.) It took China just six years between 1979 and 1985 to create a policy environment sufficiently liberal that a rural private sector with 10.5 million businesses strong, with 40 percent nonagricultural employment, had emerged. China may not have embraced the Washington Consensus, but it moved away from the Moscow Consensus at a rapid and purposeful speed.

Some China scholars believe that this development occurred spontaneously without much prodding from the government (Zhou 1996). This is not entirely wrong, but it is incomplete. Even if some of the specific initial reforms were spontaneous, they occurred against the backdrop of a relatively flexible political environment. The most famous example of spontaneous reforms is the household responsibility system. The HRS was not launched by the Chinese leadership from the top down but instead by a group of farmers in the poor village of Xiaogang in Anhui province. According to many accounts, farmers from 18 households in Xiaogang village secretly adopted the HRS on their own at a meeting in December 1978. They entered into a pledge – apparently written in blood – that they would contribute toward the costs of raising the children of the leaders of the reforms if the ringleaders were to be arrested.[49]

But, this action did not take place in a vacuum. The timing of the event – December 1978 – is highly significant. The 18 Anhui farmers entered into this pledge during the middle of the historic Third Plenum of the Eleventh Central Committee that launched the economic reforms. We do not know if the Xiaogang farmers knew about the deliberations at the Third Plenum, but they certainly would have had access to other information that suggested an imminent departure from the orthodox Maoist policy stance of Hua Guofeng. In the second half of 1978, several significant political events preceded the Third Plenum. During the summer, there was a famous debate on "seeking truth from practice" that explicitly challenged Hua's "two-whatevers" position on Mao Zedong. (The "two-whatevers" referred to support for whatever Mao supported and opposition to whatever Mao opposed.) On November 15, 1978, after Hua had repeatedly expressed his opposition, the CCP passed a resolution declaring that the April 5 Movement – during which hundreds of thousands of Beijing residents protested against the Gang of Four and, implicitly, against Mao himself in Tiananmen Square – was legitimate. The Party secretary of Beijing, who had overseen the suppression of the April 5 Movement, was summarily dismissed.[50] If we assume that the Xiaogang farmers calculated the benefits and costs of their action, it is reasonable to argue that they might have rationally believed that the probability of the success of their action became nontrivial in late 1978.

The true implication of the action by the Xiaogang farmers is not that the policies did not matter; rather, the implication is that the policies accommodated the spontaneous actions on the ground.[51] This is a hallmark of the reform policies in the 1980s. Probably the best illustration of this policy openness is a group of five policy documents famously known in China as the five No. 1 documents. Between 1982 and 1986, at the beginning of each year, the Central Committee of the CCP issued a No. 1 policy document about the rural reforms. The label, No. 1 document, was intended to signal that the rural reforms were a top policy priority of the government. Each No. 1 document addressed the questions of private-sector development and liberalization. They did so in a progressive manner: the later No. 1 documents provided solutions to problems and issues raised in earlier ones. These No. 1 documents are the best true example of the sequential, pragmatic, and learning-by-doing reforms.

The 1982 No. 1 document, the first of such documents, addressed private-sector development only in the context of agricultural production and marketing of agricultural products. The 1983 No. 1 document began to touch on the issue of private-sector development in nonagricultural activities, such as long-distance trade, rural processing of agricultural raw materials, access of rural residents to urban markets, and so on. The 1984 No. 1 document addressed the ideologically sensitive issue of employment by private-sector businesses, land contracting, reforms of rural credit cooperatives, deepening reforms of rural supply cooperatives, and rural industrialization. The 1985 No. 1 document abolished compulsory grain purchases by the state and instituted a contract system, permitted some interest-rate flexibility among rural financial institutions, allowed private mining, and opened infrastructural construction to private participation. The 1986 No. 1 document focused on some of the social consequences of the rapid private-sector development in the previous years, such as the rising income inequalities and the persistent rural poverty in some regions.

My claim is not that all the reforms were fully implemented. Rather, the claim is that the reforms moved progressively forward. Given the ideological environment in China so soon after the end of the Cultural Revolution, some of the early reforms were path-breaking. Consider the example of share issues. Many analysts believe that the concept was introduced in the 1990s. In fact, the 1982 No. 1 document already permitted the issuance of individual shares by some public-sector institutions (Central Committee 1992 <1982>). The specific context was the reform of the rural supply cooperatives, a critical institution linking the rural economy to the urban economy by procuring agricultural products from and selling industrial products to the peasants. The 1982 No. 1 document reformed the rural supply cooperatives in two ways. One is that the higher-level cooperatives – for example, at the county level – were decentralized to the "basic level" (township and village). The other is that the basic-level cooperatives were partially privatized by issuing shares to the peasants.

Several of these No. 1 documents explicitly recognized and supported the potential role of rural residents as providers of capital and business knowledge and expertise. The 1982 No. 1 document encouraged the pooling of capital and business formation among individuals and across different geographic boundaries. The 1983 No. 1 document went one step further: It allowed the pooling of capital from individuals not just in the production stages but also in the procurement and marketing stages of the rural economy (Central Committee 1992 <1983>). The 1984 No. 1 document removed the sectoral restrictions – now, rural residents were encouraged to invest in all types of enterprises and to pool their funds to jointly set up enterprises following the principles of voluntary participation and mutual benefit. The document also pledged government protection of the investors' interests (Central Committee 1992 <1984>). The 1985 No. 1 document allowed what in essence amounted to "stock options" – issuing shares to those who contributed knowledge and expertise (Central Committee and State Council 1992 <1985>).

