

Stability in Instability. China's TVEs and the Evolution of Property Rights

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For two decades economic and social stability in China's rural areas has been based on the successful evolution of township village enterprises. These enterprises, however, feature property rights structures which according to conventional property rights theory should make these enterprises highly inefficient and prone to quick dissolution. But as closer analysis indicates, exactly these ambiguous property rights structures may be the recipe for success. They constitute highly flexible best practice solutions for corporate survival in the context of rapidly changing environments in a transition economy. But as the Chinese market economy matures, these ambiguous property rights structures will nevertheless have to make way for clearly defined – stable – property rights structures. The paper introduces some hypotheses concerning the forces underlying these evolutionary processes.

Introduction

Over the past two decades in China, "township village enterprises" (TVE)¹ have made a significant contribution to the strengthening of social structures in that they have created jobs and a second (industrial) pillar in the rural areas of the Chinese economy. Paradoxically, this "stabilizing" effect appears to depend on enterprises whose property rights structures do not demonstrate a clear distribution and which, therefore, when viewed in accordance with the Property Rights Theory, are highly *unstable* (Pei 1996, Zhang 1997, Wang 2000, Chang/Wang 1994). Theoretically, unclear property rights distributions of this kind ought to result in such enterprises operating comparatively inefficiently and ultimately being forced out of the market (Demsetz 1967). However, this expectation has been contradicted by an extraordinarily high productivity of the TVEs (Byrd 1990, Perotti/Sun/Zou 1999, Weigelin-Schwiedrzik/Hauff 1999).

Thus, on the theoretical level the question arises whether one of the fundamental assertions of the Property Rights School has been disproved or whether closer investigation of the facts may clarify the apparent contradiction. On the China-specific

¹ Here I am referring to what in Chinese are known as *xiangzhen qiye*. This includes all businesses located in rural areas, which are not involved in agriculture but instead in industry or services, and which are not explicitly (and unambiguously) state or privately owned. Because this definition is so broad, it includes — where size, type of business, and organizational structure are concerned — a comparatively heterogeneous group of enterprises, which are, nonetheless, united in their unclear property rights structures through a phenomenon which will be explained in detail below.

level it seems worth examining what specific role TVEs are playing in the evolution of a market economy system in China.

Approaching the Theoretical Problem

In the literature to date, it is possible to distinguish three main groups attempting to resolve the paradox of the property rights structures in TVEs, each encompassing numerous individual viewpoints. They are as follows:

1. *Those which refute the phenomenon of unclear property rights.* These explain the apparent paradox away as the result of observational error.
2. *Those which question the suitability of the Property Rights Theory to explain the phenomenon.* In other words, the apparent paradox is the result of invalid methodological practices.
3. *Those which attempt to explain the efficiency of unclear property rights under the existing conditions.* For the proponents of this approach, the existence of unclear property rights is accepted and understood as a best-practice solution in a world of prohibitively high transaction costs. At the same time, the validity of the Property Rights Theory is also accepted.

The **first** of these groups is united in the belief that the apparent paradox is solely the result of observational error. For the proponents of this approach, it is necessary, above all, to differentiate between *de jure* and *de facto* distributions of property rights. It is their belief that out of the anonymous mass of *de jure* owners (local population, workforce) individual decision-makers will emerge to gather all the relevant property rights into their own hands and manage the TVE through contractual constructions. The success of the TVE is therefore interpreted as the result of its successful adaptation to the conditions of doing business in the Chinese transformation economy (Ho 1994, Naughton 1994, Rawski 1995).

Accordingly, say the proponents of this explanation, there is no contradiction between the dictum of the Property Rights School and the observed success of the TVEs. Instead, the problem exists solely in the optimization of governance structures and the establishment of an optimal contractual arrangement of the relationship between principal and agent. There are, however, two problematical assumptions involved. The first is that there is a clear hierarchy between local government and management. The second is that local administrative bodies control all the property rights relevant to the business practices of the TVE. Neither assumption, however, seems to correspond completely with reality.

The **second** group (Nee 1992, Weitzman/Xu 1994) is united in their rejection of the Property Rights Theory as a suitable approach to a scientific analysis of the TVE phenomenon. At the heart of Weitzman's and Xu's methodological criticism is the claim that the Property Rights Theory is not universally valid, but, in fact, dependent on cultural factors in the particular region being studied. Thus, the Chinese, whose society has been molded by collectivism (Hofstede 1980), demonstrate a great capacity for self-organization, which makes it possible for them to organize their

interactions without specific formal rules of behavior and, therefore, without clearly specified property rights, either.

