Chapter 5

The Evolution of Property Rights in Village Enterprises: The Case of Wuxi County

James Kai-sing Kung

The ownership of China's township and village enterprises (TVEs) has recently been a subject of immense interest to those concerned with the relationship between property rights and economic development. Although lacking the exclusive private rights allegedly required for successful economic development, the strong interests that local government officials have in generating revenues from TVEs has arguably powered the engine of growth of these community-based enterprises.1 Drawing on a small sample of sixteen villages in Wuxi County, a site where most, if not all, of the village enterprises are genuinely owned and controlled by the village government, this chapter confirms, with survey data, earlier claims about the active role of village officials in enterprise development.2 For example, it shows that while cadres are not directly involved in managing the village enterprises, they appoint the managers in the majority of instances, decide their incomes, assist the enterprises in procuring loans, and are at least partially responsible for enterprise investment decisions. My findings detail how property rights are partitioned between the main actors involved in the enterprise relationship.

But the allocation of rights is not static; it changes in response to changes in the overall business environment. Indeed, a striking feature of the evolution of property rights in the sixteen sample villages is that the majority, 75 percent, have in recent years privatized their smaller, marginally profitable, if not unprofitable, enterprises, transferring the right to claim residual profits to individuals.3 Such a high incidence of privatiza-
tion must further be seen against the background that Wuxi is, by Chinese standards, the heartland of local state corporatism. It is a county that has, at least up to the late 1980s, put great emphasis on the development of collective enterprises. This chapter examines the main reasons behind these villages' decision to privatize some of their enterprises and the characteristics of the enterprises that have undergone privatization. It considers whether the observed phenomena can be adequately explained by available economic theory.

Where markets are underdeveloped, as was the case in rural China during the 1980s, access to resources is determined primarily by personal connections, or guanxi, rather than by impersonal, arm's-length transactions. That being the case, local cadres are thus in an advantageous position vis-à-vis enterprise managers with respect to both procuring scarce production factor inputs and marketing the output. This explains why strategic decisions, according to the results of my survey, are typically made by the local officials, whereas routine managerial responsibilities are delegated to the enterprise managers. But the development of markets in an increasingly competitive business environment has altered this status quo, leading to an unambiguous trend of privatization.

As markets develop, the relational-specific guanxi input formerly supplied by local cadres has become less important as it is gradually replaced by arm's-length transactions undertaken by the enterprise manager. And as competition intensifies and the number of village enterprises multiplies and businesses expand, sound enterprise performance relies increasingly on the efforts of the manager. Where these changes have been most profound, they significantly undermine the cadres' role in enterprise management, as they become less knowledgeable about the enterprises' true capabilities. But with managerial compensation held in check by powerful egalitarian social norms embedded in the village community and the perception that the villagers are owners, local cadres have been constrained to remunerate enterprise managers proportionately to the latter's contribution, as is evidenced in the narrow spread of incomes—a ratio of less than three—between managers and workers. As will be seen later, many enterprise managers therefore sought to maximize their own nonpecuniary benefits rather than profits, eventually leading many village authorities to give up their claim to residual profits from smaller enterprises, while retaining ownership and control of the larger, strategic ones. In addition to shedding light on the decision to privatize, the second, more important objective of this chapter is thus to shed light on the evolution of property rights in village enterprises in Wuxi over time.6

### Table 5.1

<table>
<thead>
<tr>
<th>Township</th>
<th>Qiangjiao</th>
<th>Luojiao</th>
<th>Gangxia</th>
<th>Luqi</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNP (in million yuan)</td>
<td>22</td>
<td>2</td>
<td>5</td>
<td>31</td>
</tr>
<tr>
<td>Per capita GNP</td>
<td>(256.53)</td>
<td>(758.38)</td>
<td>(590.23)</td>
<td>(187.36)</td>
</tr>
<tr>
<td>Gross output value of industry and agriculture (in million yuan)</td>
<td>12</td>
<td>2</td>
<td>7</td>
<td>31</td>
</tr>
<tr>
<td>Gross industrial output value (in million yuan)</td>
<td>12</td>
<td>2</td>
<td>7</td>
<td>31</td>
</tr>
<tr>
<td>Gross industrial sales revenue (in million yuan)</td>
<td>11</td>
<td>3</td>
<td>7</td>
<td>30</td>
</tr>
<tr>
<td>Gross profits and taxes (in million yuan)</td>
<td>(1328.90)</td>
<td>(2331.06)</td>
<td>(1509.82)</td>
<td>(537.40)</td>
</tr>
<tr>
<td>Industrial net output value (in million yuan)</td>
<td>(10-1054)</td>
<td>(79.49)</td>
<td>(115.76)</td>
<td>(24.04)</td>
</tr>
<tr>
<td>Ratio of sales to output value (as percentage)</td>
<td>28</td>
<td>5</td>
<td>11</td>
<td>15</td>
</tr>
</tbody>
</table>


**Notes:** There are altogether 35 townships in Wuxi County.
though it is conveniently located near the county seat. Luqu township's performance pales in comparison with the economic progress of the other three sample townships, a result to some extent attributable to its remote location on the border of Wuxi and neighboring Wujing County. A total of sixteen villages were in turn chosen from the four sample townships. Based on the same economic indicators used in the township ranking, data for these villages confirm the above pecking order (see Table 5.2).

Property Rights in Wuxi Village Enterprises

Rather than referring to official ownership categories, a more fruitful approach to the study of property rights in China's village enterprises is to examine in empirical detail the bundle of rights held by different parties to the various aspects of control that collectively define the firm's ownership. A salient feature of the institutional arrangements of village enterprises in Wuxi has been the substantial retention of control rights by village Party secretaries over the strategic aspects of enterprise management. In addition to directly appointing enterprise managers and deciding on their incomes, these senior village officials play a key role in the decision-making process pertaining to enterprise investment and loan procurement, among other managerial responsibilities. In short, although cadres are not directly involved in day-to-day enterprise management, the latter still demands a lot of direct effort from them. For the more troublesome, less profitable enterprises, which contributed little revenue to the village coffers, the amount of effort incurred by these senior leaders is not justified from the standpoint of organizational efficiency. It was the high costs of monitoring enterprise managers that predisposed village authorities to shed these unprofitable enterprises. As a prelude to understanding how problems pertaining to managerial supervision have led to privatization, the remainder of this section looks at how much control of enterprise management village Party secretaries initially exercised.

The first question is whether village leaders are directly involved in managing their enterprises, in the same manner as capitalists would monitor their own firms. To the extent that the answer is negative, it implies the need to assign some management rights to the manager, in which case the village authority will likely face the classic problem posed by the separation of ownership and control. Table 5.3 (panel a) shows that this is indeed the case, as the majority of village Party secretaries, twelve, or 75 percent, are not ordinarily involved in managing the enterprises, but delegate such responsibilities to the chosen managers instead. Since the majority of enterprise managers, 81 percent (Table 5.3, panel b), are directly
TABLE 5.3
Allocation of Control Rights Between Village Cadres and Enterprise Managers

a. Do cadres directly manage the village enterprises?