As I showed previously, the distribution sector claimed more than 50 percent of the rural private-sector businesses. This did not occur by chance. Service-sector reforms were launched very early on. Service-sector reforms are important because, by definition, the service sector touches on the rural–urban linkages. The essence of the service-sector reforms was to allow rural residents to directly source their industrial inputs and to directly market their products to urban residents. This was a significant move in a number of ways. One is because of the substantial rural/urban segmentation created by the *hukou* system. The other is because they allowed rural access to urban markets and thus multiplied the size of market opportunities available to rural entrepreneurs by several fold. Mr. Nian, our sunflower-seed entrepreneur from Anhui, was a direct beneficiary of these reforms because he was allowed to sell not only to consumers in Anhui but also to the much richer consumers in Shanghai and Beijing.

The 1982 No. 1 document permitted direct marketing by peasants, essentially breaking the marketing monopoly held by the rural supply cooperatives. This policy was reinforced in all subsequent No. 1 documents. In 1982, Wan Li, a senior vice premier, called for an end to the state monopoly in the distribution channels. Private entry into marketing activities was to be permitted immediately and rural supply cooperatives were to be run by their members, not by the government (Wan Li 1992 <1982>). To entice investments in the rural supply cooperatives, in 1984 the Chinese government authorized the rural supply cooperatives to issue what amounted to convertible bonds – potential rural investors could receive both a fixed-interest payment and a variable dividend payment (State System Reform Commission, Ministry of Commerce, and Ministry of Agriculture 1992 <1984>).

The service-sector liberalization was quickly followed by policies to reduce inter-regional trade. The 1983 No. 1 document endorsed private entry into long-distance trade between different rural areas as well as between rural and urban areas. "Peasants in their private capacity," the document declared, "can engage in trade. They can go into cities and leave their counties and provinces." A State Council circular issued in 1984 specifically authorized rural entrepreneurs to operate stores and service outlets in cities. The 1984 document also called for a reduction in the size of local governments in the rural areas and for instituting caps on fees and taxes levied on the peasants. The document tried to involve the local people's congresses in scrutiny of the enactment of rural fees and taxes.

3.2 Creating Policy Credibility

The reformist leaders made several moves very early on with a clear intention of signaling an improvement in property rights security. In 1979, the Chinese government returned confiscated bank deposits, bonds, gold, and private homes to those people who had been classified as "capitalists." The number of people affected by this policy was around 700,000 (Zhang Houyi and Ming Lizhi 1999, pp. 29–30). Mindful of the frequent political reversals and cycles during the Cultural Revolution, the reformist leaders went out of their way to repeatedly stress the continuity and the durability of the reforms. The wording is strong and explicit. Consider the following paragraph from a major policy document on agriculture (Central Committee 1979):

> Those policies that have proven to be effective in practice shall not be changed. Otherwise, credibility with the people will be lost and the incentives of the peasants will be undermined. At the same time, those policies that are harmful to the incentives of the peasants and to agricultural productivity must be resolutely revised and corrected . . .

The Chinese leadership sought to improve the property rights security of private entrepreneurs not through constitutional reforms but rather through enhancing the political status of the entrepreneurs. Many Western analysts believe that the political breakthrough for China's private sector occurred in 2001 with the promulgation of Jiang Zemin's "Three Representations" theory, which endorsed the idea that the CCP could recruit members from among private entrepreneurs. Again, as in so many other issues, this is simply not the case. As early as 1981, a major policy document, "Expanding channels and enlivening the economy, and solving employment problems in cities and townships," already endorsed the idea of recruiting Party members from the private sector. The policy document referred to private entrepreneurs as individual households or individual laborers, which persisted in usage in the 1990s, and called for the same political treatment for individual laborers as for workers in the state sector (Central Committee and State Council 1982 <1981>). The term *private enterprise* (*siying qiye*) first appeared in a major policy document in 1987 (Editorial Committee of TVE Yearbook 1989b, p. 518).

These developments expose another myth – that the ideological stigma against private sector came down only in the 1990s. Yes, it is true that the Chinese leadership began to tone down this ideological stigma since the mid-1990s, but much of this ideological stigma was actually revived by the leadership of the 1990s in the wake of Tiananmen events. The explicit prohibition against recruiting CCP members from the private sector was instituted in 1989, by Jiang Zemin himself. In a speech dated August 21, 1989, Jiang (1991 <1989>, p. 584) remarked, "The document of this conference said that private entrepreneurs were not allowed into the CCP. I agree with this view." (I come back to this topic in the next chapter.) The effect of Jiang Zemin's much-heralded "Three Representations" theory in 2001 was to lift the policy restriction his own leadership had instituted 12 years before.

My archival research uncovers at least five occasions when China's top leaders held public face-to-face meetings with private entrepreneurs in the 1980s. In the still rigid ideological environment of the 1980s, this gesture mattered enormously. In the first instance, in 1980, two vice premiers paid a visit and brought New Year's greetings to Ms. Liu Guixian in her restaurant. Liu was the first private entrepreneur to have been granted a private business license in Beijing (Wu Xiaobo 2006). In the second instance, in August 1983, Hu Yaobang, then CCP general secretary, attended a conference celebrating the employment achievements of collective firms and individual businesses.[52] In the third instance, Zhao Ziyang, the premier at the time, came to the founding meeting of the Association of Individual Laborers. In the fourth instance, Zhao Ziyang visited a private entrepreneur in Hubei province whose bra business was able to enter the European market.[53] In the fifth instance, on September 6, 1987, top Party and State Council officials invited 10 rural entrepreneurs to a meeting in Zhongnanhai (the official residence of the top Chinese leaders). The 10 were selected as the best rural entrepreneurs at what amounted to a business competition event organized by the Chinese Central Television station (Editorial Committee of TVE Yearbook 1989b, p. 359). In the 1990s, while it was customary for China's top leaders to attend forums with the CEOs of MNCs (e.g., the Fortune Global Forum), there is not a single documented case of top Chinese leaders attending similar functions organized by indigenous private entrepreneurs. This is so despite the fact that indigenous private businesses created employment opportunities several multiples that of the opportunities created by foreign firms.

