

The Rise and Demise of the Rural Co-operative Fund: 1984-1999

WEN TIEJUN

PART ONE

THE RISE AND DEMISE of the Rural Co-operative Fund (RCF) is closely related to the overall national condition and the changes made to financial policies.

In the first place, its rise is due to the collapse of the People's Commune in the mid 1980s, when the household responsibility system was put in place. Throughout the country, collective assets were audited and debts were transformed into loans from the 1980s to the early 1990s. The RCF played an important role in rural financial reform and economic development. As a result, it spread throughout the country. Its importance as a mechanism of raising funds in the development of local economies is such that not only the local government increased its intervention and control, but also the central authority throughout the period between 1984 and 1993 lent its support. Even in the period of rectification, from 1994 to 1996, the central authority still regarded it in a positive manner.

In the second place, the mid 1990s saw a loosening of control by the state in bonds, futures and real estate investments, all three being rather speculative. There was a squeeze of capital throughout the country, resulting in high interest rates. The RCF (mainly at the township level and above) ran into problems similar to other financial institutions. Hence, at the peak of its development in 1997, the higher authorities carried out rectification and decided to merge or close the funds. In the ensuing years between 1998 and 1999, even though problems occurred mainly at the

township level, funds that were established at the village level suffered the same fate.

In the third place, under the direction of the central authorities, the decision to rectify and close the RCF was soon carried out. Immediately, this created new problems. On the one hand, the administrative decision to close the RCF and to stop lending activities rather abruptly was bound to create large-scale bad debts. On the other hand, nothing was done to insure against this risk. Even though local governments pressed the central authorities hard for credit, there was not enough money to meet the need for hundreds of billions of yuan. As a result, governments at the village level were heavily in debt; and in the end these debts were passed on to the peasants and township enterprises. The outflow of capital from the village worsened. Capital for agricultural investment was stretched far and thin. Grassroots-level lending and borrowing, as well as usury, reappeared and spread to wide areas.

This essay sketches a brief outline of the emergence, development and decline of the RCF.

Historical background and causes of the emergence of RCF

The emergence and development of the RCF is by no means an accidental economic phenomenon. It is due to the following four aspects of underlying realities.

1. In the course of the reform of the People's Commune, hundreds of billions of yuan was lost. Under instructions from the central government, local governments carried out audits of collective assets. By setting up fund organisations, debts were either cleared out or transformed into loans. At the time, directives from the central government were positive or even encouraging; and with the continuing improvement of marketisation, liquidity of rural capital diversified and further expanded.

Rural policy directives from the central government at that time contained the following clear and positive statements:

The central government's Document Number One of 1984 pointed out, "capital from peasants and collectives is allowed to flow freely, or to be organised to flow without any territorial restriction."

Central government's Document Number One of 1985 declared, "to loosen and enliven rural financial policies, and to enhance the effects of capital liquidity."

Document Number 27 of 1986, issued in the middle of the year,

supported the practice under certain conditions. It said, "In recent years, some rural co-operative organisations put together idle capital that belongs to the collectives and utilise them in profitable ways to support local villages, local co-operative organisations and peasant households in developing commodity production. As long as they do not attract deposits from outside sources, and carry out lending/borrowing activities only among themselves, such practice should be allowed to be tried out."

To show its support for the development of RCF, the Agricultural Bank of China also issued in 1986 Document Number 414, which demanded that "agricultural banks throughout the country and credit associations should not meddle with the internal lending and borrowing activities of rural co-operative economic organisations. Instead, they should guide them by doing business with them."

The central government's Document Number 5 of 1987 further pointed out that "some township or village economic co-operatives or enterprises have established co-operative funds. Some have set up investment trusts. Such activities are in line with the different demands of the development of commodity production. It helps to pool idle capital, and alleviate the contradictions arising from the lack of credit given out by the agricultural banks and other credit associations. In principle, it should be supported."

The 1990 central government Document Number 19 also pointed out the need "to manage well co-operative funds that are not profit-seeking, and to fully utilise capital belonging to collectives."

The resolutions of the Eighth Plenary Meeting of the Thirteenth Congress of the Communist Party of China (CPC) held in November 1991 asked local governments to continue overseeing the smooth functioning of RCF. At the same time, two documents jointly promulgated by the finance and agricultural departments were fully supportive of the development of RCF.

In 1992, the State Council, in its resolution to develop high-yield and high-quality agriculture, once again declared the need to "continue to develop RCF so as to fulfill the need of high-yield and high-quality agriculture."

From 1984 up till 1992, the central government constantly voiced its support, which was effective in softening the fierce opposition coming from established financial institutions in their bid to keep their monopoly and to prevent competition. It was this favourable policy orientation that propelled the development of RCF.

2. As the household production-based agricultural reforms deepened,

the rural economy boomed. With the increase in peasants' income, both commodity production and monetised relationships were strengthened. One million agricultural collectives and two hundred million peasant households became the basic units of production as well as owners of properties in rural areas. Due to the pressure of unemployment, many peasants turned to non-agricultural sectors. Many more still held other jobs while remaining on the land. Hence, demand for investment in rural areas was strong, and a variety of credit networks sprang up from grassroots levels to fulfill the need, putting pressure on established rural financial institutions to reform and to adapt themselves into more flexible institutions that can respond to the needs of the new situation. In this regard, rural reforms and the ensuing marketisation were the pre-conditions for the emergence of RCF.

3. The resulting rise of income from reforms, in particular, the rise of per capita cash income for peasants, resulted in the rapid expansion of financial resources within rural communities. For example, in 1988, per capita income reached 544.9 yuan, an increase of 353.6 yuan over the 1980 figure of 191.3 yuan. However, in the latter part of the 1980s, the recession that occurred in urban areas dampened demand, and the agricultural sectors also became sluggish. Its previous comparative advantage decreased, bringing down with it peasants' incentive for investments. For most peasants, they only knew how to invest in their own farms. Other than that, they knew very little. Yet they still wanted to use their idle capital in such a way that they could obtain additional income. At the same time, the development of township and village enterprises meant that demand for capital was on the rise. While both supply of and demand for capital within rural areas were increasing, the monopolistic state financial institutions were unable to seize the new opportunities - and that caused the widespread development of RCF.
4. With the agricultural bank as its flagship, the rural financial system, which included village credit associations, had maintained its monopolistic position as well as its closed and ossified way of functioning. Its main function was to absorb capital in rural areas and transfer it to non-agricultural sectors. Its involvement with supplying capital to agriculture and the development of rural areas was inadequate. With the coming of the 1980s, peasant households became the basic production units. For village credit associations, the

change meant that instead of dealing with a smaller number of large collectives, they had to deal with a multitude of peasant households and other economic entities.