<table>
<thead>
<tr>
<th></th>
<th>n</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Yes</td>
<td>3</td>
<td>18.8</td>
</tr>
<tr>
<td>ii. No</td>
<td>12</td>
<td>78.0</td>
</tr>
<tr>
<td>iii. No answer</td>
<td>1</td>
<td>6.3</td>
</tr>
</tbody>
</table>

b. How are enterprise managers chosen?

<table>
<thead>
<tr>
<th></th>
<th>n</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Directly appointed by the Party branch secretary</td>
<td>13</td>
<td>81.3</td>
</tr>
<tr>
<td>ii. Elected by villagers</td>
<td>1</td>
<td>6.3</td>
</tr>
<tr>
<td>iii. By competitive bidding</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>iv. Both (i) + (iii)</td>
<td>2</td>
<td>12.5</td>
</tr>
</tbody>
</table>

c. Who decides enterprise managers' income?

<table>
<thead>
<tr>
<th></th>
<th>n</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Village cadres</td>
<td>14</td>
<td>87.5</td>
</tr>
<tr>
<td>ii. Enterprise employees</td>
<td>1</td>
<td>6.3</td>
</tr>
<tr>
<td>iii. The enterprise manager herself</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>iv. Both (i) + (iii)</td>
<td>1</td>
<td>6.3</td>
</tr>
</tbody>
</table>

d. Who makes decisions regarding major enterprise investments?

<table>
<thead>
<tr>
<th></th>
<th>n</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. The enterprise manager</td>
<td>3</td>
<td>18.8</td>
</tr>
<tr>
<td>ii. Village cadres</td>
<td>5</td>
<td>31.3</td>
</tr>
<tr>
<td>iii. Enterprise employees</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>iv. Both (i) + (ii)</td>
<td>8</td>
<td>50.0</td>
</tr>
</tbody>
</table>

e. Who is responsible for obtaining credit for the enterprise?

<table>
<thead>
<tr>
<th></th>
<th>n</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. The enterprise manager herself</td>
<td>6</td>
<td>37.5</td>
</tr>
<tr>
<td>ii. The village authority</td>
<td>4</td>
<td>25.0</td>
</tr>
<tr>
<td>iii. Contributions from enterprise employees</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>iv. Both (i) + (ii)</td>
<td>6</td>
<td>37.5</td>
</tr>
</tbody>
</table>

f. Personal decisions are usually made by:

<table>
<thead>
<tr>
<th></th>
<th>n</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. The enterprise manager</td>
<td>13</td>
<td>81.3</td>
</tr>
<tr>
<td>ii. Village cadres</td>
<td>2</td>
<td>12.5</td>
</tr>
<tr>
<td>iii. Both (i) + (ii)</td>
<td>1</td>
<td>6.3</td>
</tr>
</tbody>
</table>

g. Who makes decisions about employment and wages?

<table>
<thead>
<tr>
<th></th>
<th>n</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Village cadres</td>
<td>2</td>
<td>12.5</td>
</tr>
<tr>
<td>ii. The enterprise manager</td>
<td>8</td>
<td>50.0</td>
</tr>
<tr>
<td>iii. Both (i) + (ii)</td>
<td>6</td>
<td>37.5</td>
</tr>
</tbody>
</table>

(continued)

1. Who do you consider the owner of village enterprises?

<table>
<thead>
<tr>
<th></th>
<th>n</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. The village government</td>
<td>3</td>
<td>18.8</td>
</tr>
<tr>
<td>ii. All the villagers</td>
<td>11</td>
<td>68.8</td>
</tr>
<tr>
<td>iii. Cannot say for sure</td>
<td>1</td>
<td>6.3</td>
</tr>
<tr>
<td>iv. Both (i) + (ii)</td>
<td>1</td>
<td>6.3</td>
</tr>
</tbody>
</table>

Note: The Party branch secretaries of sixteen villages were asked the above questions in a questionnaire in November 1985.

appointed by the Party branch secretary, who also determines managerial income in most instances (88 percent) (Table 5.3, panel c), he is undoubtedly the most powerful person in the village community.11

To see why market competition would create pressures to change enterprise ownership, it is important to recognize the inherent tensions or constraints the Party branch secretary faces in setting the enterprise manager's income. On the one hand, the village Party secretary needs to consider carefully the opportunity costs facing the enterprise manager, which have risen in an increasingly liberalized economic environment. On the other hand, he needs also to balance this concern for managerial incentives against informal constraints. Managerial income is powerfully checked by villagers' perceptions of fairness.12 This kind of informal constraint exacerbates the classic principal-agent relationship and predisposes village authorities to sell their unprofitable firms.

Although the Party branch secretary has delegated management rights to the enterprise manager, he is not completely divorced from managing the enterprises, especially with respect to procuring bank loans and making major investment decisions (Table 5.3, panels d and e). The finding that in half of the reported cases investment decisions are made jointly by the enterprise manager and the local Party boss can be explained by the peculiar nature of ownership in village enterprises: namely, that the former is not the residual claimant in terms of financial risk-bearing. This also explains why, in the remaining cases where such decisions were made by only one party (31 percent, n = 5), it was usually the village Party secretary rather than the enterprise manager.

Further inquiry reveals that these villages are either among the largest industrialized village economies in my sample in terms of enterprise output value—such as Bingkou (first) and Shengfeng (third)—or at the other extreme, among the smallest—such as Huayuan (twelfth), Yinzheng (sixteenth), and Luijatang (eleventh). This finding is not surprising given that it is easier in smaller than in bigger village economies to retain tight con-
trol over enterprise management. It would be more instructive to examine the manner in which control rights are exercised in the big industrialized villages, which can be illustrated by the interesting, if atypical, case of Bingkou.