The leaders in the 1980s sought to elevate the political status of private entrepreneurs but also they were harshly critical of the state sector. At the 1983 employment conference of the collective and private sectors, Hu Yaobang coined the term "glory project" (*guancai shiye*). He said that only business activities undertaken by the state sector were traditionally viewed positively – as "glorious" – and that activities undertaken by the private sector were automatically viewed with suspicion. To eradicate the ideological stigma of the private sector, he then went on to proclaim that the economic contributions by the private-sector were "glorious." This was in 1983.

According to a biography, in 1984, Hu Yaobang issued the following instruction in reaction to a complaint by 20 peasants from Hebei about difficulties to enter the transportation business. The tone was remarkably harsh (Chai Hongxia, Shi Bipo, and Gao Qing 1997, p. 127):

> There are two issues here. One is that some basic-level cadres and SOE managers took advantage of scarce supplies and engaged in hoarding and monopolistic practices. They jacked up prices and extorted and blackmailed the masses. The other issue is that SOE managers are incompetent and they use the name of SOEs to exclude and attack individual enterprises.

Recent revelations about internal policy deliberations during this period show that maintaining policy credibility and stability was a top concern of the Chinese leaders. Deng Liqun, the head of the Propaganda Department between 1982 and 1985 and a leading CCP theoretician, revealed some fascinating details about this period. One contentious issue at the time was employment by private-sector firms. The Party ideologues challenged the policy of permitting large-scale employment by private-sector businesses. They argued that the policy amounted to allowing exploitation of labor. When Deng Liqun proposed convening a conference to discuss the issue, the reformist leaders, Hu Yaobang, Zhao Ziyang, and Wan Li, vetoed the idea. Hu Yaobang, as quoted by Deng Liqun, said, "If you convene this conference, it is a signal to the people lower down that the policy will change."[54]

3.3 Security of Proprietors vis-à-vis Security of Property

To be sure, none of the policy measures described previously amounted to a genuine institutional guarantee of private property rights. The CCP never allowed itself to be subject to any external constraints. What these documents reveal is that the reformist leaders were showing a degree of self-constraint and were fully cognizant of the reputational effects of their actions. In the early 1980s, such political self-constraint was reasonably credible. Again, the baseline benchmark matters here. Relative to the completely arbitrary behavior of Mao, these straightforward pronouncements of fairly specific policy rules by the top leaders helped establish a sense of confidence and stability on the part of those contemplating going into business in the 1980s.

The area where the policy changes matter the most is the sense of personal security on the part of first-generation entrepreneurs. Here, I draw a distinction between security of proprietors and security of property. The explicit and strong legal protection of private property was not promulgated until the 2004 Constitutional amendment and the 2007 Law of Physical Property. (Even with the passage of these legal documents, there is still a question of how they can be enforced fairly in a top-down, authoritarian system.) But, in the early 1980s, the appropriate benchmark is the baseline of the 1970s. Let me offer an extreme but nevertheless realistic scenario to illustrate this point. Imagine that during the Cultural Revolution, as soon as someone went into private commerce, he would be arrested. (This was especially true in the urban areas.) Now, imagine in the 1980s, a private entrepreneur simply in her capacity as a private entrepreneur no longer feared such a fate. The incentive effect between being arrested and not being arrested must have been massive. The cumulative effects of the policy changes in the 1980s resulted in an increase in the security of proprietors. The security of the proprietor is the necessary condition for the security of the property itself. In the 1980s, China completed the necessary conditions toward establishing property rights security.

The steady changes in policies and the business environment documented in the previous sections really mattered to the first generation of Chinese entrepreneurs who took calculated risks to go into business so soon after the Cultural Revolution. The following short cases show the intimate interactions between policies and the incentive effects of the first generation of Chinese entrepreneurs.

Table 2.2 shows that Hebei province had the highest output share of private TVEs in the country, already 70.4 percent in 1987. Hebei, about average in its economic development level, is a northern province (bordering both Beijing and Tianjin). Our first case comes from Qinhe county of Hebei province. This was a poor region with very few collective assets with which to start. In 1983, the county government launched a number of collective TVEs, but none of them was successful. Because of its poor financial situation, the county government ended up accumulating payroll arrears to its own staff. This experience led the county government to turn to the private sector for economic development. The first policy act by the county government was to rehabilitate more than 100 individuals who had been prosecuted during the "anti-capitalist tail" campaign of the Cultural Revolution. The county government also awarded the title of "model worker" to individuals who grew rich. The strategy seemed to work. By the late 1980s, Qinhe had developed a sizeable cluster of industries (all based on household businesses), and it was a large supplier of motorcycle components (Editorial Committee of TVE Yearbook 1989b, p. 233).

To be sure, there were policy setbacks in the 1980s, but how these policy setbacks were resolved is also telling of the era – some of the local officials publicly and proactively reversed their own mistakes. These quick corrections, rather than stubbornly persisting with policies that clearly did not work, established and consolidated a sense that the liberal policy environment was durable. Two episodes from the severe policy setback in 1982, when the central government cracked down on "speculation," are illustrative of this point.

