The Political Economy of Farmer Co-operative Development in China

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by
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ABSTRACT

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Supervisor: Dr. Murray E. Fulton

This is a study to understand and interpret the governance structure of and the pattern of development followed by farmer co-operatives in China. China’s farmer co-operatives have developed rapidly since the Farmers Co-operative Law came into force in 2007. Unlike their counterparts in western democratic capitalist systems, however, farmer co-operatives in China are owned and controlled by individuals and groups other than farmers – the resulting structure is referred to as the Company+Household (C+H) co-operative. As a result, the small farmers who make up the majority of members have very little participation or control in these organizations. This thesis also uses the development of farmer co-operatives as a lens through which Chinese agriculture and rural development can be viewed and understood. The proposition examined in the thesis is that the pattern of co-operative development is the expected outcome given the challenges that China is facing in its agricultural sector, China’s economic development goals, and the political economy of the country.

The thesis examines the governance structure – i.e., the way in which business entities are structured and controlled – of C+H cooperatives using political economy theories. This theory argues that corporate governance structures reflect public policy choices. These policy choices are fundamentally the result of political decisions, decisions that are heavily influenced by the preferences and power resources of different groups in a society, as well as by the existing political and economic institutions. China’s political economy shapes “a capitalism with Chinese characteristics.” All capitalist systems require mechanisms that coordinate decisions and expectations. Due to a lack of institutionalized trust (e.g., trust created by reliance on the rule of law and independent judiciaries), China relies on other mechanisms for this coordination. Meanwhile, minority shareholder protections (e.g., auditing and disclosure rules) are virtually absent. The outcome is an economic system in which a blockholder ownership pattern emerges as the most effective governance structure, with the state and large investors (both of which have close
personal ties to other investors and other state officials) as the blockholders. Within this system, there is little room for the small investor. Consequently, China’s political economy provides an environment in which farmer co-operatives that are owned and operated by small farmers, and in which the state and large private interests are largely absent, would be very unlikely to exist.

The thesis also uses industrial organization theory to analyze C+H co-operatives in the context of agricultural industrialization. The argument developed in this thesis suggests that C+H cooperatives have also emerged as the most likely organizational structure for reasons unique to the agricultural sector. Specifically, the industrialization that has occurred in agriculture around the world during the last two decades has created a need for much greater coordination within agricultural supply chains as companies within this chain attempt to provide a rapidly increasing range of products that must meet increasingly higher standards of consistency, quality and safety. Therefore, agro-processors increasingly specify the type and quality of product produced by farmers, who are often contractually required to buy inputs from and to sell output to a particular processor.

A key outcome of the research in this thesis is that the development of farmer co-operatives has to be seen as an endogenous response to the political and economic interests operating in China at the time the co-operative law was introduced. The beliefs and associated behaviours of those that benefit from the emergence of this particular policy helped to enforce and reinforce the emergence of new organizational forms that further perpetuate the power of those that initially benefitted. This self reinforcement (i.e., positive feedback) creates path dependency, which in turn explains the persistence of high modernism, capitalism with Chinese characteristics and patron-client structures, all of which contributed to formation of C+H cooperatives. The C+H co-operatives not only have a governance structure that fits into the political structure, but they provide a large degree of control by the company (i.e., the agro-processor) over the decisions made by farmers, which are crucial to meet the coordination needs of modern supply chain. The conclusion is that the political and economic institutions in China today do not provide an enabling environment for the establishment and the success of farmer self-help groups. As a consequence of both China’s larger political economy and the conditions specific to agriculture, it
is to be expected that the C+H model of a co-operative has emerged as the dominant organizational form for co-operatives in China.
ACKNOWLEDGEMENTS

I first heard of the Ph.D program at the University of Saskatchewan in 2003 when I met Dr. Bernie Sonntag during a World Bank mission in northwest of China. Dr. Sonntag recommended that I contact Professor Murray Fulton, whom I then met in Beijing in 2004 when he attended a CCICED conference.

My Ph.D program formally started in January of 2005. The current iteration of the thesis represents the seventh version of a document that I been working with under the supervision and mentoring of Professor Fulton. As a doctoral student whose native language is Chinese, the writing process is undoubtedly the most challenging to both the student and his perfection-oriented supervisor. Both are struggling with language, cultural and logic differences. But this process is what I was looking for – learning something different in a different way.

My deep gratitude and heartfelt appreciation go to my supervisor Professor Fulton, Johnson Shoyama Graduate School of Public Policy. Professor Fulton provided invaluable guidance, constructive advice and consistent encouragement at all stages of my research and writing; he also has provided financial support. I am most grateful for his contribution of considerable time and effort in editing and improving my work, which has made my thesis much better.

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ABBREVIATIONS

AAPC: Advanced Agricultural Producers’ Co-operatives
ACFSMC: All China Federation of Supply and Marketing Co-operatives
BOD: Board of Directors
C+B: Cooperative+Big Households
C+C+H: Company+Co-operative+Households
C+H: Company+Households
CCICED: China Council for International Cooperation on Environment and Development
FPCL: China Farmers Professional Co-operative Law
CIDA: Canadian International Development Agency
CPC: Communist Party of China
DRC: Development Research Centre
FPA: Farmers Professional Association
HCRS: Household Contract Responsibility System
ICA: International Co-operative Alliance
IOF: Investor Owned Firm
LE: Leading Enterprises
LRI: Legal and Regulatory Infrastructure
KMT: Nationalist Party
MOA: Ministry of Agriculture
NPC: National People’s Congress
NSC: New Socialist Country
P+C: Private Firm+Households
RMB: Chinese Yuan
Sannong: Agriculture, Village/Rural Society, and Farmers
SMS: State Grain Purchasing and Marketing System
SMC: Supply and Marketing Co-operative
SME: Small and Medium Enterprise
TSS: Tax Sharing System
TFP: Total Factor Productivity
UNDP: United Nations Development Program
UNRISD: United Nations Research Institute for Social Development
VAT: Value Added Tax
RTFR: Rural Tax and Fee Reform
Chapter 1

Introduction

1.1 The Issue

Agri-food systems around the world are restructuring rapidly, and these changes are happening in developing and transitional countries as well as in major industrialized countries. Major structural changes are occurring in food production and distribution, as well as in the nature of the relationship between producers and consumers (Boehlje and Schrader [1998]).

Chinese agriculture is no exception. Indeed, the structure of China’s agri-food sector is changing at an unprecedented rate. Over the last 30 years, China’s agriculture has transitioned from subsistence farming (where much of the output was consumed by the household) to commercial agriculture (where most products are sold on the market).

Since China’s agricultural markets are largely liberalized and, enforced by China’s access to the World Trade Organization (WTO), open to international trade, these trends provide the basis for a rapid development of integrated supply chains. Chain supermarkets, in particular, have been growing at an extraordinary pace since the early 1990s. According to Hu [2005] and Hu, Reardon, Rozelle, Timmer, and Wang [2004], supermarket store units have increased at an annual growth rate between 20 to 30 percent between 1998 and 2002. The number of supermarkets increased from 2,500 in 1995 to 74,000 in 2003. Their sales expanded from US$ 0.4 billion of 1994 to US$ 71.2 billion in 2003. Chain-stores and hyper markets will soon dominate China’s retail food market.
The Political Economy of Farmer Co-operative Development in China

The Chinese government plays a key role in shaping China’s agriculture (Fulton and Zhao [2009]), with agricultural industrialization and modernization playing a key role in the government’s rural development strategy. Two goals drive this development strategy.

First, Chinese agriculture needs to become increasingly efficient in order to feed China’s large and growing population and to ensure food security. Second, government also has to deal with a growing income disparity between urban and rural China, and between eastern China and western China (the latter area is more rural). The average urban resident earns over three times more per capita then the average rural resident, a gap that is among the largest in the world (World Bank [2007]). China’s rural economy is predominantly based on farming and has not kept up with the economic growth of the urban centres because of the small scale of farming operations and because of competing claims for natural resources.

The New Socialist Countryside (NSC) program is a core component of the government’s strategy for rural development. Its objectives include developing agricultural production, raising rural living standards with tidy and clean villages, and instituting mechanisms to ensure the development of an orderly rural society based on civic values and democratic management (Communist Party of China, Central Committee [2005]).

Government is not the only stakeholder interested in rural agricultural industrialization. Central and local governments are being lobbied by agri-food business groups to make small-holder agricultural production compatible with the vertically coordinated agri-food production system favoured by large business groups. Thus, an additional challenge for the state is to make the agricultural production methods of hundreds of millions of small producers compatible with large agri-food production.

The experience of developed countries suggests that farmer co-operatives have played a key role in rural development and agricultural industrialization. According to World Bank [2008], producer organizations such as farmer co-operatives have engaged in a broad array of activities, including trade negotiations and domestic agriculture policy making. They may also help to improve the terms of access to output and input markets, support the generation and adoption of technological innovations, support diversification into new activities, and contribute to natural resource management.
Farmer co-operatives have also been an important building block of the agriculture-for-development agenda, and have actively engaged in participation governance, particularly in relation to decentralization and community-driven development approaches. Chinese policy analysts argue that farmer co-operatives would be an ideal instrument to organize individual production and to meet the needs of a closely coordinated agri-food production system. They could also act as an interim step while farmland is consolidated by more efficient producers and small farmers are moving out of the farming sector.

Studies indicate that there are a number of reasons why small farmer co-operatives might be effective and useful in China. First, farmers can gain mutual advantage from working together for the sake of the common good. Second, as Nourse [1944] pointed out, co-operatives can be organized to help members measure performance of other firms dominating the market channel. Third, co-operatives can help farmers to access services not available to individual farmers in their rural communities, and to access services at a reasonable price (Torgerson, Reynolds, and Gray [1998]). The highly concentrated nature of the agricultural supply chain, a prime motivator in early co-operative organizing efforts, remains the underlying rationale for co-operative efforts by farm operators (Torgerson [1977]).

The China Farmers Professional Co-operative Law (FPCL) was passed in November of 2006 and was enacted in July of 2007. After years of internal legislative processing, the FPCL was able to placate local government’s concern about the potential threat of farmer groups to their authority.

With the passage of this legislation came the rapid development of farmer co-operatives. According to statistics from the State Industry and Commercial Bureau, by the end of September 2008 there were 79,600 registered farmers co-operatives, with a membership of 1.08 million. Out of this total, 1.04 million members (96 percent) were farmers. The statistics show that on average each member, as a legal entity, contributed RMB 810,000 as equity to the co-operative.

As tables 1.1 and 1.2 illustrate, the majority of farmer co-operatives are organized by non-farmers, most commonly government officials or leading agribusiness enterprises. Farmer led and organized co-operatives are usually headed by a large wealthy household with significant economic and political influence in their village and township. While it is not evident from
tables 1.1 and 1.2, most farmer co-operatives are organized in the “company + households” (C+H) model, with a leading company and other key shareholders (e.g. government officials) controlling the shares in the co-operatives. Under the FPCL, these firms can be members of the co-operative. These heterogeneous – or mixed – membership co-operatives (i.e., co-operatives with both farmers and agri-business firms as members) are favoured by local government, and therefore, receive a great deal of support from local officials, including tax breaks and subsidized interest on loans and grants.

Table 1.1: Organization of agricultural co-operatives in China, 2008

<table>
<thead>
<tr>
<th>Co-operative Organized By</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Party committee</td>
<td>40</td>
</tr>
<tr>
<td>Leading households</td>
<td>20</td>
</tr>
<tr>
<td>Government department</td>
<td>25</td>
</tr>
<tr>
<td>Leading enterprise</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: Li [2008].

Table 1.2: Leaders of farmer co-operatives, Jiangsu Province, 2007

<table>
<thead>
<tr>
<th>Large Farmers or Households</th>
<th>Officials</th>
<th>Extension Staff</th>
<th>Dragonheads (leading enterprises)</th>
<th>Village Officials</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>14</td>
<td>8</td>
<td>36</td>
<td>15</td>
<td>9</td>
</tr>
<tr>
<td>Percent</td>
<td>16.7</td>
<td>9.5</td>
<td>42.9</td>
<td>17.9</td>
<td>10.7</td>
</tr>
</tbody>
</table>

Source: Sun [2007].

In general, the content of the FPCL is in line with international standards of co-operative legislation (Munkner [2006]). However, the critical features that distinguish co-operatives from other business organizations are neither properly regulated nor enforced. As a result, international co-operative principles are not commonly followed by heterogeneous membership co-operatives in China. Instead, the FPCL allows the traditional agricultural industrialization model to continue and does not seek to regulate and protect co-operative values by constraining and defining the role of investor members. The result is that Chinese agricultural co-operatives are largely
investor driven and controlled. They have adopted the title of "farmer co-operative" as a flag of convenience.

The nature of a co-operative is distinguished by the ownership and control of resources employed by each organization (Fama [1980], Jensen and Meckling [1979], Condon [1987]). In the typical Chinese agricultural co-operative, the investors control the finance and management of the co-operative and become the primary beneficiary, while the small farmer members, who make up the majority of members, have very little participation or control. The co-operative is typically used by the investor as an instrument to ensure a consistent supply of quality products in compliance with food safety regulations, and as a source of produce to meet the needs of flow scheduling and capacity utilization.

Most co-operatives in China are, in reality, purposeful entities designed by their creators to maximize wealth and income, or to meet other objectives defined by the opportunities afforded by the institutional structures of society. In addition, they are a part of a blockholding governance structure, one that restricts ownership and control, limits competition and offers little protection to minority shareholders (Gourevitch and Shinn [2005]).

Outside China, agricultural co-operatives are defined by the notion that they are enterprises owned and controlled by farmers members for the benefit of these members (USDA [1995]). Structured in this way, co-operatives are a part of a diffuse governance system model – one with rigorous prohibitions on insider trading, strong protection of minority shareholders, and effective rules for market competition and antitrust (Gourevitch and Shinn [2005]).

Given the definition of co-operatives in the West, it is clear that most of the so-called co-operatives formed in China since the passage of the FPCL are not, in fact, co-operatives. Although some true small farmers co-operatives exist, they often prove to be ineffective due to the limited means of action and the imbalance of power that groups of small farmers have compared to other organizations in the agricultural supply chain. Furthermore, these co-operatives are rarely on the radar of local authorities, which limits their access to funding and other support measures. As a result, spontaneous grass-roots organizations are marginalized in the co-operative sector, a sector in which government has a strong presence.
1.2 Purpose and Objectives

The purpose of this thesis is to understand the pattern of development followed by farmers co-operatives in China. The thesis explores the international co-operative principles that are not followed in China, and examine why Chinese co-operatives have developed so differently in terms of their nature, purpose and structure from those in the West. The thesis also examines the mechanisms that enable local business leaders and government officials to manipulate co-operatives to institutionalize and perpetuate their power, while leaving small farmers powerless to impose their own sets of preferences upon the organization.

Somewhat more formally, the thesis examines the proposition that the FPCL, and the resulting pattern of co-operative development, is the expected outcome given the challenges that China is facing in its agricultural sector, China’s economic development goals, and the political economy of the rural sector. Although there is an expectation from the history of co-operatives in the West that traditional farmer-owned and controlled co-operatives would be likely to emerge at this stage in the development of a capitalist economy, the proposition to be examined in this thesis is that such a development is not consistent with the institutions and the political and economic forces operating in China today.

The thesis uses the development of farmer co-operatives as a lens through which Chinese agriculture and rural development can be viewed and understood. In particular, the thesis explains the relationship between political institutions and the governance structure of co-operatives. In short, the thesis asks “Who are the residual claimants in a farmer co-operative and who controls them.” This thesis draws upon the work of Gourevitch and Shinn [2005], who argue that institutional structures play a role as social filters and define the opportunities for various actors to take actions, make investments in relations, and influence the form and nature of economic development.

A key outcome of the research in this thesis is that the development of the FPCL has to be seen as an endogenous response to the political and economic interests operating in China at the time it was introduced. The beliefs and associated behaviour of those that benefit from the emergence of this particular policy helped to enforce and reinforce the emergence of new organizational
forms that further perpetuate the power of those that initially benefited (Bardhan [2001], Greif and Latin [2004]). This self reinforcement (i.e., positive feedback) creates path dependency, which in turn explains institutional emergence, persistence and change (North [1990], Pierson [2004]). An understanding of these dynamics provides insights into why the FPCL is a “law on the books” and is often not enforced, or if it is enforced, why the law’s interpretation typically takes a particular form.

The thesis raises several questions with the hope that their articulation will pave the way for their solution. First, why did the state not explicitly define the purpose of co-operatives as the promotion of the economic and social interests of its members? Why did the state instead adopt a flexible, even lenient, stance in its definition that left an opening for opportunists? Second, why did the state emphasize in the FPCL that farmers co-operatives should serve as an instrument to achieve government policy? Further, why does government play a key role in directing, guiding, and supporting co-operative development? Thirdly, why did the state create a legal framework that allowed for heterogeneous co-operative membership which allows farmer co-operatives to be led by enterprises for the purposes of vertical integration? Lastly, why are local governments inclined to support the C+H model rather than support the development of co-operatives along the West model that would provide benefits to small farmers?

1.3 Methodology

The thesis begins with an outline and an elaboration of the challenges facing the rural sector in China, including those brought on by natural resource constraints, economic globalization, and agricultural industrialization. The thesis also examines the economic and political problems that need to be addressed by rural actors.

The thesis then lays out the theories of political economy that are used to interpret the dynamics of rural and agricultural development. The thesis defines a number of key concepts including high modernism, crony capitalism, and the endogeneity of institutions that determine the institutional structure of society in China. The ideas in this part of the thesis rely on the work of authors such as Scott [1972, 1976, 1985, 1998], Gouvevitch and Shinn [2005], and North [1981, 1990].
The Political Economy of Farmer Co-operative Development in China

The thesis analyzes the creation of the FPCL as an incremental evolution of state institutions. In this evolution, the existing power structures are largely responsible for the shape that change takes. The thesis argues that the form taken by the co-operative law is an endogenous response to the need to industrialize agriculture and the need to satisfy the political and economic needs of the major players in the political and economic system (agri-business firms and local government officials).

The development process of farmer co-operatives is explored, and a number of examples are used to emphasize who controls and benefits from particular co-operative models. Details are given about how the co-operative principles and values have been stretched and modified to achieve the objectives of those with power.

The thesis then examines the implications of following the current development path of farmer co-operatives and whether farmer co-operatives are helping to address the major issues facing rural China, namely income disparity, environmental degradation, and the need for greater and safer food production.

Finally, the key findings of the research are summarized. In addition, the limitations of the research as well as areas for further research are discussed.

In addition to drawing on literature from economics, political economy and institutional evolution, the thesis is based on findings from the author’s field studies undertaken in co-operatives based in Beijing, Sichuan, Jilin, Shaanxi, Henan, Xinjiang, Yunnan, Gansu, Zhejiang, Chongqing and Hubei. The geographical locations of these provinces is presented in Figure 1.1. Information on the co-operatives interviewed, the provinces where the co-operatives are located and the major crops grown around the co-operative are available in Appendix B. The questions used in the interviews are included in Appendix C. In addition, case studies conducted by Chinese researchers dealing with producer associations and credit unions, as well as results gleaned from projects funded by the World Bank and CIDA, are drawn upon. The author was involved in a number of these projects either as an employee (in the case of CIDA) or as a consultant (in the case of the World Bank). Ethical approval was obtained for the interviews used to develop the case studies.
chapter 1. introduction

Provinces where co-operatives were interviewed are located.

Figure 1.1: Map of China
1.4 Organization and Structure

The structure of the thesis follows. Chapter one introduces the problem, defines the objectives of the study, and provides a brief overview of the research methods.

Chapter two presents an overview of the rural sector and of the major challenges faced by the key players – e.g., small farmers, rural government, and agri-business groups. The chapter also contains a review of agricultural industrialization and modernization, the problems faced by local government, and the environmental challenges facing rural China.

Chapter three examines the history of collective actions taken by farmers worldwide. In developed countries, where farmer co-operatives emerged as an integral part of social development, they play an important role in enabling the underprivileged populations (e.g. small farmers) to be involved in social and economic development. But when farmer cooperatives were introduced into developing countries as field tested models to be applied and replicated as part of rural planned development strategies, they were either manipulated by the government as a state-dominated development vehicle or captured by the elites to perpetuate the existing system.

Chapter four reviews a number of theories of political economy that are applicable to the co-operative development case. First, the state-peasant relationship is examined in the context of market-based agricultural industrialization and national modernization strategies. Then, to better understand the current institutional structure, a historical review of the previous institutions and political developments that modernized the Chinese economy (e.g., village collectives, capitalism with Chinese Characteristics, and the Household Responsibility System) are examined.

Chapter five describes and analyzes the co-operative law that was introduced in 2007. The thesis examines how this law was developed to achieve a number of objectives, among them the vertical and horizontal coordination necessary to increase agricultural output, the need to meet the interests of local business elites, and the need to buttress the role and power of local government officials.

