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## *Getting markets to work in the countryside*

### The 'dilemma' posed by China's agricultural reform

Why was China's agricultural reform so successful before 1985 but frequently problematic after that? In which policy direction should China proceed in the 1990s – introducing agricultural protection or internationalising agricultural production? And what is the best strategy for achieving domestic food security as well as sustaining rapid economic growth? These are questions that puzzle many Chinese policy analysts and Western economists who are closely watching China's economic reform and development.

Agricultural reform in China started at the end of 1978. Reform in the early stages, mainly the giving back of responsibility to farming households and increases in state purchase prices for agricultural products, led to large improvements in agricultural production. From 1979 to 1984, agricultural production expanded by 7.4 per cent per annum and grain output grew at an annual rate of 5 per cent. From 1982 to 1984 growth was spectacular with grain output increasing, on average, by 27 million tonnes a year (about 8 per cent of the annual output) (figure 1.1). Agricultural reform was widely regarded as being very successful, with the extraordinary growth recorded in the wake of the initial reforms being called a 'miracle' (Longworth 1989; Huang 1993a).

After 1985, when the government pushed forward with market reforms, problems were felt in agricultural performance. Growth rates in agriculture dropped back to less than 4 per cent. The average annual growth rate of agriculture was 3.8 per cent during the period 1984–94. Although not low by international standards, this rate of growth represented a considerable slowdown. Grain output increased by only 0.9 per cent per annum. Grain output dropped significantly first in 1985 and then, to a lesser extent, in 1988, 1991 and 1994 (figure 1.1). More seriously, increasing agricultural prices in 1993–95 and reduced grain output caused significant macroeconomic problems. According to the

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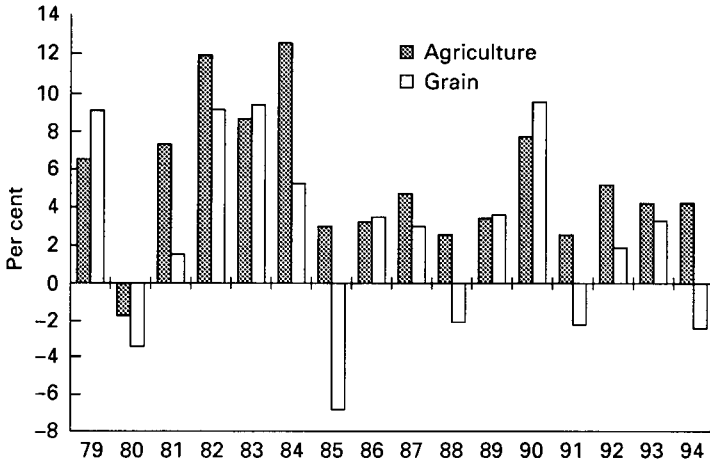


Fig. 1.1. Growth rates of agricultural and grain output, 1979 to 1994.  
(Source: SSB, *China Statistical Yearbook 1995*.)

Chinese State Statistical Bureau, food prices rose by 32 per cent in 1994 contributing about 12.1 percentage points (or 55.8 per cent) to overall inflation.<sup>1</sup> High inflationary pressures were transmitted to consumers' cost of living, to enterprise production costs and, partially, to the government's budget. As a result state intervention in agricultural production became more pronounced in 1994 and 1995.

The sharp contrast in agricultural performance between the periods before and after 1985 fuelled criticisms of reform policies (table 1.1). Many economists pointed to declining investment in agricultural infrastructure on the part of both farmers and the government. Others questioned the direction of agricultural reform. Rural market reform introduced in the mid-1980s was regarded as a premature and overly-optimistic policy response (Niu and Calkins 1986). Calls for re-collectivisation of agricultural production were also made, particularly around 1988. Liberalisation of grain prices in the early 1990s was criticised as being reckless. Some Chinese economists stressed the special significance of grain production within the Chinese economy and recommended special policy measures to achieve food security and political stability. It was seriously suggested that agriculture should be exempted from trade liberalisation. These discussions caused inconsistent changes in agricultural policies throughout the reform period. While market reform was often pushed forward when agricultural supplies were abundant, resumption of state intervention and controls was frequently observed when domestic agricultural products were in short supply.