In 1982, the State Council issued a policy document decrying the poor quality of products produced by the emerging private firms and the price hikes supposedly due to the speculative activities by private traders. The 1982 campaign against market speculation bore the classic symptoms of an ailing state sector using its political power to shut out its more nimble competitors. One of the first victims of the 1982 crackdown was Han Qingsheng in Wuhan, the capital city of Hubei province in interior China.[55] His crime was to have had received 600 yuan for providing technical assistance to a TVE. Mr. Han, an engineer at a SOE, like many engineers, also worked as a consultant for a TVE. Such engineers were known as "Sunday engineers" because they spent their Sundays at the TVEs. But, in 1982, with the adverse change in the environment, Mr. Han was sentenced to 300 days for engaging in "technological speculative activities."

The fate of Mr. Han became a huge media event. (This is another lesser known fact about the 1980s: The Chinese media in the 1980s were quite free and active.) Intellectuals and scientists strongly objected to his treatment. The Wuhan government then backed down, and Mr. Han was released. Not just that: The mayor of Wuhan city, apologizing on behalf of the city, personally delivered the court's verdict and the 600 yuan that the government had confiscated to the home of Mr. Han.

The 1982 crackdown also reached Wenzhou in Zhejiang province. In 1982, the Ministry of Machinery Industry issued a ban prohibiting private firms from producing electric transformers. The official reason was that products made by private enterprises were poor in quality and lacked safety standards. The document singled out Wenzhou for criticism because Wenzhou was emerging as a manufacturing center of electric transformers. Zhejiang province then initiated an investigation into the business activities of the eight richest private entrepreneurs in Wenzhou. (They were known as the "eight big kings" at the time – they each had accumulated wealth in excess of 100,000 yuan.) Seven were arrested and one fled the city.

The economy of Wenzhou crashed immediately. In 1980 and 1981, industry had expanded by 30 percent. But, in 1982, it screeched to a halt, contracting by 1.7 percent (Wu Xiaobo 2006, p. 84). Private fixed-asset investment fell from 280 million yuan in 1981 to 155 million yuan in 1982. The Wenzhou government swiftly reacted to the downturn. In 1984, it released all the imprisoned private entrepreneurs and restituted their assets. Not only that, the Wenzhou government published the decision in local newspapers explaining why it had erred. It was unprecedented – and it is still unprecedented today – for a branch of the Chinese government to openly and so publicly acknowledge its own mistakes. The following is an excerpt from a later account of this event:[56]

> The teleconference [announcing the release of the private entrepreneurs] and the rehabilitation of the "eight big kings" were headline news in the local newspapers. Lower-level officials were emboldened and those with previous reservations then began to feel relaxed. The urban and rural areas of Wenzhou economy were greatly stimulated. In the rural area of Wenzhou, commercial activities began to proliferate massively.

Fixed-asset investment data support this qualitative assessment. For the first time after a two-year contraction, fixed-asset investments in 1984 exceeded their 1982 level and then in 1985 they expanded another 42 percent. This marked the beginning of the Wenzhou miracle. The man credited with this policy is Yuan Fanglie, the Party secretary of Wenzhou from 1981 to 1984. Today, many Wenzhou entrepreneurs regard Yuan with respect and gratitude. In a revealing 2001 interview, Yuan recalled why he took such actions. He noted that Wenzhou was poorly endowed with natural resources, but Wenzhou had one asset – its human capital, especially the commercial and trading skills of its entrepreneurs. Unusual for a Chinese official, he knew what was holding back a full utilization of these skills – lack of confidence in the durability of the reforms. Yuan then quoted a popular saying – "The policy of the CCP is like the moon, taking different shapes every fifteen days" – to illustrate his point. He came to the conclusion that it was essential to create a safe environment for the entrepreneurs to go into business. A footnote to the policy directive issued by the Ministry of Machinery Industry is that today Wenzhou is the home of China's largest producer of electric transformers, the Zhengtai Group, also one of China's largest private-sector firms. The SOEs that the Ministry of Machinery Industry had sought to protect have long since gone bankrupt.

Our final case comes from the famous No. 4 document of 1984 that recognizes the legality and status of private TVEs. The document stipulated specific provisions; for example, it entitled private TVEs to the tax incentives previously reserved for collective TVEs. But, it was also a political document. The No. 4 document decreed that TVEs should be granted the same policy treatment as SOEs. This was a policy milestone. Recall our earlier discussion that the No. 4 document defined TVEs in such a way as to include private firms. Thus, in effect, the No. 4 document of 1984 equated private firms notionally with SOEs.

The No. 4 document had a huge psychological impact on potential private entrepreneurs. Contemporaneous accounts recount what happened after the No. 4 document was announced – a massive wave of private placements. Within one month, rural residents in the county of Yiwu in Zhejiang province reportedly raised 10 million yuan and established 500 businesses. (In 1984, the entire agricultural output of Yiwu was just 200 million yuan.)[57] In the city of Shenyang, when a notice went out about raising capital for a private garment factory, peasants formed long lines the night before the shares were to go on sale. The venture raised 100,000 yuan in one day. In the same region, another proposal to raise 110,000 yuan for a food factory was fully subscribed in just 40 minutes. In the Nantong city of Jiangsu, a private commercial building project raised 1 million yuan in three days. In 1984, Zhejiang province created 250,000 private-sector businesses; Shandong, another 700,000. In Yichang of Hubei province, 50,000 peasants created 17,000 businesses. In Huanyuan county of Anhui province, 8,700 peasants pooled capital to form 205 private enterprises (Zhang Yi 1990). Thus, 1984 should be designated the year of embryonic private equity and organized capitalism in China. The entrepreneurial contagions were not confined to rural China. Lenovo, Stone, and Kelon were all founded in 1984; the Hope Group, China's largest agribusiness firm, was founded in 1983.

3.4 Getting the Incentives Right

If you want to bring the initiative of the peasants into play, you should give them the power to make money.