Even though the state had foreseen this and had carried out financial reforms to speed up the process of marketisation, the more the financial sector was marketised, the less suitable it became for the diverse needs of a rural economy dominated by small peasant households. On the one hand, there was no way for the state to end the monopoly of state banks just as it was incapable of fundamentally changing China's single ownership structure of its financial institutions. On the other hand, agricultural banks and credit associations are not only strictly controlled by the state as regards scale and structure of credit, but also chastised by large-scale bad debts and overblown credit due to money used up in purchase of agricultural goods. On top of it was the inflexibility of their operation, making them unresponsive to the diverse needs of an environment undergoing reform and marketisation. A vacuum was thus created for RCF to fill.

Internal Dynamics

The four above-mentioned background factors and their dynamics only provide the ground and the external infrastructure for the emergence of RCF. The cause that started off the process was the need to strengthen management of rural collective assets and to safeguard their well-being and growth. The major factors leading to the emergence of RCF are:

1. The need to rebuild the mechanism of collective savings and to utilise them in profitable ways. In some areas, this was the primary cause for the emergence of RCF. In changing the three-tiered and production brigade-based People's Commune, the lack of timely institution-building linking the different property structures of village collectives and rural households so as to provide proper management of rural savings resulted in the drain of collective savings that were accumulated in the time of the Commune. This is due to:
 - a. Widespread damage, corruption and waste in the course of the handover of collective assets. It is estimated that assets handed down to households depreciated by 40 percent. A large proportion of loans to members of communes or outside units never returned. According to one estimate made in 1987 in 26 provinces, cities and areas, there were three hundred thousand commune cadres who had committed corruption, theft of collective assets or illegal

use of funds totaling 1.17 billion yuan.

- b. In some places, management of collective assets was in such a mess that accounts that had been audited turned out to be unreliable, or assets continued to disappear even during the very process of auditing. Due to the power wielded by village cadres and their penchant for wasteful investments, capital accumulated by rural collectives was dispersed into diverse channels, resulting in chaos and lack of liquidity. All these were totally unacceptable to the peasants who reciprocated by refusing to pay dues and undertaking other forms of collective protests, straining the relationship between peasants and cadres, and calling into question the security of rural areas.

In 1985, the Jin County in Liaoning Province transformed its collective assets into shares in accordance with policy instructions. Shares totaling 14.04 million yuan were formed while the collective still held 23.66 million yuan as capital. However, audits carried out in 1987 found the amount of 18 million yuan unaccounted for.

- c. A considerable amount of rural collective funds deposited with credit associations was seldom touched. However, when peasants needed to borrow, they had to pay higher interest to agricultural banks or credit associations. There was likewise no guarantee that they would be loaned the money. Unsurprisingly, peasants resented this.

To resolve such problems, some regions took the opportunities offered by the audits of village collectives. They transformed collective assets into shares for co-operative funds and allocated them to households. Other regions turned debts into new loans and incorporated them with the business of co-operative funds, enabling the effective collection of village collective debts. The setting up and efficient functioning of RCF thus became an effective way to manage and fully utilise collective assets. It not only stopped the drain of collective assets, but also helped to realize the further accumulation of collective assets.

2. The search for new mechanisms for insuring agricultural investment

In the course of rural reform, the implementation of the household responsibility system and the increase in prices for agricultural by-products resulted in a change of urban-rural relationship on the one hand, and relationship between central government and local authorities on the other. Fiscal decentralisation and other reforms in investment policies resulted

in an increased lack of funds for agricultural infrastructure and decreased incomes for peasants in rural areas, thus adding to the burden of local governments. Fields were deserted; and at the macro level, the further development of agriculture was called into question.

As the process of marketisation gathered momentum, it became more difficult for private capital to flow into agriculture, which is marked by long production cycles, high risks and low returns. If no readjustment is made to the peculiarities of different sectors, the survival and development of agriculture will not be guaranteed. However, the reality of reforms in China is such that it is rather difficult to carry out readjustments to different sectors. This is evidenced in three aspects.

Firstly, fiscal decentralisation is actually the result of the adoption of "replacement of profit by tax", which leads to conflicts of interest between different government bodies. Decentralisation consists of delineating the levels of income for central government and local government respectively. While the interests of the two are thus delineated, there is no provision as to who will bear the burden of looking after the weak agricultural sector. Moreover, with the completion of primitive capital accumulation in China, the proportion of industrial output within the national economy is twice that of agriculture. Government income has come to rely less and less on agriculture. This is the background to the decrease in investment in agriculture since the reform of "replacement of profit by tax" and fiscal decentralisation.

Secondly, collective saving capabilities are weakening, resulting in a decrease in agricultural investments. According to the statistics, the ratio of contribution to village administrative fees to total net income in the village is down from 16.7 percent in 1978 to 10.2 percent in 1988. Agricultural investments made by township enterprises are also down from 15.4 billion yuan in the five-year period between 1979 and 1983, to 5.5 billion in the period between 1984 and 1988. For peasants, a land lease of fifteen or even thirty years does not imply an increase in investment, as agriculture is a high-risk and low-return business. In actual fact, peasants' households have increasingly turned to investing in non-agricultural sectors.

Thirdly, as the main financial bodies in rural areas, agricultural banks and credit associations have all along acted as the main channel of capital outflow from agriculture. The increase in peasants' income and the rise in savings also saw an increase in the volume of outflow. What should be noted in particular is the conflict of interest these bodies face. Since the mid 1980s, budget deficits have become the norm. As a result, the cost of agricultural subsidies is shifted to departments responsible for purchase

and sales, which in turn pass it on to agricultural banks in the form of accounts payable. Banks are therefore loaded with overdue loans. For instance, our research of 1992 shows that the proportion of such loans to all other loans at the agricultural bank in Anhui, an important province for agriculture, is 38 percent, causing credit to be overblown. With the adoption of the market principle in 1992, banks naturally seek higher profits and shun agriculture which is high-cost, high-risk and low-return. This means that the central government is unable to do anything even though it does want to help.

