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The Theoretical and Practical Implications of China's Development Experience: The Role of Informal Economic Practices

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Abstract

China's economic reform has been understood mainly in terms of the "new institutional economics," emphasizing the role of marketized private firms and related laws. Andrew Walder and Yingyi Qian, however, have pointed out instead the crucial role played by Chinese local governments, especially their township and village enterprises. Neither interpretation, however, can account for what has happened in China since the mid-1990s, when the main engine for development shifted to local governments' competition for and active support of outside investment. Typically, local governments have provided land and related infrastructural support below cost, plus special subsidies and tax privileges, and also circumvented formal rules and regulations on labor use and environmental protection. Those informal practices and the huge accompanying informal economy, not just the new enterprises drawn in, have been the main dynamic both for China's striking GDP growth and its mounting social and environmental crises. The analysis presented here is historical-cum-theoretical and calls for a new understanding of China's development experience and of its practical implications.

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The dominant view of China's economic reform has come from the so-called "new institutional economics," associated especially with Ronald H. Coase. Its view of China's development has emphasized mainly the role played by marketized private firms and related laws, overlooking the crucial role played by Chinese local governments. Andrew Walder and Yingyi Qian, among others, have pointed out this failing by showing how Chinese local governments behaved, in effect, like marketized firms during the early Reform period, most especially in their township and village enterprises (TVEs), which provided the main engine for the development of the early period.

Neither of these two influential interpretations of China's economic reforms, however, can account for what has happened in China since the mid-1990s, when the main engine for development shifted from TVEs to local governments' active support of and collaboration with outside and domestic enterprises drawn in under the widespread competition for *zhaoshang yinzi* 招商引资, that is, "attracting businesses and investment." That is what has powered the striking development of China's gross domestic product (GDP) since the mid-1990s. Typically, local governments have accomplished zhaoshang yinzi by providing land and related infrastructural support below cost, plus special subsidies and tax privileges, and also circumventing formal rules and regulations on labor use and environmental protection. The wide resort to such "informal" practices has been crucial in China's development experience, providing effective coordination between the new market economy introduced in the reforms and the bureaucratic government inherited from the old planned economy. It has also resulted in the massive presence of an "informal economy" working at much lower wages than the formal economy, outside the protection of state laws and regulations and without welfare benefits.

Past analyses have spotlighted either the private enterprises or the local governments, but not their interrelationship, thereby overlooking this crucial dimension of China's development experience. That neglect has meant a failure to grasp not only this crucial coordinating mechanism in the Reform-period Chinese economy but also the past and present social dimensions of that development. The analysis presented here is historical-cum-theoretical and calls for a new understanding of the nature of China's development experience; it calls also for ameliorative actions in a direction different from past analyses.

Existing Analyses and the Historical Record

The New Institutional Economics

Three theorists have been particularly influential in interpretations of China's Reform-period development and "mainstream economics" in China: Friedrich A. [von] Hayek (1899–1992) and Janos Kornai, for analyzing the old planned economy, and Ronald H. Coase and "the new institutional economics" that he represents, for analyzing market economy. The influence of these theorists is well evidenced in Wu Jinglian's work, which may be taken as representative of mainstream economics in China.

To begin with Hayek, his signal contribution to the issue at hand is the argument, presented in its first instance as an argument against neoclassical economics, that imperfectly rational individuals with imperfect information making decisions according to price signals in a free market, though far from the perfectly rational individuals making up a perfectly competitive market presupposed by neoclassical economics, is much superior to planning. Hayek represents his view of imperfect individuals as a "true individualism," not the falsely constructed individualism based on the myth of perfect Reason, à la neoclassical economics. What price signals reveal is imperfect but true knowledge, far preferable to the kind of knowledge that scientistic economists aspire to. The fault with many economists, in Hayek's view, consists in their equation of the ideal with the actual and their preoccupation with mathematical models. It was that kind of scientistic mentality, carried to an extreme, that led to the planned economy, which sought to substitute planning by a few for market economy and its price signals (Hayek, [1948] 1980: esp. chaps. 1 and 6; cf. Hayek, 1974).

In his close identification with individualism, and his complete rejection of state interference in market mechanisms, Hayek was in his political convictions unmistakably a "classical liberal," as he called himself. It is not surprising that, in the West, Hayek became one of the favorite economists of the new ideological tide of neoconservatism, honored by the likes of Ronald Reagan, Margaret Thatcher, and George H. W. Bush ("Friedrich Hayek," www.wikipedia.com, citing Ebenstein, 2001: 305 and passim). In the political-economic environment of Reform China, Hayek, who had played such a prominent role in the great debate of the 1930s between planned and market economy, naturally came to wield a great deal of influence.

Janos Kornai is the theorist who has elaborated on the specifics of the "socialist" planned economies, with a comprehensive modeling of what he considers the internal logics of the system. Particularly important are his two notions of "soft budget constraint" and "shortage." Because the socialist system rests on total power of the Communist Party and on state ownership, under which ownership "belongs to all and to none" (Kornai, 1992: 75), and on "bureaucratic coordination" rather than market coordination of the economy, its enterprises are not subject to market disciplines; they continue to be maintained by bureaucratic management even when operating at a loss. A nonprofitable enterprise will not just fail and shut down as in a market economy; rather it will always be bailed out by the system. And, because the enterprises do not operate according to market mechanisms of demand and supply, as determined by price signals based on "horizontal relations" (or "linkages") between seller and buyer, but are rather based on "vertical relations" between superiors and subordinates in a bureaucracy, they do not provide the goods actually needed by society, and hence result in chronic shortage (accompanied also by unneeded surpluses). This aspect of "shortage" Kornai dubs "horizontal shortage." In addition, because the crucial relationship in a socialist system is between subordinate enterprises and their superiors in the bureaucracy, there is always a tendency for the lower level to try to maximize appropriations of inputs and minimize targets of outputs, while the upper level tends to the opposite. The result is that there are never enough resources to go around, leading to what Kornai calls "vertical shortage." For Kornai, as for Hayek, these problems can only be overcome by reliance on market rather than planned mechanisms (Kornai, 1992: esp. chaps. 11, 15).

For market economy, Ronald H. Coase's theory of "the firm" has been the most influential. According to Coase, neoclassical economics, in emphasizing the behavior of the individual rational man, overlooked the crucial importance of organization, the firm. In a market economy, "transaction costs" are crucial. Information, negotiations, contracting, enforcement, and settling disputes all require costs, and firms arise to organize individual producers in order to minimize the contracting and subcontracting costs that would otherwise be incurred. The size of the firm is determined by the relative marginal cost of its further expansion versus that of contracting on the market; the firm will stop growing when that marginal cost exceeds the cost of contracting for the same thing on the market. Now, given the reality of such transaction costs, laws exist to minimize them. Imagine, Coase says, a stock or produce exchange without laws and regulations: transactions would not be able to take place smoothly, and the transaction costs would be huge (Coase, [1988] 1990, 1991). Therein is the core of what has come to be known as "the new institutional economics."[1] Its signal contribution is to focus on the role of the firm and of law for economic development.

Other theorists associated with this brand of the new institutional economics that has been so influential in China and in our understanding of China's Reform-period development experience include Theodore Schultz and Douglass North. The former, in his Nobel Prize lecture of 1979 (Schultz, 1979), elected to spotlight the theme of "human capital" for economic development,[2] and the latter, law and legal institutions, most particularly clear-cut property rights (North, 1981, 1993). Four of the above five, of course, were laureates for the Nobel Prize in economics (Hayek, 1974; Schultz, 1979; Coase, 1991; North, 1993), and three of them taught at the University of Chicago, very much the bastion of the new institutional economics.

Hayek-Coase-Kornai's core ideas and insights, summarized above, make up the conceptual frame for Wu Jinglian's influential textbook on Chinese economic reform, which can be taken as the standard "mainstream" opinion in China (Wu, 2005).[3] In the opening chapter of the book, which reviews different theoretical traditions and arguments, Wu identifies explicitly with Hayek. He singles out in particular the Hayek (and Kornai) notion that price signals, however imperfect, are a kind of feedback from the millions of people using millions of resources, while in a planned system, which rejects the use of market mechanisms, a few select people try to develop perfect information to replace the market price signals (Wu, 2005: chap. 1, esp. 13–14, 18–20).

Kornai is the one Wu Jinglian relies on the most for more specific analyses of the problems with planning, especially for his analysis of the twin ideas of "soft budget constraint" and "shortage." We can see elements of the influence of these ideas throughout Wu's work (e.g., Wu, 2005: 29–30, 71, 73, 141; more below).