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Excerpt

[More information](#)*Getting markets to work in the countryside* 3Table 1.1. *Economic growth and agricultural prices, 1978 to 1995*

	GNP growth (per cent)	Agricultural growth (per cent)	Grain output (million tonnes)	GNP per capita (yuan) (1985 prices)	Price indices	
					Agricultural purchases <sup>a</sup>	Food markets <sup>b</sup>
1978	12.3	3.9	304.8	398	59.9	81.4
1979	7.0	6.4	332.1	420	73.2	83.4
1980	6.4	-1.8	320.6	442	78.4	88.4
1981	4.9	7.1	325.0	457	83.0	90.0
1982	8.2	11.8	354.5	487	84.8	91.5
1983	10.0	8.5	387.3	529	88.5	91.9
1984	13.6	12.9	407.3	593	92.1	92.9
1985	13.5	2.7	379.1	663	100.0	100.0
1986	7.7	3.0	391.5	703	106.4	106.1
1987	10.2	4.5	403.0	762	119.2	112.6
1988	11.3	2.3	394.1	835	146.6	132.1
1989	3.7	3.2	407.6	853	168.6	156.7
1990	5.1	7.5	446.2	881	164.2	160.9
1991	7.7	2.3	435.3	936	160.9	163.7
1992	12.8	5.0	442.7	1047	166.4	170.2
1993	13.4	4.0	456.4	1174	182.5	182.1
1994	11.8	4.0	446.2	1295	264.6	240.3
1995	10.2	5.9	460.0	1409	306.9	288.4

Notes: <sup>a</sup> Agricultural purchase prices are weighted averages of both state and market purchase prices.

<sup>b</sup> Food prices are prices in rural markets.

Sources: SSB, *China Statistical Yearbook 1995*; Asia Pacific Economics Group, 1996.

The events after 1985 presented a dilemma for China's agricultural reforms. On one hand, it was widely agreed among government officials and economists, and in the public arena, that the ultimate objective of reform was to develop an agricultural market economy in which consumers and producers would make their own decisions, resources would be allocated between sectors according to relative prices and market prices determined by demand and supply conditions. On the other hand, the reform measures being introduced by the Chinese government to achieve these ends, seemed to be causing serious problems – from grain shortages to high inflation. This dilemma is clearly illustrated by the difficult choices posed by continuing grain policy reform in the 1990s. To encourage domestic grain production, prices needed to be raised further and controls removed. But increases in grain and food prices, were already 'unbearable' for consumers and the government. Chinese policymakers in the mid-1990s are not sure that market reform is the right direction for Chinese agriculture.

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##### Reform – a process of getting institutions right

There is evidence that market reforms in China's agriculture since 1985 have not been successful in delivering all that was expected of them, but this evidence does not give grounds for the conclusion that free market mechanisms are not appropriate to Chinese agriculture. Although distortions are a widespread phenomenon in agriculture, even in the developed world, agricultural development is steady and stable in most of the developing world where free markets are in use. There is evidence – from the former Soviet Union and pre-reform China – of the inappropriateness of the central planning system. The 'problems' incurred in Chinese agriculture have arisen in the process of reform and are associated with the transition to a market system rather than with the direction of the reform. It is to be expected that in an economy that is transforming its institutions, special problems will be generated by time lags in institutional adaptability, the incompleteness of the reform and a lack of experience in policy implementation.