Bingkou is unusual in that its village economy is managed by a native entrepreneur, who first started a number of industrial enterprises in the 1970s and later founded the Xasi Conglomerate, of which he is director. And yet these enterprises are not regarded as private, but as owned collectively by the entire village community. Of the Y285 million worth of industrial output value produced in this village in 1994, this giant conglomerate accounted for Y200 million, or close to 50 percent. In this village, new investment opportunities were mostly identified with Zhu laozong (or chief executive officer, as he is respectfully addressed), the local entrepreneur. Zhu appointed competent supervisors from existing enterprises he founded to become managers of new ventures. This allowed the number of enterprises in the village to multiply and become independent profit centers, resembling those of a multi-divisional firm, in the thriving local economy, as well as leaving Zhu in overall control.13

An interesting aspect of the development process in this village is that Zhu has recently been nominated to become a Communist Party member and, in fact, the Party branch secretary. Amazingly, Zhu had remained politically independent notwithstanding his phenomenal business success. However, according to a township cadre who accompanied us on the village visit, “it would be more convenient for someone like Zhu to acquire a formal [meaning political] status” for legitimacy’s sake. Indeed, with business and communist politics so closely linked, the wearing of a “red hat” can confer tremendous, although intangible, political security to an entrepreneur.14 But this political “baptism” benefits the Party, too, in that it now “internalizes” scarce entrepreneurial talents, and possibly wealth, like Zhu’s. Such entrepreneurs are thus included among the Party’s valuable assets.

As with enterprise investment decisions, credit market imperfections have similarly obliged the village Party secretary to play an active role in loan procurement (Table 5.3, panel e).15 Although only a quarter of my subjects are assuming this critical function in isolation, the magnitude soars to 63 percent if we include cases in which both parties jointly carry out this function. In the six cases where the enterprise manager is the only party responsible for obtaining credit, only one, Zhuj village, is located at the bottom of the hierarchy in terms of enterprise output value. The remaining ones—Chenxu, Xixiang, Xinkaihe, Zhangmiaohe, and Qianxiang—are big industrialized village economies with sizable enterprise output value (see Table 5.2). The precise reasons why these radically different villages are clustered together with respect to this particular function are not entirely clear. One possibility is that managers of large enterprises in these wealthier villages may behave more like private entrepreneurs than their counterparts in smaller enterprises do, because they may have acquired greater independence in obtaining inputs, such as credits, from local financial institutions. For example, in Xinkaihe, there are only six enterprises, but in 1994 they collectively employed 1,221 workers, averaging well over 200 employees per enterprise. In addition, the enterprise manager-to-worker income ratio there was the second highest among the sample villages that year. Both these indicators tend to lend support to the foregoing conjecture. We may reasonably expect village cadres to typically assume the gatekeeping role in small, tightly knit communities, where managers of village enterprises directly approach their superiors for the required funds.

In addition, smaller, less industrialized village economies such as Yinzheng and Zhuj, located in the less affluent township of Luqu, are, according to their cadres, often forced to rely on their own savings and investments to finance development. The main reason they do not find it easy to obtain credit as their more industrialized counterparts, I surmise, is that being small and presumably less competitive, they are regarded by financial institutions as carrying greater credit risks—a phenomenon some economists call “credit rationing.”16 (Although intuitively plausible, however, this explanation must be treated as speculative.)

If village cadres are heavily involved in enterprise management, what then is left of the dimensions over which enterprise managers are able to exercise control? Are they allowed to make decisions pertaining to personnel management, for instance? The fact that 81 percent of the enterprise managers were found to be in sole charge of this function (Table 5.3, panel f) suggests that this may indeed be the case. However, such a finding is deceptive. First, the overall enterprise wage bill is determined at the outset by the local Party boss based on such major enterprise indicators as profits, sales, output value, and tax remittances. Second, to the extent that village enterprises are genuinely owned by the village authority, local cadres are typically responsible for assigning jobs among villagers, who, under ordinary circumstances, are eligible for employment in these non-agricultural enterprises. These arrangements are partially reflected in Table 5.3 (panel g), which shows that in half of the cases, decisions concerning employment and wages were, at best, jointly made by the village Party secretary and the enterprise manager, suggesting that the independence of enterprise managers from their local Party bosses, even in this less strategic respect, may be more apparent than real.17

Summing up, enterprise managers are largely in charge of day-to-day operations, leaving the key control rights, as well as right to dispose of
residual profits, in the hands of village officials, in particular the Party branch secretary. Although such property rights arrangements prove to work well when competition is limited and business transactions rely heavily on the input of village officials, this kind of highly centralized institution nonetheless requires substantial supervisory effort from them. This explains why village officials are predisposed to shed some of their smaller, especially poorly managed enterprises when things have taken a turn for the worse. The best way to motivate managers to work hard without personal supervision by village Party secretaries is to sell them the right to residual profits.

Social Norms and Property Rights

Privatization is also a response to village social norms and the “collective” nature of village enterprises. The preference of villagers for a “fair” or equal income distribution scheme has limited the ability of village officials to remunerate managers according to their contributions to enterprise performance, and the perception that villagers are the nominal owners of the enterprises in which they are employed has made it difficult for village officials and enterprise managers to discipline the workforce.

While we may regard the social norm of egalitarian income distribution as simply a product of the Maoist legacy,18 it is deeply embedded in the ownership structure of village enterprises. Seeing themselves as the nominal owners of these “collective” enterprises, villagers have refused to accept large income differentials between the manager and themselves. Although village officials have control rights over enterprise management, they are nonetheless constrained by these perceptions, which have effectively resulted in property rights being split between village officials and villagers. The Party branch secretary of Shengfeng village eloquently states the constraining effects of these powerful social norms:

Enterprise managers’ incomes are constrained by people’s perception of fairness. You cannot reward managers simply on the basis of how much profit they bring in; to do so straightforwardly would invite suspicions, if not outright criticisms, that we must have been part of an illegitimate plot to siphon money from the village’s coffers into our own pockets. This is an issue that we need to deal with very carefully.

In point of fact, the income spread between managers and workers in the majority of villages was rather narrow, amounting to an average of less than 3:1, and in the case of smaller, presumably less affluent townships such as Luqu, it was even narrower (see Table 5.2, col. 10).

Similarly, the “collective” nature of village enterprises has made work-

force discipline a serious problem. As an informant explained, an important reason why some workers are predisposed to shirk on the job is because “they see themselves as owners of the collective firm, a status that accordingly gives them the inherent right to be employed; poor work attitude and performance, in other words, cannot therefore be a cause for dismissal as long as these enterprises are owned by the village.”

That villagers regard themselves as owners of village enterprises is well corroborated by the evidence of how the village Party secretaries view the ownership issue. In responding to the question of who owns the village enterprises, the majority of respondents, 69 percent, refer to “all the villagers” (quantu cummin) instead of the village government as owners, despite their own heavy involvement in enterprise management (Table 5.3, panel b).59 Although this is doubtless the politically correct answer to give, such perceptions may be partially explained by the fact that, unlike the township administration, the village is basically a self-governing organization, a semi-governmental body with no formal authority to pass local legislation, and no budget that is subject to fiscal scrutiny from above.90

Such differences are further reinforced by the much larger size of townships. Consisting of thousands of households, a township is hardly a community with the organic cohesiveness of a typical village, in which job entitlement is a public good desired by everyone. This is partially responsible for the different perceptions of job entitlement in townships.