Chapter six explores the development of several farmer co-operatives through the use of examples taken from the field studies. These examples document the key players involved and
how the structure of the co-op was manipulated to achieve ownership and control of the organization by those players. A number of measures were developed to evaluate how the international co-operative principles were stretched.

Chapter seven examines the governance structure of co-operatives – in particular, who owns and controls the C+H co-operative – through the application of co-operative principles and property rights theory. The chapter also looks into reasons why C+H co-operatives dominate the co-operative sector in China. The examination of these co-operatives also describes the relationships between key players and the purposes, strategies, and structures of these co-operatives.

Chapter eight presents a summary and the conclusions. The chapter also examines the policy implications of the work presented in the earlier chapters. Specifically, the chapter examines whether there are policy changes that could be made that would better position farmer co-operatives as a development tool for farmers. It is argued that since the institutional and power structure of the Chinese state and economy has a profound influence on the development of farmer co-operatives, and since this structure is unlikely to change, little or no change in the role or nature of co-operatives is likely in the foreseeable future.

However, there are some mechanisms that can bring about desirable institutional change. The first and most important activity is to redefine the role of the state. To do so, democratic pluralism can play an important and crucial role in creating the needed checks and balances to the power of particular players, such as government officials. Other actions could include: setting a constitution that clearly defines and secures basic political, civil, and economic freedoms, and designing a legal and regulatory infrastructure that creates an enabling environment for all private enterprises including co-operatives.
Chapter 2

Sannong Challenges
(Agricultural, Rural, and Farmer Challenges)

China faces a number of challenges in its agricultural and rural sector. These challenges are often referred to as Sannong issues (the word Sannong is derived from San meaning three; Nong is the prefix to the words agriculture, farmer and rural). The purpose of this chapter is to outline the Sannong issues, which in turn serve as a backdrop for the examination of the role of co-operatives in the agricultural and rural landscape of China.

China’s agricultural sector has experienced a period of rapid growth, followed by relative stagnation, over the last three decades. Following the introduction of the Household Contract Responsibility System (HCRS) in 1978, and the subsequent liberation of agricultural markets, China’s agricultural output grew rapidly. From 1981 to 1984, agricultural output grew at an average annual rate of 10.0 percent (see table 2.1). This growth was the first sustained expansion of agricultural output since 1966, surpassing the annual population growth rate for those years. The rapid agricultural growth in the 1980s and early 1990s was one of the factors responsible for the decline in rural poverty from 53 percent in 1981 to 8 percent in 2001 (World Bank [2008]).

However, the rapid growth was not sustained; from 1985 to 1996, the agricultural output growth rate dropped to an average annual rate of 4.1 percent and from 1997 to 2003 it dropped even further to 1.9 percent (see table 2.1). This drop in the growth rate was accompanied by a dramatic drop in total factor productivity (TFP). As illustrated in table 2.1, the fall in TFP is due to a slow growth in output and a substantial growth in inputs, particularly capital.
Table 2.1: Average Growth Rate of Output, Capital Stock, Labour Growth Rate and Total Factor Productivity (TFP) in China’s Agriculture Sector, 1981-2003.

<table>
<thead>
<tr>
<th>Years</th>
<th>Average growth rate of output</th>
<th>Capital stock</th>
<th>Labour growth rate</th>
<th>TFP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981-1984</td>
<td>10.0</td>
<td>2.3</td>
<td>1.5</td>
<td>7.98</td>
</tr>
<tr>
<td>1985-1996</td>
<td>4.1</td>
<td>7.6</td>
<td>1.1</td>
<td>-0.25</td>
</tr>
<tr>
<td>1997-2003</td>
<td>1.9</td>
<td>22.7</td>
<td>0.7</td>
<td>-9.80</td>
</tr>
</tbody>
</table>

Sources: World Bank, World Development Indicators 2005; Database of State Information Center, China and Zhang [2005].

The slowing of agricultural output growth is not the only problem facing China. Income disparity between rural and urban residents has steadily increased despite substantial rises in farm and rural incomes since 1978. Examining the ratio between annual incomes of urban and rural residents shows a marked increase in the urban-rural income ratio from 1.86:1 in 1985 to 2.72:1 in 1995 and then to 3.36:1 in 2008. In absolute terms, the rural-urban income gap amounted to RMB 10,000 in 2008 (Ministry of Agriculture [2008]).

This income disparity is likely to become a major source of political and social tension (CCICED [2005]). Low-income rural households are economically restrained from investing in education, health, and other human and physical assets. These investments are not only necessary for long term increases in agricultural productivity, but also for facilitating the transition of farmers out of the agricultural sector.

A number of reasons have been identified for the decline in the growth of agricultural productivity and the increase in the urban-rural income disparity. First, farms are fragmented, and plot sizes are small and getting smaller. Second, a lack of clear land ownership and a difficulty in securing land title have resulted in the inability of farmers to collateralize land. As a result the land rental market functions poorly, and households with opportunities off the farm are not able to rent out their land. Furthermore, those left in the village in need of land to rent are not able to do so. The problem is further reinforced by the pull-out of state financial institutions from the countryside, a development that has limited access to credit for small farmers (CCICED [2005]).

Third, important natural resources, such as water and the forests, are being degraded and over-harvested as a result of unsustainable practices. Lastly, research and extension services are underfinanced and the quality of services offered is poor.
Chapter 2. Sannong Challenges

The slowing of agricultural output growth is a concern to Chinese policy makers that place high priority on food security given the nation’s large and growing population, and limited resource base (CCICED [2005]). In fact, China’s population is expected to increase to 1.4 billion by 2030 from its current level of 1.3 billion (UNDP [2005]). While China can and will import food to meet shortfalls, the government prioritizes food security at a national level. Thus politically, a drop in agricultural growth rate is of concern, since it adversely impacts both national food security plans and rural income growth.

Despite the rapid growth in urban areas, China remains highly rural with a large population that requires employment in rural areas (Development Research Center [2008]). The lower agricultural output growth rate is problematic when it is recognized that addressing the Sannong challenges will require the maintenance of a healthy small-holder based agriculture and rural economy. The United Nations Population Division projects that in 2020 China’s rural population will be 660 million people, falling to 570 million people by 2030. Compared to the average urbanization rate of 10 percent in developed countries, China is urbanizing at a rate of 40 percent. But, even under the most rapid urbanization scenarios, China will continue to have a very large rural population for many decades.

Without some changes to the nature of agricultural production, agricultural output growth is unlikely to reach the levels obtained in the 1980s, or those experienced by other countries at a similar stage of development. At present much of the transformation and resulting adjustment pressure will fall on rural farmers and households with limited means of action, who cannot compete with more efficient domestic agricultural businesses or with imports.

Generally, farmers have three options for adjustment. First, they can join the ranks of efficient commercial producers to capture more value in the modern supply chain. Second, they can seek to bridge their income gap by earning additional income from other sources, such as diversifying household income sources. The last option is to exit the farming sector altogether and become a wage labourer. Farmers and other players in the agricultural sector must make these choices in the context of the existing economic, political and social environments which often create additional limitations and barriers.
Besides these challenges, farmers also face natural resources constraints that undermine sustainable agricultural development and the growth of rural incomes. Urbanization and industrialization have led to an increase in competing claims for natural resources, especially water and land, and as a result the resource base for agriculture is being degraded.

This chapter presents a picture of the rural sector and the transformation that is required for its continued modernization. The chapter begins by reviewing the HCRS and the constraints it imposed on the farming sector. This review is followed by an examination of the challenges faced by rural governments during the rural transformation and by an analysis of the economic and political problems that small farmers encounter in the process of agricultural industrialization. Lastly, the chapter reviews natural resource degradation and the environmental problems which threaten the sustainable development of this sector.

2.1 Household Contract Responsibility System (HCRS)

2.1.1 Replacement of the People’s Commune by the HCRS

In the 1950s the collectivization movement resulted in the organization of China’s agriculture system under the People’s Commune system. This system lasted for about 20 years. In this system, all production and marketing decisions were made by commune officials according to quotas set by higher-level governments. Each commune was its own production unit and public service provider. Services were self-financed by the income from agricultural operation surpluses. Workers were given work points for the daily jobs they performed.

However, the inability to supervise the work being done led to the failure of the work point system. As Lin [1988] points out, there was little incentive to work hard on the commune and as a consequence shirking was widespread. In particular, the monitoring of labour effort was too difficult and costly in agricultural production, with the result that agricultural production remained flat and even fell.

Rural reform started in 1978, when agricultural production shifted from a collective (commune) system to a family-based farming system with the introduction of the HCRS. Under the HCRS, farmers became “residual claimants”, meaning they were allowed to retain all the production that was left over after state taxes and fees were deducted. Farmers were also given the
ability to make decisions about which crops to grow. These reforms provided farmers with incentives to increase their agricultural production and gain income rewards for doing so; the reforms also addressed the problem of supervising agricultural production at its root (Lin [1988]).

Although farmers did not gain formal land ownership title under the HCRS, farmers were given long-term lease agreements to the plot of land that they were assigned. It has been estimated that 30 to 60 percent of the growth in agricultural output that occurred during the 1980s can be attributed to the replacement of the commune system with the HCRS (World Bank [1998]).

2.1.2 The Constraints of the HCRS

The productivity gains from the introduction of the HCRS were one-time only and were soon exhausted. While the HCRS contributed to a dramatic improvement in the rural economy in the short term, some of its enduring legacies have acted as obstacles to further progress. In particular, the design and implementation of the HCRS prohibits the introduction of secure property rights to land and the creation of a well-functioning land market in rural China.

Under the HCRS, land is a common-pool resource. In many villages, land is allocated on the basis of family size and it serves as a form of insurance arrangement to provide basic food needs and a minimum income to the family. But given the abundant population and limited land, the result of the policy is that the average cultivated land per rural person is only 2.8 mu (about 0.2 hectare) (CIDA [2008]). In addition, the land holdings of a family are often fragmented and the plots distributed across several different locations. On top of this, the quality of farmland varies from parcel to parcel in terms of soil fertility and irrigation needs.

In 1986 the Chinese Ministry of Agriculture conducted a survey of land per household. Data was collected from 7,983 sample villages in 29 provinces. The Ministry found that the average cultivated area per household was 0.466 ha (7 mu), and on average the land was fragmented into 5.85 plots, each plot on average was 0.08 ha (1.2 mu) in size (Ministry of Agriculture [1993]). The fragmented structure of household farming results in large areas of cultivated land being wasted in the form of paths and boundaries separating households’ land holdings. Furthermore, fragmentation has arrested the possibilities of using relatively advanced mechanical equipment and agricultural infrastructure (Chen and Davis [1998]). A number of studies have
found a positive relationship between plot size and output for major grain crops, suggesting that fragmentation incurs a significant cost (Nguyen, Cheng, and Findlay [1996]).

Since nation-wide statistics on small-holder farming are not available, a survey conducted in a county of Zhejiang province can provide a snapshot on farm size and structure. As Table 2.2 shows, the average household consists of 4 members, of which 2.5 are agricultural labourers. Rice-vegetable growing household farms are the largest with an average farm size of 0.6 ha; rice growing household farms are 0.3 ha on average in size, and vegetable growing household farms are 0.2 ha in size. For rice-vegetable growing households, vegetables are grown 0.4 ha, with rice grown on the remaining 0.2 ha. Most farmers grow a single rice crop and three vegetable crops. For a household with 2.5 agricultural labourers, total income of those growing rice is RMB 2,709, average income of per person is RMB 677; for those growing vegetables, it is RMB 8,928, average income of per person is RMB 2,232; and for those growing vegetables and rice, it is RMB 32,748, average income of person person is RMB 8,187. According to the National Statistics Bureau, per capita income in urban area of Zhejiang in 2002 was RMB 11,716, which suggests that farmers’ scale of operation has to be expanded significantly if they rely on farming for their livelihood.

Table 2.2: Farm size and structures in households of Pujiang, Zhejiang

<table>
<thead>
<tr>
<th></th>
<th>Rice households</th>
<th>Vegetable households</th>
<th>Rice-vegetable households</th>
</tr>
</thead>
<tbody>
<tr>
<td>Family size</td>
<td>3.48</td>
<td>3.75</td>
<td>3.83</td>
</tr>
<tr>
<td>Agricultural labourers</td>
<td>2.47</td>
<td>2.57</td>
<td>2.53</td>
</tr>
<tr>
<td>Farm size (ha)</td>
<td>0.31</td>
<td>0.19</td>
<td>0.6</td>
</tr>
<tr>
<td>Vegetable land (ha)</td>
<td>0</td>
<td>0.19</td>
<td>0.4</td>
</tr>
<tr>
<td>Rice production (kg)</td>
<td>2,529</td>
<td>0</td>
<td>1,579</td>
</tr>
<tr>
<td>Vegetable income (RMB)</td>
<td>0</td>
<td>8,928</td>
<td>31,215</td>
</tr>
<tr>
<td>Crop income (RMB)</td>
<td>2,709</td>
<td>8,928</td>
<td>32,748</td>
</tr>
</tbody>
</table>


The collective ownership of land has adverse impacts on sustainable land use for several reasons. First, because land is collectively owned by the village, village members insist on equal land holdings. To compensate for the differing quality of land, land is periodically redistributed
and changes are made to land use rights. Therefore, villagers do not have secure land tenure and cannot be sure whether they will be farming the same plot of land in the coming five or ten years. This uncertainty means that long-term investments on a particular plot of land are not worthwhile. Instead farmers have an incentive to maximize returns from their lands in the shortest span of time. These facts contribute to an overuse and underinvestment in land, which leads to land erosion and degradation.

China’s growing population contributes to the decreasing size of farm plots. With each additional person the village plot per capita gets smaller. Land fragmentation and the small scale of farm operations mean that farmers face severe constraints while trying to increase their productivity. First, farmers are confined to simple production. Second, farmers find it difficult and costly to accumulate capital and invest in technical innovations. Third, farmers cannot benefit from economies of scale and scope.

The lack of secure land tenure means that households often do not receive appropriate compensation when their land is appropriated for development projects. It is not legal for villagers to sell development rights directly to developers. Instead, land must be sold to the government, which in turn then resells the development rights to developers.

Under Chinese land policy, the state is identified as the absolute owner, with the village collective (i.e., the administrative village) carrying out the administration. However, neither of the two collective economic organizations – the villagers’ committee and the villagers’ group – answer to the villagers; instead, both are an extension of the local government officials.

Media coverage has exposed instances where the village committee leaders have colluded with local government officials to appropriate farmers’ land. The ramifications of this self-dealing are particularly evident in real estate transactions where farmers regularly receive less than 5 percent of the value of their land, while developers pocket 60 percent (the remainder goes to local government officers) (Pei [2006]). An investigation undertaken by the Ministry of Land Resources indicated, in a city in the Zhejiang Province, farmers received only 2.7 percent of their land value. Obviously, the income disparity between the haves and the have-nots is reinforced by this “land enclosure movement.”
2.2 Rural Governments and Rural Transformation

As is the case in other developing countries, China’s rural governments face significant difficulties in providing farmers and rural residents with adequate and responsive services. These difficulties arise from a shortage of local taxation revenues, a dependence on central government transfers, and the inefficiencies of public expenditures in financing developmental goals. Furthermore, small farmers and rural residents have limited means to hold their local government accountable.

2.2.1 Revenue-starved Rural Governments and Falling Services

Local governments in rural areas are weak by most standards. Despite the historic precedence set in the Commune era for rural self-sufficiency and service provision, current local governments, and townships in particular, are poorly equipped both fiscally and administratively to provide services. Furthermore, China’s public service delivery is one of the most decentralized in the world. Local governments provide most of the services – e.g., education, health care, social security, agricultural extension – required by farmers and rural residents (World Bank [1998]).

The county-level government is arguably the most important level of government for delivering public services to the rural population, playing a key role in interpreting policies and controlling the allocation of resources. A typical county governs about twenty towns and townships, perhaps three hundred villages, and a population of close to half a million people. The vast majority – on average 85 percent – of a county’s population is rural. Absolute inequalities and multi-dimensional inequalities in income, wealth, human development, and public service delivery have increased significantly between and within both urban and rural areas (Ravallion and Chen [2004]). As evidenced by the United Nations Development Programme (UNDP), the Human Development Index data for 2002 shows China’s development at 0.81 for urban areas, and 0.67 for rural areas (UNDP [2005]).

At the end of 1997, China had some 2,100 counties and county-level cities (Rozelle, Huang, and Zhang [2005]). In 2003, this level of government accounted for about one quarter (23.3 percent) of all China’s public expenditures (World Bank [2007]). Local governments in China, however, are largely self-financing, a trend that has increased during the reform period. China’s provincial county and township governments in rural areas financed 42 percent of their budgetary
Chapter 2. Sannong Challenges

expenditures from local resources and collected 51 percent of the revenues (Rozelle et al. [2005]); the difference between them is the local net remittance to the central government. The poor quality of public services in rural areas compared to urban areas is largely attributable to the persistent fiscal gaps, or financial shortfall, between required expenditures and rural fiscal capacity.

Lack of funding and local government inefficiency are both responsible for the falling quality of public services. China’s small-scale farming has stifled technology development and transfer, something that is crucial for increasing food production and farmers’ incomes. During the 1990s, the extension system became increasingly dysfunctional, due to a decline in real expenditures on extension services and unfavourable decisions on the allocation of services to rural users.

Currently, many extension stations at the township level exist in name only, and extension agents often spend nearly all of their budgetary allocations on staff expenditures pursuing agendas that are not in the interests of farmers (CCICED [2005], World Bank [2007]). For example, some extension stations are selling agricultural inputs such as chemical fertilizers and pesticides to earn profits to pay staff. Such behaviour is one of the reasons for the overuse of agri-chemicals in some areas.

2.2.2 Rural Tax and Fee Reforms

In the 1990s, rural tax reform began and arguably worsened the situation in rural China as it eliminated local taxes and income fees (Fock and Zhao [2006]). Various studies (World Bank [1998, 2007] and CCICED [2005]) implicate the comprehensive reform of the fiscal system in 1993 and the rural tax and fee reform of 2000 as the policies responsible for the loss of the stable and rising rural revenue base required by rural governments to provide the level and quality of social services mandated by the national government. As a result, local governments are relying more and more on central government transfers and self-raised extra-budget funds to meet their mandates.

The first reform of the fiscal system was initiated in 1993 in response to a decline in the revenue received by the central government. Key provisions of this reform included the adoption of a value-added tax (VAT) and the introduction of a tax-sharing system (TSS). Tax sharing is based on collection, so tax rebates to local governments have largely favoured the richer
provinces (Rozelle et al. [2005]). Even with these reforms, the tax system remains centered on industry (the VAT, for instance, is assessed primarily on industrial products).

Rural governments have become increasingly dependent on VAT revenues generated by local businesses. Furthermore, increased remittances of the VAT to the national government has almost certainly increased rural budget deficits, since little progress has been made in revenue redistribution (World Bank [1998]). According to the Ministry of Finance, the VAT is administered by the State Administration of Taxation, the import VAT is collected by the customs officials on its behalf, and the revenue from it is shared between the central government (75 percent) and local governments (25 percent) (World Bank [1998]). The VAT is the major source of fiscal revenue for the government of China. In 2002, the revenue from the VAT was RMB 814.1 billion, accounting for 47.61 percent of China’s total tax revenue for the year, making it the largest tax revenue generator in China (World Bank [2007]).

Local governments are struggling with persistent fiscal gaps. Major local government expenditures include wages and the welfare packages of government employees, rural education, rural health, as well as counterpart funds required by the central government to obtain infrastructure and project development financing. Costs are escalating in all of these budget areas. The number of government employees is growing, and their wage level is set by the central government. China’s national policy has mandated the level and quality of rural education and health services, and local governments are requested to match funds for almost all infrastructure development projects.

These fiscal pressures force the rural governments to rely more and more on off-budget finances to meet their budgetary demands. Local governments have had to develop off-budget revenue sources because county and township governments do not have legal authority or ability to borrow. In addition to extra-budget funds and self-raised funds, which are levied mostly on local enterprises, various fees have been collected from farmers. In some cases the fee burden placed on farmers was so heavy that it was reported that rebellions took place across the country. The national government had to take action to correct this.

The Rural Tax and Fee Reform (RTFR) was started in 2000. The first phase entailed raising the existing agricultural tax rate and the agricultural special products tax, while abolishing all
administrative fees that were levied on farmers, including the unified township levy and the village accumulation levy (World Bank [2007]). This reform reduced the overall fiscal burden on farmers. By banning extra budgetary levies, the government aimed to harden the budget constraints and curb the excesses in taxing and spending at the grassroots level (World Bank [2007]).

The second phase of RTFR was the abolition of agricultural taxes. The first part to be eliminated, in 2002, was the agricultural special product tax that was assessed on horticultural commodities, cash crops, and some livestock and aquaculture sales. The agricultural tax was completely phased out in 2003.