In a word, given the state's difficulty in making macro adjustments, there is the need for mechanisms to guarantee further investments in agriculture.

3. To fill in the "credit vacuum" left by banks, to stem the tide of usury

Even with the implementation of households as units of production, agricultural banks and credit associations continued their practice of lending to collectives and ignoring peasant households. Their hands were tied by the limits imposed by the state on the amount and composition of loans. They were not equipped to meet the demands for small loans from two hundred million peasant households, who then had no choice but to borrow from underground sources which had been in existence all along. As such practices spread, the financial situation in rural areas was bound to worsen. When some underground operators disappeared with large funds, the locale was thrown into chaos and unrest.

RCF, which was set up spontaneously, took the role of extending small amounts of credit to peasants, thus filling in the gap left by the banks. At the same time, judging from the results of recent years, only in areas where RCF was well-developed was the practice of usury contained.

External Forces

It should be said that heads of all levels of local governments and agricultural banks were strongly driven by their own self-interest, which greatly influenced the development of RCF.

1. Local Governments

Since the mid 1980s, all levels of local governments have had to cope with two new situations. One is financial reforms which abolished the old practice of the state taking all incomes and paying all expenses. Instead, various forms of fiscal decentralisation were put in place. Local governments had much greater say over their own financial resources. As

a result, they had every incentive to increase their own resources through investments. Another factor is that as banks gradually adopted the market principle, the ability of local governments to influence them diminished. They could only watch as capital flowed out of rural areas, and banks channeled their resources to non-agricultural sectors. As the gap between supply and demand grew, the local governments welcomed the setting-up of alternative regional financial mechanisms which would meet the need for local capital shortfall and thus enhance the authority of local governments to control local finances.

2. Departments for the administration of agriculture

In China, the departments for the administration of agriculture form an all-embracing system. They are responsible for policy guidance as well as provision of services. They oversee the finances of rural collectives. They field a large number of personnel to audit rural collectives. They resort to administrative means and launch campaigns which produce results that have proved to be adverse or ineffective. The need to adopt new management practices and develop new mechanisms that will prevent the drain of collective assets is something that has come to be appreciated by everyone within the departments for the administration of agriculture. What must be pointed out is that in overseeing all new as well as old collective assets, the department does not profit a cent. Its operation is supported by the government budget which is enough to maintain the personnel but not enough to do business. Hence, the management at township level is particularly interested in making their collective funds become live capital, so that they can make profits in the process.

PART TWO

The process of development: reform, experiment, rapid expansion, rectification and abolition

The process of development of RCF can be roughly divided into five phases.

1. Formation (1984-1986)

As early as the second half of 1983, some villages in Heilongjiang, Liaoning and Jiangsu Provinces had experimented with lending money held by collectives to members of the collective as a way of better utilising resources. Such activities produced positive results. While safeguarding the security of collective assets, new channels of agricultural investments

were established. Peasants welcomed the practice; and the economic branches of local governments gave their support. Since the formal set-up of an RCF in a village in Hebei Province in 1984, similar experiments took place throughout the country. By the end of 1986, rural communities in the provinces of Heilongjiang, Liaoning, Hubei, Zhejiang, Guangdong, Sichuan and Jiangsu had all developed some forms of internal lending and borrowing, laying the foundation for rural co-operative financial institutions.

The central government had, on occasions, supported such spontaneous developments of internal financial arrangements. The 1984 central government Document Number 1 mentioned that "the free flow of capital belonging to peasants and collective is allowed." This is the policy base for the activity of internal lending and borrowing in rural areas. As to the setting up of RCF, the earliest documentary support came from the 1985 central government Document Number 5, which lent its support to "the development of diverse forms of capital liquidity."

2. Reform and Experiment (1987 - 1991)

In this phase, the benefits of RCF, which are the spontaneous creations by peasants to provide capital, gradually came to be appreciated by the authorities. In August 1986, the central government instructed that as long as deposits and lending remained within the collectives, they should be allowed to continue. In January 1987, the Politburo passed a motion to deepen agricultural reforms. Part of it stated that "the co-operative funds set up by villages or enterprises are fulfilling the different demands of commodity production. They help pool idle capital and ease off the pressure put on banks and credit associations for supply of capital. In principle, it should be supported."

In 1987, under Document Number 5 passed by the Politburo, various bases for the experiment of rural reforms were set up in Heilongjiang, Hebei, Shandong, Guangxi and Sichuan to carry out experiments that would institutionalise RCF. These well-run, well-organised bases steadily promoted co-operative funds at the grassroots level and their umbrella organisations. The framework of a new system of co-operative funds was taking shape.

Supported and promoted by the central government, RCF spread throughout the country. The period between the end of 1986 and the end of 1988 saw the fastest growth of internal capital flow in rural areas. There was an increase of 4 billion yuan in these two years. For example, in 1988, 80 percent of the townships and villages in Jiangsu province had set up co-operative funds, with the capital reaching 800 million yuan. In

Sichuan, half of the townships and villages had financial organisations that mainly relied on co-operative funding as their source of capital, which amounted to 201 million yuan. In Hubei, RCF was set up in 40 percent of the townships and in 5,927 villages, with a total capital worth 280 million yuan.

In November 1991, the resolution of the Eighth Plenary Session of the Thirteenth CPC Congress required local governments to continue to develop RCF. Earlier, in January of the same year, the agricultural department circulated the document *Notices on the Institutionalization of RCF*, which gave further impetus to the development of co-operative funds.

Encouraged by the resolution of the Eighth Plenary Session of the Thirteenth CPC Congress, rural co-operative financial organisations spread out from the successful bases, and entered the stage for complementary reforms. In Shangzhi City, 341 co-operative funds were formed, utilising a total of 39.664 million yuan. In Yutian County, which already had 34 co-operative funds, an umbrella organisation was formed, and total lending amounted to 420 million yuan. In Pingdu City, total deposits amounted to 264 million yuan, while the figure for loans was 250 million yuan. All these show that the capacity for accumulation within the agricultural sector was increasing, and the problem of outflow of capital from villages was temporarily solved.