In the economic literature, an institution is a broad concept on which economists do not agree completely.<sup>2</sup> According to North, 'institutions are the rules of the game in a society, more formally, are the human devised constraints that shape human interaction' (1990: 3). Theoretically, institutions represent a varied array of elements ranging from cultural values to contracts, labour unions and political parties. Markets for agricultural products, labour and capital are institutions because they define the rules for exchange and mechanisms for price determination. Government purchase and marketing policies are institutions for similar reasons. Subsidies, taxes and state plans are institutions because they constrain producers' and consumers' behaviour. Ownership and production organisations, including production teams and household farming, are also institutions because they determine an individual's involvement in the production process and resultant income distribution. Cultural values and codes of conduct are also important institutions, but they will not be considered in this study. The institutions of concern to this study are those governing relationships among individual farmers, between farmers, consumers and the government, between agriculture and other sectors, and between China's agriculture and the world economy. The focus is on flows of factors, outputs and other resources (including income), and the way they are organised – through either administrative or market measures.

Two broad institutions lie at the centre of a study of Chinese institutions: one is the central planning system and the other is the market

mechanism. From an institutional perspective, 'market' does not narrowly mean the market-place where products are exchanged. Market is an institution that contains rich assumptions about consumer/producer behaviour (or characteristics of production and utility functions), information, transaction costs and rules for exchange. In the real world there are different forms of markets. The market in Japan is sometimes regarded as operating differently to those in Europe and North America. Different forms of market are defined by their different institutional structures.

In theory, two optimality theorems of welfare economics are attainable in the market economy: first, if there is perfect competition, resource allocation is Pareto-efficient; second, any specified Pareto-efficient resource allocation that is technically feasible can be achieved by establishing free markets and an appropriate pattern of factor ownership. The operation of a market economy is, at the same time, influenced by other institutions, including government intervention. Well-defined property rights are another critical institution for the proper working of market mechanisms.

Even after nineteen years of reform China has not established typical market institutions. China had about thirty years' experience of central planning. The pre-reform Chinese economy was one of institutional distortions that affected all areas of economic activity – from property rights to factor flows and from price determination to production/consumption decisionmaking. None of the important assumptions for attaining welfare efficiency existed. Institutions in pre-reform China were determined by state ideology that relied on bureaucratic decisions and not value in the market-place to determine how resources were used. Central planners believed that any equilibrium reached by market mechanisms could be achieved by a planning system. Prices would arrive at market equilibrium levels because the planners would observe (see Kowalik 1994) the differences between demand and supply and changing price levels. Public ownership would help to achieve economic benefits, including scale economies, while preserving the advantages of private ownership. The central planning system would overcome market failures. The autarchic system was brought to China from the Soviet Union where it had been inspired and created by Marx, Lenin and Stalin. Thus development strategy based on giving priority to heavy industry was fundamental to the rationale of allocating resources. Central planning would deliver a more efficient allocation of resources, particularly of scarce resources which needed to be directed to the development of 'leading sectors' of the economy. Central planners

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aimed to build a 'more efficient' planning system to replace market institutions.

Some success was achieved by the central planners in the early years with investment in new activities, but the industries selected for promotion in China were not appropriate to its resource endowments.

Experience worldwide has demonstrated that market equilibrium and welfare optimisation have never been achieved under a central planning system because of the difficulties and expense in monitoring economic activity and the time lags involved in government responses. Heavy state interventions proved vastly inferior to a free market system in the allocation of resources.

In an analysis of agricultural price policies, Timmer (1986) observed that many developing economies tried to get agricultural prices 'correct' through policies. He observed that instead of 'getting prices right' governments that tried to influence prices usually got them wrong in the end. Similarly, 'getting institutions right' was not the end of the story in countries where central planning and heavy state intervention were introduced, but 'getting institutions wrong' usually was. 'Wrong institutions' existed not only in the former centrally planned economies but also in many developing and industrial economies. Wrong institutions reduced an economy's efficiency and prevented the growth of income and productivity.

After several decades governments which had adopted central planning systems started to move back to market institutions. Changes in agricultural policies in China in the past nineteen years are one such example. Economic reform is a process which aims to eliminate institutional distortions and establish market mechanisms to get institutions right. Increases in state purchase prices for agricultural products in China were an attempt to get rid of price distortions. The introduction of free markets was an important step in phasing out administrative intervention in the market. And the introduction of household responsibility was targeted at correcting the distorted microeconomic system for agricultural production – formerly the commune system.