Though Wu does not specifically cite or refer to Coase, throughout he speaks with great approbation of the concepts of transaction costs, legal protection of property rights, the firm, and also democracy (Wu, 2005: esp. chaps. 1 and 2). The planned economy, Wu argues, comes with impossibly high information costs, and therefore impossibly high transaction costs, since distortions and falsehoods are unavoidable. In line with Hayek-Kornai, Wu also advocates liberal democracy as a necessary political condition for economic development.[4]

A variant, but much oversimplified analysis is that of Justin Lin, who wrote chiefly as a development strategist. Lin articulated what might be seen as the "mainstream" view of the superiorities of the market economy over the planned economy (though he cites neither Hayek nor really any of the important economic theorists of the new institutional economics). To Lin, the turn to marketization-cum-privatization meant that economic policies became more congruent with China's factor endowments, shifting emphasis from heavy to light industry, and from capital-intensive to labor-intensive production, thereby taking advantage of China's large labor supply, which Lin terms "comparative advantage." That, to Lin (and his coauthors Fang Cai and Zhou Li), is the single most important factor behind Chinese development (Lin, Cai, and Li, 2003).[5]

The body of ideas associated with Hayek-Schultz-Coase-North-Kornai and echoed in Chinese writers Wu-Lin has been shared to a great extent by powerful wings of the decision makers in the Chinese government and acted upon. There have been steady marketization and privatization, elaborate legislation, the mushrooming of Coase-ian firms, the rise and glorifying of entrepreneurial talent, and so on.

The Walder-Qian Criticism

On the empirical level, the main problem with this mainstream analysis is that it overlooks the important role that local governments have played. That oversight has led to the emergence of an alternative line of theorizing that can be identified with sociologist Andrew Walder's analysis, developed from political scientists Jean Oi's idea of "local state corporatism" (Oi, 1992, 1999) and Susan Shirk's argument that governmental decentralization was the crucial "political logic of economic reform" (Shirk, 1993). Walder's argument would target in particular Kornai's theoretical scheme, and would be followed by economist Qian Yingyi's notion of "Chinese federalism." Together, Walder-Qian constitute the most important empirical and theoretical challenge to the mainstream analysis outlined earlier.

Walder took on directly Kornai's analysis of "the socialist system." As one moved down the Chinese administrative hierarchy and its respective jurisdictions, from center to local governments (in which Walder includes township and village governments), the characteristic of "soft budget constraint" identified by Kornai applies less and less. Information becomes more complete, welfare costs lower, and government concerns with profits and revenues tied to the enterprises become stronger. TVEs, Walder argues, actually operate largely with hard budget constraints (Walder, 1995).

Walder's line of argument was articulated in mathematical and more purely economic terms by Qian Yingyi to characterize the local government as a firm-like organization, in which incentives and competition mechanisms operate. Like Walder, against the Kornai argument, Qian argues that the Reform-period local Chinese governments are in fact "market preserving." He makes the conceptual link by arguing that Kornai's "soft budget constraint" is overcome under decentralized governance by local governments' concern for enterprise and tax revenues. Competition for revenues among local governments leads to unwillingness to bail out enterprises and to harder budget constraints. To place his argument within the Western (American) academic discursive context, Qian employs the term "Chinese federalism" to liken Chinese local governments to states in the American federal system (more below) (Qian and Roland, 1998; Qian and Weingast, 1997; Montinola, Qian, and Weingast, 1995).

The Walder-Qian argument may be seen as an important corrective to Kornai's analysis, which was concerned with ideal-typical "regularities" in "the socialist system" (and in "the political economy of Communism"), sharply juxtaposed against those of capitalist market economy. By pointing out a crucial operative difference between decentralized Reform China and, for example, the more highly centralized former Soviet Union/Russia, Walder-Qian show that government actions can be not just antimarket, but also promarket. By implication, this challenges the either/or dichotomizing of market and government, capitalism and socialism. Their argument underscores, we might say, the irony that despite the Hayek-Coase-Kornai mainstream new institutional economics' avowed emphasis on "institutions," it has in fact suffered from a blind spot that has made it unable to perceive the crucial role of local governments, their enterprises, and their competition in driving Chinese development.

At the same time, however, the Walder-Qian argument makes clear that the debate would still be waged on the terms of mainstream institutional economics and within its framework. Planning is rejected in toto; market dynamics are not questioned. Walder-Qian's efforts, in the end, are to demonstrate that the market principles of price mechanism, competition, and profit making can work even with government organizations, not that market principles are not adequate to explain China's development experience.

Each of the above views has the strength of covering an important part of the story: Coase-ian analysis in spotlighting the role played by private firms and their entrepreneurs in the expanding economy, as well as by the ever larger body of Chinese laws and regulations in the increasingly complex economy; and Walder's and Qian's by spotlighting the role played by local governments in the Reform period: in "market preserving federalism," with sufficient decentralization and fiscal incentives for local governments to impose hard budget constraints on their enterprises, and compete with one another for their own benefit.

Between these two main opinions and their variants, it would seem, the realities of the first decade of the Reform era are captured fairly well. The weaknesses of both analyses would only be revealed by developments of the Chinese economy in the later Reform period, brought to light by new empirical research.

The Later Reform-Period Experience

From the mid-1990s on came the new realities: the crucial variable became neither just local governments nor just nonstate firms, but the relationship between the two. The cutting edge of development shifted from local government enterprises to the influx of outside investment (i.e., "foreign invested," *waizi* 外资, and Hong Kong-Macao-Taiwan, Gang-Ao-Tai 港澳台) and the rapidly expanding nonstate corporations (*gongsi* 公司) and smaller private enterprises (*siying qiye* 私营企业, which averaged 13 employees in 2006), and the role of local governments changed from starting and running their own enterprises to drawing in outside enterprises with proffered support. As the sizes of investments and enterprises grew, the locus of economic activity also shifted upward along the administrative hierarchy from the townships and villages to the counties, provinces, and municipalities.

Tables 1, 2, and 3, show the record and the new realities. In the 1980s and the first half of the 1990s, the most striking development was the TVEs, the majority of them owned and operated by local governments at their inception. One good index of the changing nature of the Chinese economy is the numbers and proportions of the workforce employed in enterprises of different kinds of ownership registrations: in the cities, of state-owned, collective, larger domestic corporations, outside-capital-invested enterprises, small private firms, and the self-employed; and in the "rural" areas (which in standard Chinese statistical practice include towns below the level of the county seat), the rural TVEs, small firms, and self-employed. As shown in the tables, the fastest expanding sector of the economy down to the mid-1990s was rural TVEs. By 1995, they had come to employ a stunning 128 million people who "leave the land but not the village," this compared to the total of 190 million urban employed that year.

Even so, as Tables 1 and 2 show, as late as 1995, the old urban state sector still accounted for fully 59.1 percent of the urban workforce; larger nonstate corporations and smaller private firms were still relatively insignificant (a mere 1.7 percent and 2.5 percent, respectively, of the urban workforce), as were firms with outside capital (2.7 percent of the urban workforce).[6]

But then the picture changed dramatically through the very rapid expansions of large domestic corporations and smaller firms, as well as outside-capital enterprises, to reach a total of 97.8 million employees or almost a third

Table 1. Number of Employed Persons in Urban Areas by Registration Status (10,000 persons)

Year	Total	State-Owned	Collective	Other[a]	Corporations[b]	Hong Kong-Macao-Taiwan	Foreign-Funded	Private Enterprises[c]	Self-Employed	Unregistered[d]
1980	10,525	8,019	2,425	0					81	
1985	12,808	8,990	3,324	38			6		450	
1990	17,041	10,346	3,549	96		4	62	57	614	2,313
1995	19,040	11,261	3,147	53	317	272	241	485	1,560	1,704
2000	23,151	8,102	1,499	197	1,144	310	332	1,268	2,136	8,163
2005	27,331	6,488	810	233	2,449	557	688	3,458	2,778	9,870
2008	30,210	6,447	662	207	3,034	679	943	5124	3,609	9,505

Source. Zhongguo tongji nianjian, 2009: table 4-2.
a. Cooperative units (*gufen hezuo danwei*) and joint-ownership units (*lianying danwei*).
b. Limited liability corporations (*youxian zeren gongsi*, referring to those "with investments from 2–50 investors") and share-holding corporations, ltd. (*gufen youxian gongsi*, referring to those "with total registered capital divided into equal shares and raised through issuing stocks") (Zhongguo tongji nianjian 2008: 32). Limited liability corporations include "state sole funded corporations" (*guoyou duzi gongsi*), but those account for only 17% of all employed persons of the limited liability corporations (Zhongguo tongji nianjian, 2009: table 13-1).
c. "Profit-making economic units invested and established by natural persons, or controlled by natural persons using employed labour" (Zhongguo tongji nianjian, 2008: 32).
d. Computed by deducting from the total number employed (counted in the population census) the numbers of employed persons reported by registered units.

Table 2. Number of Employed Persons in Urban Areas by Registration Status (Percentage)

Year	Total	State-Owned	Collective	Other	Corporations	Hong Kong-Macao-Taiwan	Foreign-Funded	Private Enterprises	Self-Employed	Unregistered
1980	100	76.2	23.0						0.8	
1985	100	70.2	26.0	0.3					3.5	
1990	100	60.7	20.8	0.6			0.4	0.3	3.6	13.6
1995	99.9	59.1	16.5	0.3	1.7	1.4	1.3	2.5	8.2	8.9
2000	100	35.0	6.5	0.9	4.9	1.3	1.4	5.5	9.2	35.3
2005	100.1	23.7	3.0	0.9	9.0	2.0	2.5	12.7	10.2	36.1
2008	99.9	21.3	2.2	0.7	10.0	2.2	3.1	17.0	11.9	31.5

Source. See Table 1.