“The relationship between a township enterprise manager and workers is a much more straightforward one, involving little more than provision of and response to pecuniary incentives,” an informant remarked. “After all, before they have their household status [nukou] changed, many township residents have, until recently, been villagers.”

Last, but not least, while the manager of an unprofitable township enterprise may be assigned to a less preferable job, he is at least spared the peer pressure that the village Party secretary has to bear from villagers who have lost their jobs. The same informant put the difference succinctly in perspective once again:

True, the township enterprise manager may have to face the grim prospect of job reassignment, but that is precisely what saves him from having to live with the unceasing pressure that the village Party secretary will inevitably face in the event a village enterprise goes under, in which case the burden falls disproportionately upon him. Unlike the township enterprise manager, the village Party secretary is usually a native villager and a permanent resident in his home village, and as such he is subject to villagers’ collective judgment even after he steps down as village leader.92

This picture of village Party secretaries as prisoners of their own villages helps capture the subtle behavioral differences that must be noted.
in distinguishing township from village enterprises and is basic to understanding the nature of property relations in China's village economy. These constraints on village Party secretaries go a long way toward explaining why, in choosing among institutional alternatives, cadres have increasingly opted for privatization as opposed to the shareholding system.

The Evolution of Property Rights: Agency Problems and Privatization

As mentioned earlier in the chapter, the high incidence of privatization in the sixteen sample villages, as summarized in Table 5.4, must be viewed in the context of the fact that Wuxi is, by Chinese standards, the heartland of local state corporatism and famous for concerted development of collectively owned enterprises.

A good starting point for understanding the main reasons behind such privatization is to examine changes in the macroeconomic environment within which village enterprises operate. In seeking to explain the success of township and village enterprises in the 1980s, many see as pivotal

<table>
<thead>
<tr>
<th>Township</th>
<th>Village</th>
<th>Privatization</th>
<th>Total (a)</th>
<th>Nature of ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qianqiao</td>
<td>Shengfeng</td>
<td>Yes</td>
<td>11</td>
<td>0</td>
</tr>
<tr>
<td>Qianqiao</td>
<td>Xizhang</td>
<td>Yes</td>
<td>19</td>
<td>0</td>
</tr>
<tr>
<td>Qianqiao</td>
<td>Xiaoying</td>
<td>Yes</td>
<td>23</td>
<td>0</td>
</tr>
<tr>
<td>Qianqiao</td>
<td>Weihe</td>
<td>Yes</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Luoxie</td>
<td>Bingkou</td>
<td>Yes</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Luoxie</td>
<td>Qiaoxi</td>
<td>Yes</td>
<td>11</td>
<td>0</td>
</tr>
<tr>
<td>Luoxie</td>
<td>Xinkou</td>
<td>Yes</td>
<td>6</td>
<td>0</td>
</tr>
<tr>
<td>Luoxie</td>
<td>Hongnian</td>
<td>Yes</td>
<td>9</td>
<td>0</td>
</tr>
<tr>
<td>Gangxia</td>
<td>Lujiazhang</td>
<td>No</td>
<td>8</td>
<td>0</td>
</tr>
<tr>
<td>Gangxia</td>
<td>Chenxi</td>
<td>No</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Gangxia</td>
<td>Qianqiao</td>
<td>Yes</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>Gangxia</td>
<td>Zhangmiao</td>
<td>No</td>
<td>8</td>
<td>0</td>
</tr>
<tr>
<td>Luoxie</td>
<td>Zhiji</td>
<td>Yes</td>
<td>8</td>
<td>0</td>
</tr>
<tr>
<td>Luoxie</td>
<td>Yinzhen</td>
<td>Yes</td>
<td>6</td>
<td>0</td>
</tr>
<tr>
<td>Luoxie</td>
<td>Huayan</td>
<td>Yes</td>
<td>9</td>
<td>0</td>
</tr>
<tr>
<td>Luoxie</td>
<td>Shengan</td>
<td>No</td>
<td>3</td>
<td>0</td>
</tr>
</tbody>
</table>

| NOTE: Numbered columns are (1) collectively owned and managed; (2) collectively owned but leased out for management; and (3) private enterprises.
| Privatization in Bingkou, Qianqiao, Xinkou, and Shangqian occurred in 1993 and is therefore not reflected in 1994 statistics.

TABLE 5.4
Privatization of Enterprises in Sixteen Sample Villages, 1994

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shengfeng</td>
<td>.20</td>
<td>.16</td>
<td>.06</td>
</tr>
<tr>
<td>Xizhang</td>
<td>.06</td>
<td>.15</td>
<td>.09</td>
</tr>
<tr>
<td>Xiaoying</td>
<td>.22</td>
<td>.06</td>
<td>.05</td>
</tr>
<tr>
<td>Weihe</td>
<td>.09</td>
<td>.11</td>
<td>.04</td>
</tr>
<tr>
<td>Bingkou</td>
<td>.10</td>
<td></td>
<td>.17</td>
</tr>
<tr>
<td>Qianqiao</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Xinkou</td>
<td>.10</td>
<td>.12</td>
<td>.12</td>
</tr>
<tr>
<td>Lujiazhang</td>
<td>.00</td>
<td>.02</td>
<td>.05</td>
</tr>
<tr>
<td>Chenxi</td>
<td>.10</td>
<td></td>
<td>.06</td>
</tr>
<tr>
<td>Shangqian</td>
<td>.24</td>
<td>.33</td>
<td>.05</td>
</tr>
<tr>
<td>Zhangmiao</td>
<td>.20</td>
<td>.11</td>
<td>.05</td>
</tr>
<tr>
<td>Zhiji</td>
<td>.99</td>
<td>.13</td>
<td>.10</td>
</tr>
<tr>
<td>Yinzhen</td>
<td>.15</td>
<td>.18</td>
<td>.14</td>
</tr>
<tr>
<td>Huayan</td>
<td>.10</td>
<td>.02</td>
<td>.07</td>
</tr>
<tr>
<td>Shengnan</td>
<td>.09</td>
<td></td>
<td>.10</td>
</tr>
<tr>
<td>Mean</td>
<td>0.13</td>
<td>0.12</td>
<td>0.08</td>
</tr>
<tr>
<td>Mean output value</td>
<td>0.19</td>
<td>0.12</td>
<td>0.08</td>
</tr>
<tr>
<td>Correlation coefficients between enterprise profit rates and output value (level of sig.)</td>
<td>0.73</td>
<td>-0.36</td>
<td>-0.63</td>
</tr>
</tbody>
</table>

Table 5.5 shows the profit rates, obtained by dividing enterprise profits by the output value, of all the enterprises in the sixteen sample villages for three selected years. The aggregate data unambiguously show that villages on the whole were able to maintain overall profit rates of roughly 12 percent up to the year 1988, but subsequently dropped to single-digit profit rates by 1994. With the exception of Xinkou village in Luoxie township, which experienced robust growth in profit rates even after 1988, we otherwise see a basically similar pattern when we disaggregate the data at the village level. In order to ascertain if differences in profit
rates between the three time periods are statistically significant, an F-test was performed. The results, reported also in Table 5.5, are consistent with what one would intuitively expect: there is no difference in profit rates between 1981 and 1988, but significant variations are found between 1981 and 1994, and, more relevant, between 1988 and 1994. Many of the sample villages were unable to maintain the double-digit profit rates they had previously enjoyed.