The removal of institutional distortions is not an easy job. It is difficult enough to identify what the distortions are. Economic reform is, therefore, a process of institutional learning and innovation. Institutions within any economy are interdependent and individual. An institution which works effectively in one economy may not do so in another. Institutions can sometimes evolve 'inefficiently'. An institutional change is only desirable if it achieves 'institutional efficiency', usually defined as a reduction in transaction costs and an improvement in productivity.

There are circumstances where efficient institutional innovations are reversed because of the special interests of some dominant groups, or of the government.

The process of 'getting institutions right' can be either gradual or radical. Different approaches to economic reform of formerly centrally planned economies have been applied. In the former Soviet Union reform was abrupt ('shock therapy'), while in China it was gradual.

Hayami and Ruttan (1985) proposed a theory of induced institutional innovation extending their work on induced technological change. It can be applied to Chinese institutional reform. The choice of institutional arrangements and realisation of institutional change are endogenous and determined by various economic forces. In an economy like China which adopts a gradual approach, economic forces play a greater role in defining the direction and paths of institutional change.

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China has taken a gradual approach to agricultural reform as it has to reforms in other areas of the economy.<sup>3</sup> At the Communist Party's Third Plenum, held in December 1978, the Chinese leadership put revolutionary politics and class struggle aside and set out to make the nation wealthy and powerful. At that time agricultural production was not meeting the demands of China's huge population, or even farmers themselves in many areas. The government moved to increase state investment in agriculture and to raise the purchase price for agricultural products.

At the beginning the government did not intend to change the commune regime and the central planning system. All practices that disrupted the existing system of agricultural organisation were strictly prohibited. Farmers in some poor areas, however, experimented with household-based production responsibility systems. At first the new systems were permitted by the government in poor areas only. But they spread and were adopted as a national policy at the beginning of the 1980s. By the end of 1983, about 98 per cent of production teams throughout China had adopted the household responsibility system. Meanwhile, the government continued to raise state purchase prices.

In 1985, rural market reforms were introduced to abolish the unified purchasing and marketing system. All agricultural products were assumed to be bought and sold in free markets. State purchases of grain, cotton and edible oil were maintained but through a newly instituted

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contract system under which both quantities and prices of state purchases were determined mutually by the government and farmers.

A number of other policies were also implemented to encourage diversification of non-agricultural, non-grain production in the Chinese countryside. Feedgrain sales were subsidised with the aim of stimulating the growth of the animal husbandry industry, while tax-exempt and subsidised bank loans were devised to encourage rural industrial development. But reform in agriculture was not to proceed smoothly as the government struggled to overcome instability in the wider economy induced by the inflationary effects of higher agricultural prices while at the same time trying to best guess supply responses to price changes.

The government response to agricultural difficulties in the mid-1980s was to retreat from some areas of reform. Stop-go reform was the result for the decade after 1985. Following significant falls in production, contract purchases of grain and cotton were quickly made mandatory again in 1985 and 1986 although liberalisation policies for other agricultural products were maintained. In 1988 and 1989, to avoid confusion caused by the form of 'purchase contract' and associated difficulties in meeting procurement targets, the term 'state purchase quota' was officially re-introduced, implying the revival of a unified purchasing and marketing system for these products.

On the other hand, in May 1988, the government made its first attempt to reform marketing policies for non-staple food in urban areas. Lump-sum subsidies were paid to urban consumers in an effort to abolish existing price subsidies on consumption of agricultural products. At the same time, a series of experiments was carried out to reform grain policies and the land tenure system.

From 1989, the government again raised state purchase prices for grain in response to several years' stagnation in grain production. Alongside the implementation of the wider austerity programme to cool down the 'overheated' economy, state intervention through quotas for the purchase of grain was re-iterated in policy. Previous preferential policies toward the livestock sector and rural industry were terminated.