(32.3 percent) of all urban employment in 2008 (as shown in Table 2). With the disemployment of large numbers (perhaps 50 million) of former state-enterprise employees in the late 1990s, followed by the massive privatization of state-owned enterprises in the first years of the new century, the state and collective sectors had shrunk by 2008 to a mere 71 million, or 23.5 percent of the total urban labor force (see Table 2).

Although the National Bureau of Statistics (NBS) does not provide accurate data for the output value of the different registration types, it can perhaps be assumed that the proportions of output value occupied by (nonstate) corporations and firms and outside-capital enterprises were considerably larger than their one-third proportion of the labor force. According to the NBS's (somewhat problematic) statistical category of "total industrial output [value]" (*gongye zong chanzhi* 工业总产值) of "above-designated-size" (*guimo yishang* 规模以上, i.e., with operating revenues above 5 million yuan a year) industrial enterprises by registration types, in 2008, state and collective enterprises' share had shrunk to only 11 percent of the total, while nonstate and outside-capital firms had grown to fully 88 percent of the total (see the appendix and the accompanying table).

By contrast, as Table 3 shows, rural enterprises did not undergo anything resembling their earlier dynamic expansion. The TVEs (increasingly privatized and no longer local government owned and operated) had leveled off at 26 percent of the rural workforce between 1995 and 2000.[7]

The enlarged numbers and proportions of nonstate enterprises allow the mainstream institutional economics and marketist view to continue to claim legitimacy. China was indeed becoming ever more "capitalist," with private capital playing an ever greater role in its stunning development. But, we must

Table 3. Number of Employed Persons in Rural Areas by Registration Status (10,000 Persons)

Year	Total	Percentage	Township and Village Enterprises	Percentage	Private Enterprises	Percentage	Self-Employed	Percentage	Agricultural[a]	Percentage
1980	31,836	100	3,000	9.4					28,836	90.6
1985	37,065	100	6,979	18.8					30,086	81.2
1990	47,708	99.9	9,265	19.4	113	0.2	1,491	3.1	36,839	77.2
1995	49,025	100	12,862	26.2	471	1.0	3,054	6.2	32,638	66.6
2000	48,934	100	12,820	26.2	1,039	2.1	2,934	6.0	32,141	65.7
2005	48,494	100	14,272	29.4	2,366	4.9	2,123	4.4	29,733	61.3
2008	47,270	100	15,451	32.7	2,780	5.9	2,167	4.6	26,872	56.8

Source. Zhongguo tongji nianjian, 2009: table 4-2.

a. Derived by subtracting township and village enterprises employed, private enterprises employed, and self-employed from the total rural employed.

ask, "Can China's development be understood simply in terms of Coase-ian capitalist firms? In other words, in the terms of mainstream institutional economics' notions of private property and legal institutions to reduce transaction costs?"

The Blind Spot of Existing Analyses

Again, the mainstream new institutional economics opinion cannot quite account for the role played by local governments, as Walder-Qian's line of analysis had already demonstrated for the earlier period's development experience, even though that analysis too falls short of being able to explain the later Reform-period experience. Walder-Qian's focus had been mainly on local governments acting like firms, owning and managing or controlling enterprises themselves. Their analyses, written in the early and mid-1990s, were obviously based mainly on the Chinese development experience of the early Reform period, when TVEs were the crucial engine of development. What is missing from their analysis is that from the mid-1990s on, local governments have no longer been engaged mainly in setting up, running, or controlling enterprises directly, but rather have played more of a facilitative role in attracting nonstate enterprises and investments.

In the Chinese institutional environment, that interrelationship between the local governments and the new enterprises has arguably been the truly crucial element, more important in the past decade and a half than either the market transaction costs of nonstate firms or local government enterprises. The interrelationship is captured in the term "attract businesses and investments," which has become the top priority for local governments. They compete aggressively for such outside investments in order to promote local GDP growth, by which their performance as local officials is finally measured (Wang Hansheng and Wang Yige, 2009). (That decentralized competitiveness, it should be pointed out, occurs within a system in which the party wields highly centralized authority over cadre selection and discipline; Huang, 2010.) We need to know just what is the content of this attracting of investments and how does it work.

This is not a question that Kornai entertains seriously. To him, the socialist and capitalist systems form coherent wholes unto themselves, each obeying a contradictory logic: the socialist system that of totalitarian power under the Communist Party, the capitalist system that of liberal democracy. Each is incompatible with the other; mixing of the two can only lead to "incoherence" and conflict: "totalitarian" power can only conflict with the growth of civic power; bureaucratic management with capitalist enterprise; soft with hard budget constraints; planned production with market price mechanisms, and so on. From these incoherences and conflicts, only crass commercialism and corruption can emerge, as in China (Kornai, 1992: esp. chap. 15; cf. chap. 21, esp. 509–11; cf. 570–74). What his scheme leaves unanswered, however, is the question, "If the Reform-period Chinese economy has indeed thus been plagued by incoherences, how then does one explain its stunning record of development?"

The either/or binary between capitalism and socialism, market economy and planned economy, has in fact shaped profoundly the terms of past debate about China's economic reforms. We have seen how Hayek-Kornai, and following them, Wu Jinglian–Justin Lin, take that dichotomy for granted. (As for Coase, his theory of the firm simply takes for granted the preexistence of a fully marketized economy, governed by contracts and laws.) The surprise is that the counterargument of Walder-Qian also comes, perhaps unwittingly, without challenging that either/or binary. Their argument, in the end, is not about the misunderstanding bred by that binary, but rather that local governments in Reform China came to behave like capitalist firms. In their analyses of the local governments and the TVEs, the key ingredients are the same as those of mainstream economics: market incentives and competition, and hard budget constraints. One might even say that while the Hayek-Kornai-Coase argument emphasizes economic development driven by private capitalist firms, the Walder-Qian argument counters by highlighting economic development driven by local governments that behave like capitalist firms. Both agree without qualification that capitalist market mechanisms work the best; neither focuses on the new interrelationship between government and enterprise, plan and market in late Reform-period China.

We can see in hindsight that the terms of debate had in fact been set entirely by the new institutional economics with its unmistakable neoconservative (or classical, laissez faire liberal) sympathies. Both sides take for granted that the planned system has proved completely mistaken and a total failure, and that only pure market mechanisms permit a rational allocation of resources. Walder-Qian's is in the end not an argument against the presumed either/or binary, but only that even governments can work by capitalist principles and market mechanisms. Both views take for granted that "transition" means a total transition from plan to market, socialism to capitalism. Neither considers "transition" from the point of view of the coexistence of the two, and hence both neglect the nature of their changing interrelationship.

True, there has been a flowering of private entrepreneurial activity, but just what has been its relationship with local governments on the level of actual operation? True, there has been local government competition, but just what is that competition vis-à-vis the new enterprises? Just what have local governments done or not done in competing for private enterprises in the later Reform period? These questions must be answered for us to have a more precise grasp of the Chinese development experience.

Informal Practices and the Informal Economy

Seen historically, the Chinese Reform-period economic system is obviously a mixed system, combining features inherited from the old planned economy with the new market economy. While Kornai is surely right to point to incoherences between the two, we must ask in addition, "What has coordinated the two to produce the stunning development record of China in the Reform period?"

The key, I argue, has been great "flexibility," commonly dubbed *biantong* 变通, in the actual operations of the economy, mostly in informal practices that circumvent or even run counter to formal laws and regulations. What follows is first a thumbnail sketch of the actual, operative relationship between local governments and enterprises since the mid-1990s, brought to light by recent empirical research, and then a consideration of the theoretical, methodological, and practical policy implications of that development experience.

Operative Relationship between Local Governments and Enterprises

An undeniable weakness of the planned system was its stifling of entrepreneurial innovation and competition, because of the hugely burdensome bureaucratic system, still intact in the Reform period. By the same token, however, that system's strength was its ability to mobilize resources on a large scale in short order, because of its concentrated governmental power. What this means first of all is that government support is almost the only way an enterprise can overcome otherwise impossibly elaborate bureaucratic obstacles, to obtain all the necessary permits and resources for smooth operation. In the language of institutional economics, the bureaucratic system imposes impossibly high institutional costs; unless, that is, it is that same bureaucratic government that is eager to smooth the way, circumvent, bend, or even violate the rules for a targeted enterprise. This is the first and most obvious sense in which we can say that local governments' informal actions serve to provide coordination between the old bureaucratic system and the new market enterprises.

