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The Political Economy of China's Urban Reforms

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## **2. The Political Economy of China's Urban Reforms**

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### **Abstract**

Why did China's national authority (the center) allow some provinces to adopt deeper urban reforms than others? This paper evaluates alternative answers found in political-economic literature. My data analyses suggest that the center, in implementing urban reforms in the provinces, primarily tried to increase revenue income. The center also attempted to garner political support from the rural consumers and surplus labor, and generate higher returns from material inputs in the provinces. Interest groups appear to be irrelevant. This conclusion is reached by testing the growth, revenue, political-support, and interest-group explanations for different extents of provincial involvement in urban reforms.

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### **Urban Reforms and Research Agenda**

Why did China's national authority (the center) allow some provinces to adopt deeper urban reforms than others? Which model from the existing political-economic literature best accounts

for the center's differing stances toward urban reforms in individual provinces? These are the questions I hope to answer in my research.

As scholars argue, the Chinese leaders devolved economic decision-making power to the provinces and localities in order to stimulate their interests in the reforms and build up the reform momentum in the country (Shirk 1993). Urban reforms stand out as an example of China's decentralization-for-reforms strategy. During 1981-1992, the center selected 76 cities to experiment with urban reforms. This policy entails two processes. In the first process, the center selected 72 pilot-reform cities in the provinces between 1983 and 1987. In the second process, the center declared 17 line-item cities between 1984 and 1989, listed them separately in the national economic plan, and granted them provincial-level economic power. Some of these line-item cities overlapped the 72 cities. The center authorized these 76 cities to try out numerous urban reform initiatives, such as overhauling state industrial and service sectors, and exercising jurisdiction over their adjoining counties, and re-structuring municipal administration (Gao et al 1993, 129; 201). This reform measure would enable rural enterprises in the neighboring counties to take advantage of capital, skilled technicians, equipment, resources, and goods in the cities. As a result, these enterprises might grow faster. It was believed that cities could use their extended authority to promote urban non-state sectors.

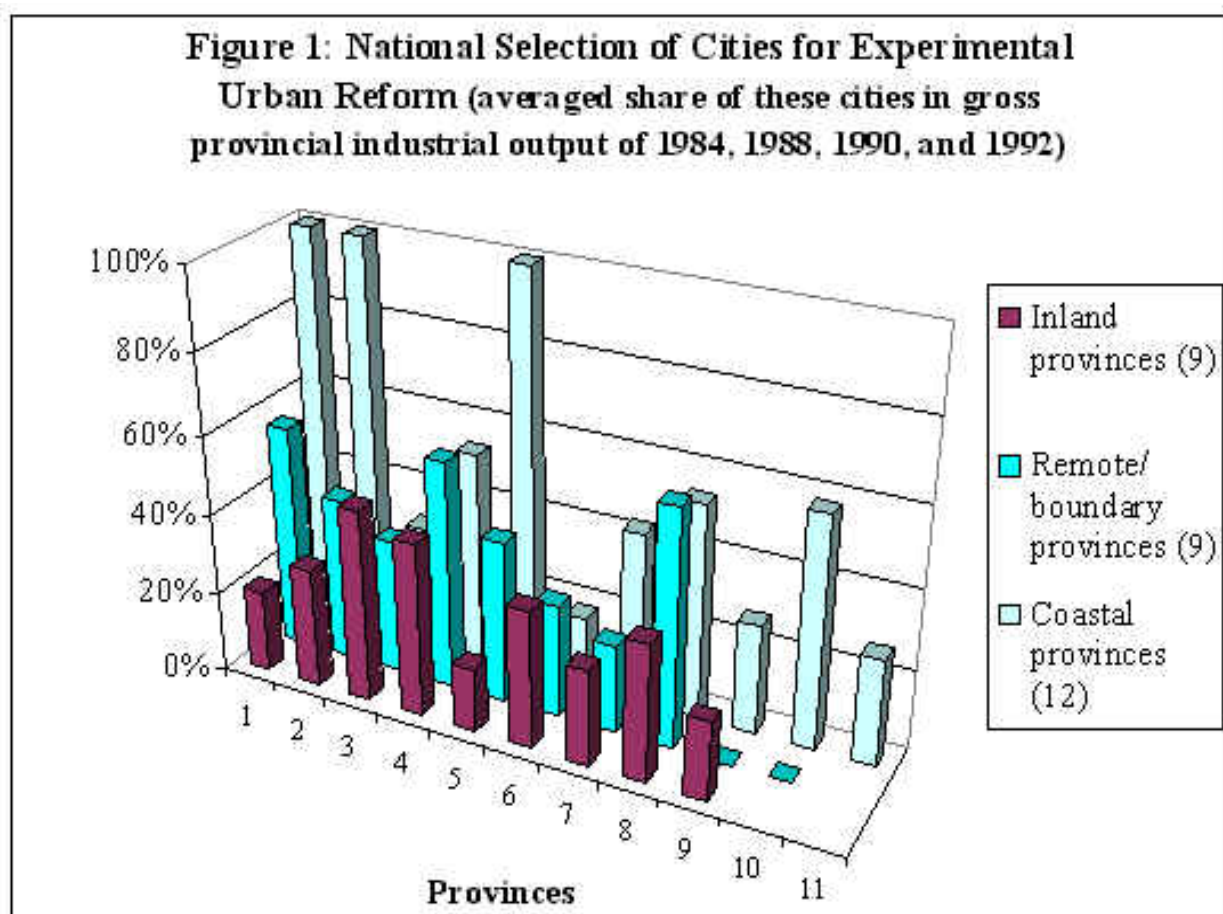
The extent of urban reforms, measured by the share of the pilot-reform and line-item cities in provincial industrial output, however, differed significantly among the provinces. An analysis of variance (ANOVA) test on the variation among the provinces in 1988, 1990, and 1992 (these years are selected for good data are available) suggests that inter-provincial variation in this share is large, significant at the  $1.2 \times 10^{-53}$  level and far beyond the conventional 0.05 level. A graphic display of the averaged share of these cities in the provincial industrial output also shows striking differences across the provinces (Figure 1). Again, this sharp regional variation in reforms leads us to ask: Why did the center allow the provinces to expose to urban reforms differently?