While these measures benefited farmers, they had the effect of making the rural government more revenue-starved. Indeed, the revenue gap at the local level is substantial, and in order to fill the gap the central government has had to increase transfers. The growth in transfers from the central government has been in the form of earmarked grants for specified purposes rather than for general expenditures. This has the dual effect of constraining the budget allocation authority of local governments, and giving central government further influence over local governments’ financing of public services.

Although the central government has increased transfers, pressure has still increased on local government finances. Local governments are being requested to provide matched funding, and to cover the operation and maintenance costs of new developments to be eligible for central government programs. Due to revenue shortages, local governments are turning to borrowing. Although they cannot borrow in the financial market, they can access earmarked funds from the central bank for borrowing or obtain a loan from a local bank. Other borrowing options include intergovernmental loan, special state bonds, foreign loans, salary arrears, and funds available from individuals such as contractors.

Debt in the townships is increasing as a result of borrowing. Between 2000 and 2004, debt rose by 23 percent (World Bank [2007]). County-level governments, the most important level for the provision of public services, can have debt as high as 14 percent of their GDP. According to Wang (2006) the average ratio of debt to own revenue, disposable revenue, and total revenue is estimated to be, respectively, 335 percent, 255 percent, and 138 percent under a best-case
scenario; and 558 percent, 425 percent, and 231 percent under a worst-case scenario. Even the lowest debt to own revenue ratio (138 percent) is much higher than the international standard for developing countries, which ranges from 60 to 80 percent.

To fill the taxation gap created by RTFR, local governments are increasingly using alternative methods, such as land-related transactions, to generate off-budget revenues. Revenues from government-dominated land transactions are an important part of the income of local governments (World Bank [2005]).

### 2.2.3 Accountability

Undoubtedly, the fiscal gap is partly responsible for the decline of services in rural areas. But more funding will only solve one part of the problem. Another obstacle to improving rural public finances and services is the inefficiency of many local governments. Higher-level governments lack the incentive and capacity to effectively monitor and evaluate lower-level governments, and because local level budgets and decision making are not transparent to the general public, accountability is largely non-existent (World Bank [2007]). The 2004 World Development Report (World Bank [2004b]) explores the accountability relationship between the government, service providers, and citizens/clients. They found that Chinese rural residents do not have any formal institutions to which they can appeal to exercise their democratic rights and to hold local governments accountable. Politics and political life are totally banned for most farmers.

Unfavourable appropriation decisions made by local governments that penalize rural citizens are partially responsible for the low quality of service provision observed in many Chinese provinces. The vast government apparatus is staffed by a large and rapidly growing number of officials, whose salaries and benefits command an increasing share of the budget.

In contrast, the share of capital and administrative expenditures for agricultural investment has declined over time (CCICED [2005]). Field visits by researchers found that agricultural extension services, police stations, and even emergency services were overstaffed to the point that nearly all of their budgetary appropriations were spent on staff. The result was that little or no funding was left for the vehicles and fuel needed to take the personnel into the field (World Bank [2007]).
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Over time local governance systems have developed histories of supporting patron-client networks and distributing patronage in ways that perpetuate the dominance of a particular political faction, at the expense of promoting development. The functioning of local governance systems is therefore also partly responsible for the decline of services in rural areas. In rural China most government agricultural policies are made to favour larger producers and leading enterprises rather than the majority of smallholders. Benefits are concentrated among larger producers and enterprises to support their role as engines of agricultural industrialization. More importantly, in the eyes of government, these companies contribute a large share of local taxation revenues and have strong personal ties with local leaders.

In contrast, small farmers are thought to be hopelessly backward. Hence government policies intentionally try to foster a productive and competitive modern agricultural sector by driving the majority of smallholders out of the sector rather than improving their competitiveness and productivity, although this intent is not stated explicitly. Small farmers are also excluded from various government support programs, and most are unable to participate in the policy-making process and therefore cannot influence policy in ways that would benefit them.

In the internal work report of a large donor agency, it was reported that several million RMB were earmarked to finance several projects including two 100-cow farms, ten 10-cow dairy farms, one milking station, and sixteen commercial mutton sheep fattening households. Instead, the donated funds were lent out to one private company without consulting the donor. This company utilized the funds to procure 400 cows and construct one milking station. The reimbursement request provided by the county government project office shows that disbursement was made to fund three 100-cow farms, ten 10-cow farms and one milking station.

According to the original funding proposal agreed to by the donor, at least one hundred small farmers would have participated and benefited from the project in its original state, and more would have benefited by emulating the successful operation of different farm models. However, with the new method of disbursement all the benefits are concentrated with one private company.
2.3 Agricultural Industrialization

The industrialization of agriculture refers to the consolidation of firms in the food production and distribution system, and the integration of the stages of food production (Urban [1991]; Barry, Sonka, and Lajili [1992]). The industrialization of agriculture has also been defined as “the application of modern industrial manufacturing, production, procurement, distribution, and coordination concepts to the food and industrial product chain” (Boehlje [1998], p. 4).

Prior to industrialization small farmers were engaged in traditional forms of production. Farmers decided what they would produce since most of the produce was for self consumption, and any surplus production was sold on the spot market. In addition, most agricultural inputs came from the farm – in essence farmers were self sufficient.

Today, farmers are no longer isolated in rural village communities. Their lives and production choices influence, and are being influenced by, highly developed world markets as their produce becomes incorporated into a modern global network of exchange (Mann [1990]). Farmers are sourcing more of their inputs from off the farm and performing less value added processing that results in the final food product.

As a consequence, the number of linkages farmers have with the marketplace has generally increased. At many points along the food production chain these linkages have been internalized. Functions such as wholesaling, retailing, and the distribution of inputs or food products which were previously performed by many independent firms are now being integrated.

Not only are the number of linkages changing, but the nature of those linkages is also changing. The open spot markets at which farmers used to sell their excess produce are being replaced by negotiated, personal, and sometimes closed contractual linkages between farmers and agri-food companies. To reduce transaction costs, some linkages between stages in the food chain that once were external have now become internal through acquisition and integration (Boehlje and Schrader [1998]).

2.3.1 Agricultural Industrialization in China

Agricultural industrialization is changing the structure of China’s agri-food sector at an unprecedented rate. Change began with the introduction of the household contract responsibility system
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(HCRS) in 1978. The HCRS gave small farmers the right to generate an income from the produce grown on their land. As outlined above, the resulting incentive caused a major increase in agricultural productivity.

Since then, China’s agriculture has transitioned from subsistence farming to commercial agriculture, with most farm produce now sold on the market. As a consequence, small farmers have to deal with a host of business players along the food supply chain including traders, middlemen, market inspectors, processors, and supermarkets.

Recent rapid changes are driven by China’s rapid population growth and urbanization. The emergence and rapid growth of an urban middle class, with disposable income, has lead to stronger consumer demands for high-value food products with adequate safety and phytosanitary standards. The rapid development of integrated supply chains in China is supported by liberalized agricultural markets, China’s access to the WTO and an openness to international trade.

The commercialization and industrialization of agriculture has left many small-holder farming operations unable to meet the demands of large-scale commercial food processors, particularly those that are export-oriented. From the outset of market reforms, agricultural products were the top source of foreign exchange income for China. Japan, the most important foreign market for Chinese produce, desires specific and stringent quality attributes, ones that are very different from those of Chinese consumers.

To meet these demands, some firms developed specific supply chains to meet the regulations and consumer needs of the Japanese market. Likewise, similar chains were developed for other foreign markets. Trade in agricultural products was the first important factor in the trend to increase the vertical coordination of the agricultural supply chains in China. This was particularly true in coastal regions, and suburban areas where large-scale processors are concentrated.

When China began experimenting with agricultural industrialization, the focus was initially on areas where there was relatively high commercialization and potential for exports, and areas that already had a reasonably well-developed production chain. These areas were conveniently also ones where product specialization and higher production efficiency already existed.

The first agricultural industrialization efforts occurred in Shandong province in 1993 where the Weifang municipal government formulated the first agricultural development strategy. Thanks
to its geographic location, Shandong is the leading exporter of agricultural products to Japan and Korea. The main elements of Shandong’s agricultural development strategy were: (1) the identification of a leading commodity or industry in accordance with regional comparative advantages; (2) the designation of zones where production of this commodity would be carried out; and (3) the identification of so-called dragonhead processors that would take a leading role in mobilizing this industry. The processors were viewed as the head of the supply chain (which was conceived of as a dragon; the long body and tail were the small farmers who supply products to the processor) and the ones best able to mobilize and drive the large number of small producers. Their role was to provide a market outlet for small producers.

New policy initiatives in China are often introduced as trials or experiments that are tested in a small number of locations. Higher-level government officials, or researchers sent by them, evaluate these trials and often replicate them elsewhere. If they prove to be successful, they are then implemented as national policies by the central government.

Experimentation with agricultural industrialization followed this pattern. Following the introduction of the dragonhead model, the Agricultural Commission of Shandong (ACS) organized a field study in Weifang and submitted a report to the provincial government entitled “Recommendation for Industrialization of Agriculture as Agricultural Development Strategy.” This report was followed by articles in the federal Ministry of Agriculture’s Farmers Diary that called for the industrialization of agriculture as a key strategy for market-based agriculture. These articles were the first attempt to promote agricultural industrialization in China (Fulton and Zhao [2009]).

After years of reform and economic development, per capita income in China has increased significantly. An increasing amount of disposable income and urbanization have resulted in a class of richer domestic consumers that are more demanding. They expect quality controlled products with specific characteristics to be readily available. Furthermore, their demand for product diversity is increasing, and their diet is changing. Products in the marketplace are now differentiated based on what they do not contain, as well as what they do contain. Some attributes are achieved through processing, while others are achieved during production. Consumers in
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China are also specifying how they would like products to be produced, a pattern that has been noted in developed countries (Boehlje and Schrader [1998]).

To meet consumers’ demands for safe food products, the governing authorities have set and increased both safety and phytosanitary standards. These new standards are proving very difficult for traditional open spot markets to meet, since these markets are not set up to convey the information concerning produce attributes – quantity, quality, timing and safety – that consumers now demand.

It is also difficult to achieve the coordination among input suppliers, producers, processors, wholesalers and retailers that is necessary to meet these demands. Increasingly supermarkets have emerged as important players able to meet specific consumer demands related to production processing and quality, particularly for high-value products (Orden, Torero., and Gulati [2004]). Conforming to specific quality standards can be more easily accomplished in China, as elsewhere in the world, with a contract or ownership coordinated system. Compliance with food regulations on the use of drugs and chemicals also requires a greater degree of coordination throughout the food system (Boehlje and Schrader [1998]).

Thus, agricultural transactions that were traditionally made in spot markets are now increasingly made within vertically-coordinated markets (Saxowsky and Duncan [1998]; Reardon and Barret [2000]; Peterson, Wysocki, and Harsh [2001]). The rapid rise of supermarkets in the procurement system is institutionalizing contractual exchanges by demanding compliance with specific product and/or process requirements for procured produce (Reardon, Timmer, Barret, and Berdegue [2003] and Berdegue, Balsevich, Flores, and Reardon [2005]). Supermarkets coordinate actions along the supply chain by standardizing product requirements across suppliers. Their standards specify and harmonize product and delivery attributes, thereby enhancing efficiency and lowering transaction costs (Reardon and Gulati [2008]).

The modernization of the procurement system by supermarkets poses major challenges for small farmers looking to enter the high-value market for agricultural products, or to capture more surplus from the supply chain. This stricter procurement system translates into increasingly demanding requirements from suppliers with respect to volumes, consistency, quality, costs and commercial practices (Henson and Reardon [2005], Reardon and Gulati [2008]).
The Chinese government directly supports the development of supermarkets, and supermarket chains, as part of their modernization strategy. In the 1990s the Chinese government invested heavily, using stock market financing, in its primary national supermarket chains to increase their competitiveness with multinational chains such as Carrefour and WalMart (Reardon and Gulati [2008]). At the same time, regulations were introduced to directly or indirectly constrain the development of traditional wet markets.

As a result, supermarkets flourished. Although they were virtually unknown only 20 years ago, there are now 23,000 supermarkets in China, with total annual sales of 303 billion RMB. In recent years the number of supermarkets has been growing 26 percent annually, and their sales are growing at 24 percent per year (China Statistics Bureau [2007]). To take advantage of new economies of scale, to increase the quality and safety of produce, and to deal with transaction costs, supermarket chains are becoming centralized. Supermarkets are shifting from a store-by-store procurement system that relied mainly on traditional wholesale markets and brokers to a centralized distribution centre model that uses specialized, dedicated wholesalers and large commercial producers (Berdegue et al. [2005]).

China’s agri-food sector is experiencing a trend toward closer vertical coordination driven by supermarket standards. Supermarkets are determining the conditions for procurement such as scale, volume, quality and safety standards, packing, packaging, and consistency. Buyer-driven chains, such as supermarkets, are characterized by high levels of governance, regulations, and long-term vertical coordination between producers, supply-integrators, processors and retailers (Vorley [2003]). This builds further momentum for the government’s rapid agricultural industrialization strategy.

However, as Vorley [2003] points out, the high capital requirement needed from farmers in order to enter the buyer-driven supply chains is eliminating the traditional advantage of small-holder production. Farmers now require technology, financial capital, human capital, and organization in order to participate in the new vertically coordinated markets (Boselie and Kop [2004]).

In 1996, the National People’s Congress approved China’s ninth Five-Year Development Plan. Agricultural industrialization was one of its components. The following year the 15th
Party Congress indicated that agricultural industrialization was a realistic method to reach the goal of agricultural modernization. In 2000 the Central Party Committee and the State Council made it clear that support for agricultural industrialization was equal to support for agriculture, and support for dragonhead enterprises was equal to support for farmers.

The need to generate tax revenues and create a source of local income pushed local leaders to initiate rural industrialization (World Bank [1998]) and to introduce various policies to attract investment. Dragonhead enterprises were attracted to areas by the market exclusivity, and the resulting lack of competition, that they were often granted by local governments.

2.3.2 Dragon Head Companies and the Company+Households Model

According to Ministry of Agriculture [2006], there were about 70,000 dragonhead enterprises in China in 2005. Most of the dragonhead enterprises are agro-processors. Some were established in the era of the People’s Commune as county and township-run enterprises. These enterprises were later contracted out to their managers in the 1990s and then privatized, but their traditional ties with government are still kept. In other cases, the enterprises were established as private firms. In a majority of these organizations, production is coordinated by contracts (57.7 percent); the remainder of production is coordinated by co-operatives/associations (15.3 percent) and by shareholders (15.1 percent) (Ministry of Agriculture [2006]).

The company + household (C+H) model is the most widely used organizational structure to coordinate production and to finance investment. Under this model, the dragonhead provides young animals (e.g., chicks or piglets) with feed, vaccines, and technical services at set prices to farmers. The contracts signed between the dragonhead and the farmers also include the price offered for the finished products. Individual farm producers are at a disadvantage and typically have little voice or ability to bargain with the dragonheads. As a result the contract terms usually lack transparency (Fulton and Zhao [2009]).

While small producers do benefit from gaining entry into the coordinated supply chains dominated by processors, large processors often use their market power to take advantage of small producers through unfair contract conditions. In the North American model for resource-providing contracts, the buyer usually assumes a greater proportion of the risk and may retain
ownership of the product, with the farmer, in effect, being paid a management fee (Hobbs and Young [2001]). In this model the buyers provide a market outlet, supervise production practices, and supply key inputs. They have a great amount of control and risk.

In contrast Chinese companies do not want to make such investments and bear the risks, but they do want a similar level of control over production and the ability to appropriate profits from the operation. This desire creates a conflict between the dragonhead and its small producer-suppliers.

Further tensions have emerged over time due to the unfair practices of the agro-processors. For example, during a market downturn, the dragonhead may find an excuse to refuse to purchase the finished products from farmers. In addition, input prices are often adjusted because of market price fluctuation. Another important issue that causes tension is performance evaluation. Payment premiums typically depend on the farmer meeting quality standards and achieving target volumes. If a dispute arises over whether a small producer has met the standards, the farmer has limited means to settle the dispute fairly.

The practices and strategies used by dragonheads to wield their power and magnify their advantage provides another source of conflict between dragonheads and small producer-suppliers. Dragonhead companies may collude with each other to set their prices, standards, payments, and establish contract rules.

To protect their market power, processors actively prevent small producers from forming their own associations to bargain collectively. Furthermore, to the disadvantage of farmers, local authorities support the dragonheads in their efforts to prevent collective action, a trend that has historical roots. The Chinese government has still not ratified the Agricultural Fair Practices Act (AFPA) of 1967; this act would provide protection to farmers to organize collectively. The AFPA prohibits handlers and processors from discriminating against or intimidating producers due to their membership in any organization or due to the exercise of their right to organize grower associations (Hamilton [1996]).

As a consequence, another common problem for the C+H model is the defection of small farmers. To protect themselves, farmers either avoid entering formal contracts with other trading parties or they behave opportunistically to minimize risks. Opportunistic behaviour often means
that farmers do not comply with contracts, and end up selling their produce to another company or trader that can offer a better price and/or more immediate payment. Poor small farmers are fully aware that they are not equal partners; as a result they behave opportunistically to gain what they can from their work. Taking into account the huge number of small producers, the litigation costs are typically so high that the dragonheads seldom sue farmers for breaking a contract.

Transaction cost economic theory can help us to understand the factors determining the behaviour of the parties in a vertically coordinated system. Three key concepts underlie the theory of transaction cost economics: asset specificity, bounded rationality and opportunism (Hobbs and Young [2001]).

Asset specificity refers to an investment in an asset specifically required for a particular task, with little or no value in alternative uses (Hobbs and Young [2001]). Bounded rationality means that the ability of contract partners to accurately evaluate all possible contingencies is limited (Williamson [1985]); therefore, no contract can specify all contingencies. The resulting contract incompleteness, combined with asset specificity, means that the party without the specific asset has an incentive to act opportunistically – namely to renegotiate the contract in a manner favourable to them, but not favourable to the other party. The opportunity for a favourable renegotiation arises because the party with the specific asset has very limited uses for the asset it has purchased and hence can only leave the contract at substantial cost.

The possibility of opportunism creates a hold-up problem. Knowing that they are subject to potential opportunism, parties that are being asked to make an investment in a highly specific asset may decline to do so, since they know that they will be unable to make a return on their investment.

The hold-up effect inhibits small producers from expanding the scale of production, developing more sophisticated skills, or investing in specialized equipment or capital. Specifically, asset specificity may render agricultural producers vulnerable to opportunistic behaviour by product purchasing firms (Torgerson et al. [1998]). If producers react to this vulnerability, they will not make the required investments in their farm operations. The result will be that dragonheads may find it difficult to achieve their volume targets and to ensure that all farmers comply with quality standards, in particular those associated with the use of drugs and chemicals.
Disagreements between farmers and processors on acceptable terms for sharing risks and rewards in a contract coordinated system can often lead to hold-up problems. Specifically, if opportunism and contract renegotiation are widespread, contract coordination is less likely to occur and good economic investments are not undertaken. The economic outcomes of market failure are an inefficient allocation of resources and a loss in social welfare (Boehlje and Schrader [1998] and Hobbs and Young [2000]).

For capital-intensive processing to be cost competitive, a variety of processes need to be working efficiently. These processes include: flow scheduling; capacity utilization; and product availability that meets adequate quantity, quality, and safety standards, as well as the other desired consumer features. Agro-processors have met these needs through closer vertical coordination, accomplished by the use of contracts, integration, or joint ventures in the food production and distribution chain.

Processors in China have to manage thousands of small producers to ensure a consistent supply of quality products and inputs. One method of vertically coordinated management is contracting. However, contract coordination will not occur unless there is a perception that an economic advantage exists, and currently farmers often do not see the advantages of making a commitment. As discussed above, farmers under the existing contracts retain all the risks associated with production, but are not guaranteed a good price for their finished products and inputs.

One alternative to vertical coordination is vertical integration. Vertical integration is defined as the “coordination of technically separable activities in the vertical sequence of production and distribution under the control of an organization by ownership” (Shaffer [1987]).

However, vertical integration is not a viable option for most agri-businesses in China due to several limiting factors. First, farm management is very labour-intensive and detail-oriented. It is very hard for bureaucratic organizations like companies to justify the costs of monitoring and evaluating the performance of such a large number of farm labourers that are geographically dispersed. Second, a very large investment and considerable risks are necessary to acquire the working capital to purchase farmland, labour, and processing facilities. Lastly, land acquisition is risky because there is no market-based system that provides price certainty.
The new relationship that farmers now have with downstream product handlers and processors is raising concerns such as risk, control over management practices, and access to markets (Hobbs and Young [2001]). Domestic markets are increasingly concentrated, with companies from the processing and retailing sector having monopsony status over producers. The abuse of market power by members of the supply chain and the weak bargaining position that small farmers hold compared to processors have adverse impacts on the balance of power between chain members and the efficiency and transparency of the food supply chain.