This explanation appears to explain the patterns of interaction in a small TVE which has settled in a small village community.² But it is equally true that, if only because people within the village community are so likely to be confronted with each other again, opportunistic behavior, or free riding, will receive immediate punishment. This potential for sanction alone already provides a sufficient basis for self-organization (Ben-Porath 1980, Carr/Landa 1983, Klein 1985, Telser 1980). It is not necessary, therefore, to reach for such explanations as "culture" or, in this case, a heightened cultural affinity for cooperative behavior. At the same time, this approach is completely unable to explain TVE groups. Such enterprises are so large and complex that a cultural affinity for cooperative behavior could hardly induce sufficient self-organization processes (Chen/Jefferson 1999).

The **third** approach starts from the conviction that unclear property rights structures represent a phenomenon which actually exists and which must be understood as the result of rational choice (Che/Qian 1998, Li 1996, Smyth 1997). An approach which must neither deny the existence of unclear property rights distribution nor relegate the validity of the Property Rights Approach to a dependency on cultural specifics is offered by the Theory of the Commons (Ostrom 1990). This theory holds that communal property can represent an efficient solution to organizational problems if the transaction costs of setting up or pushing through private ownership rights are prohibitively high compared with expected profits (Li 1996, Krug 1997, 2000). In other words, prohibitively high transaction costs leave regulatory structures at a level where the Standard Property Rights Theory does not yet pertain, or, better put, where standard property rights distribution is not yet relevant. This explanation also assumes a certain capacity for self-organization. Unlike the Weitzman/Xu approach outlined above, however, this argumentation does not rest on a cultural affinity for collective trading but on the transaction costs of economic interaction.

Pre-requisites for a Rational Choice of Unclear Property Rights in China

This research project is based on the assumption that the third proposition has the greatest explanatory power. However, in order to test the validity of this approach with regard to the phenomenon of Chinese TVEs, three problems must be solved:

1. Why would rational individuals invest energy in the founding and operation of a TVE without a clear disposition of property rights to guarantee them a secure claim to residual income?

The answer to this question must be sought against the backdrop of the as yet incomplete market framework within which economic transactions must be made. If returns are sought from locally available resources, capital, or business concepts in

² Statistically, the average workforce of a TVE consists of only six people. However, there are also large enterprises (TVE groups) with tens of thousands of employees (*Nongyebu xiangzhen qiyeju xinxi tongjichu* [Office of Information and Statistics on Township Village Enterprises of the Department of Agriculture] 1999).

the absence of markets where they can be sold, this can be done only through their transformation into income flows, that is, through their investment in productive processes (Naughton 1994).

2. To what extent does a prohibitively high level of transaction costs prevent the establishment and achievement of private property rights?

In answering this question, it is necessary to take into account ideologically motivated resistance against open privatization of former collective property. Numerous TVEs in the People's Republic of China evolved from group and community enterprises (Putterman 1997). Even more significant is the lack of formal institutions which could lay the groundwork for market transactions (Krug/Polos 2000). TVEs were — and many still are — severely handicapped in their access to external investment, acquisition and distribution channels, and the like. Moreover, insufficient contract security and the phenomenon of state predation combine to create a particularly insecure transaction climate. Inasmuch as enterprises must operate under gray market conditions and their management cannot influence the decisive parameters of entrepreneurial results, any forced establishment of private property rights really would represent the inferior strategy. Instead, in this context, community property shared by management and local political leadership appears to be a strategy which will secure the input necessary for operating a business (Hsiao/Nugent/Perrigne/Qiu 1998). That is, in the face of otherwise prohibitively high transaction costs, the transaction partner is internalized (Williamson 1985). Only in this way can the opportunity-to-risk ratio be reduced to an acceptable level and the transaction (the founding and operation of the TVE) take place at all.

3. Do local government bodies have an interest to commit themselves to the well-being of local TVEs?

The efforts of the enterprise to attract local government bodies must be complemented by a corresponding interest in participation on the side of the local political organization. As Che and Qian (1998) have shown, local government bodies can profit by acting as middlemen between enterprises and central government. Through their participation in TVEs, local government bodies can, on the one hand, defend the enterprises from excessive taxation by the central government and, on the other, protect the central government from excessive revenue hiding by the enterprises. In this way, they contribute to a reduction in the informational asymmetry between the two parties and thus even have a positive effect on the development of the economy as a whole. In this context, unclear property rights structures in TVEs may even be considered institutional innovations that promote efficiency — much as Kirzner (1973) described.