By 1992, throughout the country, there were 17,400 townships and 112,500 villages which had co-operative funds as their chief financial institutions. The figure represented 36.7 percent of all townships, 15.4 percent of all villages, and a total capital of 16.49 million yuan accumulated by the end of 1992. Each of the two provinces of Sichuan and Jiangsu had more than 2 billion yuan; figures for Hebei and Shandong are close to that.

Summing up the results of experiments and experiences of different locales, the department for agriculture issued Document Number 8 in 1993, which said, "On the premise of persevering with the present right of ownership of capital as well as its concomitant incomes, the RCF is formed by village collectives and households out of their own will for mutual aid. The aim is to serve the peasants, to boost agricultural production, and to further develop the economy of village collectives."

3. Rapid Expansion (1992 – 1995)

With Deng Xiaoping's tour to south China in 1992, economic growth picked up its pace under the impact of highly speculative sectors such as securities, futures and real estate. The whole country was seized by a new round of investment fever. Investment stimulated demand, thus benefiting

rural economies. The gap between demand for capital and its supply grew rapidly, resulting in high interest rates in capital markets. Under such conditions, the now established RCF encountered the contradictions of expansion. Many funds were forced by local governments to lend blindly to village and township enterprises that were in dire need of capital.

According to central government documents, Yutian County in Hubei province began to set up community economic organisations in 1987, and RCF was one of the main items. In 1994, its capital reached 176 million yuan, of which 48 million came from collectives, while individual peasants contributed 128 million. With its flexibility, low operating costs, and the fact that it was operating outside the framework of official financial institutions, it succeeded in rapid expansion. However, as the whole country was seeking high growth, the funds came to be used increasingly in non-agricultural sectors. In 1998, when the funds in Yutian went into receivership, it had loaned a total of 230 million yuan to village and township enterprises. The figure represented 38 percent of its total capital. Ninety percent of these loans were made under the heavy hands of local governments, with 70 percent bound to be written off.

With the coming of financial reforms, agricultural banks and credit associations gradually turned into commercial enterprises. Their role as instrument of policy weakened. *Every financial institution tried to bypass agriculture - RCF was no exception. Industry and commerce became favoured clients.* Co-operative funds began to operate outside its base, and accepted deposits from non-members. The funds further expanded. For instance, by the end of 1995, the number of funds set up in Sichuan grew to 5,349, or 84.7 percent of the townships. Capital accumulated amounted to 14,526 million yuan, an average of 2.7157 million for each fund, or a growth of 62.4 percent and 50.8 percent respectively, compared to the previous year.

By the end of 1996, the year the central government decided to close the operation of the RCF, there were 21,000 funds at the township level and 24,000 funds at the village level throughout the country, with total capital amounting to 150 billion yuan.

During this period, the finance sector was all chaos, with various government bodies such as sales and marketing co-operatives, planning commissions, village bureaus and ministries for labour and social security all competing to form funds and join the field of high-interest rate lending. RCF had relied on a policy of interest rates higher than those sanctioned by the government for their deposits as well as loans. Higher interest rates naturally attracted more deposits, while the lack of supply of capital meant that it was possible to lend at higher rates. The fact that such a policy worked meant that it reflected the actual price of capital markets. However,

with frequent interventions from local governments, the lack of check and balance, low management quality and high risks, the efficacy of the funds became diminished. The proportion of loans to non-agricultural sectors was too big, and worse still, small-scale runs on the bank occurred in some places.

4. Rectification (1996 - 1998)

Issued in August 1996, *The State Council's Resolution on Rural Financial Reform* still affirmed the contribution of RCF to boosting agricultural production and easing the pressure on peasants. At the same time, the document criticised the funds' practice of issuing shares, which was, in fact, a form of deposit. As shareholders were not members of funds, the practice actually violated the law. To counter the practice, the *Resolution* proposed three measures: stop the issuing of shares by co-operative funds to attract deposits, incorporate those funds which have been running like banks into official financial institutions after they have been properly audited, and require those funds which cannot be incorporated to remain co-operative in nature.

Such measures were the outcome of compromises made by different government bodies. Both criticisms and policy measures were mild, and some problems were not addressed. One problem had to do with those funds which were not fit to be incorporated, but the capital was tied by bad loans. Another problem was that of the government's responsibility for agriculture. The document did not discuss the inability of official financial institutions to meet the needs of small farmers.

Since 1994, related departments had issued instructions to rectify co-operative banks. On such directive, Document Number 21 of the Village Economic Development Bureau required officials from village economy departments to fulfill administrative duties, while the supervision of co-operative funds should be left to The People's Bank. Village officials should not intervene in the running of funds; instead, they should help watch if anyone had overstepped the line. In 1995, another directive, *Rules on the Management of RCF*, was circulated.

All these actually reflected the struggles among different government bodies as to who had the actual power over the funds. Hence the work of rectification was put on hold for a long time. Still, some progress was made. During this period, the increase of funds slackened. Attention was directed to the quality of management. One way was to hand out guidelines for lending and borrowing, and to implement rules and procedures for audits. Another way was to enforce the practice of making provisions for bad debts. Further training of personnel was also a way forward.

In Sichuan, where capital accumulated by RCF was comparatively high, the number of funds established since 1996 was small. By the end of 1998, there were 4,052 funds throughout the province, a growth of only 0.5 percent compared to the previous year. The percentage for townships is 82.6 percent, a mere 1.7 percent growth rate over the previous year. In 1998, the total capital of RCF in Sichuan amounted to 21,378 million yuan, while on average each fund held 5.276 million yuan, an increase of 12.3 percent and 11.8 percent respectively.

Merging co-operative funds with official financial institutions is something easier said than done. Bad loans from both credit associations and co-operative funds will not simply go away; and when a run on banks occurs, it becomes a social problem. Another factor is that while agricultural banks and credit associations are monitored by the state, local government departments have been heavily involved in the running of co-operative funds. Both are subject to government interventions, complicating the business of merging.