In summary, the Chinese government is concerned about how the agricultural supply chain can be effectively coordinated to adapt to dramatic changes in domestic and overseas markets, and how they can access revenues generated from the agri-business firms engaged in the processing and handling of agricultural products. In the government’s mind, small farmers are hopelessly backward. To achieve agricultural industrialization and modernization the only solution is for the majority of farmers to exit the sector.

One tool that the government appears to be using to achieve its agricultural goals is co-operative legislation. The farmers co-operative legislation – the FPCL – was introduced to function as an instrument for helping to vertically coordinate the supply chain.

This role for co-operatives in Chinese agriculture appears to be quite different from the one that co-operatives played in western countries. In those countries, they functioned as an avenue for farmers to take political and economic action on a collective basis, rather than as a tool to horizontally and vertically coordinate production. The next chapter examines in more depth the nature of collective action undertaken in western economies over the last 100 years.

### 2.4 Environment and Natural Resources Constraints

Environment and natural resource degradation pose another major challenge to the sustainable livelihood and income growth desired by hundreds of millions of small Chinese farmers. In the process of developing China’s food production capacity, in some places and in some sectors, an accumulated environmental debt remains as a legacy. This environmental debt has many dimensions. It includes soil erosion on cultivated land, degradation of grasslands, salinity on irrigated lands, ineffective river basin management, depletion of ground water and surface aquifers, pol-
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The resources most crucial to farm production are being depleted. Much of the weight of growth and development in China is falling on its land systems. As a result, land degradation is widespread and increasing. The natural forests have been in a continuous state of decline for 50 years. Almost all of China’s unique and globally significant regions of biodiversity, and the resources they hold, are under stress. Many species in China are seriously threatened.

China has some of the worst water erosion problems in the world, and the highest ratio of actual to potential desertified land. China’s grasslands are rapidly degrading. In addition, some of China’s best cultivated land is being lost to expanding urban and industrial areas, and to the development of road networks and railways (World Bank [2001]).

Water availability and quality continue to be a critical problem, particularly in northern China. Urbanization, industrialization, and population increases all demand more water. According to a World Bank Report published in 2006, China as a whole will soon join the global group of water-stressed countries (World Bank [2006a]). Meanwhile the water quality of rivers, lakes, and groundwater basins will continue to deteriorate in many areas. There are growing pollution problems arising from industrial wastewater, municipal wastewater discharges and agricultural emission from intensive livestock production (World Bank [2001]).

China’s food and food-safety standards pose another possible set of food security concerns. China is now the world’s leader in both inorganic fertilizer and pesticide consumption. In the past 30 years, the global total of nitrogen fertilizer applied has increased seven times while China’s nitrogen use for crop production has increased 45 times. On average, nitrogen use per hectare is about three times the world average. Pesticides are also being used on a large scale. Many pesticides that are used in China are known to leave toxic residues in the environment and are banned by other countries. Intensive fertilizer and pesticide use can adversely affect farm produce by contamination, and can pose a serious threat to the agro-ecosystem and to human health. According to some estimates, nearly 25 percent of cultivated land is contaminated to varying degrees by the over-application of inorganic fertilizer and pesticides. It is reported that
about 10 percent of China’s grain, more than 20 percent of livestock produce, and nearly half of the nation’s vegetable and fruit production suffers from quality problems (CCICED [2005]).

There are technical dimensions to these problems. But the current environmental malaise is not a technology problem. Much of the science and technology needed to tackle environmental problems is already in China (CCICED [2005]).

As in other countries and situations, the cause of resource degradation is institutional (Acheson [2003]). Ineffective management institutions include ill-defined property rights to land, government failure to manage extension services, and the absence of community-based organizations. Instead of farmers being allowed to own their land, farmers are provided with 30-year leases to their land. Because farmers are not sure whether they can pass on their leased land to their children, poor management, and overuse of chemicals resulting in widespread pollution, is common. Poor agricultural extension services make this worse. Some extension staff make a living by selling chemicals, and intentionally encourage their customers to overuse them. Furthermore, some government programs provide free or subsidized fertilizers and/or pesticides, which also induces over-application.

An important reason why governments are failing to control resource degradation is the problem of agency. Government officials and politicians are opting to serve their own interests rather than those of public (Cook and Levi [1990]; Moberg 1994; Shleifer and Vishny [1998]). Local officials try to cover up problems that happen on their watch, either because they are profiting from the businesses in question, or because they fear that problems could cut into their chances for a raise or a promotion. Corruption is a serious problem in Third World countries (Wade [1982, 1985]).

Another source of government failure is the tendency for governments to give in to pressure from interest groups that want goods and services redistributed to them at enormous costs to the public (Buchanan and Tullock [1962]; Olson [1965]; Becker [1983]). Environmental pollution is the biggest regressive redistribution of wealth, with the powerful often making a fortune at the expense of the livelihoods and lives of the poor.

Local level management and community-based solutions to tackle environmental pollution do not work for two reasons. First, local communities often lack a sense of community, social
The combination of the above factors results in significant environmental problems. Natural resource degradation is destroying natural resources bases, and making it impossible for small farmers to comply with stringent product quality and safety standards. Environmental problems will not only reduce farmers’ incomes, but it will also endanger their livelihoods and pose a threat to social and political stability.

2.5 Concluding Comments

In summary, urbanization, globalization, industrialization and natural resource degradation are creating major challenges for small farmers. The small scale of farm operations, combined with the monopoly and monopsony behaviour of dragonhead enterprises, create the conditions for market failures and inefficiencies. Local governments in rural areas often fail to provide small farmers with adequate services, because they are poorly equipped fiscally and administratively.

The above analysis points to the institutional structure, which defines opportunities for various players in the rural sector, as being responsible for the marginalization of small farmers. For instance, given the market and government failures, the experience of other countries indicates that there is a strong potential for farmers to group collectively to take action for their mutual benefit. However, even with the passing of the new Farmers Cooperative Law, it is still impossible for small farmers to coordinate both horizontally and vertically to increase bargaining power and capture surplus from the supply chain. Instead, farmers co-operatives are being controlled by leading enterprises to coordinate production vertically.

To better understand the root causes of China’s Sannong problems, and why agricultural policies appear to be biased against farmers and the natural environment, the political economy of agriculture and rural policies must be examined. This political economy examination begins with an overview of the development of collective action efforts by farmers in both the developed and developing world. As the next chapter outlines, the development of co-operatives is heavily
influenced by the institutional rules and framework that exist in a country. An examination of these institutional rules and framework – the political economy of agriculture in China – is the focus of Chapter 4.
Chapter 3

Collective Action by Farmers

3.1 Introduction

Collective action by farmers, particularly via co-operatives, has been very important in the development of agriculture in Europe, North America, and other developed countries. Co-operatives, organized by farmers for various reasons, were invaluable in moving products to markets, influencing pricing and other terms of trade, providing fair services otherwise unavailable, and protecting farmers from exploitative opportunism. Moreover, collective action increased the overall economic efficiency and competitiveness of the marketplace by correcting market power imbalances and providing fair treatment (Torgerson et al. [1998]). Thus, agricultural co-operatives have been a fundamental part of rural infrastructure in North America.

In addition to the above functions, co-operatives have been shown to provide increased services and empowerment to underprivileged populations, such as small farmers, the urban unemployed, and women through positive economic and social changes (Fairbairn [1994, 2004], Develtere [1992], MacPherson [2007]). Farmers co-operatives can also function as a yardstick by which members can measure the performance of other firms dominating the market channel (Nourse [1944], Knapp and Nourse [1979]).

In North America, the development of co-operatives was influenced by pragmatism, whereas in Europe co-operatives were more affected by social reform and the associated philosophies of the time. Co-operatives have changed in response to technological and economic changes,
as well as to social trends like individualism and the advent of integrated agri-food production systems.

Over time co-operatives have adapted to the changing agricultural environment. For example, to tackle the free rider problem inherent in the provision of capital and to integrate downstream to address the need for greater supply chain coordination, new generation co-operatives introduced limited membership and strong linkages between substantial equity contributions and producer delivery rights for producers (Harris, Stefanson, and Fulton [1996], Fulton [2000]).

In contrast, co-operatives were introduced to developing countries as field tested models to be applied and replicated as part of rural planned development strategies (Hyden [1993]). However, this kind of institutional mono-cropping proved to be unsuccessful. This is evidenced by the unique organizational forms that co-operatives have taken in Latin American, Africa and Asia, forms that are totally different from those of co-operatives in developed countries (Develtere [1992], Hyden [1993], Worsley [1971], Dore [1971], UNRISD [1975] and Enriquez [1986]). The biggest institutional differences arise from a lack of political pluralism and democratization in developing nations.

In these developing countries, the state had formidable power in shaping social and economic life – generally speaking, the check and balance of power was not in place or did not work. Farmers co-operatives were used as a development tool to serve the purpose of achieving goals set by the state (UNRISD [1975]). Thus, co-operatives were introduced into social and political environments in which member control was not valued. The result was that co-operatives developed a different structure and operated differently from co-operatives in the West. However, after dramatic changes occurred in the pattern of governance in many countries, a renaissance of the co-operative movement was achieved (Develtere, Pollet, and Wanyama [2008]) and co-operatives were able to play a role as an engine of growth that provides opportunities for the poor (Birchall [2004]).

3.2 History of Modern Co-operatives

According to a Chinese saying, “history can mirror today.” By reviewing the history and evolution of modern co-operatives, and the idea of co-operativism in Europe and North America, it is
possible to shed some light on why co-operatives in some developing countries followed different developmental paths and trajectories.

The Rochdale Society of Equitable Pioneers established what is generally believed to be the first formal co-operative in 1844. They were the first to apply co-operative principles in a comprehensive way to solve a range of problems for both members and the business itself (Abrahamsen [1976]). This co-operative inspired the global co-operative movement, and articulated the fundamental principles for all co-operatives that followed (Fairbairn [1994]).

The founders of Rochdale were economically, politically and socially disadvantaged, and the co-operative became a means of mutual self-help to combat the hardship they faced. Inspired by idealism and critical social thought, the founders of Rochdale organized themselves consciously for a new and better social order (Develtere [1992] and Fairbairn [1994]).

The history of modern co-operatives in western countries is intrinsically intertwined with social movements (Develtere [1992]). Social developments are defined as “spontaneous collective attempts to further common interests or secure common goals through specific organizations which represent the ideology of the movement” (Develtere [1992], p. 21). Co-operatives were formed against the background of the industrial revolution, the advent of technology which brought with it modern management and corporate ownership, and the democratic politics of the modern state (Fairbairn [1994, 2004]).

Although co-operatives can have important economic consequences, their development has never been simply a movement for the more efficient performance of economic operations. Co-operatives are attempts made by people to steer and guide development, and to shape their own futures within the changing world (Fairbairn [2004]). Co-operative identity is not simply the result of interactions among its own praxis, ideology, and organization, but rather it is determined by the broader social movements to which it is related. Specifically, co-operativism embodies the elements in a democratic society that champion the concepts of decentralization, participatory action, communitarianism, and sometimes utopianism or pacification (Worsley [1971]). Therefore, co-operative development was part of a broader social trend. The ideology and organizational structure of the co-operative was defined by the images and values of the social movement for a utopian society (Gerard and Martens [1987]). Fairbairn [1995] argues
“strong co-operatives developed mainly where social movements succeeded in creating a sense of obligation for people to support the co-operatives.” (p.13).

Effective co-operation is therefore rarely successful under authoritarian leadership. The European experience suggests that without an equalizing trend, and the gradual evolution of democratic constitutional forms, which enable groups of equals to secure effective and respected leadership, modern forms of co-operation are impossible (Dore [1971]).

3.3 Co-operative Identity and Principles

The definition of a co-operative is an important part of the co-operative identity, since it helps to create a clearer understanding of the unique structures and purposes of a co-operative (MacPherson [1994]). The International Co-operative Alliance (ICA) defines a co-op as “an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise” (International Co-operative Alliance [2010b]). According to the USDA [1995], “a co-operative is a business that is owned by its users (i.e., members), controlled by its users and operates for the benefit of its users” (p. 1).

The co-operative identity is also shaped by the principles by which co-operatives operate. Principles are governing laws of conduct. By abiding by co-operative principles, co-operatives have been able to distinguish themselves from other types of businesses (Barton [1989]). The revisions made to the co-operative principles over time can help to explain the uniqueness of the movement as it has evolved, as well as a changing set of political, social and economic conditions (MacPherson [1994]). There will never be one final and definitive list of co-operative principles or a single definition because co-operatives are a living movement in a changing world (Fairbairn [1994]). This is evidenced by the way the principles of Rochdale have been reinterpreted in light of the needs and challenges of the times. This is the reason for periodically revisiting and rethinking the principles inspired by the spirit of Rochdale pioneers (Fairbairn [1994]).

The first version of the principles were constructed by the Rochdale pioneers in the 1860s. The Rochdale co-operative society had both pragmatic economic purposes and long-term social
purposes. The objectives of the society were to establish a connection between ideology and pragmatic action. They envisioned their philosophical idealism within the context of a commercially successful co-operative.

The principles that the Rochdale pioneers established to reflect these objectives are as follows. “(1) That capital should be of their own providing and bear a fixed rate of interest; (2) That only the purest provisions procurable should be supplied to members; (3) That full weight and measure should be given; (4) That market prices should be charged and no credit given nor asked; (5) That profits should be divided pro rata upon the amount of purchases made by each member; (6) That the principle of “one member one vote” should obtain in government and the equality of the sexes in membership; (7) That the management should be in the hands of officers and committees elected periodically; (8) That a definite percentage of profits should be allotted to education; and (9) That frequent statements and balance sheets should be presented to members” (Fairbairn [1994]).

These principles were concerned with the nature and role of capital in a co-operative. According to these principles, capital should be contributed by the members and capital should earn a fixed rate of interest. In addition, the principles dealt with co-operative business practices such as quality, honesty, market pricing, and cash trading. Democratic governance and the provision of education and key information to members were also included. These principles arose from a time when labourers were dependent on merchants who often exploited the helpless and poor by selling at exorbitant prices, adulterating goods, or trapping them with offers of credit (Fairbairn [1994]).

In the 1890s, an international organization of co-operatives, the ICA, was formed. The purpose of the ICA was “To promote co-operation and profit-sharing in all their forms” (Wang [1970], p. 39). Profit-sharing was the only principle mentioned. It was not until the 1930s that the ICA stipulated seven principles for co-operatives. The 1937 principles established by the ICA were as follows: “(1) Open membership; (2) Democratic control; (3) Distribution of the surplus to the members in proportion to their transactions; (4) Limited interest on capital; (5) Political and religious neutrality; (6) Cashing trading; and (7) Promotion of education” (International Co-operative Alliance [2010a]).
The need to formalize co-operative principles arose in order to judge how the meaning of a co-operative could be enforced, and whether some so-called co-operatives could be excluded from the movement. For instance, in the 1960s, the practices of co-operatives in some of the Communist and developing countries posed the critical question of what constituted a genuine co-operative. In response, the ICA updated its principles. As [Fairbairn, 1994, p. 36], the principles were “intended as a description of the rock-bottom minimum features of co-operatives.” The 1966 principles were as follows:

“1. Membership of a co-operative society should be voluntary and available without artificial restriction or any social, political, religious or racial discrimination to all persons who can make use of its services and are willing to accept the responsibilities of membership; 2. Co-operative societies are democratic organizations. Their affairs should be administered by persons elected or appointed in a manner agreed by the members and accountable to them. Members of primary societies should enjoy equal rights of voting (one member, one vote) and participation in decisions affecting their societies. In other than primary societies the administration should be conducted on a democratic basis in a suitable form; 3. Share capital should only receive a strictly limited rate of interest, if any; 4. Surplus or savings, if any, arising out of the operation of a society belongs to the members of that society and should be distributed in such manner as would avoid one member gaining at the expense of others. This may be done by decision of the members as follows: (a) by provision for development of the business of the co-operative; (b) by provision of common services; or (c) by distribution among the members in proportion to their transactions within the society; 5. All co-operative societies should make provisions for the education of their members, officers, and employees, and the general public, in the principles and techniques of co-operation, both economic and democratic; 6. All co-operative organizations, in order to best serve the interests of their members and their communities, should actively co-operate in every practical way with other co-operatives at local, national, and international levels” (International Co-operative Alliance [2010a]).

In the 1990s the principles were again revised to reflect the changing sources of capital in co-operatives, substituting the term outside capital for members’ own capital. The principles emphasized an “equitable economic structure (member economic participation)” (Fairbairn [1994],
In addition, the principles of autonomy and community responsibility were included. Based on an exhaustive survey of its members, the ICA came up with a clear set of values and principles on which base the co-operative identity (Birchall [2004]). These principles are: “(1) Voluntary and open membership; (2) Democratic member control; (3) Member economic participation; (4) Autonomy and independence; (5) Education, training and information; (6) Co-operation among co-operatives; and (7) Concern for community” (International Co-operative Alliance [2010b]).

3.4 Farmer Co-operatives in Developed Countries

In the late 19th century, farmers began to organize co-operatives as a reaction to the development of industry, the emergence of interest-group politics, and the concern over the economic concentration of power in trusts and monopolies. Influenced by the pragmatist approach, the Rochdale model was thought to be poorly suited to farmers that wanted rapid growth, market power, and maximum returns with minimum investment. A number of farmer co-operatives broke with and went beyond Rochdale principles (Fairbairn [1994]).

For instance, the pooling plan championed by Aaron Sapiro in the United States (and later Canada) sought to correct imbalances in grower treatment and improve marketing coordination by using co-operatives organized along commodity lines to achieve more orderly marketing through the pooling of products and the centralization of marketing (Sapiro [1920], Larsen and Erdman [1962], Torgerson et al. [1998]).

For farmers, co-operatives in the late 19th and early 20th century were a way to contest modernity. These actions took many forms, including protest against urban centered policies, regions or classes resisting economic domination by others, idealists fighting secular values, or citizens revitalizing their communities in the face of adverse forces (Fairbairn [2004]). As FAO [1998] identifies, the key condition for co-operative formation is self-help.

While social conditions have played a key role in co-operative development, market failure and government failure have usually also been necessary for the formation of farmer co-operatives (Fulton [2005]). Theoretically, co-operative action can address market failure. Co-
operatives allow their members to vertically integrate, thereby diminishing transactions costs and the likelihood of opportunism relative to the for-profit sector (Sexton and Iskow [1993]).

Collective action is often necessary in order for farmers to vertically integrate. Because of the disparity between the minimum efficient scale of operation in farming in relation to the scale of upstream and downstream industries (Sexton and Iskow [1995]), farmers need to join together to provide sufficient volume to be able to allow their co-operative to operate efficiently. By using vertical integration through co-operatives, farm operators are able to gain direct economic benefits and negotiate with powerful processors (Torgerson et al. [1998]).

In additional to agricultural co-operatives, financial co-operatives (i.e., credit unions) were formed to correct market failures in rural credit services. Credit unions allow people to have access to credit for the purchase of inputs and equipment. In Canada, credit unions were formed around a common bond of association for their members. Against the backdrop of powerful central institutions in banking and insurance, the Desjardins movement emerged in Quebec as an important financial organization. By the 1990s, more than two-thirds of the people in that province were members of caisses populaires, which had become the dominant retail banking institutions and leading commercial lenders for small and medium enterprises (Fairbairn [2004]).

In Saskatchewan, the Credit Union Act, passed in 1937, led to the development of credit unions across the province for the provision of financial services to members. In 2006, there were 88 credit unions, 332 service outlets and 309 banking service outlets; these entities employed 3,065 employees. Credit unions were the only financial service provider in 157 communities. The market share of credit unions, in loans and mortgages, is 35 percent. Saskatchewan credit union membership today is about 54,300 (Saskatchewan Regional Economic and Co-operative Development [2007]).

The first credit union in the U.S. opened in 1909. They not only provided credit for consumer purchases and opportunities for savings but also supported the growth of the emerging industry. Today, more than 20,000 credit unions have over 86 million members and offer financial services to nearly one-third of all Americans (NCBA [2009]).
3.4.1 Challenges Facing Co-operatives

While co-operatives have their strengths, they also have weaknesses. These weaknesses stem from the collective nature of the organization. For instance, since members typically do not receive benefits on the capital they invest, but do benefit in proportion to their use, there is an incentive for members to overuse and underinvest in a co-operative. At the root of the problem is a free rider problem – each member wants to use the co-operative as much as she can while investing as little as she can (Sexton and Iskow [1988]).

Co-operatives also suffer from other problems, including the portfolio, the horizon and the control problem. The portfolio problem arises when members are reluctant to contribute to the co-operative because by doing so they fail to diversify their investments (e.g., since the fortunes of their farm and the co-operative often are correlated, farmers may wish to diversify their investments by putting their money elsewhere) (Baker and Soren [2004]).

The horizon problem arises when a member is unwilling to make investments because the benefits of the investment will be available only after the period of their involvement with the co-operative (Sexton [1991]). Long term market and product development are examples of investments that are often under exploited because of the horizon problem.