In 1991, grain market reform accelerated. Based on experiences of the 1988 reform of the non-staple food policy and regional policy reform experiments, the government, for the first time in about thirty years, significantly raised state market prices for grain. Again, in 1992, urban market prices were brought to the levels of rural purchase prices. By so doing, the government expected to remove the increasing burden of grain subsidies on the state budget. The state still intended to buy certain amounts of grain, but prices were to be determined by the market. In



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1994, the government abolished the State Price Bureau, signalling the end of forty years' massive state intervention in prices.

Owing to dramatic increases in grain and food prices in 1993–95, many administrative measures were revived. The government stressed the importance of maintaining basic self-sufficiency in grain and a new grain policy was announced in March 1995 requiring every provincial governor to be responsible for grain supply for his/her own province. Grain coupons again became a fact of life in many cities in 1994 and the State Price Bureau was re-established in May 1995.

### Some outstanding questions

In the middle of the 1990s, plotting the future directions of agricultural reform in China is causing confusion among policy analysts and policy-makers. There are broadly three competing arguments. The first stresses the special role that agricultural products, especially grain, play in the cultural, social and economic life of the whole country. The argument is that because political stability and food security are of crucial importance for a country's sustainable growth, grain is not a normal but a political commodity. Recent changes in China's grain market following policy liberalisation – including supply shortages and sharp price rises – are used to support this argument. Markets will lead to greater fluctuations in supply and price which will threaten the economy's stability and are, thus, undesirable.

The second argues that grain is a commodity (although with some special features) that can be regulated by market mechanisms. This view has it that the problems that occurred in grain markets during the early 1990s were not caused by the introduction of reform policies but by the incompleteness of the reforms introduced. The only way to eliminate the problems being experienced is to complete market reform. Agricultural trade liberalisation, if appropriately introduced, will help to stabilise the domestic grain market and prevent the rapid rise of domestic food prices.

The third line of argument runs that, while fully operating markets should always be held as the ultimate objective of reform, including reform of grain policies, a certain degree of state intervention in prices and grain procurement is necessary. To the supporters of this argument complete liberalisation of agricultural markets is not compatible with China's current economic conditions because of the high Engel coefficient in consumption and the government's limited fiscal abilities.

These important policy issues are taken up in this study in a

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systematic way by applying an institutional approach. Three broad questions are asked in the process of the analysis, and these are introduced in the following paragraphs.

- What was wrong with the pre-reform agricultural institutions?

To understand what the problems of the current system are, it is helpful to start from an analysis of the pre-reform regime. Pre-reform agricultural institutions provided a complete set of policies carefully designed for the purpose of promoting heavy industrial development. Different components had different functions, but they all worked to serve the chosen development strategy. It is particularly useful to analyse which functions of a market institution were distorted by those policies and how individual institutional elements constrained individuals' behaviour in the pre-reform period.

- What institutional distortions have been corrected during the reform period and how successful were these reforms?

While a return to household responsibility, increases in purchase prices and liberalisation of state controls are commonly regarded as the most important reforms in agriculture, it is important to relate these changes to the functioning of the market mechanism. Economic reforms can facilitate the proper working of markets only if they help to eliminate effectively those factors that blocked the operation of free markets in pre-reform China. Some policy changes may be effective and others may not. Some policy changes may bring about new problems while eliminating 'old factors'. Such analysis helps to assess the usefulness and effectiveness of past reform and provide understanding of current problems.

- What are the major problems with the current agricultural institutions?

Agricultural reform in China has experienced difficulties in recent years because of unexpected changes in agricultural production and prices, following the introduction of policy changes. The analysis of the problems of the existing agricultural regime can begin with the examination of these new problems and exploration of their causes. Generally, there can only be two conclusions about recent changes in agricultural markets – they were either normal responses of the market mechanisms or they were abnormal, at least in magnitude. If they were normal outcomes, efforts should be made to seek additional policy instruments that can smooth market fluctuations and confine them within an acceptable range. On the other hand, if the changes were abnormal, correction