– Deng Xiaoping comment to *New York Times* magazine delegation in October 1985
– ("Sayings of Deng Xiaoping" 1997)

It is well known that the commune system suppressed the financial incentives of its members. One telling indicator is that the faster-growing crops fetched lower returns under the commune system.[58] The rapid demise of the commune system is evidence of the improved incentives under the HRS. Another source of improvement came from the price adjustments. Research shows the substantial impact on the income of Chinese peasants resulting from the rising agricultural procurement prices, the reductions in rural taxation, and the increased flexibility to enter into higher-return nonagricultural activities (Sicular 1988).

My interest here is not to repeat this well-researched story of improved financial returns and the rising incomes of Chinese peasants during the early 1980s. Instead, I provide an account of a change in the way the Chinese political elites framed the incentive issue. Notice the wording by Deng Xiaoping quoted previously. He did not say giving money to peasants but to "give them the *power* to make money" (italics added by the author for emphasis). This is a critical distinction. Even during the Maoist period – and during the 1990s and under Hu Jintao in the 2000s, sometimes the government would raise the agricultural terms of trade to increase rural income. What is different about the 1980s is that there was liberalization – to give the peasants the power to make money.

To put it simply, the prevailing thinking during the Maoist era was a zero-sum mentality – gains achieved by the peasantry were viewed necessarily as losses incurred by the state. The reformist leaders very early on repudiated this idea and embraced a positive-sum thinking. That thinking had three essential elements, although they were never explicitly articulated. First, rural welfare, in and of itself, was important. Second, improving rural welfare was entirely consistent with improving the welfare of the country as a whole. Third, improving rural welfare was the mechanism by which to improve the welfare of the country.

The change in the policy idea was visible quite early on. In April 1979, *Red Flag*, the theoretical mouthpiece of the CCP, argued for an incentive approach. In order for the peasants to contribute more to the state, the article argued, the state should, first and foremost, guarantee the economic interests of the peasants (Zhou Reli 1979). In one of the first major policy pronouncements on agriculture adopted by the reformist leaders, "Decision of the Central Committee of the CCP concerning the acceleration of agricultural development" promulgated in September 1979, the issue of incentives was highlighted prominently. Consider the following statement (Central Committee 1979):

> While strengthening socialist education among our peasantry, we must show genuine concern for their material welfare in economic work and must provide a complete guarantee for their democratic rights in political work. *Without material welfare and certain political rights, it is impossible for any class to have innate incentives* (italics added by author for emphasis).

Considering that this was three years after the Cultural Revolution, such an explicit recognition of fundamental market economy principles – stable future expectations, excludability, and individual welfare – is truly remarkable. Throughout this historic document, words such as reputation or credibility (*shixin yumin*), incentives (*jijixin*), material welfare or interests (*wuzhi liyi*), democratic rights (*minzhu quanli*), and political rights (*zhengzhi quanli*) frequently appear.

This positive-sum stance led to a host of concrete policies. For one thing, it justified the costly decision to raise procurement prices, a decision, as Naughton (2007, p. 89) points out, involved substantial trade-offs – planners had to reduce investments and scale back technology imports in order to pay for the grain imports.

The other implication is that the state came to trust the spontaneous forces of the market rather than imposing its own vision on the economy. This sentiment was best expressed by Wan Li, the vice premier in charge of the rural sector and a pioneering reformer. He had this to say: "Ordinarily, our work should accommodate the needs of agricultural development rather than forcing the peasants to accommodate to us" (Wan Li 1992 <1982>, p. 149). In the same speech, Wan put forward the view that officials should not prohibit activities even if they are at odds with the prevailing rules and regulations. In the form of a question, Wan asked whether the rules and regulations should be relaxed further (rather than, as implied, banning the activities themselves). He did not explicitly say yes, but he implored government officials at all levels to fully debate the merits and demerits of the issues. This kind of policy flexibility and market-consistent stance goes a long way toward explaining how China moved so far in the direction of a market economy in the 1980s, even as the overall political environment seemed to be prohibitively forbidding.

The accommodation to the reality on the ground is probably the single most significant hallmark of the 1980s. Naughton (1996) has a succinct formulation for this period, stressing the importance of the "crucial first move" by the central government – by reducing rural tax rates, raising agricultural prices, and increasing investments in the agricultural sector. But the fact that the Chinese leadership was willing to be so accommodating to the spontaneous market forces on the ground is not a trivial fact. Respecting market signals – by policy elites with unconstrained power – is a tall order. In the next chapter, I document the decisions of the leadership in the 1990s to dramatically curtail the highly productive credit allocations to rural entrepreneurs in order to carry out their own technocratic blueprint of economic development.

3.5 Microeconomic Flexibility

The policy of accommodation explains the expanding scope of microeconomic flexibility in the 1980s. The most impressive example can be found in the size of private-sector employment. In the early 1980s, the employment size of private businesses was considered ideologically sensitive. In 1981, the *People's Daily* carried a series of articles and readers' letters debating the issue of private-sector employment. The tone, as noted by Chinese researchers, was frank but measured and rational (Zhang Houyi and Ming Lizhi 1999). The root of the controversy was the Marxist theory of labor surplus. The 1983 No. 1 document issued a rule that rural household businesses – with two owners – could employ up to five "apprentices." This formulation established what was often viewed as the ceiling on private employment at seven workers per firm. (In *Das Kapital*, Karl Marx used a fictional example of a private firm employing eight workers to illustrate his labor surplus theory.)

The reality is that the reformist leadership never rigidly enforced the seven-employee rule. The World Bank TVE study could not find a single known case of private entrepreneurs being punished because they exceeded the seven-person employment rule (Lin 1990). Mr. Nian, as noted before, employed hundreds of workers and he was by no means alone. I have also provided survey evidence – based on PSS1993 – that rural businesses employed far more workers than the seven-employee ceiling. This is true both in terms of the average employment size as well as the employment size of the firms in the 90th percentile.