The control or agency problem is the result of a divergence of interests between the managers of the co-operative and the board of directors (who are assumed to represent the membership) (Cook [1995]). Since it is costly to monitor the activities of the managers, they can often undertake activities and investments that are not in the best interest of the members. And, unlike publicly traded companies, the information provided by and the external pressure exerted by publicly traded equity instruments is not available to co-operatives.

In addition to the above forces that are internal to co-operatives, forces external to the co-operatives, especially technology and member individualism, also challenge co-operative growth (Fulton [1995]). Farm operators were historically provided with a portion of the residual value of the product they produced; as residual claimants, farmers then had the incentive to efficiently manage their farming operations. Technological progress in agricultural science, however, now makes it easier to monitor the activities of farm operators, thus removing the need for them to act
as the residual claimant. The result is that the farming operation can be more easily incorporated into vertical supply chains, thus removing the need for independent farmers. As independent farmers disappear, so too does the need for co-operatives.

Individualism is closely linked, in the case of co-operatives, to private property rights. The foundation of co-operatives is based on common property rights. Thus, a movement towards more individualistic attitudes and the desire for private property rights undermines the basis of co-operatives (Fulton [1995]). Furthermore, unless farmer co-operatives can make the shift from an impersonal market to contract/ownership coordination, the opportunity for maintaining a controlling role will likely be lost (Boehlje and Schrader [1998]).

To solve the long-standing problems of conventional co-operatives (such as the free-rider, insufficient member capital contribution and horizontal problems), and to meet external challenges, co-operatives are being redesigned. Central to this redesign is the development of new mechanisms that take residual claim and control rights into account (Cook and Chaddad [2004]).

A new generation of co-operatives are now being organized around limited membership, and the requirement of a substantial equity investment from members in exchange for product delivery rights (Harris et al. [1996]). These capital-intensive co-operative enterprises integrate downstream to take advantage of the higher profit levels that are associated with more advanced levels of processing and distribution (Egerstrom, Bos, and Dijk [1996]). To avoid intense competition and enhance coordination among agricultural co-operatives, many co-operatives band together to form federations and common use marketing agencies (Torgerson et al. [1998]).

The above discussion demonstrate that in developed countries, agricultural co-operatives have changed in response to technological and economic developments, government policy change, and social trends. As a response to change, co-operatives are strategically adjusting and repositioning their operations. However it is important that co-operatives protect the values and principles that are fundamental to their success (Geu and Dean [2009]). Co-operative businesses will prosper if they adhere to democratic principles (which are crucial to their governance structure), the fair dispersion of benefits, shared ownership, and managerial supervision in the interest of members. The principles can be constantly redefined to suit the diverse needs and various challenges of the present, but the spirit of intent must be retained.
Chapter 3. Collective Action

3.5 Farmer Co-operatives in Developing Countries

Co-operatives in the developing world have followed very different development trajectories regarding adherence to co-operative principles. Some have been very successful at achieving their intended development goals. According to World Bank [2008], producer organizations engage in a broad array of activities. They participate in trade negotiations and domestic agriculture policy making, improve access to output and input markets, support the generation and adoption of technological innovations, support diversification into new activities and undertake natural resources management.

Producer organizations, like co-operatives, are fundamental building blocks of the agriculture-for-development agenda. Their active engagement in participatory governance is particularly important in relation to decentralization and community-driven development approaches.

Among the better-known producer organizations in the world are the Indian Dairy Cooperatives Network and the National Federation of Coffee Growers of Colombia. In 2005, the Indian Dairy Cooperatives (IDC) had 12.3 million members, accounting for 22 percent of the milk produced in India. Sixty percent of the IDC membership are either landless, very small holders, or women (World Bank [2008]). A report released by Boston Consulting Group (BCG) indicated the IDC collects 6.5 million litres of milk a day, and boasts one of the longest-running and best-loved advertising campaigns in India. It has already shown “immense resilience” in the face of multinational competition. Its ice-cream business survived the arrival of Unilever; its chocolate milk has thrived despite the entry of Nestle (The Economist [2008]).

Created in 1927, the National Federation of Coffee Growers of Colombia (NFCGC) now has 310,000 members, most of them small holders (less than two hectares). The NFCGC provides production and marketing services to 500,000 coffee growers. NFCGC revenues are contributed to the National Coffee Fund which finances research and extension activities and invests in services, like education and health care, as well as basic infrastructure for coffee-growing communities such as rural roads and electrification (World Bank [2008]).

Despite the success of many co-operatives, in a number of developing countries the co-operative model has not been effective at achieving its desired economic and development goals,
due to the unique economic, political and social settings of these countries. Some examples will illustrate what happened.

Experts from the United Nations Research Institute of Social Development (UNRISD) examined rural co-operatives from countries in Asia, Africa and Latin America from 1970 to 1976. The countries examined included Pakistan, Iran, India, Congo, Cameroon, Tanzania, Uganda, and Colombia. In their 1975 Research Report, the UNRISD claimed that co-operatives fell short of the generally accepted principles and practices, and that they had little impact on their communities as institutions for socio-economic development.

The report indicated that rural elites had taken control of the co-operatives to become their primary beneficiaries, passing on little benefit to the poor masses. The existing structures of the community permeated the co-operatives and in turn the co-operatives reinforced pre-existing socio-economic inequalities. The genuine self-help co-operatives of poor farmers dedicated to member interests were small and lacked the power to survive against opposing interests. In short, the structures in place in rural communities were highly unsuitable for the introduction of co-operatives as agents of change and development (Enriquez [1986]).

In India and Tanzania, a co-operative-development strategy was introduced as part and parcel of an overall national development strategy. Governmental organizations promoted co-operatives by contributing capital to them, participating in their management and direction, and influencing the development of individual co-operatives (Develtere [1992] and Hyden [1993]).

In reality, most co-operatives in developing countries failed to live up to their expectations. Rural poverty and inequality were not reduced and agricultural production did not increase to finance industrialization. “In many cases they became hotbeds of political conflict, administrative inefficiency and corruption of all kinds” (Attwood and Baviskar [1993], p. 8). The blueprint approach – which assumes that a tested model exists which can be applied and replicated in an effort at planned development – prohibited potentially creative trends and undermined confidence in public institutions (Hyden [1993]).

In China, farmers’ organizations became vehicles for economic exploitation and political control during the period extending from the 1950s to the 1970s. All means of farmers’ production were confiscated by the Commune. The Commune, functioning as a level of government, was
responsible for education, public works, militia organization, and health care. The purpose of collectivization was to break the traditional Chinese social structure and extract surplus to finance urban-based industrialization. As a result, farmers were deprived of their autonomy and freedom. The path of co-operative development in China stands in stark contrast to that in western countries which attempted to link democratic control with economic ownership. In the West, development was controlled by the people it affected (Fairbairn [1994]).

In all of the cases discussed above, the co-operative model was imported without any sense of whether it was compatible with the existing institutions and the existing power structure in the countries in question. Without reshaping the distribution of power that underlies the institutional arrangements in these countries, farmers co-operatives were endogenized into the existing system, and the opportunity for co-operatives to affect the course of rural development was lost.

As North [1990] indicates, institutional frameworks have a fundamental influence on the organizations that come into existence and how they evolve. No amount of tinkering with set institutional frameworks by co-operatives is likely to alter these basic conditions (Attwood and Baviskar [1993], Scott [1976, 1985]). And without a change in the basic conditions, the co-operative model is unlikely to be successful. In short, the institutional monocropping of the co-operative model has proven futile. There is no universally applicable institutional “magic formula” for economic growth (Dunning and Pop-Eleches [2004]). Thus, the spontaneous collective action, described and suggested in some co-operative theories, usually does not happen.

In many developing countries the traditional community is authoritarian. There is a lack of formal co-operation and genuine social interaction due to uneven power relations, and the informal co-operation that does take place in the village is usually quite selective, seasonal, short, exploitive and regressive (Bandyopadhyay and Eschen [1993]).

In rural communities, the mass of rural poor feel powerless to make change. Instead, the more well-off and influential took the initiative and manipulated the so-called co-operatives to perpetuate their dominance. Therefore, community-wide co-operation is depressed. These “co-operatives” are not governed by formal rules and they do not function on the basis of “institutionalized suspicion” – i.e., through checks and balances (e.g., election of officials and
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audits) that have been built into the system. Dore [1971] argues that institutionalized suspicion is an exclusive characteristic of modern contractual co-operation, which distinguishes itself from traditional co-operation. A major conclusion of the UNRISD [1975] is that rural co-operatives in developing areas bring little benefits to the masses of poor inhabitants and cannot be generally regarded as agents of change and development for such groups.

Co-operatives thus did not emerge in developing countries as spontaneous movements like they did in developed countries that were affected by great social reforms and pragmatism. Instead, co-operatives were imposed by colonial governments as an ideological instrument that had no connection to local ideology or practice (Develtere [1992]). After their colonial independence, governments in these countries played a key role in advocating for institutional change. Some governments adopted a blueprint approach to promote co-operatives as an instrument of agricultural industrialization and modernization.

As Korten (1980) points out, the member-controlled co-operative has long been an idea with almost universal appeal, being widely promoted in much of the developing world as an integral instrument of national development policy. The values and principles associated with the co-operative model were introduced to these countries as well. However, when co-operatives were implanted onto rural society (rather than growing out of them), members did not relate to them in the same way as people did in Europe at the turn of 20th century, when workers (and then farmers) joined hands and formed co-operatives of their own (Hyden [1993]). The co-operative organization was a foreign body, with elites interpreting and enforcing their own values and principles on its structure and principles. In developing countries the farmer co-operative laws that preceded the organization and operation of co-operatives were co-opted to support government goals (Su [1989]).

The distinctive feature of co-operatives in developing countries was government involvement in the promotion, direction, and control of the co-operative sector. Co-operatives were considered to be an integral part of the overall development process (Develtere [1992]). The nature of the transitory states explains a great deal about the traditional involvement of government in co-operative development in developing countries (Holmen [1990]). Inspired by high-modernist theories, there was strong belief in the manageability of accelerated economic growth. The
state’s planned interventions in economic and social policy were endless, and centralization of the administrative apparatus began (Scott [1998] and Develtere [1992]).

With the top-down development approach, government creates organizations to provide a ready-link to the rural community to make the environment more orderly and manipulable (Hyden [1993]). Behind this approach was the government’s desire for farmer co-operatives to be a means of taxing the enormous small farmer population to support national industrialization (Scott [1998]).

According to Develtere [1992], the government in developing countries dominated and controlled five characteristics of the co-operative sector. First, government controlled the intensity and extent of co-operative development. Second, co-operatives were held under the wing of government, thus giving power holders full confidence in the movement. Third, governments in many countries shifted their initial policies for co-operatives from inducement to coercion. Fourth, government-sponsored and controlled co-operative structures were used as social control instruments. Fifth, the diversify of the co-operative sector was managed by the state. As a result, co-operative organizations did not adhere to their democratic principles nor to the processes of co-operation (member bargaining, consensus, control, and a focus on serving the membership) which have proven central to the prosperity of co-operative businesses.

One of the greatest problems with the development approach taken by co-operatives in developing countries was the attempt to redefine social behaviour in foreign terms. Rather than allowing co-operatives to grow out of the country’s public and social institutions, the blueprint approach prohibited any potentially creative trends. It also undermined confidence in public institutions by imposing values and principles that could not be upheld by society (Hyden [1993]).

While the history of co-operatives in developing countries before the 1990s was disappointing, a series of case studies of co-operatives (Birchall [2004]) and surveys (Develtere et al. [2008]) indicated that after this period co-operatives did emerge as an organizational form that could provide opportunities for the poor, while guaranteeing their security (Birchall [2004]).

Field studies conducted in sixteen African countries indicate that since the 1990s co-operatives have been playing a key role in resolving some of the major challenges the continent is facing. Among other things, co-operatives create employment and income-generating opportunities, re-
inforce the traditional social security system, create social capital by creating a bridge between
the poor and the relatively well-off in social and economic development initiatives, and enable
the poor to participate the decision-making process by representing their interests (Develtere
et al. [2008]).

As an example of the role played by co-operatives, there are 150,000 collective social-
economic undertakings in the countries surveyed and most of them are registered as co-operatives;
the result is that seven percent of African households belong to a co-operative-type organization
(Develtere et al. [2008]). Some of the co-operatives have been very successful. For example,
Mwalimu Savings and Credit Co-operatives Society of Kenya has accumulated one hundred
million US$ savings, while Mooriben in Niger provides 25,000 households with affordable and
nutritious food (Develtere et al. [2008]).

The renaissance of the African co-operative movement is made possible by the conditions
created by the institutional changes that have taken place since the early 1990s. Dramatic changes
have occurred in governance patterns across the continent since then (Barkan [2009]). The model
of one-party state controlling all sectors of the economy was demonstrably bankrupt and has
now been replaced (Kpundeh [1992]). In addition to multiparty elections, there is now space
for civil society. The press and broadcast media is free and no longer a state or party monopoly
in many African countries (Barkan [2009]). Governments also shifted their role in co-operative
development from a planned and top-down approach to one that was hands off (Develtere et al.
[2008]). New co-operative laws, which adhered to key international principles, were passed and
coopératives were ‘co-operativised’ – i.e., given back to their members and reconstituted as
genuine member-owned businesses (Birchall [2004]).

3.6 Conclusion

Co-operatives develop in the context of social, political, and economic forces. They develop
as historical subjects carrying past legacies and are permeated by the sociological features of
the external environment (Develtere [1992]). Co-operatives in developing countries did not start
with the utopia phase, necessary to describe the long-term social purposes of the co-operative
and to develop its membership base. They were not inspired by charismatic leadership, vision, and the power of collective mobilization.

Furthermore, co-operatives in developing countries lacked a social movement phase, which is necessary for the formalization and institutionalization of these organizations dedicated to common interests and goals of a group of disadvantaged people (Develtere [1992]). These phases were crucial for the development of western-style co-operatives. Instead, in developing countries co-operatives were introduced by the state as an instrument to control, manipulate, and instill modern values onto local society. As a result, these co-operatives did not follow the path that was predicted and did not function according to the principles ascribed.

The next chapter focuses on describing and analyzing the institutional structure into which Chinese co-operatives are being inserted. An understanding of this structure is required to shed light on the particular development path that co-operatives are taking in China today.
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Chapter 4

The Political Economy of Chinese Agriculture

The preceding chapters argued that, due to market and government failures, much of the transformation and pressures of recent changes in agricultural markets have fallen onto farmers and households that have limited means of action. As well, the Chinese government created policies that favoured leading enterprises and business groups, and worked against small land holders who account for the vast majority of the rural population.

In such circumstances, it is difficult for Chinese farmers to use organizations such as co-operatives to improve their position within society, a strategy that farmers in western countries often used historically. Even with the enactment of the FPCL, which theoretically should have allowed farm groups to correct imbalances in grower treatment and to improve marketing coordination, few farmers chose to use co-operatives as a means to organize themselves along commodity lines and to negotiate contracts with processors. Instead, co-operatives were formed by agri-business entities largely to coordinate production and to market farmers’ products at a lower cost; these so-called co-operatives act in the best interests of the better-offs rather than focusing on improving farmers’ positions.

The changes in the agricultural system over the last decade or so have increased the income disparity between rural and the urban residents, and the rural population’s access to public services has remained inferior. However, this outcome does not mean that government policies have been a result of ignorance or lack of knowledge. Instead, it is believed that the outcomes were a result of the political economy of rural China.
To search for explanation, this chapter examines how economic and political institutions are established and how they affect long-term rural development. In particular, the chapter examines the evolution of the institutions under which farmers and agriculture operate.

According to North [1990], institutions are “the rules of the game in a society or, more formally, …the humanly devised constraints that shape human interaction” (p. 3). Institutions determine the incentives and constraints that people face and provide the context in which the market functions. Institutions are the outcome of complex historical processes that reflect the interests of influential individuals and groups in society and result in different political structures (World Bank [2006a]). Institutions define their opportunities to advance socially and economically, as individuals and organizations adapt to existing institutions.

As North [1990] points out, the institutions present at any point in time can only be understood by tracing the incremental evolution of institutions over a lengthy period. Since institutional development is subject to positive feedback, path dependency, which is often an outcome of positive feedback, is likely to play a role in explaining patterns of institutional emergence, persistence and change.

As a result, the first part of this chapter discusses positive feedback and path dependency. The second part of this chapter is concerned with the Communist Party of China (CPC)’s rural and farmer policies during the times of the Soviet command economy and imperial Confucianism. The third part of this chapter examines farmer and rural policies made by the CPC after 1978 when a more market-based economy emerged. The fourth part of this chapter explores how the patron-client structure permeated the social and political life of rural people.

4.1 Path Dependence and Positive Feedback

Levi [2008] explains that, “Path dependence has to mean, if it is to mean anything, that once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice. Perhaps the better metaphor is a tree, rather than a path. From the same trunk, there are many different branches and small branches. Although it is possible to turn
around or to clamber from one to the other – and essential if the chosen branch dies – the branch
on which a climber begins is the one she tends to follow” (p. 28).

This idea of the difficulty in moving from one path (or branch) to another will be used in
this thesis to argue that the current institutional environment in Chinese agriculture is one that
will be difficult to change. It will also be used to argue that the seeds for the current system were
sown by policies and events in the past. Both of these features are part of what is referred to as
path dependency.

The crucial feature of a historical process that generates path dependency is positive feedback
– each step along a particular path produces consequences that increase the relative attractiveness
of the path for the next round (Arthur [1994] and David [2000]). In short, there is positive rein-
forcement. As the outcomes in the early stages of a sequence feed on themselves, the probability
of further steps along the same path increases with each move down the path and the costs of
switching to some previously plausible alternative rise.

Four features of a technology (or way of doing things) and its social context generate positive
feedback and subsequent path dependency (Arthur [1994]):

1. Large set-up or fixed costs. When set-up or fixed costs are high, individuals and organi-
zations have a strong incentive to identify and stick with the existing technology. This is
because those who are thinking of switching to another technology are not able to afford
it due to high set-up and coordination costs.

2. Learning effect. Knowledge gained in the operation of complex systems leads to higher
returns from continuing use. With repetition, individuals learn how to use given technology
more effectively, and their experience is likely to spur further innovations related to the
technology.

3. Coordination effects. These occur when the benefits an individual receives from use of a
given technology increases as others adopt the same technology. If technologies embody
positive network externalities, a given technology will become more attractive as more
people use it. Coordination effects are especially significant when a technology has to be
compatible with a linked infrastructure. Increased use of a technology encourages investments in the linked infrastructure, which in turn makes the technology more attractive.

4. Adaptive expectations. If options that fail to win broad acceptance have drawbacks later on, individuals may feel a need to “pick the right horse” – i.e., to make sure that they choose the same option that others do. As a result, projections about future aggregate use patterns may lead individuals, via self-fulfilling expectations, to adapt their actions in ways that help to make those projections come true.

While the language used above is for technologies, the framework can also be applied to examine the emergence, persistence, and change of institutions. As North [1990] says: “All four of Arthur’s self-reinforcing mechanisms apply, although with somewhat different characteristics. There are large initial setup costs when the institutions are created de novo. …There are significant learning effects for organizations that arise in consequence of the opportunity set provided by the institutional framework. …There will be coordination effects directly via contracts with other organizations and indirectly by induced investments through the policy in complementary activities. …Adaptive expectations occur because increased prevalence of contracting based on a specific institution will reduce uncertainties about the permanence of that rule” (p. 95).

Therefore, established institutions will typically generate powerful inducements that reinforce their own stability and further development, and once in place, institutions are hard to change (David [2000] and Pierson [2004]). In short, creation of new institutions is typically very difficult.

Pierson [2004] argues that a key source of positive feedback is the allocation of political authority to particular actors. He says that if “certain actors are in a position to impose rules on others, the employment of power may be self-reinforcing. Actors may utilize political authority to change the rules of the game to enhance their power. These changes may not only shift the rules in their favour, but increase their own capacities for political action while diminishing those of their rivals. And these changes may result in adaptations that reinforce the trend, as undecided, weakly committed, or vulnerable actors join the winners or desert the losers. …The process of positive feedback can transform a situation of relatively balanced conflict into one of great
inequality. Political settings where one set of actors must initially impose their preference on another set through open conflict may change over time into settings where power relations are so uneven that anticipated reactions and agenda control and ideological manipulation make open political conflict unnecessary” (p. 36-37).

Positive feedback and path dependence theory not only provide an explanation for the emergence, persistence and change of institutions, but suggests that the causes and effects are separated in time. The dynamics of self-enforcing beliefs and the associated behaviour is central to endogenous institutional change (Greif and Latin [2004]).

4.2 High Modernism

4.2.1 Definition

High modernism is a school of thought that believes in the scientific and technological progress associated with industrialization. More importantly, high modernism is characterized by massive social engineering and virtually unrestrained use of the power of the state as the most important instrument for achieving these advances. At the centre of this school of thought is a supreme confidence that by imposing high modernism’s prescriptions for a new society there will be an expansion of production and growing satisfaction of human needs (Scott [1998]).