But that is only a small part of the picture. The use of concentrated government power for development (which had been shown in the earlier period by the local governments' TVEs) has been demonstrated repeatedly in the later Reform period also by the way local governments have massively requisitioned land for the use of development. That requisitioning has been made possible in part by China's unclear landed property rights, in which use rights belong to the peasants and ownership to the collectivity, while the state retains the right to requisition land for development.[8] Despite the central government's declared intention to control this sphere strictly and to prevent abuse, the reality is that an estimated total of at least 40–50 million peasants have lost their land through requisitions for development (Tianze jingji yanjiusuo, 2007: 7; Tao Ran and Wang Hui, 2010).[9]

This land-requisitioning has been done by local governments usually at relatively low cost, especially if compared to the appreciated market value to come (more below). That has been a key factor in the local governments' ability to attract investment, and also a key source of local governments' revenue and, to a considerable degree, the very secret of their "success" (more below).

Land alone, of course, is not sufficient; it must come with infrastructural support: public utilities, roads, and transport. Those too have made up part of the package offered by local governments in attracting investment. That is why infrastructural development has enjoyed the highest priority in local governments' actions, part and parcel of their efforts to attract investment.

The surprise is that local governments have been willing and able to provide land and infrastructural support to new enterprises at as low as half the cost to themselves. A study of Zhejiang province found that about a quarter of the land had been sold to enterprises for less than half of what it cost the local government to develop it for sale. The average was 86 percent: land that had cost 100,000 yuan per mu to develop went for an average of 86,000 yuan. In the still more competitive areas of southern Jiangsu (such as Suzhou, Wuxi, and Changshu), land for industrial use (*gongye yongdi*, 工业用地) that had cost the local governments 200,000 yuan per mu to develop for sale, went for an average of 150,000 yuan per mu, with neighboring areas offering up comparably developed land for as little as 50,000–100,000 yuan per mu. Tao Ran and Wang Hui, who have done multiple studies of the topic, report that local governments were willing to take a loss of as much as 100,000 yuan per mu in order to draw in investments (Tao Ran and Wang Hui, 2010; Tao Ran et al., 2009).

Local governments also often provide direct subsidies to targeted firms. A good illustration is what has happened with large agricultural-produce firms, documented by the Ministry of Agriculture's first full-length report on "vertical integration" (from production to processing to marketing) of agriculture, published in 2008. Between 2000 and 2005, the report shows, the central government put in a total of 11.9 billion yuan of subsidies for large, "national grade" (*guojiaji*) agricultural "dragon-head enterprises" (*longtou qiye* 龙头企业). The more developed provinces and municipalities followed suit with 50 million yuan per year each in subsidies (in cash or subsidized loans) for targeted dragon-head enterprises, plus another 10 million yuan in subsidies provided by the city and county governments within the province, in addition to 10 million yuan or more in tax benefits. Such support for agricultural dragon-head enterprises has obviously become part and parcel of the local governments' competition to attract businesses and investment, done under the leadership of the central government. (By contrast, agricultural cooperatives, which had emerged largely spontaneously to meet the needs of peasant family-farms, have received little support from the government; in fact, they have had to operate under a kind of systemic discrimination, in that they receive little in the way of government subsidies and have been unable to obtain loans from government-controlled banks; Zhongguo nongye chanyehua fazhan baogao, 2008: 219, 194, 179, 199, 188, 236; Huang Zongzhi, 2010b.)

Local governments have been willing to take losses and offer up subsidies to attract investment from outside enterprises because of the rewards down the road. First, there are the expected revenues from enterprise taxes (although 75 percent of the value-added tax and 50 percent of the enterprise income tax go to the central government). More important are the chain reactions to follow: services and smaller businesses that will emerge to support the new enterprises and generate new sales and income tax revenues (*yingyeshui* 营业税 and *suodeshui* 所得税), which go 100 percent to the local government.

Even more important is the housing that will be developed and its inevitable appreciation in value. Here the local governments can sell to real estate developers at a considerable profit, much more than the cost to themselves in requisitioning the land from peasants. Research shows that, in the Yangzi delta, the average compensation paid by local governments to peasants in requisitioning land has been about 25,000 to 30,000 yuan per mu, but the price obtained by the local governments when they sell the land to real estate developers (*churang jia* 出让价) averages 140,000 yuan to 350,000 yuan per mu, while the final fully developed market price averages 750,000 to 1,500,000 yuan per mu, or 30 to 50 times the original land-requisition cost paid to the peasants. It is not surprising that in the more developed areas as much as 60 to 70 percent of local governments' extra-budgetary revenues have come from land development (Tianze jingji yanjiusuo, 2007: 8, 10; cf. Huang Xiaohu, 2007: 46). Requisitioned land, we might say, has been the single most important source of funding for local government development projects.

From the enterprises' point of view, they obtain not just subsidies and support but, given a good continuing relationship with the local governments, also shelter from all kinds of potential fees and taxes and administrative restrictions. The latter stem from the distinctive nature of the Reform state system: it says one thing and does another. Labor laws are ignored or compromised to varying degrees, with complicity of the local government; the same goes for environmental laws. To a considerable extent, the same is true also of the tax system—enterprises enjoy not just tax exemptions, reductions, or refunds up front, but can also be protected later on from taxes that could be imposed but in the end are not (Zhang Jianjun and Zhang Zhixue, 2005; cf. Tao Ran and Wang Hui, 2010; Tao Ran et al., 2009).

Even if the local governments pressure an enterprise to observe formal laws and regulations, as sometimes happens especially with larger outside-capital enterprises or big domestic corporations, those enterprises still benefit from their ability to hire cheap informal temporary workers on an extralegal basis. They also benefit from the low-cost support services provided by informal small firms and the large numbers of self-employed (i.e., the old and new "petty bourgeoisie," which I have examined in a separate article—Huang Zongzhi, 2008a), which are far cheaper than, say, the cost to a multinational firm of expanding its formal organization in lieu of subcontracting in the low-cost "informal economy" (more below).

All this puts enterprises from outside the locality in the catbird seat, because of the intense competition among local governments (picture hundreds of county governments gathered at a fair to compete for outside business and investment), and the substantial benefits in land, energy and transport, tax considerations, and outright and hidden subsidies, plus the huge low-cost supporting informal economy.

That has been part of the secret of China's ability to attract more inflow capital than any other developing nation. It is also how, by the "total industrial output" index, outside capital-invested enterprises have come to account by 2008 for 30 percent of the total, roughly on a par with large domestic corporations (and nearly three times that of the state-owned + collective sector at 11 percent) (see the table in the appendix). It is also why the goods-traded-to-GDP ratio (i.e., exports plus imports as a percentage of GDP) of China was as high as 64 percent by 2005, much higher than the ca. 20 percent for the United States, Japan, and India (or Brazil's 25 percent) (Naughton, 2007: 377). And it is how China's foreign direct investment (FDI) as a percentage of GDP, averaging about 4 percent from 1996 to 2002, is much higher than that of Japan, Taiwan, or Korea (Naughton, 2007: 404–5). The economic development of the later Reform period might indeed be seen as "export-led," as many writers have asserted.

Local governments' informal practices, their application of formal rules with informalized flexibility, are what lie at the heart of the system. That system as a whole might be characterized as including features of both the old planned economy (with its overbearing bureaucracy, its power to mobilize resources on short order, and its customary aggressive intervention in economic development), and the new market economy (with its capitalist firms, market price signals, supply and demand, and competition). What joins the two together in the new late Reform-period system, we might say, is the informalized uses of local government power and resources in a kind of *planned informality*, with the tacit approval of the central government.

System Costs/Benefits

Given the importance of this local government–private enterprise relationship, it is not surprising that there has been a spate of empirical studies of the political connections of firms, including studies of the role of former officials in private enterprises (e.g., Wu Wenfeng, Wu Chongfeng, and Liu Xiaowei, 2008), even attempts to quantify "political capital" by counting the presence of Political Consultative Conference and National People's Congress members on the boards of enterprises, and then correlating such with the performance of the enterprises (e.g., Hu Xuyang, 2006; Hu Xuyang and Shi Jinchuan, 2008). There have also been attempts to analyze in detail specific actions and strategies required of enterprises to establish and maintain the needed political connections (e.g., Zhang Jianjun and Zhang Zhixue, 2005). Studies like these have helped flesh out the empirical picture summarized in the preceding section.

Some analysts have equated the phenomenon with American states' competition for foreign enterprises, in an attempt to follow the lead of American public sector economics. They cite in particular the striking examples of how Alabama won the competition for a Mercedes Benz plant in 1994 and Kentucky for a Toyota plant in 1989, both by offering large subsidies.[10] However, the Mercedes Benz and Toyota examples are actually anomalous rather than typical, occurring in a weakened sector of the American economy. As Paul Krugman and others (Graham and Krugman, 1995; Glickman and Woodward, 1989) have pointed out, the American posture toward foreign investment is in the main one of "neutrality," to treat foreign and domestic firms alike; the location of firms has been determined largely by the "aggregation effect" (of industries wanting to be some place because everyone else is there), not by special subsidies. What is truly prevalent in the United States is lobbying to influence legislation, not the kind of government subsidies of the Mercedes Benz and Toyota examples (Grossman and Helpman, 1994; Biglaiser and Mezzetti, 1997).