Ironically, this secular trend of declining village enterprise profits occurred against a background where enterprise output value continued to increase in absolute terms. In 1981, the mean enterprise output value was just under Y1.1 million, but by 1988, it had soared to almost Y18 million, and in 1994, to almost Y113 million (Table 5.5, penultimate row). Since expansion in an increasingly competitive market environment might be an important reason for dwindling enterprise profits, a correlation coefficient analysis between the two variables, namely, profit rates and output value, was done for the three selected years, which showed that they correlated with one another positively in 1981, but negatively in both 1988 and 1994 (Table 5.5). Although the results are statistically insignificant, owing perhaps to the small size of the sample, this may nevertheless be taken to support my conjecture. Albeit anecdotal, the following remarks made by the Party branch secretary of Shengfeng, a village whose profits were severely eroded between 1988 and 1994, corroborates this: "Market competition is the main force driving down village enterprise profits in recent years. To be sure, output value has increased, but there has not been comparable growth in profit rates."

Why the expansion of village enterprise business should have led to declining profit rates is not clear. Diminishing returns to management as the size of the operation increases may be one cause, and increasing competition from private enterprises may be another. Available village-level evidence indicates that the smaller, ill-managed enterprises were the targets of privatization. As cadres in Hongmin and Yinzeng villages separately explained:

The two enterprises that we have sold were not actually operating in the red, but they were not particularly well managed either. The dealings involved did not amount to much. What was worse, since transactions were usually in cash, it was very difficult for us to know the accurate profit figures. These enterprises were making profits of a little more than Y100,000, of which enterprise managers were remitting a meager Y40,000 to Y50,000 to us. After they've turned private, the land use and management fee alone would amount to Y80,000, almost double what they were paying.24

There were two reasons why we decided to sell the two small enterprises in 1994. First, they were only making negligible profits, about Y20,000 to

Y30,000 each. So these enterprises were making little, if any, contribution to the collective. Second, their books were rather messy. Since the collective wasn't able to get much benefit out of them, we decided to get rid of them instead. The result? We now get more revenue in the form of [fixed] rental income and management fees than before, as a result of keeping both the land and the factory premises.

Owing to an increase in both the number of village enterprises and the growing volume of business transactions, village cadres have experienced increasing difficulties in managing all their enterprises. This is another important factor behind the privatization drive. In Qianxiang village, for instance, only the largest, "backbone" enterprise, a factory producing diesel engine frames for tractors, remains in the hands of the village authority; the other nine enterprises were sold in early 1995 to the incumbent managers for precisely this reason (see Table 5.6): "Some enterprises are rather small, so that village officials have to spread their efforts thin in managing them. But if we sell them, our leaders [fengdiao] can focus their energies on the "backbone" enterprises [guan gong qiye]."

As can be seen from Table 5.6, none of the enterprises sold were in fact showing losses, although a couple of them had relatively low profit margins (enterprises nos. 6 and 8). Note, however, that profit rates—whether calculated using actual realized sales or output value as the denominator—do not appear to have been the guiding criterion for privatization (Table 5.6, cols. 11–12). The village has sold some highly profitable enterprises, most notably enterprises nos. 3, 4, 9, and 10. With the exception of enterprise no. 3, which is a relatively large establishment, the other three are rather small firms, as indicated by the absolute figures for gross profits, sales, and output value (Table 5.6, cols. 1–3). On the contrary, although the enterprise over which the village authority has retained ownership and control was performing slightly below the mean average profit rates, 9 percent, as opposed to 10 percent in 1994, it nonetheless accounted for almost half the output value and sales revenue of all the village enterprises taken together, 49 percent and 48 percent respectively; 45 percent of the enterprise gross profits; and, perhaps most important, 32 percent of remitted taxes; moreover, it employed 37 percent of the village's nonagricultural labor force.

From the village leader's standpoint, the retention of ownership and control over this particular enterprise is likely motivated by the strategic importance of a firm of this size for the local economy. Most significant are the proportionately large contributions it makes to tax revenues and nonfarm employment respectively.25 In absolute terms, the total wage bill of the largest enterprise in Qianxiang was four times bigger than that of the second largest enterprise and almost twenty times more than that of the
### Table 5.7

**Net Output Value of Village Enterprises in Qianxiang, Luoshe Township, 1994**

<table>
<thead>
<tr>
<th>Nature of enterprise</th>
<th>Net output value</th>
<th>Wages (%)</th>
<th>Tax remitted to village authority (%)</th>
<th>Net asset value (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Diesel engine frames</td>
<td>8.66</td>
<td>2.17</td>
<td>1.33</td>
<td>5.16 (60%)</td>
</tr>
<tr>
<td>2. Vacuum cleaners</td>
<td>1.99</td>
<td>0.51</td>
<td>0.58</td>
<td>0.90 (45)</td>
</tr>
<tr>
<td>3. Gearwheels</td>
<td>4.66</td>
<td>1.08</td>
<td>0.94</td>
<td>2.44 (55)</td>
</tr>
<tr>
<td>4. Crane machinery</td>
<td>0.90</td>
<td>0.23</td>
<td>0.13</td>
<td>0.54 (60)</td>
</tr>
<tr>
<td>5. Electrical appliances</td>
<td>1.21</td>
<td>0.35</td>
<td>0.23</td>
<td>0.63 (52)</td>
</tr>
<tr>
<td>6. Automatic control devices</td>
<td>0.82</td>
<td>0.18</td>
<td>0.64</td>
<td>0.85 (70)</td>
</tr>
<tr>
<td>7. Farm machinery</td>
<td>1.21</td>
<td>0.31</td>
<td>0.05</td>
<td>0.85 (70)</td>
</tr>
<tr>
<td>8. Paper cartons</td>
<td>0.22</td>
<td>0.07</td>
<td>0.14</td>
<td>0.01 (5)</td>
</tr>
<tr>
<td>9. Electronic control devices</td>
<td>0.58</td>
<td>0.15</td>
<td>0.07</td>
<td>0.36 (62)</td>
</tr>
<tr>
<td>10. Walking tractors</td>
<td>20.05</td>
<td>5.05</td>
<td>4.11</td>
<td>10.89 (53)</td>
</tr>
</tbody>
</table>

*Source: Author’s fieldwork, 1995.*

The smallest one in the same village (Table 5.7). Furthermore, a large strategic enterprise may also enhance cadres’ bargaining power vis-à-vis their township superiors in terms of credit provision and assignment of other resources, because enterprise status has long been tied to output value, sales revenue, and gross profits. Finally, it is highly unlikely that private entrepreneurs would be willing and able to finance the purchase of enterprises with net asset values as large as that of the largest enterprise in Qianxiang village (Table 5.7). Thus, unless the profits of an enterprise are substantially below average, the preference of cadres to retain ownership and control over large, strategic firms rather than smaller ones is readily understandable.