In the eyes of the high-modernist state, the future is known and achievable. Progress is objectified by a series of preconceived goals set by the state; these goals are largely quantifiable in nature and it is believed they can be achieved through savings, labour, and interim investment. Followers of high modernism are thus convinced that the many short-term sacrifices being made will be justified by the certainty of a better future.

In countries ruled by authoritarian high modernist leaders, there was enthusiasm for applying industrial methods to agriculture – the result was agriculture practiced on a large scale and with scientific and centralized management. Consequently, small farmers or peasants were thought to be hopelessly backward and a drag on progress. The state imposed this transformation of agrarian life and production by replacing small farms with state-run farms. The aim of this transformation was to move from small, backward, and fragmented peasant farms to consolidated, large, public farms, that can be provided with machines and equipped with modern technologies.
Moreover, these farms were thought to be more able to be brought under government control. They were also buyers of industrial products, including machinery, which are crucial to the overall industrialization of the country. The collectivization of agriculture created an institution form and production unit for monitoring, managing, appropriating and controlling from above – both economic and politically.

Given the ideological advantages of high modernism as a discourse, it is common that many postcolonial and newly independent states have adopted high-modernist approaches to industrialize their countries (Scott [1998]). Like China, many underdeveloped countries adopted Soviet-style high-modernist central planning in the early 1950s (Lin [1989]). As Bauer [1984] indicates, a principal component in the development literature of the early postwar years was the necessary role of comprehensive government planning to achieve economic growth. In particular, agriculture was collectivized to extract revenue and grain from the countryside to support city-centered industrialization.

The next section examines the collectivization of agriculture in China, as well as the development of the Household Contract Responsibility System (HCRS). As will be shown, high modernism was a key theme in the collectivization of agriculture.

### 4.3 Collectivization of Agriculture in China

Since its foundation, the Chinese Communist Party (CPC) used farmers and agriculture as one of the crucial resources for supporting the revolution and later for modernizing the nation. During the period of armed revolution, CPC leaders formulated agrarian policies to co-opt peasants to contribute labour, taxes, corvee, and army service. Inspired by high-modernist beliefs, the CPC ruling regime designed its political, social, and economic institutions to extract surpluses from farm operations to finance urban-based industrialization at the expense of the farmers’ living standards and liberties. Farmers were never treated as equal partners, and had little say in the policy making processes that impacted their life. Instead they were recipients of various government programs, although farmers paid huge prices for setup of the institution-high modernism with other actors.
4.3.1 Rural and Farmer Policies under Mao

The CPC was established in 1921. Although it initially focused its attention on an uprising of workers in urban areas, it shifted its attention to the mobilization of small farmers after its proletarian revolution strategy experienced a series of failures. The theoretical basis for this shift was Mao Zedong’s analysis of China’s social groups. In this analysis, small farmers were the means to creating a revolution rather than the ends of the revolution. Ironically, most of the CPC leaders descended from urban-based working class and bourgeois families. These pre-1949 policies set the departure point and the development path for the rural sector after 1949.

The CPC first took power in China in 1949 by defeating the Nationalist Part (KMT) in battle after a civil war that lasted almost two decades. At the beginning of the civil war with the KMT, the CPC emulated their Russian comrades’ experience. The CPC organized and mobilized three million Chinese working class citizens to incite revolution in the cities. As Lenin suggested, the 400 million peasants in the rural areas were largely ignored. Peasants were seen simply as forms of production, hopelessly backward, and as mere historical vestiges that would undoubtedly be swept away (Scott [1998]).

CPC leadership considered the role of the Chinese peasantry in the revolution to be subsidiary until they were defeated by the KMT in major urban areas in 1927. After this major failure, CPC leaders started to review and reform their strategy for promoting revolution. Mao Zedong was the first communist leader who began to pay attention to peasants and to engage in the mobilization of the peasants’ movement (Chao [1960]). In early 1927, Mao pointed out that poor peasants, comprising 70 percent of the rural population in China, were the main force of the Chinese revolution and the vanguard in overthrowing feudal forces (Mao [1964]).

At that time, landlords comprised only 3-4 percent of rural households, but possessed 26-46 percent of the cultivated land. In contrast, the poor peasants and labourers that accounted for roughly 70 percent of the households possessed only 14-22 percent of the land (Luo [1985]). More and more families were losing their land, and urban capital accelerated this process (Chao [1960]). The rural areas were characterized by a non-egalitarian land distribution, and the landless peasants had a strong desire to see land redistributed. However, the rural elites that held the
support of state power were not inclined to reverse the trend of land concentration. Furthermore, there were no institutions that could bring landlords and peasants together to compromise, bargain and negotiate. Peasant rebellions and discontent were taken advantage of by the CPC and translated into guerrilla war.

Another important source of strength for rural guerrilla warfare was the low mobility of wealth in rural areas. As the experience of other countries showed, land owners often chose to co-operate rather than defect, if they were offered a choice.

Under Mao’s leadership the CPC shifted its focus to rural and peasant issues, and the salient method for inciting revolution was changed from promoting urban uprisings to promoting rural guerrilla warfare. The CPC identified itself as being at the vanguard of the agrarian revolution of the peasantry. This was inconsistent with Lenin’s judgment of peasants and was thought of as being unorthodox for some time. However, the vanguard party “merged the elementary destructive force of a crowd with the consciousness destructive force of the organization of revolutionists” (Scott [1998]).

The vanguard party was the thinking organ of the revolution, ensuring that the otherwise diffuse brute force of the masses was effectively used. The masses in general and the peasants in particular became the ‘body’, while the vanguard party became the ‘brain’. In Mao’s eyes, the urban-based working class and bourgeois did not have unquestioning obedience to the will of Soviet leaders, leaders that were to use their profoundly hierarchical and authoritarian methods to destroy the old order and to then rule autocratically to establish a social utopia (Mao [1964]).

Obviously, other social groups who were relatively better educated and wealthy did not buy into the ideas and values advocated by the CPC; even for them that can receive the benefits generated from the proposed institutional changes advocated by the CPC, it was recognized that the benefits did not outweigh the costs associated with them.

From 1927-1937, with the purpose of demonstrating the benefits of a revolution to its rural constituents and of generating its own source of revenues, the CPC implemented a number of radical agrarian policies, including: confiscation of all land, Soviet-type government ownership of land; provision of inferior land to rich peasants, and no provision of land to landlords that had their land expropriated (Chao [1960]). But these policies proved to be counterproductive. According to
Perkins and Yusuf [1984], the Communists heavy-handed attempts to incite peasants, combined with the brutal methods used to eliminate the wealthier classes during this period, were the main cause for the failure of the Jiangxi Soviet base era. Thus began the ‘Long March.’

4.3.2 Rural Land Reform: Building the CPC Power Base

The CPC’s land policy underwent a number of changes during the 1920s-40s. Lessons were learned and a moderate land policy was made to strategically gain the support of the rural poor. During the Anti-Japanese Invasion war (1937-45), the CPC and KMT built an alliance to fight off the Japanese invaders. The CPC’s power was legitimated in the areas it occupied. The CPC also took lessons from the previous Jiangxi Soviet base period and attempted to win support of all rural social classes. It changed the policy of confiscating landlords’ land into one of reducing rents and interest. The objective of this institutional adjustment was to reduce tensions between the peasantry and landlords, and the CPC regime and landlords. At the time landlords made up a large constituent of mainstream society and controlled most of the resources and political power.

During the civil war with KMT (1945-1950) a number of radical policies were formulated to secure political support from poor peasants and to build the CPC’s power base. These policies included: the compulsory purchase of excess land held by landlords; equal distribution of village land amongst the entire rural population; rich peasants were to be eliminated as a class; poor peasants’ associations were formed, and, with the aid of state coercion, peasants were encouraged to act severely towards the dispossessed class (Liu [1983]).

During the period 1945-1953, the CPC maneuvered strategically to buy rural acquiescence while their power was being consolidated. This was called “land reform” and was more moderate than before 1945. The rich peasant economy was maintained, which meant that most of the taxation revenues were contributed by the relatively rich farmers who owned their land, and industry and commercial enterprises owned and operated by landlords were not confiscated. These policies won political support for the CPC from the massive peasantry and reduced resistance to rural reforms (Liu [1983]).

Land reform in the 1945-1953 period brought about profound institutional changes to the wealth and power structure in China. For instance, 46.5 percent of the nation’s total area under
cultivation was either confiscated or requisitioned and distributed during the land reform. About 300 million peasants (60-70 percent of the total rural population) benefited from the land reform. Land rent exemptions alone saved poor peasants 35 million tons of grain a year, and poor peasants were also given gifts of draft animals, farms tools, houses and grain (Chao [1960]). Some 20 million landlords lost their property and privileges, and had their social status changed from that of a ruling class to a ruled class (Chao [1960]). The number of poor peasants decreased from 60 percent of the rural population to 30 percent, while the number of middle class peasants increased from 30 percent to 60 percent (Riskin [1987]). These changes indicate that land reform was successful in redistributing rural incomes and reallocating agricultural resources (Liu [1983]), and improved the living standards of the majority of peasants (Schran [1969]). The reforms increased peasants’ enthusiasm for production enormously, and agriculture saw a period of rapid recovery and development (Luo [1985]). But the most important impact was that land reform allowed the CPC to build a solid power base in rural areas.

Furthermore, as Liu [1983] points out, land reform set the political grounds for innovation in rural institutions after 1953. The reform helped the communists destroy the social foundation of traditional elite rule and to rally massive numbers of peasants to support the new regime. Reforms enhanced the legitimacy of the new state in the eyes of the peasants, indoctrinated the masses into the new ideology, and organized individual peasants to facilitate the implementation of government policies. As a result, poor peasants replaced landlords and village elites in local political positions, thus completely changing the power structure.

Reforms also helped state power penetrate into the villages, placing them under state control in an unprecedented way. Land reform fostered a new political top-down leadership and a set of modern organizations between the state and rural communities. It introduced new political institutions to villagers which became a powerful means to further alter rural institutions. Consequently, the CPC regime became increasingly efficient at producing revenue, grain, and conscripts from the countryside, a crucial factor in the defeat of the KMT and the stabilization of the CPC regime.
4.3.3 The Founding of the People’s Republic

When the CPC seized power in the violent 1949-50 revolution, the environment seemed particularly favourable for the flourishing of high-modernist ideology. When China’s revolutionary state defeated the ancient regime in the battlefield, the CPC was given the mandate to remake society. Facing a pro-state civil society with limited means of active resistance, the propaganda produced by the revolutionary party was easily sold. Civil society’s capacity to resist had been shattered by four decades of war. The top priority of civil society was the stability and unification of this war-torn country. The CPC government was anxious to achieve national modernization, as quick as possible, and to catch up with other leading western countries.

Consequently, the whole country was mobilized into achieving the goal of economic construction. The ubiquity of five-year plans in socialist states, including China, is an example of the conviction that the future could be planned and implemented. For example, China’s 10th Five-Year Plan (2001-2005) laid down: “achieve an average annual economic growth rate of about 7 percent … increase the number of surplus rural labourers transferred to the cities to 40 million … achieve growth for the primary industry at the rate of 13.51 of GDP …” (Government of China [2006a]). In the 11th Five-Year Plan, the development blueprint for the countryside projects “large grain, cotton and edible oil production base and quality grain industry projects … fertile soil projects, aimed at transforming medium- and low-yield farmland into high-yield cropland ….” (Government of China [2006b]).

The CPC conceived of its mission as the dragging of a technically backward, unschooled, subsistence-oriented population into the twentieth century. Its self-assigned cultural role as educator of the people become doubly grandiose. Having a historic mission of such breadth provided the ruling intelligentsia with high morale, solidarity, and the willingness to make and impose sacrifices. This vision of a great future is often in sharp contrast to the daily disorder, misery, and scrambling for advantage that elites witnessed and in which they partook. One might speculate that the more intractable and resistant the real world became, the greater the need became for CPC propaganda promising utopia to fill the void that would otherwise invite despair. The elites
who prophesied the future utopia implicitly represented themselves as exemplars of the learning and progressive views to which their compatriots should aspire.

The legacies of traditional institutions that had evolved over 2,000 years had fundamental implications for China’s modernization. The social hierarchy system, the overwhelmingly large peasant population, the importance of family and village, the special role of the gentry, and the relationship between the state and society in traditional China all had significant impacts on China’s modernization.

As discussed earlier in this chapter, institutional changes are limited by path dependence. As a result, the institutional changes in rural China introduced beginning in 1949 do not represent a sharp break from the imperial monarchy. The centralized authoritarian government of traditional China was an economic and political consequence of a rural population base living on small family farm plots dispersed across a vast country. The centralized state in traditional China always embraced small farmers economically because they were a more accessible source of tax revenue, and politically because they were far less threatening than the powerful big estate owners (Huang [1980, 1985, 1990]).

Traditional Chinese elites used the official ideology of Confucianism to legitimize their rule, justify social order, and control the minds of the masses. The purpose of social control was to make peasants into tractable, diffident, and helpless human beings. Elites instilled a fear of authority in the minds of the people and fostered in them a willingness to accept the status quo. The prevalence of Confucian thought helped maintain the social order, and the Chinese people got used to being ruled by an imperial monarchy and its emperors. The most important function of Confucianism was to safeguard the exiting social order. The state sought to indoctrinate all subjects thoroughly with the basic precepts of Confucianism and thus make them obedient to autocratic rule.

Confucianism reconciled the high centralized political system with the scattered family farming economy (Ren [1993]). As the discussion in this and the preceding chapter indicated, ideology is a key institution for reducing transaction costs of ruling a state. The PRC in 1949 inherited the legacy of these institutions – the close relationship between the centralized state and scattered farming families, and the heavy state interference in the economic system in traditional
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China. Furthermore, after 1949, with unrestrained use of the power of the state, mass social engineering was conducted to bring about enormous changes in people’s habits, work, living patterns, moral conduct, and worldview, which were supposed to be compatible with the new society imposed by the state. This was inspired by the “best practice” of the Soviet Union.

Generally speaking, the high-modernist Leninism imported from abroad and traditional path dependence can explain the CPC’s takeover and the development of the one of the most authoritarian regimes in the world, led by the dictatorship of the proletariat.

4.3.4 Agriculture Collectivization

The collectivization of agriculture changed both the organization of agricultural production and the benefit and incentive structure associated with it. It also profoundly altered the traditional rural social structure to serve the purposes of state appropriation and control. The Soviet model of economic development gave top priority to urban-based industrialization. China followed this model without exception. In the name of national interest a series of policies were made to extract agriculture surpluses from farmers to fund national modernization goals. Collectivization of agriculture was just one part of this institutional arrangement.

The communist leadership after 1949 gradually and repeatedly began to emphasize the subordination of the peasantry to the leadership of the working class. The ultimate goal became that of industrializing and socializing China to increase state wealth. The government adopted a resource plan characterized by state ownership and a new rural institution – the people’s commune – developed to ensure surpluses were used in accordance with state strategy. The expansion of agriculture was believed to be a basic condition for ensuring the development of industry (Schran [1969]).

In the early 1950s Mao implemented a strategy, emulating the Soviet Union, using agriculture to accumulate capital to fund the socialist industrialization process. In China, free market mechanisms were strategically excluded from the development strategy so that the government could artificially forced down the prices of inputs for the industrialization process. Raw materials, labour, and credit costs were cut down to aid the development of heavy industries. The state was able to extract agricultural surpluses through price scissors applied within the constraints of
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the class structure. Since the state did not have absolute control of agricultural production, the price scissor was referred to as the “invisible hand.”

The low prices offered for agricultural products dampened the peasants’ incentive for selling their products to the state. As a result the state was unable to procure sufficient agricultural products from the farmers. To overcome the shortage in grain supply, in 1953 the state introduced the state grain purchasing and marketing system (SMS). Through the SMS the state was able to monopolize the trade in farm produce. However, the SMS was not effective in achieving its goal because farmers refused to sell their grains to the grain stations run by the state.

The efficiency of an institutional arrangement, such as the SMS, depends on the existence of other related arrangements (Lin [1989]). In this case farmers had access to an underground market where they were able to receive a higher price for their produce, so they chose not to sell to state grain stations. Hence the state had enormous difficulties procuring agricultural produce from over 110 million households. Local authorities did not have information on the production of each household and therefore could not force households to sell their grains to the state. The problems associated with the SMS provided a strong justification for farms to be collectivized with local government’s support, so that agricultural production could be planned, monitored, appropriated and manipulated.

The major form of the state’s control over rural society was a combination of government administration and economic management. To extract large amounts of capital from a limited agricultural surplus, the state repressed the living standards of peasants by forcing down the prices of farm products, while at the same time attempting to ensure that the minimum needs of the peasants were met so that social stability was maintained. This policy was only supported by the poor and lower middle class peasants that did not lose as much from the institutional change as the rich peasants did. The state used political institutions to elevate the poor peasants to a superior political status and made them feel they were an integral part of the ruling class. Thus they help the party rule other peasants.

The above institutional arrangements were made to create a conducive environment for promoting communes. Mao linked the SMS directly to agricultural collectivization in 1953 (Chen [1958]). Agricultural collectivization was a logical extension of the SMS because agricultural
collectives could provide the institutional guarantee for the successful operation of the SMS. After 1956, the state was able to give quotas for grain delivery to 700,000 collectives instead of having to purchase grain from over one hundred million peasant households (Bo [1991]).

Moreover, agricultural collectives placed the poor and lower middle class peasants in a dominant position over the rich peasants who strongly resisted the SMS. The interests of the rich peasants were harmed the most by the state grain trading and collectivization. The class struggle turned the rich into the class being ruled, and open opposition to state institutions was repressed.

Agricultural collectivization followed three set stages planned by Mao and other CPC leaders (Chao [1970]). The first stage entailed the formation of mutual aid teams (MAT). Peasants, while maintaining ownership of their means of production such as labour, animals and farm implements, pooled their resources and worked together. The MAT was a kind of self-help group. It was able to increase the economy of scale of farming operations, raise productivity of members, and increase incomes (Chao [1970]). But MAT was not useful to the state because it did not help to control farm production or marketing.

The second stage entailed the formation of elementary producers’ co-operatives (EPC). In an EPC, land, labour, farm implements, and draft animals were contributed by members to the co-operatives, but ownership of them was kept in each member’s hands. Peasants could join or withdraw from the EPC on a voluntary basis, although the state actively promoted membership. Two thirds of the production surplus was distributed to members on the basis of each member’s work effort. The rest of the surplus was distributed proportionate to each member’s capital contribution. Obviously, this benefit structure was favourable to both poor and middle class farmers.

The third stage was the establishment of advanced agricultural producers’ co-operatives (AAPC), which entirely changed peasants’ private property rights (Liu [1983]). The AAPC was defined as a socialist, collective economic organization (Chao [1960]). The AAPC owned all production means, created production plans, managed production and the use of all productive resources, and remunerated the membership. The agricultural yield was distributed to members according to the work points earned, after production costs, taxes, public reserve and welfare funds were deducted. In just a few months AAPCs were established throughout the countryside.
and were busy depriving peasants of their property by writing off compensation for peasants’ means of production contributed to them (Du [1995]).

In the spring of 1958, Mao believed that the infant stage of communism, envisioned as agriculture, industry, commerce, education and military affairs in one unit, could be spawned from the combination of government administration and economic management in the countryside. The result was the nation-wide establishment of the People’s Commune. People’s Communes were used to assist industrialization through the Great Leap Forward (GLF). The GLF was a plan for rapid industrialization, an attempt to catch up with Britain in 15 years.

The commune system was aimed at creating a uniform local government to administer all aspects of rural life. This system was achieved by merging agricultural collectives and the lowest administrative units into a single entity (Aziz [1978]). The township government was the lowest administrative unit; the township originally lay between the district government and the natural village. The state made the township part of the fabric of the commune by increasing the township’s size and amalgamating it with the district government.

According to Liu [1983], commune economies functioned on three unit scales: the commune, the production brigade, and the production team. There were several major economic functions of the commune. The commune was used to coordinate, supervise and guide all activities of the production brigade and team. It had a responsibility to discharge supplementary functions that were beyond the capacity or scope of the brigade and team. It also was to undertake large projects requiring a considerable workforce or substantial financial resources.

The commune provided leadership, guidance and assistance for agricultural and rural development through production planning, provision of essential inputs, diversification of the rural economy and provision of certain social services. The very limited surplus produced by the commune for consumption was distributed to meet the minimum needs of the peasants and keep them alive. Public welfare funds were deducted from the commune’s surplus to finance basic public services, such as education, medical clinics, social relief, on-farm works, and extension programs. Farmers shouldered these public services as collective goods.

The economic function of the production brigade was to coordinate the annual production plans of the teams on the basis of the quotas assigned to the commune, and to dispense cer-
tain agricultural inputs. The brigade played an important role in undertaking investment and development activities on a scale that was too large for production teams.