In China, there is little that is comparable to American firms' lobbying; its reality needs to be understood instead in terms of the particular nature of the Chinese state system and the mixed (plan and market) nature of its economy. What has been the rule in China is in fact anomalous in the United States; one should not be likened to the other.

What is distinctive to the Chinese system is the very high degree of informality in its actual operation. Such informality exists in any system, but rarely to the extent of the Chinese system. The formal system in China occupies a relatively small proportion of the total national economy, and is often very much just for looks rather than for real (though perhaps an expression of an ideal for the future): the operative reality at present is primarily informal rather than formal.

It is a system in which what might be called "system benefits" (derived from dealing with the Chinese political-economic system) are actually greater than "system costs" (incurred in dealing with the heavy-handed bureaucracy and maintaining good connections with it)—an especially advantageous institutional environment for investment. Local government connections help not only to dramatically reduce "transaction costs" in the Chinese institutional environment, but they also bring sizable overt and hidden subsidies. This is the obverse side of what Kornai sees as incoherence and corruption. It might in fact be the key to the puzzle posed by the findings of Qian Yingyi and others in their 2006 exploratory but quite rigorous study of the return to capital in China, which concludes,

> The aggregate rate of return to capital in China fell from roughly 25 percent between 1979 and 1992 to about 20 percent between 1993 and 1998 and has remained in the vicinity of 20 percent since 1998. These rates of return are above those for most advanced economies calculated on a similar basis. They are also high relative to a large sample of economies at all stages of development. (Bai, Hsieh, and Qian, 2006: 62)[11]

This is of course consistent with the fact that China has drawn the most FDI of all developing countries. A United Nations Conference on Trade and

Development (UNCTAD) survey in 2005 of experts and multinational corporations showed China ranking at the very top as the most desirable destination for outside investment, by a considerable margin (Gao Bai, 2006: table 7).

What all this means is that in the reformed Chinese economic system, (what I have called) "system costs/benefits" have been crucial, at least in the past decade and a half, more important than the kinds of formal contracting costs spotlighted by Coase's theory, and also more important than whether local government enterprises are under soft or hard budget constraints, as spotlighted by Kornai and Walder-Qian. They determine to a large extent whether and how well an enterprise can operate and to what extent it will be profitable.

The Informal Economy

Part and parcel of the late Reform-period system is the rapid rise and spread of what in the development economics literature has long been called the "informal economy," which I have considered in detail in a separate article (Huang, 2009). Informal practices have led, despite the highly formalized/bureaucratized rule inherited from the planned economy, to a huge informal economy. First, in the "urban" sector (*chengzhen*, including towns and cities of county-seat rank and above), there is a multitude of unregistered workers (mainly the *nongmingong*, migrant workers from the countryside who "leave both the land and the village," distinguished from TVE workers who "leave the land but not the village"): close to 100 million by 2005, or 36 percent of the total urban workforce (see Table 2). These workers are "informal" in the sense that they work for lower wages, without the protection of state labor laws and regulations, and without the benefits accorded regular employees (*zhigong*), which is also the definition of "informal economy" adopted by the United Nations' International Labor Office (ILO). According to the authoritative investigative study convened by the Research Office of the State Council in 2006, the nongmingong worked an average of 11 hours a day, six or seven days a week, or nearly 50 percent more than formal employees, but received only 60 percent of the pay, and that is not counting the difference in benefits (Zhongguo nongmingong wenti yanjiu zong baogao, 2006; Huang, 2009: 408).

If one adds the urban workforce employed in small private enterprises and the self-employed, the great majority of whom are either nongmingong or urban disemployed workers (disemployed from formal units in the late 1990s, that is, *xiagang gongren* 下岗工人), without benefits or legal protections, the total employed in the informal economy comes to more than 60 percent of the urban workforce (Table 2).[12]

This informal economy, and its stunning expansion in recent decades, is characteristic of most developing countries, but not usually of the developed Western nation-states or the erstwhile planned-economy socialist states in such large proportions. It is, to a considerable extent, the result of globalization, of the widespread movement of capital across national boundaries in search of cheap labor. The spread of the resulting vast informal economy, both to supply cheap labor for global capital and to supply cheaply the many small-scale support services to the new economy, has been a striking phenomenon since the 1960s. China is something of a latecomer to globalization and to this phenomenon that has characterized the developing world for nearly half a century.

The record of Reform in fact has been very much a record of the informalization of the largely formal economy under the planned system. As shown in Tables 1 and 2, the number of formal employees has shrunk from nearly 100 percent of the urban workforce under the planned economy down to just 40 percent by 2008.

The general phenomenon of the rise of an informal economy in developing countries worldwide has been so striking that the ILO of the United Nations has long made it the focus of its attention, focusing on the extralegal, often inhuman conditions under which the workers of the informal economy labor, and calling for "decent" treatment for these large numbers of people who are variously hired as temporary workers by formal enterprises or provide all kinds of low-cost services for them, generally outside the encompass of formal state regulations, protections, and benefits, sometimes even under the active suppression of the government (ILO, 2002). For its efforts on behalf of informal workers, the ILO was awarded the Nobel Peace prize in 1969 (Huang, 2009).

What is distinctive about China's informal economy, in addition to its later emergence as part of the process of marketization in China, is first of all its sheer and almost inexhaustible size, this a consequence of its vast supply of surplus labor (still an estimated 100–150 million of the agricultural labor force). It is a characteristic that only a few other developing countries—for example, India—share.

Even more distinctive is the extent to which the Chinese state has deliberately seized upon the informal economy as a "comparative advantage" in competing for investment from outside capital through a system of vigorous competition among local governments, as has been seen. Like many other developing countries, China has furnished cheap labor for global capital, and informal and semiformal services to support that new sector of the economy. But unlike many other developing countries, China has in place a strong centralized political system presiding over intense competition among decentralized local governments (for a more detailed discussion, see Huang, 2010), to pursue investment from outside with a vengeance. Under that system of (what we might call) "centralized decentralism,"[13] China has in fact turned its informal economy into a powerful tool for attracting external investment, in a kind of "planned informality." The result, we have seen, has been the largest foreign investment by far in any developing country, and the fastest expanding and largest informal economy in the world.

This reality has remained "hidden" to a considerable extent, in that official Chinese statistics do not take it formally into account, to result often in the eliding of this entire sector.[14] Its number of employed persons can only be calculated by deducting from the total number of employed (from the counting of real people in the population census) the numbers of employees reported by units of various registrations. In reality, as we have seen, the informal sector totaled, by 2008, 182 million of the 302 million of the urban workforce, or 60 percent (Table 1).

If we add to this figure nonagricultural workers in the "rural" (again, including towns below the county-seat level) economy, including the more than 150 million working in its TVEs,[15] the almost 30 million working in its small private firms (*siying qiye*), and the 22 million self-employed, that would be another 200 million (Table 3). If we add, finally, the 270 million agricultural workforce, who also work largely without benefits and legal protections, we would be talking about a total of 650 million, or 84 percent of the national total workforce of 772 million, urban and rural (Tables 1, 2, 3; cf. Huang, 2009).

This entire sector lies largely outside the scope of vision of mainstream Chinese economists. When attended to, as for example by Cai Fang in an application of Arthur Lewis' "economic dualism" analysis (of a "dual economy" comprising a traditional sector with "unlimited supplies of labor," on the one hand, and a modern urban sector, on the other) (Lewis, 1954, 1955), it is argued that the informal sector is on the verge of disappearing because of the arrival of the Lewis-ian "turning point," as the dual economy comes to be integrated with development into a single modern, national labor market (Cai Fang, 2007; Huang, 2009).

In fact, of course, far from shrinking to the verge of disappearing, the informal economy has grown at explosive rates and, as we have noted, accounts today for the great majority of China's workforce. When we consider the fact that the formal economy, and its formally employed workers (chiefly the first six categories in Tables 1 and 2, from state-owned to foreign-invested) have expanded from 95 million in 1978 to only 115 million in 2006, or by just 20 million in thirty years, compared to the mammoth scale of the informal sector of 650 million (which includes an estimated 100–150 million surplus workers in agriculture), we can begin to appreciate the gross exaggeration involved in announcing the coming of the Lewis-ian turning point. Full integration of the informal economy into the formal economy in fact can only be a hugely difficult and long-term process.

Mainstream institutional economics, in its preoccupation with law and property rights and the private firm as the crucial determinant for economic development, has tended to focus almost entirely on the formal economy, and therefore overlook the contribution of the informal economy to development. The Walder-Qian counter-analysis, on the other hand, while highlighting local-government owned, run, or controlled enterprises, also largely overlooks the late Reform period's much larger economy in which the key is neither private enterprises nor local government enterprises, but rather the informal practices of local governments that occur between them, and the consequent rise of the informal economy.