## **Explanations**

A growing body of political-economic literature suggests that governments, in making economic policies, attempt to achieve economic efficiency, improve revenue, secure popular support, or appease interest-groups (Eggertson, 1990; Peltzman 1976; North 1981; Shirk 1993).

These models, however, are rarely applied to and tested in the reforms in the ex-communist economies, especially China. Instead, the existing studies focus on the history, outcome, and socio-economic aspects of these reforms (Aronson et al 1994; Nee and Stark 1989; Slider 1994).

My research will apply four major political-economic explanations drawn from the political-economic literature to the center's differentiated policies toward urban reforms among the provinces. These models are growth, revenue, political-support, and interest-groups. The following paragraphs outline the logic and hypotheses (in italics) of each explanation.



The growth (efficiency) explanation holds that national leaders tried to generate rapid economic, especially industrial growth when formulating reform policies (Yang 1990). A large industry increases national leaders' political influence, prestige, and disposable resources. However, the resources for materializing reforms and growth were limited. Shortage in energy supplies, for example, forced enterprises to scale back their production. In addition, the provinces contended fiercely for a large share of domestic capital and resources. Provinces with

good infrastructure, human capital, and access to the international market would attract more capital and raw materials after reforms and produce higher returns from investment. *Therefore, the growth-oriented center would push for faster reforms in the provinces closer to the coast, and with better transportation and telecommunication systems and a higher literacy rate.*

The revenue explanation maintains that the revenue-hungry government tried to maximize its revenue income through reforms. Prior to and years after the reforms, the government collected most of its revenue from state industry because of its easy access to the financial records of state industry, its control of the state sector, and the large, albeit declining size of state industry (Naughton 1995, 34). State industry remained fiscally important also for two other reasons. First, it would take years for the center to establish an apparatus to collect taxes from newly emergent non-state industry (NSI). Second, NSI needed a tax break in the early years of its business in order to offset the high entry and start-up costs. As late as 1993, 70.5 percent of the taxes on industry came from the state sector, even though NSI produced half of industrial output (Statistical Bureau of China 1994: 380-81).