The production team was the basic accounting unit. It owned the land and was responsible for all decisions involving the deployment of available manpower, management of production and distribution of the income generated by the team. Its overall planning of production was subject to certain state-set guidelines such as quotas for grain and other basic commodities which must be sold to the state at fixed prices.

During this era, China was facing sanctions and embargoes imposed by western countries and the Soviet bloc, so it had to be self-sufficient in food production. The state strictly controlled grain and cotton production and banned all private trading of such products. Each commune was allocated a production quota of grain no matter what its natural conditions and resource endowments were.

The commune had profound implications for the economic and social life of farmers. Land reform did not profoundly change the traditional rural social structure. But when agricultural collectivization was implemented, the whole pattern of traditional peasant life was altered (Bennett, Kieke, and Yoff [1978]). The communist state not only placed the family, clan and village under its direct control through the economic and administrative institutions of collective farming, but the CPC’s organization and its members also became the core force of leadership in rural areas, replacing the gentry and clan organizations of traditional China. Although the Party encouraged popular participation in administration, controlling power always laid in the hands of the Party.

In addition, the Party exerted its influence through various institutions and organizations in the villages (Shue [1980]). These organizations included the Children’s Pioneer Corps, the Youth League, the Women’s Federation, and the People’s Militia. Their activists provided the nucleus and vanguard of many agrarian programs in China (Chao [1960]). These various organizations were coordinated by the Party Branch, which served as engineer, supervisor and adviser to almost all major programs.

To enhance the legitimacy of the Communist regime and the commune as an institution, the state employed methods of persuasion. Through propaganda, indoctrination, training and education the state supplanted the firmly established morals and traditions of the people with
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the ones desired by the state (Chao [1960]). Commitment to families, kinship, and clans were replaced by moral obligations to the Party and the State (Perkins and Yusuf [1984]).

The most important institutional arrangement for reducing the costs of providing services is ideology (Lin [1989]). Ideology can be defined as a set of beliefs about the world, including beliefs about the morality of the division of labour, income distribution, and the existing institutional structure of a society. According to North [1981], ideologies have three stylized features:

1. Ideology is an economizing device by which individuals come to terms with their environment and are provided with a “world view” so that the decision-making process is simplified.

2. Ideology is inextricably interwoven with moral and ethical judgments about the fairness of the world that the individual perceives.

3. Individuals alter their ideological perspectives when their experiences are inconsistent with their ideology. In effect, they attempt to develop a new set of rationalizations that better “fit” with their experiences. However, it is important to stress that inconsistencies between experience and ideologies must accumulate before individuals alter their ideology.

A successful ideology must also overcome the free-rider problem (Lin [1989]) – i.e., people will need to be educated to yield to the plan and solutions devised by the state rather than have other competing sources of judgment. For example, the CPC and the commune needed to subsidize the production and peasant accumulation of ideological capital by investing in ideological education, so that they would not need to monitor the efforts of peasants. Mao called ideological control the other “gun,” one which is as equally important to the regime as the real guns (i.e., military force).

**Agricultural collectivization in summary**

The effect of agricultural collectivization was all-encompassing. It eliminated the focal points for an autonomous public life. The tavern, rural fairs and markets, the church, and the local mill all disappeared. All traditional social groups were demolished and banned, including religious groups following Buddhism and Daoism. In their places stood the commune office, the public
meeting room, and the school. Non-state public spaces gave way to the top-down state space of government agencies, albeit local ones (Scott [1998]). The self-reliance provided by civil society did not survive such a highly authoritarian regime. Strict censorship was used to keep the voices of dissidents from reaching the people. As a consequence, the traditional ties that bound rural residents to each other were destroyed.

To keep peasants in the commune and to minimize the number of rural migrants who benefited from the superior social welfare of urban areas, the state introduced an internal passport (or household registration) system, which is still in place. Without government approval, people were not allowed to migrate between the countryside and cities. As they were under serfdom, peasants were again legally immobilized. Only a small number of rural residents who had finished university education and/or had became cadres were allowed to register as urban residents and to have access to the superior welfare. This policy drained talent from rural areas. For much of the peasantry, the authoritarian labour regime of the commune seemed not only to jeopardize their subsistence but it also revoked many of the freedoms that the peasants had fought for over thousands of years.

The above analysis suggests that the commune was an institutional change imposed by the state, rather than an institutional change that was initiated voluntarily. The goal of the commune was to extract capital to support the CPC’s ambitious industrialization plan. The commune provided cheap food to urban residents, and raw materials to industry at a state fixed price which constrained peasant’s needs to a minimum. The peasants’ property was appropriated during the third stage of collectivization, a process which destroyed the economic and social units of the peasantry.

The rich peasants who had a means of resistance were subordinated by the poor peasants under the state initiated “class struggle.” With aid of state coercion, the class struggle reduced tensions between the state and peasantry, and reduced the transaction costs of the new commune (especially information and enforcement costs).

The new institutional order of the collective farm (commune) evolved to be compatible with the state’s strategy of appropriation and directed development (Scott [1998]). Since the transaction costs of a particular arrangement depend on other arrangements (such as laws, customs, and
ideologies), the organizations that come into existence and how they evolve are fundamentally influenced by institutional frameworks (North [1990, 1995]). The most efficient institutional arrangement is also a function of other arrangements in the institutional structure (Lin [1988]), this can be attributed to coordination effects. With aid of learning effects, the CPC created other institutional arrangements to reinforce the commune such as the state monopoly trading of grain system (SMS), household registration, ideologies, and the replacement of traditional institutions by Party-led masses and other rural institutions. These new institutions were designed for the seamless rural control of peasants, who were an accessible source of tax revenue, politically powerless, and willing to accept the status quo and the fate they were given thanks to the adaptive expectations.

4.3.5 Collapse of Collective Agriculture and the Introduction of HCRS

Agricultural collectivization was not successful, however, over the long run. Key reasons for the failure of collective agriculture in China were the high monitoring costs and the loss of freedoms suffered by commune members. Since the establishment of communes in the early 1950s, agricultural collectives were the basic unit of agricultural production, administration and accounting. Peasants on each production team were accredited with daily work points for the jobs they performed. At the end of the year the net team income, after deductions, was distributed according to the work points each individual earned during the year.

Various systems of work points were used over the years. In one system, a price point was set in advance for each task. Thus, fixed points were earned when jobs were assigned to workers. In other systems, workers recorded the number of days worked. At the end of the year, each worker proposed the rating they deserved, and after evaluation by his or her peers, he or she was awarded points ranging from six to ten. The result was his total work points. In yet another system, one member of the team was chosen to be the “pacesetter.” The rest judged themselves in relation to the performance of the pacesetter and assigned themselves work points accordingly. In all these systems work points were intended to reflect the quality and quantity of work provided by each worker.
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Monitoring the labour efforts of peasants in agricultural production is extremely difficult and very costly because of the sequential nature and spatial dimensions of agriculture (Allen and Lueck [2004]). As Alchian and Demsetz [1972] argue, the incentive to work in a team is lowered if the monitoring of effort is not perfect. The degree of monitoring for a production team was minimal, and as a consequence the incentive to work was low and under-contributions of effort became an epidemic. As Bardhan [1993] suggests, when it comes to team dynamics, people are motivated by the norm of fairness. They do not want to free ride on the co-operation of others, but they do not want to co-operate when few others are doing so.

In addition to the technical factors previously described, the inefficient operation of communes was deeply rooted in the institutions imposed by the State. The unitary administrative structure of the commune and the imperatives of central planning created a clumsy machine that was utterly unresponsive to local knowledge or to local conditions (Scott [1998]). The commune deprived the peasantry of their property and freedoms, and the peasantry saw this action as illegitimate. Having taken from the peasants both their (relative) independence and autonomy, as well as their land and grain, the state created a class of bound labourers. Peasants responded with the same forms of foot-dragging and resistance that labourers used everywhere.

The dismantlement of the commune and the introduction of the household contract responsibility system (HCRS) in the early 1980s were a result of both Deng Xiaoping’s reform policy, and an induced institutional change initiated by Chinese peasants. An induced institutional change refers to a modification or replacement of an existing institutional arrangement, or the emergence of a new institutional arrangement that is voluntarily initiated, organized, and executed by an individual or a group of individuals in response to profitable opportunities (Lin [1989]).

The HCRS was not a brand new policy when it was introduced in the late 1970s. Rather, it had its own developmental path. According to Liu [1983], the practice of ‘household contract production’ repeatedly appeared in the countryside from 1955 to 1959. It occurred again in 1960 and in mid-1962; during this time about 20-30 percent of rural households were farming under this system. Many of the major leaders including Deng Xiaoping supported the policy. However, Mao concluded that the repeated occurrence of the policy was reflective of the struggle between the socialist and capitalist path, and therefore actively suppressed this policy innovation.
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The HCRS was introduced in the late 1970s and early 1980s after the People’s Communes were disbanded. The HCRS had three basic features at the outset. The first feature was that the collectives (administrative villages) owned the land and had the responsibility of issuing contracts for land use rights to each household. The second feature was the issuance of defined contracts. Each contract stated how much of the specified products the household was expected to produce and deliver to the state at a set price. The household has the right to use any excess production beyond this amount at their own discretion. The third feature of the HCRS was that households were allowed to make their own decisions and control their own input costs (Gottschang [1995]).

At the beginning of the HCRS reform, grain fundamentalism (the provision of relatively inexpensive and stable supplies of grain for the urban population) still prevailed in the form of quotas, marketing regulations, direct and indirect subsidies (albeit reduced from previous levels), and social pressure from local officials (World Bank [1998]). But, in late 1979, the government started to raise the price of grain. The government was attempting to address grain supply issues by using a market solution rather than traditional command and control.

An institutional innovation, such as the commune, cannot be sustained if the institution does not have a proper foundation, even given the coercive power of the state and the personality cult of a leader that personally identifies with the ideology he promotes. Imposing new institutional arrangements that make changes to the original institutional structure may undermine the legitimacy of the ruler’s authority. As such, new arrangements often become possible only after an old ruler is replaced by new rulers. An example is the change from the collective system to the household farming system in China under the leadership of Deng Xiaoping (Lin [1989]).

However, as discussed earlier, institutional change is typically difficult because of large setup costs, learning and coordination effects and adaptive expectations. And where change does occur, the new institutions often take on a form and structure that can be linked to the previous institutions. The next two sections examine the economic and political institutions that have developed within China since the collapse of the People’s Communes. As will be seen, these institutions are influenced by the institutions that came before them.
4.4 Capitalism with Chinese Characteristics

4.4.1 Introduction

By the end of 1970s there was strong evidence that the central planning and high-modernism approach in China had failed miserably. Since that period, China has been transforming its economy from a command regime to a more market-oriented capitalist regime.

According to Hall and Soskice [2001], business enterprises are crucial actors in a capitalist economy and are responsible for the overall level of economic performance. For a company to be competitive and effective in developing, producing, and distributing goods and services, it has to coordinate both internally, with its own employees, and externally, with the rest of the players in the value chain (Hall and Soskice [2001]). In short, companies face a number of coordination problems. The firms that are successful are those that are able to solve these coordination problems and who can reduce transaction costs (Janvry, Sadoulet, and Thorecke [1993]).

There are five spheres in which companies have to develop relationships to resolve coordination problems central to their survival and competitiveness (Hall and Soskice [2001]). The first is the sphere of industrial relations – i.e., how companies coordinate bargaining over wages and working conditions with their labour force. The second is the sphere of vocational training and education – i.e., how the companies secure a workforce with suitable skills. The third is the sphere of corporate governance – i.e., how the companies access finance. The fourth is the sphere of inter-firm relations – i.e., how the companies work with other enterprises to secure a stable demand for its products, secure a supply of inputs and gain access to state-of-art technology. The fifth is the sphere of relations with their own employees – i.e., the companies have to ensure their employees have the requisite competencies and co-operate well with each other.

The manner in which these coordination problems are solved depends on the nature of the capitalist system in which a firm operates (Hall and Soskice [2001]). In liberal market economies (LMEs), “firms coordinate their activities primarily via hierarchies and competitive market arrangements. …Market relationships are characterized by the arm’s-length exchange of goods or services in a context of competition and formal contracting. In response to the price
signals generated by such markets, the actors adjust their willingness to supply and demand goods or services, often on the basis of the marginal calculations stressed by neoclassical economics. In many respects, market institutions provide a highly effective means for coordinating the endeavors of economic actors” (Hall and Soskice [2001], p. 8).

In coordinated market economies (CMEs), “firms depend more heavily on non-market relationship to coordinate their endeavors with other actors and to construct their core competencies. These non-market modes of coordination generally entail more intensive relational or incomplete contracting, network monitoring based on the exchange of private information inside networks, and more reliance on collaborative, as opposed to competitive, relationships to build the competencies of the firm. In contrast to LMEs, where the equilibrium outcomes of firm behaviour are usually given by demand and supply conditions in competitive markets, the equilibria on which firms coordinate in CMEs are more often the result of strategic interaction among firms and other actors” (Hall and Soskice [2001], p. 8).

The categorization of capitalist economies as either LMEs or CMEs is primarily a result of a focus on and an analysis of the OECD economies. In this categorization, the United States is seen as a prototypical LME, while Germany is a prototypical CME. As Redding and Witt [2009] point out, this categorization does not apply particularly well to the Asian economies. Specifically, while the coordination problems need to be solved in the Chinese economic system just as much as they need to be solved elsewhere, the manner in which they are solved appears to be different.

A critical element in solving the various coordination problems is confidence that contracts and agreements will be adhered to, and that policy will be not arbitrarily changed. Moreover, there is a need to ensure that institutions that govern both the economy and political life work and fit together. As Rausser and Johnson [1993] argue, “the design of the underlying constitution that establishes the guidelines and mechanisms for the ‘rules by which rules are made’ must be credible; the legal and regulatory infrastructure that emerges from the underlying constitution must provide an environment that is conducive to a vibrant market economy; …the policies that encourage anti-monopolization forces (privatization, antitrust policy, trade policy, and foreign investment policy) must be jointly designed to attain sustainable economic growth …” (p. 676).
After the Soviet model of economic development failed in China, top leaders began to adopt more capitalist institutions. However, many of the structures, practices, and attitudes developed under the collective economy still persisted (World Bank [2006b]). Without the checks and balances to its power, the state continued to make interventions in the social and economic lives of Chinese citizens. Consequently, property rights are weak and reliable legal protection is generally absent.

As China neither has professional codes nor the legal system to provide sufficient assurance that outcomes will be fair, it lacks institutionalized trust (Redding and Witt [2009]). High levels of institutionalized trust are crucial to the operation of a capitalist economy (Hall and Soskice [2001] and Gourevitch and Shinn [2005]). As a result, China’s national political economy means that its firms have to resolve their coordination problems via forms of non-market coordination that entail collaboration and strategic interaction.

As Redding and Witt [2009] argues, this coordination takes place within a structure that is unlike either the LME or the CME. Instead, China’s economic system is “capitalism with Chinese characteristics.” China’s version of capitalism is characterized by the importance of personal relationships in providing the trust that is required for the coordination of the system. China’s capitalism has similarities with capitalism in South Korea (Redding and Witt [2009]). As argued by Kang [2002], South Korea is permeated by crony capitalism – i.e., political considerations dominate policy making and state and business exchange favours. At the same time, the state still plays a critical role in economic activity, and is typically a major blockholder (see Gourevitch and Shinn [2005]). The blockholding pattern of ownership is examined in the next section, followed by an examination of Chinese business culture and crony capitalism.

4.4.2 Blockholding Pattern of Ownership

Trust is important within the firm, since investors will not be willing to invest money in a business unless they can be assured that the managers of the firm will use the money properly. As Gourevitch and Shinn [2005] point out, the problem of providing this trust can be addressed in two ways. One way is through transparency and the protection of shareholder rights – e.g., making sure that financial reports are timely and illuminating, and that an active takeover market
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exists. When these activities are successful, a diffused stakeholder ownership pattern can emerge in which many small investors are able to confidently invest in business entities.

The other way of providing trust and assurance to shareholders is through the concentration of ownership in blocks. According to Gourevitch and Shinn [2005], blockholder ownership “tightly links ownership and control. Managers are supervised by “insiders” (concentrated blockholders), with little formal protection of the outside, or minority shareholders. This model disciplines managers through direct supervision and interventions by insider owners who control large blocks of shares. The blockholder approach has several variants. In one version, large shareholder blocks are held by financial institutions, banks, or other firms. The family or ethnic network is another variant, in which personal or group ties are used to control managers. Yet another form of blockholding is the state ownership model, where public authorities use a variety of instruments to supervise firms” (p. 5). This latter form of blockholding is the one that describes China (Gourevitch and Shinn [2005]).

The emergence of either diffused ownership or blockholder ownership in an economy depends upon and reflects the legal and political system that governs that economy. Policy, in turn, reflects the political bargain among the major players; it is the outcome of preferences and power resources mediated by policy institutions. As a consequence, the nature of ownership in an economy reflects the underlying political economy of the country in which the economy exists (Gourevitch and Shinn [2005]).

Specifically, the more authoritarian the political institutions and the greater the power of a small number of groups in a society, the more likely is blockholding ownership. Investors need to be provided with a credible assurance that the capital they provide will be used wisely and that they will receive the appropriate benefits from its provision. In authoritarian states, this assurance cannot be provided, since such states lack the political institutions that can enforce the rules for noncompliance – i.e. the law on the book is not the same as the law in practice. The result is that ordinary investors are vulnerable to manipulation and expropriation by elites and special groups. Only the “selectorate” – a small number of people upon whom the rulers rely upon for support (and which in turn can be said to “select,” or at least support, the political leaders) – are given special privileges (in the form of secure property rights) in exchange for
their support. Consequently, most investors feel insecure, and diffused shareholder ownership will not take place (Gourevitch and Shinn [2005]).

Another factor at work in the emergence of blockholding is the lack of minority shareholder protections (MSPs) (Gourevitch and Shinn [2005]). MSPs include things such as auditing requirements, rules restricting non-executive members from sitting on the board of directors, rules allowing for hostile takeovers). When these protections are absent, investors will only make investments if they can acquire some protection from the actions of management. One important form of protection is blockholding, since ownership of a large block of shares allows large investors to appoint their own management, or to remove management if it is not performing.

The index used by Gourevitch and Shinn [2005] to assess MSPs suggest that China provides the least degree of protection among the 39 countries studied; the United States, in contrast, provides the greatest degree of protection. The breakdown of the components of this index are interesting. The information (disclosure and audit) component is 86 for the United States, while for China the comparable figure is 25. For oversight (board independence), the U.S. figure is 100, while China’s figure is zero. For control rules (minority voting rights over important decisions), the United States scores 100, while China scores 20. Finally, for managerial incentives (compensation of managers linked to shareholders benefits), the United States again scores 100, while China scores zero. Given this low level of MSP, it is not surprising that China emerges with a strong blockholding structure.

The blockholding pattern of ownership in China determines (and is determined by) the Chinese business culture. The next section examines this culture.

### 4.4.3 Business Culture in China

Three main patterns appear to have emerged in China regarding how to coordinate and control economic activity in China (Redding and Witt [2009]). The first pattern encompasses the state-owned enterprises (SOEs) left over from the privatization movement in the 1990s. While most medium and small state-owned enterprises were privatized in the movement, the large ones and those who were thought to be strategically important to the state were kept and merged into large-scale group enterprises. The state continues to hold about 65% of the equity of these companies.
who are publicly listed; these majority shares are not traded. The remaining 35 percent of equity is tradable (Gourevitch and Shinn [2005]). These enterprises are often granted sole licenses and trading rights, and have became national monopolies (e.g., China Telecom, PetroChina). They have also received huge amounts of state investments in the name of support to national industries that need to be globally competitive.

The state appoints the management of these companies through the State Asset Management Commission. Ex-senior government officials from line ministries or provincial governments are often appointed as management of these companies; as well, senior management of these businesses often move into government. Given their special privileges, these companies do not have to worry about the security of their investments; moreover, they can protect their investments through controlling their environment by administering prices and influencing government to ensure favourable regulatory treatment and to limit competition. These companies have also launched successful joint-stock companies in other sectors, since they are able to obtain government permits, licenses and credit that other investors cannot obtain.

The second pattern of ownership is found in local corporations that emerged mainly during the privatization movement in the 1990s. Most of these corporations used to be state-owned or collective-owned enterprises that were controlled by the local government. During privatization, many of these enterprises were bought by the managers of the state-owned enterprises. In fact, a number of them were simply given away by the state. Businesses in this group operate in the same way as their counterparts in the first group, albeit with smaller business territories that are restricted to the area where they have political connections and special privileges.