5. Liquidation and Closure (January 1999 onwards)

In January 1999, the State Council issued Document Number 3 which formally declared the dissolution of RCF. It said, "To prevent and defuse financial risks, to safeguard the security of the rural economy and society, the Party Central and the State Council have decided to carry out complete rectification of RCF.... The aim is to halt the formation of any new funds and to stop existing funds accepting deposits or making new loans. At the same time, a thorough auditing of existing funds will be carried out and bad debts written off. Those that meet the necessary requirements will be merged with credit associations. Those that are in debt will be liquidated and dissolved."

a) *Background to the liquidation and closure of RCF*

The running of RCF at the township levels is far from satisfactory. A few years back, in the heat of the rise of village and township enterprises, many township governments were instructed or required to loan directly to or act as guarantor for enterprises. However, in the three years after 1995, depression, changes to the market and poor management resulted in great hardship for small enterprises throughout the country, with some going bankrupt. Many local governments were heavily in debt, with this debt comprised mainly of loans from co-operative funds.

The township of Jianyang in Sichuan had a net debt of 18.3228 million yuan, of which 9.973 million were debts owed by

enterprises – 51 percent of the township's total debt. The enterprises had all ceased functioning, their debts all passed on to the township government, which in turn owed a total of 5.19 million yuan. This figure was, however, only that on the record, and did not include many hidden debts.

Since the tax reforms of the 1990s, local government expenditure grew, and so did the amount of debt. According to the research conducted by the Agricultural Ministry in 1997 in seven provinces, the average debt for a township government was 2 million yuan, while at the village level, it was 0.2 million. In 1999, representative researches made by some provinces showed that the highest debt level reached 40 million yuan. Nationwide, total debts for townships and villages exceeded 30 billion yuan. Some resorted to taking away peasants' production tools to force them to pay all sorts of taxes and levies. Units or individuals with abundant cash took the opportunity to lend out money at usury rates. These loans were forced onto village units. In the end, local government debts were shifted to peasants.

The combined result of the rural financial reforms of the 1980s and the tax reform in 1994 is that the fiscal power of the local government at both the county and the township levels was greatly enhanced, and the related government bodies greatly expanded. The burden put on peasants inevitably increased. With the withdrawal of agricultural banks from the agricultural sector and the decrease of government investment in agriculture (as a proportion of the national budget) to an all time low, peasants struggled to make ends meet, not to mention pay the various taxes and levies imposed by local governments. Peasants were forced to go into debt.

After the dissolution of co-operative funds, one particular problem should be noted. Some peasants whose money was held up by the funds used their share certificates as payments to the collective administrative fees, forming the so-called "empty transfer of capital".

b) *The Work of Rectification*

Judging from the practices of different locales, the work of rectification can be divided into auditing assets, classification, collecting debts and returning deposits.

Working committees were formed by local governments to audit the assets of funds under their jurisdiction. Those that were

financially with or without new injection of capital were integrated into local credit associations. Those that were considered not viable were liquidated, and their debts taken up by local governments.

Every legal means was employed to put pressure on debtors to pay their debts. In case debtors were party members or cadres, administrative measures and party discipline were imposed. To speed up the payment of loans made to shareholders, the funds were held as the first benefactor of all payments.

Returning deposits was the last step. Usually, the government tried its best to raise enough cash to pay the first installment. When it was unable to do so, the government set a date for payment.

c) *The Effectiveness of Rectification*

Although the work of rectification was by no means easy, the combined use of political pressure and administrative measures is enough to meet the target set by the higher authorities. This means that so long as the special interests of government bodies are not affected, mobilisation from top down is still effective. But co-operative funds were initiated by local governments. The fact that it had to be dissolved by orders from above is bound to harm the credibility of local governments, which has wider repercussions in the form of loss of assets.

In Yutian county in Hebei province, the combined assets for its 22 funds amounted to 393.47 million yuan. Total debt was 653.02 million yuan. The deficit totalled 206.46 million. After rectification, nine funds were merged with the local credit association, which in turn had total assets of 206.46 million yuan and total debts of 303.99 million. The township government had to inject capital of 67.13 million, and the county government, 29.8 million. The rest of the funds were dissolved. Their combined assets were 187.01 million yuan, and debt, 283.58 million. It was promised that all deposits would be returned with interest in three years.

In the course of rectification, the government injected large amounts of capital. For instance, in Wenzhou, of 191 funds, 148 were merged with local credit associations. The other 43 were liquidated. The related government bodies injected 266.2 million yuan as capital, and provided 160 million as guarantee for credits. The total was 426 million, of which 329 million were loans from the provincial government.

Even with the completion of rectification, there were lingering problems. In the first place, local governments had to borrow from banks to pay depositors. The funds' debts were thus transferred to local governments, increasing the latter's financial burden. Many local governments were already heavily in debt. They, in turn, transferred the debts to peasants in the form of dues and levies. In certain areas, the pre-1949 practice of "tax paid in advance" was resurrected.

Secondly, although there were still debts to be collected - and hence, on paper there should still be money to pay to depositors - the fact is every means had already been used in the early stages to collect debts, and those that remained uncollected would be very difficult to collect. With local governments already heavily in debt, the question becomes one of maintaining the credibility of local governments, and thus becomes a long-term political question.

PART THREE **Rethinking RCF**

TO STUDY the management system and the functioning mechanism of RCF, it is meaningful to study their nature and ownership rights since these define and control their management system and functioning mechanism.

General understanding of the nature of RCF

If we limit ourselves to past policy studies and government documents, then in the course of our analysis of the emergence and development of the funds, we can see that they are the outcome of the initiative taken by villages to rebuild the system of accumulation for agriculture following the breakup of the People's Communes. The funds are a form of capital-sharing within the community economic framework. They are self-regulated independent accounts. People join them out of their own free will and the funds are run democratically. Everyone involved shares the risks.

Data from the past is enough to support this view. Between 1990 and 1996, RCF throughout the country invested a total of 151.5 billion yuan in farming and livestock-raising. The percentage of investment in agriculture to that of total investment was 43.3 percent. In some areas, the funds not only were lent to peasants, but suggestions and information were also provided. They acted as guides for production activities.