The reason is not at all surprising. A close reading of the government decrees reveals that the employment restriction was never intended to be prohibitive. In fact, the 1983 rule itself contained deliberately flexible provisions. Local officials were urged not to promote but also not to crack down on those who exceeded the seven-employee rule. The overall tone of the 1983 No. 1 document, which set forth the seven-employee rule, was pro private sector rather than restricting its development.[59] The operative phrase in the internal policy deliberations on the employment issue was "wait and see" (Zhang Houyi and Ming Lizhi 1999), a phrase that nicely captures the essence of the policy approach in the 1980s.

Ever pragmatic, the reformist leaders proposed measures that would ease the ideological tensions of the employment issue while permitting the practice itself. The 1984 No. 1 document asked the private-run businesses to create and contribute to a "collective reserve fund," which in effect was a form of profit-sharing with employees. The document also proposed a cap on dividend payouts. These measures, although not attenuating the private nature of these businesses, were designed to ease any tensions with labor.

Another form of microeconomic flexibility was private entry into the nonagricultural sectors. Very early on, private entry was not only allowed but also *encouraged*. Consider the following paragraph (Ministry of Agriculture 1985, p. 2):

> The state, collectives, and individuals should *simultaneously* embark on businesses in *all* sectors of manufacturing, supply and procurement, science and technology, and services in the rural areas. The government should especially support voluntary forms of businesses. Supply cooperatives should be *completely* autonomous, responsible for their own profits and losses and managing operations on their own. They should be subject to democratic supervision by the masses (italics added by the author).

The 1985 No. 1 document gives explicit permission to individual businesses to bid for infrastructural construction projects and encouraged private mining (Editorial Committee of TVE Yearbook 1989b, p. 502). As pointed out in the last section, the private TVEs had a dominant market position in the transportation sector compared with the collective TVEs. The private TVEs also seemed to have engaged in building infrastructure. For example, in one city of Fujian, private TVEs built and financed three railways and they won the right to operate them as well (Editorial Committee of TVE Yearbook 1989b, p. 84). Private infrastructure financing and construction were even more substantial in Wenzhou. According to one estimate, 70 percent of the small township construction was financed by TVEs (most of which were private). Private financing and construction extended to primary and junior high schools, movie theaters, roads, tap-water facilities, bridges, electricity generation, and so on (Editorial Committee of TVE Yearbook 1989b, p. 118).

Private businesses were allowed to raise equity capital. In the same 1985 document that authorized the establishment of shareholding enterprises, individuals could purchase shares with capital or acquire shares through contributions of production materials and labor. Lifting the restrictions on TVEs occurred even earlier – in 1979 when a State Council circular removed the restrictions on the large-scale expansion of nonagricultural activities by TVEs. Around the same time, the restrictions on a number of nonagricultural activities by rural households were also lifted. The latter policy change stimulated a great spurt of private-sector development in rural China (Byrd and Lin 1990, p. 7).

I detail the financial liberalization during this period in the next chapter. Financial experiments were one of the unheralded areas of microeconomic flexibility in the 1980s. In a 1985 document, the State Council outlines 10 policy measures to revive the rural economy,[60] one of which is financial liberalization. The rural credit cooperatives were allowed to retain all profits after the reserve deposits at the central bank. They were encouraged to source deposits and lend across regions, in effect making it possible for the credit cooperatives to compete with one another. Interest rates were allowed to float within a band (as in the statement, "Some rates can approach market rates"). The rural credit cooperatives were authorized to lend to peasants in industrial and commercial businesses on the condition that the agricultural needs for credits were given priority. The document permitted informal financing.

4 Conclusion

It is no exaggeration to say that an understanding of Chinese economy and reforms requires a detailed, direct grasp of the economic policies and institutions in the 1980s. The story of the 1980s was written by the tens of millions of Chinese rural entrepreneurs. The vigor of rural entrepreneurship during that period is as remarkable as the lack of knowledge in the West about some of the basic facts. By far, the single most significant development in the 1980s was the TVE phenomenon. It is hard to identify another economic phenomenon so important and yet so systematically misconstrued.

Among top economics journals, one finds many illustrations – often backed up by sophisticated mathematical models – of how publicly owned

TVEs can nevertheless be efficient. The trouble is that the vast majority of TVEs were never publicly owned in the first place. In this chapter, I provide numerous factual details to show that TVEs, as referred to by the Chinese, designate the *locations* of firms, not the *ownership* of firms. TVEs, as used by the Chinese, include private-sector businesses and, in the 1980s, the absolute majority of TVEs were private and almost all the new entrants were private. Although individually smaller, private TVEs in the 1980s began to account for a large share of employment and output. In some regions, especially the poor regions, they produced a majority of the output.

Among 12 million or so TVEs in the mid-1980s, 1.5 million were collective TVEs. For now, let me leave aside the issue that the efficiency claims made by economists were meant to apply to all TVEs rather than to their collective subset. Let's consider the *raison d'être* of collective TVEs. One prominent theory is that collective TVEs deterred private stripping of public assets (Stiglitz 2006). Facts are, once again, inconvenient. Consider the example of Kelon. The founding entrepreneurs registered the firm as collective because there was really no feasible alternative. The collective registration provided a mechanism for Rongqi township to expropriate what ought to have been straightforward private assets in the first place.