In order to maintain its revenue income, the government had to force the state sector to increase its productivity. It could do so through introducing reforms and by allowing NSI to compete against state industry. Since state industry would remain the largest governmental revenue source after reforms, reforms would allow provinces with larger state industry to expand their primary revenue base. *In the provinces with larger state industry, or with smaller NSI, the revenue-sensitive center would encourage faster reforms.*

The political-support explanation proposes that the state would implement policies to benefit the population and gain their support (Perry and Wong 1985; Lieberthal 1995, 127). Traumatic politics during the 1960s and the 1970s had created disillusioned the Chinese and created a legitimacy crisis for the Communist Party. In addition, rapid population growth in the past decades had produced a large population of young labor that desperately needed jobs. By introducing reforms, the government hoped to provide less expensive and better manufactured goods for consumers. It also allowed NSI to expand in the cities and countryside in order to provide jobs for the surplus labor. The center therefore used reforms to reduce popular discontent, prevent mass upheavals, and strengthen the state's control. *In the provinces with a greater demand for industrial goods (measured by the per capital consumption level in the*

*economies), the popular pressure on the state for faster reforms, more and better consumers' goods and more jobs would be higher, and the center would encourage more reforms.*

The interest-group explanation suggests that reform policies resulted from the influences of the industrial sectors with a stake in reforms. Industry was composed of two main sectors-- heavy and light industries. In terms of ownership, industry consisted of state and non-state industry. These interest groups anticipated the following two effects of reforms and could demand or resist reforms accordingly. First, the state would remove its restrictions on the market and the non-state sectors. This would benefit NSI but hurt state industry. Second, after reforms the state would inevitably replace its heavy-industry-oriented growth strategy with a market-oriented strategy and emphasize balanced growth of heavy and light industry. It would benefit light industry yet harm heavy industry. As a result, *in the provinces with larger light industry and larger non-state-owned sectors (measured by their shares in the industrial output), the industrial groups' support for reforms would be stronger. The center would adopt more reforms there.*

### **Test Results**

A statistical test can help to determine which explanation best accounts for the national policies toward provincial urban reforms. In the test, the measure of the national reform policy (the share of the pilot reform and line-item cities in provincial industrial output) will be regressed on the political-economic indicators of the provinces drawn from the hypotheses at the same time. These indicators and their measures are listed in Table 1. Data come from national or provincial statistical publications that are not listed here due to limited space. In employing cross-sectional time-series regressions, I will incorporate panel-corrected standard errors (PCSE), as recommended by methodologists (Beck and Katz, 1995). I will also take into account autocorrelation, control for heteroscedasticity, and test for and minimize multicollinearity. With all the above tasks done, serious statistical problems will be avoided.

The test result (summarized in Table 2) indicates that the revenue explanation seems to best account for the national urban reform policy, followed by the support and efficiency, and interest group explanations. The national urban reform policy correlates highly significantly with the strength (size) of state industry (equivalent to 1- the size of non-state industry). The result strongly supports the revenue explanation. The other models receive weaker support. The

center tended to introduce urban reforms in the provinces with a higher level of rural consumption, and with probably more rural surplus labor. This confirms the political-support explanation, for rural consumers and surplus labor made up the majority of the population. Furthermore, the center tended to encourage more urban reforms in the provinces that were located within close proximity of ocean harbors, that had a higher level of telephone density, to a lesser extent, that had a better transportation system, and unexpectedly, a lower literacy rate. One would expect that the growth-oriented center preferred more reforms in provinces with a higher literacy rate. Therefore, the growth model receives mixed support. Scholars on China widely believe that national policies favored the coastal provinces. The above tests indicate that the proximity to the coast increased a province's chance of being selected by the center for urban reforms. Finally, the center seemed to promote greater urban reforms in the provinces with larger state industry, contradicting the prediction of part of the interest-groups model.

**Table 1. Independent Variables and Their Correlation with the National Policy as Predicted by the Four Explanations**

| <i>Explanations</i> | <i>Variables</i>                         | <i>Measures</i>   | <i>Correlation with National Policy</i> |
|---------------------|--|---|---|
| Growth              | Transportation access                    | (length of railway, highway, and waterway in kilometer times adjusted by share of each route in national turnover volume of goods)/ provincial area in 1000 square kilometers, logarithmic transformation | +                                       |
|                     | Coastal access (Distance from the coast) | Distance in kilometers between a province and the closest major ocean harbor by train, logarithmic transformation   | -                                       |
|                     | Telecommunication                        | Phones per 1000 residents, logarithmic transformation   | +                                       |
|                     | Literacy rate of the population          | The literacy rate at a population sampling or census  | +                                       |
| Revenue             | Size of non-state industry               | Share of non-state industry in provincial industrial output   | -                                       |