In accordance with instructions from above, the funds also invested in organisations that provided services to rural communities. From 1990 to 1996, 7.3 billion yuan was channeled to such organisations. The figure for 1996 represented 19.9 percent of total investment in that year.

The two above-mentioned investments took up 63.2 percent of total investment, a ratio much higher than that provided by agricultural banks and credit associations. From this, one can see that the funds were marked by the following characteristics: they are co-operative in nature, their function is to provide services, they are run on democratic principles, they combine the features of shareholding economy and cooperative economy, they are not profit-seeking, they are taken from the peasants and used on the peasants, and fairly defend the interests of the money-owners.

The actual ownership of RCF and the differences between funds at township level and funds at village level

Difference between township level and village level funds and policies that are in line with regulations of self-government

Collective assets were the initial source of capital for RCF. Those collective assets that were allocated to co-operative funds should be the collective assets of members who formed the economic body. As such, co-operative funds should be financial organisations collectively owned.

But in actual fact, after the reform of fiscal decentralisation, nothing was done to implement the system of "community share-holding", which should make the question of ownership of collective assets much clearer. As a result, peasants did not have any say over collective assets even though they were members of the collective. Under the policy of "township overseeing villages", township governments could channel collective assets by way of their subsidiary "economic management checkpoints" to the designated co-operative funds, and then lend out the money. All these could be done without the prior consent of village collectives. Hence, funds set up at township level or above were not exactly the creation of peasants or village collectives.

While funds set up at township level can be said to be rural financial bodies belonging to local governments, those set up at villages, where the policy of "township overseeing villages" had not been carried out, were collectively owned. If China is a country with a legal system in place, then it is possible to cite the village self-rule laws enacted at the People's Congress in 1988, and subsequent laws on village committees. Funds that are set up at village level are completely in line with these laws as

they are self-servicing and self-developing. And in accordance with these laws, funds set up at village levels should not be dissolved but should be required to meet certain criteria.

The proto-capital nature of collective assets and increase in collective accumulation

By nature, the existence of collective assets is one of the most general pre-conditions for the setting up of RCF. But in fact, it is not the absolute condition as ownership reforms occurred only at the brigade level or below. Collective assets owned by the top level of the commune had been placed under the control of the township government. Hence, in most townships there were no more collective assets. In the townships, co-operative funds issued shares right from the beginning, or borrowed to finance their everyday functions.

Where there were still collective assets, they could be withdrawn when turned into shares. But in normal circumstances, to maintain the smooth running of co-operative funds, it is necessary to have a certain level of capital. Otherwise, things would easily go wrong as there would be no support from the Central Bank. In practice, most funds did maintain a stable level of capital, and some, even more. From 1990 to 1996, through the funds, 6.05 billion yuan of debts owed to village collectives were successfully collected.

In view of these facts, collected shares should be looked upon as a form of "proto-capital". The initial definition of co-operative funds as a way to utilise collective assets and to promote collective accumulation also means that the collective assets are "proto-capital". Such a definition clearly shows that the funds must rely on the initial investment of the collective to promote further accumulation by the collective.

As "proto-capital", it can be withdrawn. Hence, we can only come to the conclusion that since funds at the township level are effectively held by local governments, and not by the village collectives, the latter can only be regarded as "absentee" share-holders.

Local Financial System that is Innovative and Accessible

Townships and in some places county governments, having got their hands on collective assets and the right to exploit local resources, were bypassing the central government's monopoly on finance by setting up RCF to propel the development of local economies. Given the emphasis on monopolistic arrangement in the 1990s, such a step can be considered as "innovative".

With this innovation, it became possible to solve the problem of

shortage of capital, and to develop the non-agricultural sector in rural areas. The development of village and township enterprises, in turn, ensured more profits that accrue to local governments. Between the years 1990 and 1996, a total of 157.9 billion yuan was invested in village and township enterprises through co-operative funds. In 1996, the amount invested in rural enterprises represented 36.8 percent of total investment. It is evident that in the years before 1996, the booming economies at the county level and below were directly connected with the emergence of local financial institutions.

However, controlled by local governments, the proportion of agricultural investments made by the funds declined, and the proportion of non-agricultural investments increased. In 1999, the total investments made by funds in Sichuan amounted to 21.46 billion yuan. Agricultural investments accounted for 7.88 billion or 36.7 percent of total, while non-agricultural investments took up 13.59 billion or 63.3 percent of total. The proportion taken up by non-agricultural investments almost equaled the proportion of bad assets to total assets. Overdue loans and immobile accounts amounted to 10.84 billion yuan, with peasant households (normally engaging in agriculture) taking up 3.48 billion or 32.1 percent, while loans to enterprises and others accounted for 7.36 billion or 67.9 percent.

Such figures and related researches help clarify the situation. Although the central government had always maintained that RCF was not a formal financial institution but an internal organisation of villages to help members to obtain funds, the fact is, when further reforms of rural areas are not forthcoming, the funds cannot fully realise their potential for co-operation, at least not at township levels.

Once it is clear that control of the funds by local governments is for the sake of local economic development and local government expenditures, then the interventions made by local governments in the daily running of the funds are no different from those made by the central government in its monopoly of the country's financial activities. The only difference is that when such interventions prove to be unwise and costly, local governments do not have the leverages that the central government has in issuing bonds or compensations.

Interventions of local governments are usually in the following forms:

Firstly, the compulsory set up of funds. In some places, the funds were headed by heads of local governments. In most cases, the funds were staffed by people designated by township governments. In some places, funds were set up even when requirements for capital, personnel and management were not met. In others, deposits held by village

collectives at credit associations were forcibly transferred to the funds. The workings of local government (especially at township levels) were such that interventions in the running of the funds were inevitable.

Secondly, heads of local governments always had the final say. It was not uncommon for funds to provide money to meet tax quotas or to buy government bonds allocated for the area. In some places, the funds were forced to take up the burden of infrastructure development or to build schools and hospitals, or to act as guarantor for certain government departments. Some heads of local governments even treated the funds as their own bank account. The funds had to pay for all the expenses incurred by them. Others forced the funds to lend to their relatives and friends. Most of these loans eventually turned into bad debts. For instance, in Sichuan, since 1992, of the 21.46 billion yuan loans made out by the funds, overdue loans and immobile accounts amounted to 10.84 billion yuan or 50.5% of total. Such was the work of government intervention.