Neglect of the informal economy means also oversight of the social dimensions of development as a whole, both historical and contemporary. Historical, in its neglect of how well the planned economy, by contrast, had provided for the health, education, and welfare of the majority of the people (which Nobel Prize winner Amartya Sen pointed out years ago, showing how prereform China had far outperformed India in the key indices of "social development," that is, life expectancy, infant mortality, and education [literacy], at a time when the two countries' per capita GDP were roughly comparable) (Drèze and Sen, 1995: chap. 4; Huang Zongzhi, 2010a: chap. 1). The neglect means also overlooking the realities of the current informal economy, and hence the social problems of China's Reform-period "miracle" of economic development: it is the informal economy that lies at the root, not just of China's stunning GDP development, but also its social and environmental crises.

Theoretical and Methodological Implications of China's Development Experience

All this is not to deny the validity of much of the existing analyses. The new institutional economics, in highlighting the role privatization and marketization can play in triggering and releasing private entrepreneurial energies, is well supported by the Chinese experience; at the same time, those who object to the market fundamentalism (or "classical liberalism" or "neo-conservatism") side of mainstream institutional economics are correct to point to the important role played by local governments and their TVEs.

As Hayek had long ago pointed out in his insider's critique of economics, many economists have been burdened by the excessive influence of their theoretical premises, with a strong tendency to equate the theoretical ideal with the actual (Hayek, [1948] 1980: esp. chap. 2). Most mainstream economic analyses have proceeded from the theoretical presumption of an either/or binary between plan and market, and the total faultiness of planned economy. While correct in criticizing planned economy for the immense weight of its bureaucracy, its excessive ideologizing, and its obstructing of entrepreneurial creativity and competition, they have overlooked some real achievements of China's prereform planned economy, such as its rapid development of heavy industry, its organizational prowess, and its provisions of public services. In the end, it seems fair to say that the Hayek-Kornai-Coase version of institutional economics is perhaps more ideal-typical than historical-empirical.

Historical truths, I maintain, are more likely to be found in a practice-to-theory-back-to-practice approach, as advocated here. That means relying on a more historical perspective, anchored in empirical evidence, but with theoretical concerns and implications. It is an approach that proceeds from what actually happened, to bring out "hidden" dimensions that have been obstructed from our vision by theoretical/ideological blinders. In this case, it is the local governments' informal practices and the resulting informal economy.

It should be clear that China has been tremendously successful in attracting global capital not just due to its abundance of cheap (peasant) labor, but also due to its high education and health levels, its earlier rapid development of heavy industry and infrastructure, as well as its organizational prowess (easily overlooked because of its mass-movement excesses), all inherited from the planned economy. But what is perhaps most distinctive about Reform China's development experience is not any of the above, but the unusual political-economic system of centralized decentralism, with vigorous competition among local governments to draw in outside investment, by providing informal subsidies and support, and ready access to an immense informal economy. That is what explains both China's success in economic development and its mounting social and environmental problems.

The irony is that mainstream institutional economics, à la Hayek-Coase-Kornai, and North and Schultz and others, which ostensibly focuses on the neglected dimensions of institutions and economic history, has actually overlooked this gigantic institutional-historical reality of China's development experience.

We might in summary conceptualize China's development experience on four different levels. First, it reaffirms the critical importance of informal practices and the informal economy in developing countries that combine the preindustrial and the industrial, the traditional and the modern, as emphasized by the ILO. Second, it underscores the pivotal importance of those informal economic practices in reformed socialist states, serving to coordinate between features of the planned system with those of the new market economy. Third, the sheer and seemingly inexhaustible size of the informal economy reminds us of the crucial factor of China's huge population, with which only a few countries (like India) can really compare. Finally, it highlights what is truly different about Reform China: the combination of a distinctive Chinese political-economic system with its informal economy.

To some extent, that combination characterized also the early Reform period, if we place under it the many informal ways in which local governments set up TVEs in the early period, and if we place the "leave the land but not the village" (*litu bu lixiang* 离土不离乡) peasant-workers of the TVEs within an "informal economy." But it is the later period that saw the big and dramatic changes in the urban sector: the dramatic influx of outside capital drawn in by special subsidies and the circumventing of state laws and regulations, and the explosion in numbers of migrant workers who "leave both the land and the village" (*litu you lixiang* 离土又离乡) to work in urban enterprises and provide informal services for them, without the protection of state laws and regulations and without benefits. Those urban changes are what truly dovetail with the usual sense of the term "informal economy" as it has been applied by the ILO to developing countries.

The combination of local government competition and informal economic practices in the later Reform period is what has turned unclear property rights and imperfectly developed marketization into competitive strengths, what has lent governmental support to targeted enterprises to enhance their profitability and draw in outside investment, and what has made the informal economy a "comparative advantage." At the same time, it is also what has added striking inequities within the cities to preexisting differences between city and countryside. The result has been both China's stunning GDP growth of recent years, and the social problems that cry out for remedies. It is the combination of features of planned economy with market economy, and of socialism with capitalism, contrary to the either/or binary assumed in past analyses, that explains both the successes and the failures of China's development experience.

Whither Chinese Development?

We need finally to ask, "What are the practical implications of this discussion of China's development experience?"

Applied to current realities, the above analysis means that local governments, precisely because their actions have played such a critical role, hold also the key to the future. The big issue before China is, "Will it tackle head on the problems of the informal economy that along with stunning GDP development have brought both severe social inequities and environmental degeneration?" Since local governments' informal practices have helped create the massive informal economy, it is perhaps up to them also to help remedy it.

This is not an either/or issue, of either social equity or economic development; the fact is that the preceding three decades of economic development is not sustainable. That is evidenced, first of all, by the mounting numbers (in the tens of thousands each year) of collective protests against unjust practices and environmental abuses. What the local governments have typically done is first to try to "keep the lid on" (*wu gaizi* 捂盖子); only when the protests reach a certain degree of power by organizing and mobilizing, and media exposés, and the like, will the local governments take the next level of action, of making compromises and payoffs in order to "smooth things over" (*baiping* 摆平).[16] The reason the local governments have done so is directly related to the analysis above: having made major investments to draw in outside enterprises, their interests can only be closely tied to those enterprises, leading almost unavoidably to "official-merchant collusion" (*guanshang goujie* 官商勾结), as the saying goes, all the more so because under the current cadre evaluation system, the single most important criterion in the evaluation of local officials is their "administrative accomplishments" (*zhengji* 政绩) in "attracting businesses and drawing in outside investments." Such a pattern of response to the mounting social and environmental crises, given the extreme disparity in power between protestors and the state's police apparatus, can of course maintain a kind of "stability," but it cannot possibly be a sustainable policy over the long term.

The fact that the development model of the recent past is not sustainable can also be seen in the severe imbalances in the economy: in becoming the "factory of the world," much of China's gross "domestic" product is produced under external capital and for export outside of China. By 2004 statistics, export-processing accounted for more than half (53 percent) of total Chinese trade (Gao Bai, 2006: 119). With cheap wages and reliance on the informal economy, the profits from such production devolve mainly to the outside investors, not to the Chinese workers or the Chinese economy.[17] As Gao Bai points out, the overall system forms a very sharp contrast to Japan's earlier development, which was much less dependent on foreign investment or foreign trade, its trade-to-GDP ratio never exceeding 30 percent (Gao Bai, 2006). In 2005, as noted above, Japan's foreign trade/GDP ratio was about 20 percent, like that of the United States, while China's was a whopping 64 percent.

The conclusion is an obvious one, brought home in part by the shocks to the Chinese economy from the recent worldwide economic crisis: domestic demand/consumption must be increased for China's continued development, to benefit the Chinese people more and to be truly sustainable. Indeed, something of a consensus has formed around that idea, across the Right and the Left.

What all this points to is a different path of development, in which social development would become the engine not only for social justice but also for sustained economic development. Obviously, raising the income and benefits of the poorer and lower-middle income groups will pay off more immediately in expanding consumption than raising the income of the wealthier classes, because the lower classes spend a larger share of their income for consumption. Thus, whether for the sake of social development or economic development, the present situation cries out for measures to expand the incomes and well-being of the lower classes, who make up the great majority of the Chinese people.

Even though the Chinese government has already done a good deal in this respect since the turn of the century (e.g., eliminating the agricultural tax and providing 9-years free compulsory education [though still exclusive of the nongmingong]), much more has yet to be done. In this regard, the recent experiments of Chongqing municipality provide some indication of what is needed and possible. The key idea of the current experiment there is to use the government's income from the market-appreciated value of state-owned assets to raise the living standard of the lower classes (Cui Zhiyuan, 2010). Plans that have already begun to be implemented include the provision of low-cost public rental housing for the nongmingong; the granting of urban residency and benefits to the nongmingong; allowing peasants to use their residential plots and responsibility land (and woods where applicable) use rights as security for bank loans; and systematic subsidizing of small businesses to expand the employment and income levels of the lower and lower-middle classes (*Chongqing ribao*, July 7, 2010).