Seen in this way, the phenomenon of unclear property rights structures in the TVE sector of the PRC can be interpreted as the interplay of three factors which together make unclear property rights structures appear to be a rational choice. These three factors are

1. the existence of prohibitively high transaction costs in the establishment of private ownership rights,

2. the suitability of unclear property rights structures to serve as a best practice method for internalizing those political actors with the most decisive influence on business success, and
3. the fact that they can serve as a source of arbitrage profits for local administrative bodies.

Towards Clearly Defined Property Rights

As shown above, the unclear property rights structures observed can be readily interpreted as a sensible arrangement which has been able to make an important contribution to the development of the TVE sector in China — without shaking the foundations of the Property Rights Theory. Nevertheless, these unclear property rights structures still represent an inferior institutional arrangement, which, in the course of the evolution of the entire economy, will have to give way to more productive ones (Demsetz 1967, North 1990, Posner 1980, Jefferson/Rawski/Zheng 1994).

But at which point do which factors begin to erode the (prohibitively) high level of transaction costs, thus enabling the formation of clearly defined property rights structures (private ownership rights in the traditional sense)?³

While the questions raised until now, are directed at developments that have unfolded during the last two decades, this final question targets developments that have their roots in the present but are directed towards the future.

The key to answering this question is expected to be found in the relationship between enterprise management and local government. It is suggested that development towards clearly defined property rights correlates negatively with the importance of the contribution from local government to business results (Chen/Rozelle 1999). That is to say, the less necessary local government is to management of external business affairs and the more complete the surrounding market formation, the less local governments will be in a position to obtain profits through their powerful positions in the "gray market" context. Instead, TVEs will be able to find access to external investment, make use of contractual security (a supra-personal system of law), and secure access to distribution channels, acquisition markets, export markets, import goods, etc. That is to say, the necessity of internalizing local government will disappear.

Next, according to the Property Rights Theory, the decreasing contribution of local government to business results should lead to a shift in the distribution of property rights between enterprise and local government. In accordance with the principle that residual profit retention rights be awarded to the party whose actions are least subject to control and who has the greatest influence on business success (Grossman/Hart 1983), there should be an observable transition from fixed wage contracts to sharecropping contracts (Alchian/Demsetz 1992) and then to leasing arrangements (Pan 2000, but: Zhu 1998) or joint-stock cooperatives (Herrmann-Pillath/Kato

³ It is to be expected that the erosion of the prohibitively high level of transaction costs will also lead in the end to the surmounting of the two remaining contributing factors mentioned.

1996, Vermeer 1999) and finally to creeping privatization along with, therefore, an increasingly clear definition and distribution of property rights. Initial empirical studies (Fan 1997, Krug/Hendrischke 2001, Li 1998, Lin/Ye 1998, Yep 2000, Zhou/Liang 2000) do in fact indicate various forms of a covert and even partially open transfer of unclearly distributed property rights into clearly defined ownership structures. In other words, abstract community property is being transformed into private property.

Implementation of the Research Agenda

The empirical test of the (theory oriented) hypothesis outlined above will be first of all based on semi-structured interviews in various regions featuring varying degrees of marketization and economic development. Next to the qualitative information to be gathered, the fieldwork is expected to provide a data set sufficient for supplementary quantitative analysis. The fieldwork will make use of a specific circumstance that is expected to permit a special kind of time-travel and therefore make it possible to throw a spotlight at different stages of property rights evolution in China: In China the evolutionary process outlined above should have progressed along the lines of market transition which is going along with a rise and fall of gray markets. During the past two decades the various Chinese regions, however, have gone through a very heterogeneous development process. While the coastal belt has constituted the avant-garde of market oriented institution building and economic development, the hinterland has shown remarkable inertia in terms of market transition and economic modernization.⁴ This developmental east–west slope should permit a travel through time on which different stages of property rights evolution may be encountered as one proceeds from the eastern coastal belt towards Western China.

On the China-specific level we expect this analysis to provide further insight into the specific role TVE play for the evolution of a market economy system in China. Due to the flexibility of their institutional set up TVE have been and still are much more responsive to changes in the macro-environment than for example state owned enterprises. TVE are the first who accommodate such changes in their corporate structures and by that push the market oriented institution building in China forward. Furthermore, an analysis of the parameters underlying the individual decision making processes which have become the driving force of the specification of clearly defined private property rights, may contribute to the formulation minimum requirements for corporate governance structures in a modern Chinese economic system. Such guidelines may help to prevent excessive rent-seeking behaviour, find socially acceptable ways to accommodate the expropriation of large groups of today's formal shareholders, and devise functional checks and balances for top management bodies, thus laying the foundation for sustainable, stable corporate and social structures.

⁴ See for example the marketization index provided by NERI.

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