Thirdly, in some places, units responsible for the village management treated co-operative funds as their own; and the finances, accounts and assets of the two were all mixed up.

Hence, the dissolution of these funds was necessary if the central government wanted to pursue a policy of tightening expenses. However, if the policy was to encourage growth by raising demand, the required policy measures would be the reform and formal institutionalisation of these funds. This also explains why most local governments were willing to let funds under their control to be incorporated into credit associations.

Three types of RCF

Due to differences in economic development, structures of ownership and economic conditions, there were different types of RCF throughout the country. Classified according to their range of business activities, there were three different types.

1. Community-based RCF

This type of co-operative fund was found both at the township and the village levels. As suggested above, only funds at the village level could be considered as internal co-operative credit associations of a community.

This type of co-operative fund was typically found in areas where agriculture accounted for a large share in national income. It was set up from within the community to serve the community. Such funds had their beginnings in assets audits carried out at the village level.

Their capital mainly came from the savings of the village collective and individual households, as well as assets held by village enterprises. Investment was mainly made in agricultural production of the peasant households and the village collective. Normally, business activities of the funds were confined to the community; and their loans were small and short-term, with low interest rates. Loans went mainly towards small-scale agricultural production. The funds set up in the township of Pingdu in Shandong were typical of such community-based funds.

Pingdu lies in a traditional agricultural area. Agricultural production is the main economic activity, and the majority of the population engages in agriculture. From the beginning, Pingdu's co-operative fund aimed to resolve the problem of ownership at the village level, and to build a new mechanism to utilise the savings of individual households and the village collective. Membership contributions came from the collective and the peasant households. Borrowing from outside sources was avoided. From 1988, when it first began, to 1992 when it was formally established, the total membership contribution amounted to 263.55 million yuan, of which 112.31 came from the village collective, and 66.1 million from peasant households, while 85.14 million was entrusted to the fund. As for investment, of the total investment of 145.37 million yuan, 48 percent was invested in agricultural production. Adding this to the 57 million used in agricultural infrastructure and the 30 million used in agricultural machinery and generating electricity, the proportion was as high as 83 percent. The amount invested in village and township enterprises was a mere 40.36 million yuan, or 16 percent of total. On account of the investment, conditions for agricultural production improved greatly. From 1988 to 1992, machinery power increased by 131.762 million watts, electricity cable lines increased by 2663.9 kilometres, and 23 thousand new or repaired water works were completed. Irrigated area reached 1669 thousand *mu* (1 *mu* equals 0.067 hectare, or 0.165 acre), or 64.3 percent of total cultivated area. Sustained production for agriculture was secured.

Most of the community-based co-operative funds gave priority to agricultural production. In those well-developed test-sites for co-operative funds, one-quarter of the villages received investments from the funds for their capital requirement for agricultural production.

The township of Pingdu in Shandong also serves as a leading example in its distribution of benefits. At first, Pingdu used a proportion of 4:3:2:1, with four portions going to dividend payment, three to further accumulation, two to social functions, and one to

special bonuses. Since 1993, Pingdu transformed the funds into shares, and provisions were made for risks. Every year, 2 percent of share value was to be extracted as provision for risks. If a loss occurred in the year, provisions for risks would be used to plug the gap. If this was still not enough, then the value of the shares would be subtracted to make up for the shortfall. Hence there was profit-sharing as well as risk-sharing. The further development of the fund was guaranteed, and its competitiveness increased.

The county of Meitan in northeast Guizhou is a hilly region where land is relatively abundant. Throughout the province of Guizhou, the per capita cultivated land is 0.7 *mu*; but for Meitan, it is 1.2 *mu* (1.5 *mu* according to the latest cultivation). In 1987, the State Council designated Meitan as among the first batch of test-sites for rural reforms. Peasant households were entitled to work on a fixed area of land regardless of changes to their members, and they only had to surrender roughly 50 kilos of grain per *mu* as payment for all forms of tax. With these reforms, the rural area entered a period of stable growth. The burden placed on peasants was relatively light.

In Meitan, in a village called Jinhua which is six kilometres west of the county capital, in 1999, the average annual income for peasants was 2,700 yuan, and per capita consumption of food was 60 kg. Its economic development lay within the median range. The village was organised into six groups. There were 273 households and 1,145 people. The amount of cultivated land was 1,461 *mu*, with 200 *mu* of tea gardens, half of which was collectively owned. Although there was no village enterprise, the village collective had an annual income of six thousand yuan from the tea garden.

Co-operative savings associations for peasants

As early as 1983, the household responsibility system was put in place in Jinhua village. Since then, titles to land had not been changed. Only 852 people had titles to work on land. In 18 years, the population increased by 300. These did not have land to work on, nor did they have to pay taxes. The increase in landless population put pressure on the village labour force to seek work outside. As a result, incomes as well as expenditures both increased. In recent years, peasants changed their way of farming; and the resulting ownership structure changed as well. The biggest change lay in the need for investment. But the nearest credit association is tens of kilometres away. The amount of capital required was small, and it was difficult to obtain from official financial institutions. Eventually, the village collective

decided to use the 30 thousand yuan accumulated from incomes of the tea garden as starting capital. With further funds from more than 200 peasant households, they got permission in 1998 to form a co-operative savings association for peasants.

Participation in the savings association was voluntary. But to encourage more households to take part, the village party secretary contributed 1,500 yuan, the largest amount. Next came the accountant with 1,000 yuan. The smallest contribution was 20 yuan. In all, 130,000 yuan was collected. In June 1999, after payment of dividends, there still was 2,000 yuan left. It was decided to use 12 percent of the amount to aid poor households.

Savings association would only lend to peasant households within the village. In one and a half years, 500 loans, totaling 100,000 yuan were made. At first, the monthly interest was 10 percent. Afterwards, it was fixed at 7 percent. Most of the loans were for buying seeds and fertilisers. In general, the loans were short-term loans of three to six months, and just for one hundred yuan or less. The money was usually borrowed in spring and paid back in summer. In a few cases, money was borrowed to pay for trips outside to look for work, or for children's school fees. The largest loan involved the purchase of a buffalo and amounted to 1,200 yuan.