To date, massive construction of new cheap public rental housing has already begun, with 10 million square meters scheduled for completion in each of three years, to house a total of about 2.5 million nongmingong and their offspring, or a majority of the 3 million plus currently working within city limits (*Chongqing ribao*, July 30, 2010). The targeted rent figure is about ten yuan per square meter per month. Thus, a small 31 square meter apartment for a young person or couple starting out would be a reasonable 300 yuan or so per month, while more matured families might rent units of 80 square meters, the average being 60 square meters (Huang Qifan, 2010a). To prevent the formation of a cheap rental housing "slum," the new housing will be dispersed among some 20 larger community groupings, such that rental housing would constitute just a small minority in any one group (*Chongqing ribao*, July 30, 2010).

The extension of urban-resident privileges to nongmingong has also formally begun, as of August 1, 2010. Chongqing, a municipality with a population of 32 million, of which about 10 million are urban residents, will extend urban residence to 10 million peasants in the next ten years, of which the first 3 million plus, already in the city, are slated for 2010 and 2011, and 700–800,000 each year thereafter. That will extend urban resident benefits in health, education, and welfare to those who at present are of the informal economy (*Renmin ribao*, July 30, 2010; cf. Dreyfuss, 2009; and Larson, 2010; Huang Qifan, 2010b). Included is a plan to allow for a three-year transition period in which peasants would retain their land rights, until those are traded in the government rural land exchange established for the purpose, to enable them to convert those rights into cash to help them make the transition to urban residence (while the government stores up the land for eventual development use) (*Chongqing ribao*, July 30, 2010).

One might legitimately ask, "Where will the necessary funding come from?" The Chongqing experiment can perhaps be seen as something that takes the logic of China's later Reform-period development experience one step further. As we have seen, the local governments have been instrumental in promoting local development by attracting businesses and investments, and they have done so largely by the formula of taking advantage of (and borrowing against) anticipated appreciation in market value. Thus, outside enterprises are drawn in below cost, but the local government is repaid handsomely down the road by increased tax revenues and its share of the appreciated land value. The Chongqing government will now take things one step further: the government will itself enter into real estate development based on the same calculation, but by saving the profit from appreciated real estate for public services like low-rent housing, rather than giving up most of it to private developers.

More concretely, the public housing project calls for the government to provide 20 billion yuan of the project's estimated total 50 billion yuan cost, mainly in the current value of stored-up land (requisitioned more cheaply earlier), and to borrow 30 billion yuan from banks and the national social security and insurance funds, to be secured against the anticipated value of the housing. The interest payments on the loan would be carried by the rents received from the public housing (Huang Qifan, 2010a).

While the Chongqing experiment demonstrates in encouraging ways what local governments can do to ease China's social inequities and adopt a path of social equity-driven economic development, it also underscores the huge burden of the informal economy. The Chongqing government, in addition to forward-looking leadership, has benefited from a fortuitous windfall of rapidly appreciated state assets which it had purchased at deep discounts—those assets appreciated at a rate of 19 percent a year between 2000 and 2008, compared to a national average of 3 percent (Cui Zhiyuan, 2010). That placed the Chongqing government in an unusually strong fiscal position. Even so, the transition to incorporating 60 percent of the municipality's residents into the urban benefits network is projected to require until 2020 for its completion, at which point Chongqing will still have 40 percent of its population who remain peasants and outside that network. This is yet another reminder of just how overly optimistic and unrealistic the claim that China is already at a Lewis-ian turning point is.

As for the countryside, Chongqing's leaders have identified two critical problems for peasants: the present difficulty in obtaining loans, and how to connect the "small peasant household" with the "big market" so it can take advantage of market opportunities. They have taken the important step of allowing peasants to use their land rights as security for loans but, like most of the nation in the past decade, are counting mainly on large agricultural corporations, the so-called "dragon-head enterprises," to "vertically integrate" (from production to processing to marketing) peasants into marketized production of higher-value agricultural products (*Chongqing ribao*, July 30, 2010).

It is somewhat surprising, given the Chongqing government's approach of equity-driven development to the cities, that it does not seem to be contemplating a similar approach to the countryside. Little or no consideration seems to have been given to an alternative to relying on the capitalist dragon-head enterprises to provide vertical integration for peasant family farms. Perhaps the Chongqing leadership, like virtually all of the rest of the nation, also assumes that agricultural development can only come with large capitalist farms that enjoy economies of scale.

As I have detailed in my new book on China's "hidden agricultural revolution," Chinese agriculture is witnessing the confluence of three historic tendencies: first, a fundamental shift in the Chinese diet as a result of higher incomes, with greater and greater demand for higher-value food, like meats and fish, milk and eggs, fruits, and high-grade vegetables; second, urbanization, including the migrant worker phenomenon; and third, a long-term decline in birth-rates that is now finally reflected in decreasing numbers of new workers entering the workforce each year (Huang Zongzhi, 2010a).

Together they mean the increasing spread of a new agriculture engaged in higher-value production that is both more capital and more labor intensive, but still anchored on small family farms such as the one or two mu plastic-tented vegetable farm or the four or five mu corn cum (20 to 30) pigs farm employing new technologies that use biological enzymes to convert unused grain-stalks into high quality feed. Those new-style farms are no longer underemployed like the old, but are rather approaching "appropriate scales" with full use of their labor, and hence enjoy higher labor productivity and incomes. Such farms rely not on traditional "economies of scale" but rather on "differential optimums" (e.g., grain vs. vegetable cultivation, and small-scale farming vs. larger scale processing and marketing) and on "economies of scope" (i.e., combining two or more mutually beneficial productive activities within a single unit). They are also particularly well-suited for new-age organic farming.

It is largely on the basis of such small family farms that the total output value of Chinese agriculture has risen at a rate of more than 5 percent per year during the Reform period, raising total output value five-fold in thirty years, a record that dwarfs by far typical agricultural revolutions in history, such as the eighteenth-century English agricultural revolution (that doubled output in one century) and the 1960s and 1970s "green revolution" (that saw about 2 percent increases per year, requiring 36 years to double). Such a rise in agricultural incomes has set the stage for expanded rural-urban trade, so critically important for the division of labor and specialization that Adam Smith saw as the engine of economic development (Smith, [1776] 1976: 401–6; Huang Zongzhi, 2010a: chaps. 1 and 6).

The new-style family farms producing high-value agricultural goods have in turn created the need for cooperative firms (under cooperative ownership but firm-like management) to link the peasant to the market. We now have a fairly reliable nationwide record of the contention between the two paths for such integration: one, through the capitalist dragon-head enterprises, with the massive local government subsidies and support they have enjoyed, and the other, through cooperatives, which up to now remain severely hamstrung by systemic discrimination, without significant government subsidies, and unable to borrow from banks. Even under such lopsided conditions, however, cooperatives have grown spontaneously to account by 2005 for about 8 percent of the gross revenues of all vertical integration entities (compared to 58 percent for the dragon-head enterprises, and 34 percent for government-organized specialty markets). That development has been the consequence mainly of the fact that the cooperatives are member-owned, which means that peasant owners will obtain a larger share of market profits than if they worked for the capitalist owner/investor. What the recent record reveals is the great potential for the development of cooperative firms: imagine what could happen if the local governments were to lend agricultural cooperative firms the kind of support they have given to dragon-head and outside-capital enterprises (Huang Zongzhi, 2010a, 2010b).

The Chongqing government already has in place a program to subsidize small businesses (“microbusinesses” 微型企业). Plans call for the government to provide small businesses that have an initial capitalization of, say, 100,000 yuan with a government subsidy of 50,000 yuan, plus assistance in obtaining a bank loan of 150,000 yuan, to give them a starting capital of 300,000 yuan. In addition, the government would extend tax privileges to the small businesses. The avowed purpose is added employment and opportunities for the lower and lower-middle classes (*Chongqing ribao*, July 30, 2010). Such a program, if extended to agricultural cooperative firms, could give them a tremendous boost, and allow them for the first time the true opportunity to compete on a level playing field with dragon-head enterprises (Huang Zongzhi, 2010b). Such a path of agricultural development would be more consistent with the government’s current equity-driven approach to urban development. Community-based cooperatives, moreover, might well be a viable way to extend benefits networks to the countryside and to reintegrate rapidly atomizing villages.

Simply relying on capitalist dragon-head enterprises, perhaps accompanied by complete privatization of landownership, on the other hand, would mean for China a result similar to what has occurred in India: its agriculture has witnessed the same trend toward production of higher-value products as in China, but 45 percent of the rural labor force have become landless agricultural laborers, the "poorest of the poor" and, according to the most recent World Bank study, 42 percent of the population fall below the poverty line (of U.S.$1.25 per day) (Huang Zongzhi, 2010a: esp. chap. 1).

The choice before the Chinese government, then, is not the simple capital-intensive heavy industry versus labor-intensive light industry strategy à la Justin Lin, nor simple socialism versus capitalism, plan versus market, as per Kornai, or social equity versus economic development as per the conventional divides between Right and Left, but rather how to find the appropriate adjustment from the present reality of government support for large corporations to a re-reform agenda of more government support for the lower classes. Given the sheer size and weight of China's population, government action is necessary to prevent the kind of mounting social crisis that had characterized China historically since the eighteenth century and had been the fundamental reason for the twentieth-century Chinese Revolution.