|                   |                            | <i>state industry</i>  |   |
|-------------------|----------------------------|--|---|
| Political Support | Urban consumption level    | Consumption per non-agricultural resident in 1980 Chinese yuan, logarithmic transformation     | + |
|                   | Rural consumption level    | Consumption per non-agricultural resident in 1980 Chinese yuan, logarithmic transformation     | + |
|                   | Urban unemployment rate    | Officially registered unemployed labor/ total urban labor                                      | + |
|                   | Rural surplus labor rate   | The portion of rural labor that worked outside the locality on a temporarily contractual basis | + |
| Interest Groups   | Size of non-state industry | Share of non-state industry in provincial industrial output                                    | + |
|                   | Size of light industry     | Share of light industry in provincial industrial output  | + |

Notes: + positive; - negative.



**Table 2: Results of Regression of the National Policy toward Provincial Urban Reforms on Variables from the Four Explanations (the Coefficient and Standard Error of z Score)**

| <i>Model/<br/>category</i> | <i>Variables</i>               | <i>Coefficient</i> | <i>Standard error</i> |
|----------------------------|--------------------------------|--------------------|-----------------------|
| Growth                     | Transportation                 | 0.085+             | 0.049                 |
|                            | Harbor                         | -0.070****         | 0.020                 |
|                            | Phones                         | 0.172**            | 0.064                 |
|                            | Literacy                       | <u>-0.224*</u>     | 0.093                 |
| Revenue                    | Non-state industry             | -0.735****         | 0.121                 |
| Support                    | Urban consumption              | 0.342              | 0.233                 |
|                            | Rural consumption              | 0.345*             | 0.145                 |
|                            | Urban unemployment             | 0.323              | 1.051                 |
|                            | Rural surplus labor            | 0.718+             | 0.401                 |
| Groups                     | Non-state industry             | <u>-0.735****</u>  | 0.121                 |
|                            | Light industry                 | 0.036              | 0.179                 |
| Other                      | Constant                       | -1.087             | 0.821                 |
| Statistics                 | Panel AR (1) coefficient       | 0.404              |                       |
|                            | Pr>Chi2(10)                    | 0.0000****         |                       |
|                            | Log likelihood                 | 168.17             |                       |
|                            | Case (provinces x year)        | 28 x 3             |                       |
|                            | Years of national policy       | 1988, 1990, 1992   |                       |
|                            | Years of provincial indicators | 1984, 1988, 1990   |                       |

+ : Significant at 0.10 level; \* : significant at 0.05 level; \*\* : significant at 0.01 level; \*\*\* : significant at 0.005 level; \*\*\*\* : significant at 0.001 level; underlines: significant yet contradicting the model.<sup>1</sup>

Sources of data: Statistical yearbooks of China and the provinces, as well as industrial, agricultural, urban, labor, population, transportation yearbooks or statistical yearbooks of China during 1980-1998.

The results can be stated more explicitly. In executing urban reforms in the provinces, the center seemed to be concerned with revenue, popular support, and growth, yet weigh them differently. First, the center apparently tried to maximize its revenue by selecting cities from the provinces with larger state industry for reforms. Second, it tried to induce support from rural consumers and rural surplus labor. Third, it attempted to reap the benefits of higher growth by authorizing more urban reforms in provinces closer to ocean harbors and with better telecommunication and probably better transportation. However, this attempt was weakened by its selection of cities in the provinces with a lower literacy rate. Part of the interest-groups explanation is rejected in the test. In sum, the center tried to satisfy in order of importance its revenue, popular-support, and growth considerations in expanding urban reforms in the country.

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<sup>1</sup> Tests use cross-sectional and time-series regression with Panel-Corrected Standard Errors (PCSE), correction for heteroscedasticity (HETERO), and a common first-order autocorrelation coefficient (AR1). Values of the national policy in a later year are regressed on the data on the provinces from the four models in an earlier year. For example, the measure of national policies in 1988 is regressed on the provincial variables in 1984. In this way, the provincial variables of an earlier year, or the center's consideration of these variables, could have affected the national policies in a subsequent year, but not the other way around. The reason is that the event of 1984 could have caused that in 1988, but not conversely. The regression analysis starts with 1988 so as to observe the effect of provincial characteristics in an earlier year on national policies in a later year.

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