Jinhua's savings association functioned well. So far, no bad debt had occurred. At the time of research, there was a spring drought, and overdue loans amounted to 20,000 yuan. But the village cadres were not worried. If things were normal, debts would be returned in June after the summer harvest. Procedures for loans were by no means simple. The borrower must have double guarantees; both collateral and a guarantor were required. Some poor households were unable to meet this requirement, and the cadres must step forward to help.

Handling of the Situation

According to related papers, Jinhua's savings association was to be dissolved too. The local credit association had twice urged the village to stop all business and reimburse all shares. At the moment, 18,000 yuan had been reimbursed. Since the government would not allow them to form savings associations, the village cadres thought it was no use keeping any collective funds. In future, collective funds would be used to construct public facilities.

In the course of our research, we exchanged views with both cadres and peasants. In general, people thought that:

- a. Co-operative funds or other forms of spontaneously-formed

savings associations have by nature collective management of the assets

Most community-based co-operative funds and savings associations begin life by turning liquid assets held by collectives into starting capital. Afterwards, members of collectives join in. Hence, they are by nature self-management of collective assets. Loans made out are chiefly for the improvement of the local agricultural set-up. It is entirely in the spirit of using collective assets with benefits and increasing the value of the assets. Moreover, capital is sourced within the village, and so are the loans made out. Judging from the country's constitution, agricultural laws and related regulations on village self-rule, co-operative funds fulfill the three principles of village self-accumulation, self-development and self-governance.

- b. Rectification according to related regulations on management of internal assets of collectives

To live up to the spirit of rural reforms, to face the problem of financing small-scale agricultural production, and to stem the practice of usury, rectification of community-based co-operative funds and other internal collective assets can be done along the lines of "community co-operative shares system". Liquid as well as fixed assets held by the collective can be transformed into shares and issued to households who can decide for themselves whether to pool their resources and form a management committee to manage their collective assets. In this way, the liquid part of the collective assets can be fruitfully utilised.

2. Professional RCF

This type of co-operative funds mainly relies on professional economic organisations of peasant or professional associations. The funds are set up by members of the professional organisations or associations. The main function is to provide financial services within the profession. Some may overlap with community-based funds. Some encompass several communities. But most of them are confined to particular organisations. Typical examples are those in Huanghua township of Hebei, the fishermen's co-operative funds in Shanwei, Guangdong province, the loggers' fund in Sanming, Fujian province, and the beekeepers', drivers', and miners' co-operative funds in Shenzhen, Heilongjiang province.

What should be noted in particular is that co-operative funds are very effective in stemming the practice of usury. Since rural reforms,

lending and borrowing among peasants are widespread. However, due to lack of effective control, usury is common. In an attempt to develop cash crop production, peasants often find themselves burdened with debts and even bankruptcy. Rural professional co-operative funds provide new channels of finances in addition to formal government financial networks. Compared to loans provided by individuals, these funds are well-regulated and cost less to borrow. Hence, they have significant impacts on a rural environment where competition among financial institutions has been previously non-existent. From the viewpoint of peasants, competition will lower the price of capital. In fact, where the RCF is well-managed, usury is contained. Some researches show that as a result of the development of RCF, the interest rate for loans provided by individuals fell by 30 to 50 percent.

In the test-site of Yulin in Guangxi province, there used to be a dozen or so usurers lending at extremely high rates. Among their victims were individual traders and craftsmen. With the development of RCF, more than one hundred poor households were able to obtain loans. The usurers lost their market.

Rural professional co-operative funds stress the interests of shareholders. In their distribution of profits, 40 to 70 percent go to the payment of dividends. Only 20 to 40 percent are retained for accumulation and further development. The rest go to salaries, general welfare and bonuses of employees.

From this, the co-operative nature of professional funds is far from clear. With the dissolution or closure of many co-operative funds in recent years, professional funds also lose many co-operative characteristics they might have had in the past, and regress to private lending companies.

3. Enterprise-based rural share-holding co-operative funds (financial service associations)

This type of RCF is formed by economic groupings within a community or a particular area. It is spontaneously formed, but the members are economic bodies engaged in trade or industry.

Its main function is to help capital flow readily within shareholding companies, township enterprises and private enterprises. This type of funds can only be found in places where economic development has already taken place, and economic activities have branched out into second and third sectors. It is the result of the pooling of resources of different economic bodies to further each other's development.

In the city of Wenzhou, township as well as private enterprises

have boomed. Economic units that are collectively owned are also strong. Since 1992, the year when the experiment for shareholding co-operative funds began, and up till May 2000, 52 such funds have been formed. Capital inflow and outflow are 167.32 million yuan and 186.59 million yuan respectively. Not only was the need for capital from village and township enterprises met, the practice of usury was also stopped. According to research conducted by an enterprise in Wenzhou, in 1993, there was a shortfall of 80 million yuan to upgrade technology. Banks and credit associations could only provide one quarter of the amount. Up to May 2000, the 45 co-operative funds that were in operation had provided capital in the amount of more than 300 million yuan.

The problem is when the economy is in recession or when interest rates are high, as is the case in China in the 1990s, co-operative funds that are without the support of the Central Bank and are involved in enterprises running into difficulties are bound to be adversely affected. To cope with such risks, such private funds tend to work illegally with corrupt officials, and thus give rise to extremely harsh private usury.

The rise and fall of RCF point to the inescapable fact that whether it is at the level of central or local government, the established rural financial institutions are inadequate in many respects.

With the benefit of hindsight of fifteen years, from actual experience, the following should be evident: only those co-operative funds that were established at the village level still had life in them, even though the local form they took appeared incongruent with the orientation of developing modern financial institutions.

Translated by Ma Kwok Ming, John

This paper appeared in Chinese in the "Forum of 50 Scholars", at website www1.cei.gov.cn/forum50/doc/50cyfx/200107311727.htm. The final writing and editing was by Wen Tiejun. Duan Chenju helped organize the materials. The paper combined empirical research with data and information from the Ministry of Agriculture, the Experimental Zones, Sichuan Province, and Chinese University of Hong Kong.