In conclusion, the lessons of the economic history of the past thirty years need first of all to be accurately grasped. Development has stemmed not from any simple transition from plan to market, but has rather involved the combination of features of both. There was the stunning development of the first fifteen years, driven not just by marketization but also by the planned economy's capable local cadres seizing upon abundant rural labor to develop the TVEs, helped also by the heavy industry and infrastructural base built earlier. That was followed by the equally impressive development of the next fifteen years, which drew once more on China's abundant rural labor, now driven not just by the rising tide of domestic and outside-funded private enterprises and entrepreneurship but also by a distinctive political system of centralized decentralism competing to draw in and support new enterprises. In that endeavor, local governments resorted widely to informal economic practices, of overt and hidden subsidies, and of a low-cost informal economy outside of formal laws, regulations, and benefits. This historical record does not fit easily into the either/or binary of the Hayek-Coase-Kornai variety of institutional economics.

The result of informal economic practices, we have seen, has been both rapid GDP growth and mounting social inequities and environmental degeneration. In looking to the future, it seems time to rid ourselves of the mistaken perceptions of the mainstream economic thinking of the past, of its either/or dichotomizing of market and plan, economy and government, and capitalism and socialism. An empirically grounded historical perspective allows us to see that the combination of private enterprise + local government action + informal economy has been the true dynamic behind both the economic development of the past and its accompanying social and environmental crises.

In the face of such a reality, what the Chongqing experiment is doing is to shift the emphasis of development from simple GDP growth to social development. If the first 30 years of the Reform period can be characterized as involving a kind of "planned informalization," what Chongqing is doing might be characterized as a kind of "planned formalization," not in the sense of a return to an overbureaucratized system, but of new ways to provide public services and benefits. A main method is to fund those new programs through market-appreciated values of government-developed assets. The underlying strategic calculation is that raising the incomes and standard of living of the lower and middle classes will lead to better balanced and more sustainable economic development.

Appendix

There are no accurate data for a breakdown of output value by registration type, but one possible indicator is the special statistical category of "total industrial output [value]" (*gongye zong chanzhi* 工业总产值) of "above-designated-size" (i.e., with operating revenues above 5 million yuan a year) industrial enterprises, in use since 1998. By the "total industrial output" accounting category, these nonstate enterprises (namely, domestic corporations + foreign invested + Hong Kong-Macao-Taiwan invested + private enterprises) had come to account for a total of 88 percent of "industrial output" in 2008, the outside-capital enterprises (Hong Kong-Macao-Taiwan and "foreign) alone for 29 percent. The state and collective sector, by contrast, had shrunk to a mere 10.4 percent, as the following table shows.

Total Output Value and Number of Employed Persons in Industrial Enterprises above Designated Size,[a] by Registration Status (2008)

Categories	Total	State-Owned	Collective	Cooperative and Joint Ownership[b]	Corporations	Hong Kong-Macao-Taiwan	Foreign-Funded	Private Enterprises	Other[c]
Total output [value][d] (100 million yuan)	507,448	46,857	8,956	4,962	15,8775	51,308	98,486	136,340	1,764
Percentage	100	9.2	1.8	1.0	31.3	10.1	19.4	26.9	0.3
Employed persons (10,000)	8,838	695	218	95	2,347	1,206	1374	2872	32
Percentage	100.1	7.9	2.5	1.1	26.6	13.6	15.5	32.5	0.4

Source. Zhongguo tongji nianjian, 2009: table 13-1.

a. "Above designated size" refers to "industrial enterprises with revenue from principal business over 5 million yuan" (Zhongguo tongji nianjian, 2008: 484).

b. Same as "other" in Tables 1 and 2.

c. To be distinguished from the "other" category of Tables 1 and 2.

d. "Total industrial output [value]" includes "intermediate input" during the course of production, while the "secondary industry" category of "Gross Domestic Output Value" (i.e., "Gross Domestic Product") deducts "intermediate input" and is closer to the category "value added of industry." The "total industrial output [value]" category here is used mainly for the purpose of providing some sense of relative proportions of enterprises of different registration status.

Note, however, that the term "output value," *chanzhi*, used in "total industrial output [value]," must be distinguished from the term "output value" employed in GDP (*guonei zong chanzhi* 国内总产值) accounting, which excludes the costs of "inputs during the course of production" (*zhongjian touru* 中间投入). The difference between the two amounted to a factor of about 5:1 in 2008. "Output value" in GDP accounting is really much closer in meaning to "value added" (*zengzhi* 增值).

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Notes

1. A term coined not by Coase but by his student Oliver Williamson (who was awarded the Nobel Prize in economics in 2009) in 1975.
2. A theme that was actually not as clearly argued in his influential book *Transforming Traditional Agriculture* (Schultz, 1964); for a systematic discussion of the book's insights and blind spots, see Huang Zongzhi, 2008b.
3. References here are to the 2005 English version, updated from his 1999 Chinese textbook (Wu Jinglian, 1999).
4. Despite his unmistakable theoretical allegiances, Wu's analysis, it should be acknowledged, comes tempered with a healthy dose of practical sense, shown in his specific recommendations and observations (e.g., his analysis of small farms [chap. 3], of financial institutions [chap. 6], and of social security reform [chap. 9]).
5. As for the rest of Coase's analysis, it has been echoed by many, but most recently and most forcefully articulated by Zhou Qiren. Thus, private property is what released the energies of "human capital," and also lowered transaction costs. In particular, Zhou likens planned economy to one gigantic firm, with impossibly high "institutional/organization costs" (Zhou Qiren, 2010).
6. Although the numbers of unregistered workers from the countryside had been expanding down to 1990, to reach 23 million or 13.6 percent of the urban labor force, in anticipation of things to come.

7. Though they resumed a steady rise again after 2000, to account by 2008 for 154 million workers. But the majority of those would in fact be privatized (although the NBS no longer provides a breakdown of rural firms by forms of ownership). And rural small firms also rose rapidly, to account for 27.8 million workers by 2008.
8. This is in part a matter of inconsistencies between the Law on Property Rights 物权法 and the Law on Land Administration 土地管理法. See Huang Zongzhi, 2010a: chap. 4.
9. There are no exact figures for the amount of land requisitioned. Lu Xueyi, who headed up the large-scale project studying China's new social differentiation (Lu Xueyi, 2002), gave in 2005 a rather high figure of 150 million mu, affecting 90 million peasants (Lu Xueyi, 2005). The Tianze Institute's 2007 project on China's land question gave a more conservative figure of 40–50 million peasants affected, or perhaps 40–80 million mu in total. We know that total cultivated acreage declined from 1,951 million mu in 1996 to 1,829 million mu in 2006 (Tianze jingji yanjiusuo, 2007: 7, 10), but that includes of course cultivated land lost for other reasons.
10. In 1994, Mercedes Benz planned to invest 250–300 million dollars for a plant to employ 1,500. Thirty states competed; (Vance) Alabama won the competition with a package worth $330 million, including tax breaks, provision of a plant site with infrastructure and utilities, and even a school for German children, as reported in *The Economist* in January 1994. Another prominent example is: in 1989, Toyota planned to build a plant for $800 million to employ 3,000; Kentucky won out with a package worth $126 million (Biglaiser and Mezzetti, 1997; Black and Hoyt, 1989).
11. Figure 10, p. 83, of the article shows China's return to capital compared to a set of 52 developed and developing countries. Most range from 2 percent to 10 percent, while China's is well above at 16 percent, as recalculated by the authors to match up with this index.
12. Of course, a minority of those workers enjoy some benefits, but that must be balanced against those working informally or semiformally in the formal sector, including temporary workers and contract workers for the formal enterprises, those in the "collective enterprises" and the smaller outside-capital-invested enterprises (such as the Hong Kong-Macao-Taiwan invested enterprises), many of whom enjoy no legal protection and few or no benefits.
13. Pierre Landry calls it "decentralized authoritarianism" (Landry, 2008; cf. Huang, 2010).
14. The NBS, for example, gives average wages and work hours and such information for "employed persons," but those include only the formal workers, the *zhigong*, and do not include the unregistered workers (who, as has been seen, totaled nearly

100 million in 2005) (see Table 1). The 2006 systematic study of migrant workers is the reliable source (Huang, 2009: 424; Zhongguo nongmingong wenti yanjiu zong baogao, 2006).

15. A small minority of which, to be sure, are fairly large in scale and quite highly formalized, but this should be seen in conjunction with the fact that substantial numbers in the formal sector enjoy few or no benefits, as pointed out in Note 12 above.
16. There are large numbers of studies of collective protests that illustrate this pattern. Two notable examples are Zhang Yulin, 2007, and Pan Yi, Lu Huilin, and Zhang Huipeng, 2010.
17. An oft-cited journalistic estimate has it that of the profits that multinationals earn in China, some 70 percent are taken out of China (Gao Huiqing, 2005; cf. Gao Bai 2006).

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Biography

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