The anecdotal evidence cited above suggests that in addition to the erosion of profit rates in the case of some village enterprises, the rise of the private sector or entrepreneurship is likely to have adversely affected village enterprise managers’ incentives in the following two respects. First, while certain major enterprise parameters, such as output value, profits, and tax remittances, are being stipulated in the contractual arrangements between the village authority and enterprise managers, it is unlikely that enterprise managers would regard these targets as binding, given that they are not the residual claimants in terms of financial risk-bearing. These predetermined targets serve merely to provide rough guidelines for evaluating enterprise performance in general and managerial performance in particular. That being the case, it would certainly be in the interest of enterprise managers not to remit the predetermined portion of enterprise profits when the projected profits have failed to materialize. This is pre-
Precisely what some villages have inadvertently experienced. Take the cases respectively of Shengfeng and Xiaoxing, as described by informants:

Competitive pressures in the market have substantially squeezed enterprise profitability, leading in some cases to the unwillingness of enterprise managers to submit the predetermined profits to the village. They won't, however, be able to do that after these enterprises become private, because they must pay the fixed rental and management fee respectively charged for the use of land and factory premises, which remain owned by the village [emphasis added].

Although the incentive system adopted is based primarily on the achievements of certain predetermined target quotas, such as output value, profits, and tax remittance, they are indicative rather than fixed [bushi basi], particularly in recent years, owing to wide fluctuations in the economy.

The potentially most effective approach to resolve this managerial problem, from the standpoint of alleviating the costs of monitoring, is to assign the rights to claim residual profits to the party that directly manages an enterprise. It is by this criterion that village enterprises in Wuxi are regarded as having been privatized. Because village authorities are prohibited by law from selling the collectively owned farmland to private enterprise operators, they continue to own the land and factory premises, although they have sold the other assets, an arrangement that enables the authorities to receive what are basically land rents. It is important to note that these land rental payments have made far greater contributions to local revenues than the profits of the enterprise formerly did. In Xinkaihe, for example, close to one-fifth of the revenues received in 1995 were in the form of land rents. Moreover, these revenue streams are likely to remain stable, long-term income for the village authorities insofar as the private enterprises are able to make profits. Finally, as a result of this change in residual claimancy, an additional benefit that privatization has allegedly brought to village authorities (but certainly not to the enterprises being privatized) is that the authorities now levy a wide array of "regulated fees" (guiji) on these enterprises for the express purpose of subsidizing public services such as education (including adult education in some villages), welfare for the aged, a cooperative fund earmarked for agricultural investments and flood prevention, and so forth.

This change in enterprise ownership and rights to residual claims has fundamentally altered the relationship between the village authorities and the enterprise managers in a direction that is likely to benefit both, but especially the former. In the past, although the village authorities were the legal residual claimant, their ability to claim residual profits was constrained by the selfish behavior of the managers, who possessed superior information regarding enterprise capability and performance but failed to maximize profits. By changing institutional arrangements in the manner described above, the village authorities now simply receive a fixed rent, which the "tenant"—the private entrepreneur—must pay regardless of profit fluctuations. In particular, by retaining ownership of specific assets, land in this case, the village authorities are in a position to terminate the tenancy agreement with the private entrepreneur should the latter fail to pay the rent, a threat that is far more credible than what would have been elicited under a profit-sharing contract, especially when the enterprise manager did not bear the financial risks.

A second, related way the rise of the (albeit nascent) private sector economy has affected village enterprises is the demoralizing effect it has had on enterprise managers. As seen above, even in a situation where the village Party secretary still controls major enterprise decisions, powerful social norms exist in the village to constrain the income of village enterprise managers. This can be gauged from Table 5.2 (col. 10), which shows a narrow spread in income between enterprise managers and workers. While we do not have systematic income data for private enterprise managers, anecdotal evidence appears to suggest that their incomes are higher than those of village enterprise managers. In order to minimize this income gap, it seems, village enterprise managers attempt to maximize nonpecuniary benefits, such as by indulging in conspicuous consumption. The following excerpts of commentaries made by various village leaders provide some support for this conjecture.

The difficulties involved in monitoring enterprise managers is something we have experienced only in recent years, only after our government has liberalized the economy [fangkai yi qi—literally, "opened up everything"]. Frankly, you cannot blame enterprise managers for comparing their earnings with those of their private counterparts, when they discovered that the "private bosses" [siren liuban] were making so much more than they did. For them, such a reality is indeed disturbing and demoralizing, because they had never expected that to happen. [Yinzhuang]

Unlike the situation back in the past five to six years, enterprises have now become increasingly difficult to manage. The main reason, if you ask me, is the emergence of private enterprises, which have been flourishing in recent years, and they all seem to be able to make money so easily. Few people now, as a consequence, have a good sense of responsibility. many are simply not interested working for the collectives. [Chenzhu]

Enterprise managers are not as obedient as before; in the past they would seek approval before they sought to spend money, now they won't. They have recently begun to indulge in lavish consumption; in our village, one enterprise manager spent ¥40,000 last year on cigarettes alone! [Xiaoxing]
Managers see the enterprises they manage as belonging to the collective; they therefore think that it is the Chinese Communist Party’s money when it comes to spending, and they are very spendthrift indeed. [Bingkou]

The fundamental reason why it is difficult to discipline enterprise managers nowadays is that they see these enterprises as belonging to the collective; that their financial performance has little to do with their own personal welfare. [Yinzheng]

A related reason why village cadres overwhelmingly wish to get rid of the inefficient enterprises is the difficulty of disciplining workers. As the party secretary in Shengfeng village lamented:

For one thing, you cannot dismiss them (meaning those native villagers) even when they shirk upon their work because they think the enterprise is theirs. For another, wages keep going up, and if you are unable to keep pace with the market rate, you’ll easily lose the best workers; their sense of loyalty is weak and they have become excessively footloose nowadays.

The village party secretary in Xiaoxing concurred:

The other problem is that people think differently these days. Peasants used to be very proud when they first took up factory work, and they all used to work very hard, it wasn’t just for the money. Now, they all shirk away from hard and dirty work, which has to be done by the non-locals. What is worse, they all want pay raises, and if you refuse their demand, they shirk on their jobs. What if the enterprise manager tries to fire them? Well, they’ll sure come to me and make a big fuss, this much I can guarantee you.