The Kelon example illustrates the treacherous side of directional liberalism. For many years, Kelon was effectively run as a private-sector firm. The Rongqi township respected the control rights of its true founders in part because of its goodwill and its self-constraints. But, it is also because Kelon was small and there was little to expropriate. When Kelon was worth billions, the incentives began to change. The helping hand turned into a grabbing hand. This is the price of directional liberalism: Property rights security was not institutionalized. This is the difference between directional liberalism and institutionalized liberalism. (Another difference, as I show in the next chapter, is that directional liberalism can be reversed.)

A factually correct interpretation of collective TVEs is that they enabled public stripping of private assets. Kelon was not alone. A Chinese academic draws the following conclusion, "No matter whether it contributes any capital, as long as an enterprise is established, in order to be licensed it has to be classified as township-sponsored or village-sponsored in some regions" (Editorial Committee of TVE Yearbook 1990, p. 255). Zhang and Ming (1999, p. 180) state, "Due to government regulations, construction projects could not be awarded to private firms directly, which forced rural private construction teams to wear the red hats of collective enterprises." This is expropriation *par excellence*.

Let me end this chapter where I started it. In 10 years from 1978 to 1988, the number of the Chinese poor – by the Chinese definition – was reduced by 154 million, compared with 62 million during the next 10 years from 1989 to 1999. The vibrancy of rural entrepreneurship was an important contributory factor. Table 2.2 shows the deep and wide geographic and economic reach of the private TVEs. By 1987, 688 million rural Chinese – out of a total of 860 million – lived in provinces that had private TVEs producing a moderate (above 30 percent) to high (above 50 percent) portion of rural output. And this took place only eight years after the start of the reforms. It is probably history's single biggest private-sector success story.

The achievements of the 1980s are notable because the decade was bereft of many of the factors that are widely thought of as key components of Chinese success. There was very little FDI and trade, and "Chinese infrastructures" then implied the same connotations as the Indian infrastructures today. The single-minded policy focus was absent because the politics were very complicated. Many of the conservative elders were alive and well and they were always poised to intervene. The reformist leaders, such as Hu Yaobang, Zhao Ziyang, and Wan Li, had to constantly settle for compromises and intermediate solutions. Recall that only 3 out of 29 Party secretaries supported agricultural reforms at the outset. The most salient feature of the rural reforms is that the reforms started without a solid policy consensus.

And there was no ideological commitment to economic liberalization. Just fresh from the Cultural Revolution, none of the Chinese policy makers had been exposed to free-market ideology, unlike reformers in Latin America or Indonesia (the so-called "Chicago boys" or "Berkeley boys"). Chinese reforms did not happen by "a blueprint approach" whereby the policy makers devised economic policy solutions on the basis of abstract ideas. In this aspect, I agree with the view that the key ingredients of Chinese success in the 1980s were the context-specific innovations, a heavy reliance on local knowledge and a learning-by-doing experimentation (Naughton 1996; Rodrik 2007). My disagreement has to do with how the outcome of that Chinese experiment is characterized. As I showed in this chapter, the outcome of the Chinese experiment in the 1980s was actually private ownership and vibrant entrepreneurship and a degree of institutional convergence. It was not selective interventionism by the government and public ownership of firms.

A policy approach based on learning by doing may be technically simple and straightforward, but it requires a massive dose of self-constraint on the part of the policy makers. Policy makers have to learn to hone to the realities on the ground rather than imposing their own visions. In an unconstrained political system, that the policy makers were willing to let peasants experiment and to trust them to come up with right solutions is nothing short of extraordinary. This political economy dynamics is the single most important feature of the decade of the 1980s. This point will become clearer in the next chapter where I show that the Chinese authorities in the 1990s responded to the rising problems caused by financial centralization with more financial centralization. Maybe there is no such thing as an ideology-free policy approach. Being pragmatic is an ideology in and of itself.

In its very essence, the story of the economic transition is one of two Chinas – the rural and more market-driven China versus the urban and more state-controlled China. The pace of the transition depends on which of these two Chinas has the political upper hand. In the 1980s, rural China dominated, as evidenced by the vibrant rural entrepreneurship facilitated by policy liberalization. Many of the desirable economic and social consequences ensued. In the 1990s, urban China asserted itself and, as I show in the next chapter, Chinese economic performance took a turn for the worse. We can apply the same framework to different regions in China. Shanghai is the classic and the extreme version of the urban policy model. Like China of the 1990s, GDP growth was fast but the income of average households stagnated and income disparity widened substantially. (I come back to the Shanghai story in Chapter 4.) Zhejiang represents the continuation of the rural model of the 1980s. Its GDP grew very fast but, unlike Shanghai, the household income of average residents of Zhejiang also grew very fast. Both the rural and urban policy models can produce fast GDP growth but the implications for the welfare of the average Chinese differ substantially between them.

Finally, we pay attention to the rural entrepreneurs because the rural entrepreneurs, by definition, are indigenous entrepreneurs. Many of the rural entrepreneurs are located in poor and interior regions of the country and, unlike Mr. Liu of Lenovo, they cannot easily escape from the straightjacket of illiberal economic and financial policies and institutions by accessing Hong Kong's capital market and its legal institutions. The welfare consequences are severe. The rural entrepreneurs are the poorest and yet they are most burdened by the credit constraints on private sector and regulatory restrictions. The next chapter focuses on the decade of the 1990s and I show what happened to China's rural entrepreneurs and to rural income growth as the policy environment was reversed from its liberal direction of the 1980s.