Even smaller villages are not immune to this problem. Although Yinzheng has only a handful of small enterprises, the autocratic village party secretary there has nonetheless experienced problems of a similar sort. It may be argued that such a problem may be more severe in villages like Yinzheng because almost all the enterprise workers there are native villagers, who tend to perceive themselves as having a share in these enterprises, and as such are not subject to dismissal by their appointer, the enterprise manager, regardless of the reason. The difficulty of managing village enterprise workers was further emphasized by the party secretary in Chenzhu village, who likened the prevailing situation in village enterprises to that of state-owned enterprises:

The problem of “eating from one big pot” is essentially the same for both village enterprises and state-owned enterprises. The situation in township enterprises is somewhat better, and that is because, although township residents regard township enterprises as collective, they do not evidently see themselves as having a share in these enterprises. But that is not how villagers see things. “Collective” to them means that they are not merely hired employees, but are instead stakeholders by virtue of their status as villagers, and, accordingly, the perception that “You cannot fire me because the enterprise is not private” means that you don’t want to cross them too often, at least not to the extent that you won’t talk to each other anymore; after all, you still see each other every day, and you just don’t want that to happen.

Up to this point in the analysis, we have seen why village leaders want to sell those enterprises that both are difficult to manage and have failed to turn in handsome profits in recent years. Let us now turn to two remaining issues. First, who would buy the unprofitable enterprises, and how do they finance the purchase in a rural credit market that is far from perfect? Second, why should cadres go for outright privatization instead of a less radical institutional alternative, such as the “cooperative shareholding system” (gufen kezuozhi), which is essentially a joint-stock system?

The Process of Privatization

The privatization process is essentially similar in all the villages under observation, with slight variations over the period of repayment and the source of financing. The village authority would first of all have the township Economic Management Bureau evaluate the net asset value of the enterprise destined for privatization, followed by court notarization. Depending on the selling price (or asset value) of the privatized enterprise, obtained by deducting its bad debts from the original gross asset value, the new owner is typically required to pay the capital to the village authority over a period of from one to three years. In the case of Qianxiang, for example, the stipulated rule is that for enterprises with a net asset value of Y500,000 or less, the capital must be paid within one year. For enterprises worth Y1 million, the new owner has an additional grace period of half a year. In the case where the enterprise has an asset value of Y2 million or more, the repayment period is extended to two years.

Since prospective enterprise owners are unlikely to have accumulated enough savings to meet even the first installment of the required payment, how do they come up with the necessary capital? According to my findings, many villages have assisted new enterprise owners in financing their purchases. First, entrepreneurs may borrow from local credit institutions, with the village authority serving as the guarantor and the enterprise as collateral. Second, special endeavors have been made by the authorities to collect outstanding debts. Third, some villages even allow the new owners to write IOUs, so that they are required only to meet the payment out of future profits over several installments. If these measures, taken together, still prove insufficient, perhaps because the net asset value of an enterprise is simply too high, as in the case of a machine tool factory in Xinkaihe, the net
asset value of which was Y4.16 million at the time of privatization, existing workers may be invited to purchase shares in the enterprise as an additional source of financing (in which case ownership is certainly diluted).

Whether or not the new owner will be able to have majority control over decision-making depends eventually on the relative share contribution and the corporate governance structure set up. Where capital financing does not pose intractable problems for privatization, the organizational change typically results in the kind of economic institution that resembles the classical capitalist firm with single residual claimancy, in which ownership and control reside in one person. Where this proves impossible, the new owner, middle management, the workers, and, in some cases, parties that have business relations with the enterprise, the "stakeholders" as it were, may be called upon to enter into a holding system based on their respective contributions.  

One possible means whereby village officials may privatize an enterprise is to announce their prices and invite interested individuals to bid. But in virtually all the villages where privatization has occurred, enterprises were invariably sold to the original managers. Why? According to the Party branch secretary of Xiaoxing village, "you have to sell it to the original enterprise manager, because a different party will most likely refuse to take over existing liabilities." The cadre of Qianxiang offers a different answer: "The incumbent manager is the one most familiar with the enterprise. Besides, he has also acquired a reputation that allows him to command due respect from the existing workers." While this may be part of the truth, my conjecture is that the incumbent manager has a competitive edge over his outside competitors with respect to knowledge of the enterprise in which he has worked (knowledge that, according to Oliver Williamson, arises from the idiosyncratic association with the work environment, organizational culture, physical equipment, and so forth). In a highly influential paper, Armen Alchian and Harold Demsetz explain why market competition is unable to resolve the problem of shirking when individuals work in a team context, the major reason being that outsiders are unlikely to know who is shirking and how much. Should such knowledge be freely available, existing team members would be able to correct the problem. The incumbent manager is also likely to have a good idea of the comparative advantages of each individual worker, although as a nonresidual claimant, he is unlikely to have the same incentive to monitor workers as a residual claimant. Compared with outsiders, the incumbent manager thus clearly possesses superior knowledge of the capability of the enterprise, which he has managed, and should be in the best position to ascertain whether it will be able to make a profit after the ownership change.

The very fact that incumbent managers are willing to buy up enterprises that were previously showing either losses or only marginal profits also implies that there was X-inefficiency in these enterprises, and that these managers genuinely believe that as owners, they will be able to turn them into profitable entities. In the case of the machine tool factory in Xinkaihe village that became privatized, the new management immediately laid off 37 workers out of an original 147, or roughly 25 percent of the workforce, as the first step toward enhancing organizational efficiency.

The new owner of a factory producing curtain fabric in Shangqian village is reportedly adopting similar measures. Established in 1992, this enterprise had suffered losses amounting to roughly Y500,000 each year for three years in a row, and had over the years accumulated a debt of Y2.3 million. After it was sold to the incumbent manager, the new owner closed down the factory temporarily for three days to give himself time to decide who to retain and who to dismiss. The most critical decision he made was perhaps to sack three (out of four) generously paid marketing managers. As each of these middle-level managers had previously been receiving an annual salary of around Y50,000, the new owner immediately saved Y150,000. In addition, by laying off twelve workers, the new owner streamlined assembly production and saved another Y50,000. He also adopted measures to improve cash flow so as to reduce interest payments on bank loans. The result? The enterprise no longer operates in the red; the new owner now projects that the enterprise is expected to earn net profits amounting to Y200,000—a respectable feat to say the least.