APPENDIX

A.1 TVE Semantics and Data

There are two Chinese terms that are indiscriminately expressed in English as TVEs. One term is *xiangzhen qiye*, literally meaning rural and urban township enterprise. The second term is *xiangcun qiye*, or township and village enterprise (TVE). "TVE" is now a standard reference in English but it is important to note that TVEs are actually a subset of *xiangzhen qiye*. The official Chinese documents and policy pronouncements use *xiangzhen qiye* to refer to the entire TVE phenomenon. As explained in the text, the Chinese term for TVEs – *xiangzhen qiye* – is a broad classification of firms that includes both collective TVEs sponsored by townships and villages as well as straightforward rural private enterprises. *Xiangcun qiye*, on the other hand, refers to collective TVEs only. To keep the exposition straightforward, I have retained the English usage of the term to refer to *xiangzhen qiye* in the text. I use collective TVEs to refer to *xiangcun qiye*.

In the Chinese economic studies, the standard source of data is *Chinese Statistical Yearbook* (CYS). CYS, as well as the Ministry of Agriculture cited in the text, report data on TVE employment. A reader familiar with CYS may find some inconsistencies between CYS and the data reported by the Ministry of Agriculture. CYS reports rural employment data under three categories: TVEs, private-run enterprises, and individual businesses. For 2002, CYS reported TVE employment of 132.9 million, 14.1 million in the rural private-run enterprises, and 24.7 million in the rural individual businesses (NBS 2005, p. 121).

Notice the discrepancy with the figures provided in Table 2.1, which is based on the Ministry of Agriculture (2003). Table 2.1 reports a much larger private-run enterprise employment and individual business employment (35 million and 59.8 million, respectively). Notice also that the TVE employment reported by CYS, 132.9 million, matches exactly with the data from the Ministry of Agriculture. Thus, both publications are based on the same data source, but they report the employment data differently.

The Ministry of Agriculture breaks down TVE employment into collective, private-run, and individual components but CYS does not do so. From the reporting of CYS, 14.1 million in the rural private-run enterprises and 24.7 million in the rural individual businesses are not included in the 132.9 million total. One possibility, of course, is that this is a reporting error. Another possibility is that CYS data refer to those stand-alone rural private-run and individual businesses that do not simultaneously carry a

TVE label (and, therefore, they are outside the coverage of Ministry of Agriculture data). If this is the case, the size of the rural private sector is even larger than that reported by Ministry of Agriculture. Thus, the true rural private sector consists of rural private TVEs and stand-alone rural businesses. For 2002, this would yield a rural private employment of 136 million rather than 94 million only in the private TVEs.

A.2 Surveys of Private Business

In this chapter, we drew data from three surveys on private business. All three datasets were obtained from the Universities Service Centre at the Chinese University of Hong Kong. The first is the self-employment business survey conducted in 1991 (SEBS1991), which covered individual businesses in industry and commerce (*geti gongshang hu*). These are essentially self-employment proprietorships, although some also had outside employees. Under Chinese law, those businesses that employ less than seven workers are considered self-employment businesses. The survey was implemented in November and December 1991 and included 10 provinces or cities: Shanghai, Shandong, Hubei, Guizhou, Guangdong, Chengdu, Shenzhen, Xi'an, Shenyang, and Dalian.

The survey was designed by the State Economic Reform Commission and the All-China Industry and Commerce Federation. It covered a wide range of topics, from size of business, status of development, socioeconomic characteristics of the business owners, family finance, and views of the business environment. However, many variables contain a large number of missing values. The maximum number of observations is 13,245. I have used the portions of the survey that have the most complete information and the least number of missing values.

Our second and third surveys cover the more established private businesses. In Chinese, these firms are known as *siying qiye,* or privately run enterprises. They differ from the self-employment businesses in that they are much larger and they typically employ seven or more workers per firm. I drew data primarily from three such surveys. One was conducted in 1993 (private-sector survey in 1993, or PSS1993), another was conducted in 2004 (PSS2004), and the third one was conducted in 2006 (PSS2006). PSS1993 covered 1,440 firms, PSS2004 covered 3,012 firms, and PSS2006 covered 3,837 firms.

These surveys were a part of a regular series of nationwide surveys of the private sector, covering all the provinces in China. The surveys were organized by the Department of the United Front, the branch of the Communist

Party in charge of managing relations with the non-Communist components of Chinese society and the economy, and the All-China Federation of Industry and Commerce, the organization that represents the private sector. The surveys were designed with heavy input from researchers and academics at the Chinese Academy of Social Sciences, the Beijing Academy of Social Sciences, and China People's University.[61]

The sample selection is stratified by both economic and political criteria. The private-sector surveys focus on six types of regions selected on the basis of both political and economic criteria. The political criteria were (1) the provincial capital, (2) a prefecture-level city, and (3) a county-level city. With respect to the economic criteria, the survey sampled firms located in the advanced, medium, and least advanced areas. Within each region, the firms were randomly selected from the registration lists maintained by the local bureaus of industry and commerce. This means that these firms already operated in the formal sector at the time of the survey. The potential bias here is that those private firms most severely discriminated against – and that therefore chose to go underground – are not included in the survey. This is not a debilitating factor for our purposes because it is the formal sector that provides the meaningful benchmark on entrepreneurial development in a region. The second potential bias is that the survey is probably more heavily weighted toward the larger private-sector firms because the members of the All-China Federation of Industry and Commerce are more established firms. Therefore, the results presented in the chapter should be interpreted as reflecting characteristics of the larger private-sector firms.

The main questions in the two surveys cover (1) firm size, status of development, organization, and operation; (2) management system and decision-making style; (3) socioeconomic background of the enterprise owners; (4) social mobility and network of the owners; (5) source and composition of employees and employee–employer relations; (6) self-assessment by the entrepreneurs on a range of issues related to government–business relations, the business environment, and financing; and (7) income, expenditures, and assets of the entrepreneurs. Important for our purposes, both the 1993 and 2004 surveys contain information on employment and a number of critical entrepreneurial characteristics.