The final issue that I want to address is why these villages have invariably opted for outright privatization instead of resorting to a less extreme solution, such as opting for a shareholding cooperative or joint-stock system, with the village authority, enterprise manager, middle management, and workers all subscribing to shares. The rationale, according to the Party secretary in Qianxiang village, where nine out of ten enterprises were being privatized in 1995, is simply that the costs of decision-making involving several residual claimants are likely to be high. But it is a story told by the Party secretary in Shengfeng village that is most revealing, since it makes clear the kinds of problems that halfway solutions to institutional reforms such as cooperative shareholding may potentially encounter.

This village, according to the Party secretary, had already begun contemplating the adoption of a cooperative shareholding system as early as 1993. The rationale for doing so, at that time, was to invigorate workers' participatory incentive. In particular, it was hoped that, upon becoming partial residual owners of the enterprise, workers would have strong incentives to monitor the manager, especially the latter's deployment of funds for nonproductive purposes, a notable example being entertain-
ment expenses. The scheme did not work, however, because workers either (a) did not have the funds to buy the shares; (b) did not trust their enterprise managers, or, if they did, feared possible personnel changes; (c) did not think their enterprise could make a profit; or (d) saw this as an unattractive venture when prevailing interest rates were sufficiently high and risks comparatively low, preferring to put their money in financial institutions instead.

In light of the failed attempt to sell workers shares, the village Party secretary decided in 1994 to purchase shares for the villagers using the collective funds. He presumed that villagers would be pleased to be simply given free shares in enterprises in which they were employed, and that these shares would boost their morale. Things did not work out quite as expected, however. Because dividends were paid out of the shares owned, workers simply received more income, regardless of their effort levels. Unfortunately, some workers who were given enterprise shares chose more leisure instead of working harder—behavior that economists refer to as a backward-bending labor supply curve, or simply an effect of substitution between income (disutility) and leisure (utility). In principle, this would not inevitably reduce work incentives if there were no corresponding changes occurring in other behavioral respects. Unfortunately, however, that was not the case. Because the remuneration scheme employed by enterprises in this village is primarily based on piece rates, a worker’s income is intimately tied to his or her effort, which means that those who worked less after having been allotted the free company shares were now receiving less than those whose effort had remained unaltered. Dissatisfied with the growing income disparity arising basically from varying effort contributions, these workers took the issue to the enterprise manager and the village Party secretary.

In light of this perverse outcome, it dawned on the Party secretary that perhaps the only solution to the incentive problem afflicting both enterprise manager and workers alike would be a thoroughgoing privatization; any institutional alternative short of that would likely get them stuck in the middle of a no-man’s-land. In the case of large village enterprises, of which there are three in Shengfeng, the village Party secretary intends to contract out the management rights using a payment scheme that will allow for the transfer of fixed assets over a period of two to three years. When asked why he considers it necessary to gradually alienate the fixed assets of these large enterprises, his answer, interestingly, resembles the theoretical justification given by Alchian and Demsetz, namely, that in using a (rented) piece of equipment or asset, a renter will not exercise the same degree of care as an owner. What, I asked, if the contractor eventually failed to pay the entire capitalized value? In that case, the Party secretary said, previous payments would be treated merely as interest paid for the use of capital, which would be set aside as depreciation funds, while the village authority continued to own the enterprise.

In sum, monitoring problems have driven the institutional choice of privatization. Fairness perceptions restricted cadres from adopting incentive schemes that would most adequately motivate enterprise managers. Widely held social norms that villagers, as nominal owners, are entitled to employment in collectively owned enterprises severely constrained cadres in effectively managing village enterprises. The change in enterprise ownership—from collective to private—is seen as an effective way to alter these relationships. This is amply demonstrated in the instance where the private owner of a previously collective enterprise was able to streamline staffing by sacking some of the (presumably less productive or uncooperative) employees, including middle-level managers, in a manner that village cadres were unable to do, insofar as the villagers were the firm’s nominal owners. Indeed, the right to alter a firm’s membership—presumably by hiring and firing—is precisely what the residual claimant is empowered to do when he is owner of the firm.\textsuperscript{45}

\textbf{Conclusions}

Earlier theories have attempted to explain the phenomenal growth of China’s TVEs on the basis of the “revenue incentives” with which local government officials are strongly provided, thanks to fiscal reform, making these officials the de facto residual claimants to the revenue streams profitably generated by these “collective” firms. Drawing upon the survey results of villages in Wuxi County, which has had a strong tradition of official-led rural industrial development, this study depicts the specific roles of local officials and enterprise managers in the process of local industrial development. My findings have revealed the strategic role actively played by village cadres, and the limited role assumed by enterprise managers during the early phase of village enterprise development. This “division of labor” has to be appraised within an institutional context in which markets—in particular factor markets—are yet to be adequately developed, such that business transactions have to be carried out via “relational contracting” rather than arm’s-length market exchange. It is in such circumstances that local officials are to be regarded as playing a uniquely important role in providing a wide array of factor inputs critical to the success of these unconventional enterprises, as well as in marketing the products.

But competition and the development of markets have altered this sta-
tus quo. Whereas competition results in the erosion of (above-normal) profits, the development of markets reverses the respective roles of the cadre and the manager; as business development no longer relies on personal connections, “entry barriers” break down and competition intensifies. To stay competitive, the enterprise manager must now take greater initiative and be prepared to bear greater financial risks. But such self-initiative cannot be effectively induced under a compensation scheme that does not adequately reward entrepreneurship and financial risk-bearing. First, it has been demonstrated that in the presence of powerful informal constraints, income differentials between managers and workers have remained exceedingly narrow. Second, the perception that the villagers are owners of the local enterprises has given rise to the problem of labor discipline. Taken together, these constraints have powerfully motivated village officials—in other words, the Party, which had hitherto controlled both enterprise management and alienation of enterprise ownership—simply to transfer the bundle of rights associated with ownership to the managers.44 By and large, the change in ownership may be regarded as driven primarily by the officials’ concern for economic efficiency, and their belief that the local coffers will benefit from the fiscal contributions made by the private enterprises under the new institutional arrangements; it is a change that they judge is likely on the whole to benefit the entire village community.

Owing mainly to capital constraints, small and poorly managed firms have been the initial targets of privatization. On the other hand, village authorities have striven to keep their large enterprise(s), especially given the latter’s strategic contributions to both local coffers and nonfarm employment. While the secular trend of privatizing small and poorly managed enterprises is likely to continue as China’s economy undergoes further reform, the growing number of private firms will most likely coexist with and perhaps be dominated by larger “collective” enterprises that remain owned and controlled by the local authorities. Whether what we now see marks the beginning of an important wave of change that will eventually transform the ownership of TVEs in the heartland of local state corporatism or is merely a concerted, strategic response by local officials to “agency problems” during the development process is still too early to tell, although economic theory is predisposed to believe that property rights will eventually gravitate toward private ownership with economic development.

PART TWO

Rural Shareholding Reforms
and Their Impact