The third pattern of ownership is the private sector consisting of a large number of small and medium enterprises (SMEs). They serve niche markets and often engage in export manufacturing activities as the “workshop of the world.” Since the government is not able to make a credible commitment of self-restraint to reassure investors, investors are at risk. A World Bank [2004a] study on the investment climate for SMEs in Southwest China identified investment impediments in three categories: (1) Government rules or activities that impose unreasonable burdens on SMEs or interfere with markets; (2) requirements for more complete implementation of market-economy institutions, including rule of law; and (3) needs for broader dissemination of business
information and technical or managerial knowledge. The first and second of these impediments supports Redding and Witt [2009]’s conclusion that China lacks institutionalized trust. As a consequence, business leaders have moved to blockholding forms of ownership. They have also adopted crony capitalism as part of the business culture.

4.4.4 Crony Capitalism

Crony capitalism is an economic system in which the adjudication of commercial disputes and the allocation of resources are made on the basis of association rather than economic values. Decisions are made to favour those who have a close relationship with political leaders and government officials (by family-based clans, personal relationships and informal networks). It is a system in which connections trump competence, and money supersedes merit (Wei [2001], Kang [2003]).

According to Kang [2003], countries ruled by crony capitalists typically experience significant corruption, because political considerations dominate policy making. Policy decisions are dependent upon exchanges of favours or bribes between the state and businesses. The state will intervene in ways that protect and reinforce the interests of small groups of businesses and political elites. The production of public goods are usually fortunate by-products of actors competing to gain the private benefits of state resources.

In countries ruled by crony capitalists, there is often political interference in market processes. Public regulation is ineffective and the system is often not able to enforce its rules and regulations. Relatives and supporters of the political leadership and system are provided for through giveaway privatizations, the granting of artificial monopoly rights, directed credit, and government bail-outs of politically connected enterprises. Cronyistic support is provided under the guise of industrial policy, whereby the government promotes the industries and the owners it favours. Government goes so far as to explicitly and implicitly underwrite their investments in chosen industries and to regulate the markets to protect them from potential competition. These practices naturally encourage industry to relax management, take excessive risks resulting in lost efficiency and poor investment decisions. These practices supplant free and competitive market processes with corrupt rent-seeking behaviour (Lee [1999]).
Crony capitalism also has effects on the nature of the relationships that exist outside of business. As the next section outlines, one response to a system that relies heavily on relationships among the elite is that those outside the elite have to find a way to develop relationships with those in the elite.

4.5 Patron-Client Structures

4.5.1 Definition

A vertical patron-client dyad is a personal security mechanism to which people resort in which direct personal ties based on reciprocity substitute for law, shared values, and strong institutions (Scott [1972]). The relationship between patron and client is unequal, and based on mutual benefits. According to Powell [1980] and Scott [1972], the patron-client dyad can be distinguished from pure coercion by the element of free choice that is exercised by the client. A patron-client relationship develops between two parties that are unequal in status, wealth and influence. It is a “lopsided friendship.” A client is someone who has entered a relationship of unequal exchange in which he is unable to reciprocate fully. A debt of obligation binds him to the patron.

The patron is often in a position to supply unilateral goods and services which the potential client and his family need for their survival and well being. There is an imbalance in such exchange rooted in the disparities in wealth, power and status. The development and maintenance of a patron-client relationship rests heavily on face-to-face contact between the two parties as well as reciprocity in the exchange of goods and services. The terms of exchange in such relationships depend upon the relative bargaining power of the two parties (Popkin [1980]).

When one’s physical security and means of livelihood are problematic, and when recourse to law is unavailable or unreliable, the social value of a personal defender is maximized (Scott [1972]). The development of this relationship echoes Stiglitz’s argument: “societies adapt to the absence of a complete set of markets: institutions develop to perform the functions that otherwise would have been served by the missing market” (Stiglitz [1989], p. 24).

There are fundamental problems with the patron-client structures. When most of their wealth is generated from appropriation, patrons work hard to maintain tight control over their clients. Control is maintained by directing the bottlenecks of the local production process, manipulating
outside connections and blocking a patron’s access to the market and alternative sources of help, as well as diverting public resources to clients rather than to more productive purposes.

Patron-client structures weaken ties of horizontal interdependence in the local community (Attwood [1974]). Co-operation that empowers the clients will reduce their dependence on their patrons and thus their susceptibility to appropriation. To maintain their power, patrons prevent collective action by distributing their patronage unevenly and unequally among core and peripheral groups.

Those at the top of the village hierarchy have many more resources to offer than do the rest of the villagers. In this situation, short-run interests dictate that those at the lower levels of the village hierarchy establish clientage relations with those at the top; these relations then become a substitute for ties of mutual aid and villager solidarity (Bandyopadhyay and Eschen [1993]). Even those villagers who are willing to work together have their efforts at forming self-help groups, for instance, frustrated by the patrons with power. Thus the overall amount of co-operation and social interaction occurring in the villages is severely reduced. Similarly, the social capital – i.e., the connections among individuals, social networks, and the norms of reciprocity and trustworthiness that arise from them – is reduced.

4.5.2 Application to China

Without formal democratic institutions of some sort, the democratic rights farmers have only exist on paper. Farmers cannot, for instance, form horizontal groups to empower themselves. The pervasive corruption that exists not only transfers wealth from the poorer to the richer and exacerbates socioeconomic inequalities, but it also transforms many jurisdictions into local mafia states. As a consequence, farmers have resorted to the patron-client structure to find personal security. When impersonal social control is absent or not functioning, the relationship between the patron and client, although unequal, can provide mutual benefit.

This thesis argues that the power structure of the rural community, and the whole of society, makes small farmers feel like they are frequently in jeopardy. The village officers are not answerable to the villagers; instead officers and elite peasants control the village resources and exclude most of the peasants from the decisions that impact their lives. It is widely reported in
the Chinese media that village officials corrupted million of Chinese Yuan from land acquisition and other development programs and never hesitated to suppress farmer rebellions by resorting to violence.

Authoritarian governments often do not keep their promises and they generate an atmosphere of pervasive distrust and fear (Bandyopadhyay and Eschen [1993]). In societies where the state does not function by the rule of law and other democratic institutions, it is difficult for civil society to emerge, and in the cases it does exist its development is seriously hampered (Hyden [1997]). Self-help community-based organizations are not allowed to emerge under authoritarian rule, and/or they are blocked by the power holders.

The result is that most villagers expressed profound feelings of powerlessness, lack of control over village affairs, and hopelessness about the opportunity to change things even through their own collective efforts. For example, when election of village chief was held, many villagers sold their votes at very low price (e.g. less than C$1 for each vote); when some villagers wanted to elect their own leaders, the elites did not give them votes or results of election were not announced; some village chiefs which were elected by villagers were unable to take office because they were not favoured by the local government officials (Xinhua News Agency [2004]).

When power was abused in order to appropriate from others, distrust was generated not only between the mass of villagers and the elites, but also among the masses of villagers themselves. A natural reaction to exploitation is to defensively withdraw one’s personal relations to a tight network of people who can be trusted, namely kin. Given the atmosphere of exploitation even these kinds of associations are likely to take on a predatory character (Bandyopadhyay and Eschen [1993]). However, in comparison to the more powerful and demanding interest groups, the horizontal kinship unit was often ineffective at providing security and opportunities for advancement.

Farmers were often found to be the subject of arbitrary and sometimes capricious actions of local government officials and leaders, evidenced by the growing number of protests against land seizures, arbitrary taxation or the levy of fees (CIDA [2008]). The power relations are so uneven that open political conflict is made unnecessary. The elites are in a position to impose rules on farmers, and these rules increase the leaders’ capacities for political action while diminishing
those of farmers. The learning, coordination effects, and adaptive expectations mean that farmers are less interested in changing the larger structures of the state and law than they are in working the system to their minimum disadvantage.

For small farmers the rule of law, democracy, and civil liberties paled before abuses of power. To them it is much more cost-effective and realistic to sort out their own solutions and the vertical patron-client dyad is a personal security mechanism to which many people have resorted. In the villages of China the patrons are the village chiefs, the CPC party branch heads, private business owners, and local government officials.

In a Chinese village, the farmer is usually the client seeking a range of favours from their patrons. Typical patron services include the following:

1. Access to more and higher-quality farmland and/or the opportunity to retain land already contracted to his family.

2. The license for building a house.

3. Recommendations for a job in town or joining the army.

4. Assistance in accessing various government support programs and seed, credit, and new technologies.

5. Support when farmers have a dispute with a neighbour over land or other issues.

In exchange, clients offer their patrons various forms of support. These supports services may include:

1. Voting support when an election is held.

2. Provision of support when higher-level government officials visit the village.

3. Support when fellow villagers rebel and do not follow the patron’s orders, or another patron-client group is competing for resources. This support may even include a resort to violence on the patron’s behalf.

4. Acting as whistleblowers and keeping watch on dissidents in the village.
It should be noted that the patron-client structure permeates the China’s entire society, not just its rural society. A vast patronage system becomes the real glue that has held the CPC together. The regime has used its financial resources to balance domestic interests, satisfy different constituencies, and purchase the contingent support of China’s social elites (Pei [2009]). The state has become China’s biggest patron. China’s non-ideological ruling elites have remained with the party because it continues to pay them.

The lack of recourse to the law has led even the leading social groups to enter unequal relationships with those of superior status, wealth and influence. These groups include government officials and business owners who want to get promotions, win contracts, obtain a license or loan, or gain government support. As a consequence, their are invisible rules to the games that are pervasive in China. These invisible rules are known as Guanxi and Houmen, translated to mean ties and rear door, respectively.

The patron-client ties in China are evolving into more specific exchanges of goods and services. Cash has become the most ideal currency for facilitating the frequent exchange of services among various patrons and clients. Mai Guan, the buying and selling of appointees in government, and collusion among local ruling elites, have become common, evidenced by the proliferation of corruption cases involving groups of officials who co-operate and protect each other (Pei [2009]). Government officials are not the only group receiving bribes; school teachers, doctors and other professions also demand extra pay for their services. In Transparency International’s Corruption Perceptions Index (2009), China was ranked number 79 of the 180 countries, compared to the number 1 of New Zealand, the least corrupt country.

**4.5.3 Rural Society Stratification**

When the state fails to bring justice and the organizations of civil society are not functioning, the processes of decentralization and the devolution of power, in the absence of democratic progress, run the risk of further empowering local elites (Herring [1999]). The asset-poor small farmers, who have a limited means of action to hold the local government accountable, become the most vulnerable social group in society, susceptible to various kinds of appropriation and control.
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Decentralization without democratic progress leads to small farmers being trapped in a more disadvantageous position. After the collapse of the commune, the quality of public services deteriorated. Research and extension services, rural medical and disease control networks, and medical and health services all collapsed because these local public services were funded by production surpluses from the operation of the commune (World Bank [1998, 2007]).

While China’s political hierarchy is very strong, it is one of the most decentralized countries in the world. The local government is supposed to deliver most services to its constituents with their own fiscal revenues. However, most local governments do not have the revenues to finance the expenditures required to fulfill the assigned services they are supposed to offer. Chapter 2 argued that in some parts of China, the financial situation is worsening, because with abolition of the agricultural tax and surcharges, local governments have to depend more on business taxes and the VAT which are predominantly industry based.

The local government and rural cadres, as agents of the state, do not have the necessary resources to provide public services. Further to the disadvantage of the population, corruption and asset appropriation are pervasive among those in power. Local bureaucracies are more interested in seeking rental income, and will pursue narrower goals than those set by the state (Bardhan [1989]), despite the establishment of rules that are supposed to govern their actions (North [1981]). The grassroots level of government is out of the central government’s control.

Effective policies of decentralization that are based on the devolution of power and resources can generate a virtuous circle when coupled with adequate support to enhance accountability. However, rural electorates are either powerless to impose change or are punished by officials for voting out of line. As a result, they have no means to hold the local government accountable.

As a consequence of the new political and economic structures, most villages have been gradually stratified by economic class, prestige and power. In the commune era, the rural community was economically egalitarian and the farmers’ material needs were minimized by state provisions. At the outset of reform, opportunity was widely available to ordinary households because of the low barriers to entering the business sector. After 20 years, the income gap is widening, social stratification has taken place, and the trickle down of development has slowed.
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According to Ray [1998], the new rich want to perpetuate their wealth. They form interest groups in order to secure their economic and political status. As there is no official conflict of interest law, it is commonplace for officials (cadres) and their families to get involved in business activities. As is the case in many other countries, the participation of public officials in business activities is a serious obstacle to the development of competitive markets (Rausser and Johnson [1993]).

Since 1979, rural reforms have stratified rural society into several groups: small farmers, craftsmen, small businessmen and enterprise owners and managers, workers at rural enterprises, functionaries and specialized personnel, and leading cadres at the township and village levels. It is believed that the key social groups in rural development and social reforms are the enterprise owners and managers, specialized personnel, and leading cadres (AEJ [1987]).

More recently, inequalities between rural households are also increasing. Rural households endowed with different assets, education, skills, experience (farming, business) and social connections are experiencing a widening gap in income disparity. Some of the ‘haves’ are able to acquire more land, by renting from their neighbours or from the village communal land, and become big households. Many of them also engage in the trade and transportation of farm produce.

Government rural programs are targeting these big households as a more cost-effective way to deliver technical training. Usually these households can participate in a number of government programs and receive credit, inputs, and training as demonstration households. It is quite often that these households are well connected with local government officials. The strong performance of big households can be used to exhibit local government’s achievement in agricultural development.

Local government officials are driven to build close ties with local businesses by the shift of the taxation base from farms to businesses, and the need to demonstrate performance to higher-level officials. To address the problems of small-holder farming and to integrate the supply chain, the local government is pushing farmers to join C+H models of association which aim to enhance the vertical coordination of the agri-food system.
4.5.4 Patron-Client Relationships and Agricultural Co-operatives

As discussed earlier, the China Farmers Professional Co-operative Law (FPCL) was formally passed by the National People’s Congress in November 2006. The FPCL formally recognized the legal status of farmer co-operatives, and at same time approved the legal status of the C+H structured co-operatives.

While the government claims that the C+H model is based on mutual benefits, field studies indicate that this is often not the case (the results of the field studies are presented in chapter 6). The processor has strong incentives to develop co-operatives that can ensure a consistent supply of quality products, and to reduce the transaction costs of dealing with thousands of small producers. Organizations that can achieve these goals are not necessarily mutually beneficial for both farmers and the processor.

The C+H co-operatives may also not be sustainable. Since the small producers do not believe in the co-operative as an agent with their interests in mind, they are often not committed or loyal to the co-operative. Without a consistent source of high quality product, the C+H enterprises may not be able to survive economically. Farmers do not have much trust in the C+H co-operatives because government has in effect pressured people to join co-operatives. Government does this by at least two means: (1) since co-operatives are channels for government funds and support programs, individual farmers are deprived of economic benefits if he or she decides to stay out; and (2) only co-operatives and their members are allowed to engage in the production of some products, e.g. pig and cattle (individual household production is banned in the name of animal and public health). Neither of these reasons for participating in a co-operative create the trust necessary to keep farmers from acting opportunistically.

Moreover, to prevent the farmers from organizing to gain political power, the government strictly limited the economic functions permitted by farmer groups. Rights claims and other advocacy activities are banned. Farmers’ groups cannot participate in social and political functions and are not included in decisions made about the allocation of public resources. Simultaneously, farmers experienced hostility from rural elites at the grassroots level who were threatened by the spontaneous collective action of the farmers’ self-help groups and tried to block their develop-
For example, in Sichuan, some co-operative members’ access to government credit program was denied by the village officials. Since the power of the rural elites was based on their relative power over the farmers, collective group actions would likely dilute their power.

The top-down approach for reforming policy assures the government of control over the pace and direction of reforms. In China, the state remains deeply and extensively entrenched in the economy despite three decades of economic reform. Market reforms directed by the communist regime occurred without a regime change and all officials retained their posts, thereby creating more opportunities for extracting income. This is due to the removal of various political restrictions on the accumulation of personal wealth such as the creation of new market value for access to, or trading in, existing public property such as financial capital, land, buildings, vehicles, natural resources, and enterprises. In addition the restriction removal created a new market for official discretion in regulatory decisions and to networks of influence within the government hierarchy. Government officials are in a strategic position to become a substantial beneficiary of economic reforms. China’s hybrid economy creates fertile grounds for corruption because officials wielding the power to approve projects can easily abuse it for illicit personal benefits (Pei [2006]).

Although the commune system was replaced by the HCRS very quickly, the structures, practices and attitudes developed by its key actors persisted. The long-term autocratic rule and widespread maladministration produced a patient, apathetic, timid, and docile peasant (Liu [1983]). Furthermore, if there is no democracy at the national level, then democracy will have a difficult time functioning at the local level (Bardhan [2001]). Throughout, small farmers remained powerless to obtain any degree of control over their operations. They have no means or interest in monitoring the cadres, so the cadres accumulated wealth in both legal and illegal ways.

The peasantry existed in an institutional straitjacket devised by the state to create dependence on the state. High-modernist designs for life and production tended to diminish the skill, agility, initiative, and morale of the peasants, and consequently the “human capital” of the work force was reduced. Authoritarian social engineering and social control measures damaged earlier social structures based on mutuality and social ties, and they undermined individual capacities
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for autonomous self-governance. While most subordinate classes throughout history have rarely been afforded the luxury of open, organized, political activity, they still had limited organizations and activities and some autonomy. In China, for example, the clan and the gentry played leading roles in determining the pattern and direction of organized village and public life. However, under collectivization these opportunities were eliminated. One impact of this change was that peasants increasingly became motivated to work the system to their minimum disadvantage.

After the communes were disbanded, market orientation and the deregulation of the economy changed the dynamics of rural life. Large numbers of small farmers are migrating to the cities to take off-farm jobs, and the difference between urban and rural household incomes is increasing. The new economy has led to a reduction in face-to-face communication, which is diminishing the trust and sense of community among the villagers. Social ties and interdependence are weakened by the development of commercial services as well. Both informal and formal co-operation occurs less, social capital is decreasing, and the villagers’ solidarity is further eroded.

As a result of the HCRS, which is characterized by a small scale of operation, most small farmers consume a large part of their output while selling a small amount of surplus of their produce occasionally. This means they have low frequency of transactions, make little investment in specific assets, and manage their risk by diversifying production. When independent small farmers are able to produce what is needed by agricultural processors and the rest of the supply chain, these transactional dimensions determine that markets are efficient governance structure of vertical transactions (Williamson [1989]). Thus, historically, the lack of a need to explicitly coordinate production meant that individualism dominated the psyche of small farmers, which in turn partially accounts for the low co-operation rates in many villages. As Fulton [1995] outlines, strong values of individualism can undermine the common property rights required for co-operation.

As discussed in chapter 3, strong co-operatives have developed where social movements have succeeded in creating a sense of obligation for people to support the co-operative (Fairbairn [1994]). In China, such social movements are not common. Thus most farmer groups have not incorporated modern co-operatives into their structures. As will be discussed in subsequent chapters, relying on personal benefit is often not sufficient to support co-operative formation.
In conclusion, the modern institutions that would make western-style co-operation possible are missing in China. Instead of strong horizontal relationships through mutual self-help and co-operation, a vertical patron-client dyad has developed as a personal security mechanism to which people resort when their security is in jeopardy and when impersonal social controls are unreliable. In this context, direct personal ties based on reciprocity – e.g., crony capitalism and the patronage system – substitute for law and mutual aid.

4.6 Summary

A review of China’s economic and political institutions revealed the strong presence of path dependence – i.e., developmental trajectories that are difficult to reverse. Although the three institutions – i.e., high modernism (as exemplified by collectivization), crony capitalism and patron-client structures – emerged at different times, strong historical echoes can be found among them. For example, although the “opening up” and the reform policies in China can be called “a revolution”, these policies were intended to keep intact as much of the original social structure as possible, while still modernizing the economy.

Although the reforms allowed business enterprises to become crucial actors in the economy, the power of the state remains strong. Indeed, China has neither the professional codes nor the legal system to provide sufficient assurance that outcomes will be fair; it lacks institutionalized trust. As in other authoritarian states, this assurance is difficult to provide, since the political institutions that can curtail the power of the state are lacking. The results is that the law on the books is not the same as the law in practice.

At the same time, in order for business to prosper and for economic growth to occur, it is necessary to find ways of ensuring that the key elements of a capitalist policy are put in place. These elements focus on the need for the various actors in the economy to coordinate their actions. While developed countries have tended to migrate towards one of two coordinating structures – the liberal market economy or the coordinated market economy – China has adopted an alternative.

China’s version of capitalism – “capitalism with Chinese characteristics” – is characterized by the importance of personal relationships in providing the trust that is required for the coordination
of the system. In this system, the state still plays a critical role in economic activity, and is typically a major blockholder. The “selectorate” are given special privileges (in the form of secure property rights) in exchange for their support. Since China lacks protection for minority shareholders, investors have also moved to blockholding forms of ownership. One manifestation of this blockholding structure is crony capitalism.

Not surprisingly, the blockholder ownership structure is found in agricultural co-operatives, and with it the practice of crony capitalism. Although the small farmers in rural China cannot participate in this structure, they do use patron-client relationships to mitigate some of its impacts and to take advantage of the (few) opportunities that exist.

In summary, individuals and organizations adapt to existing institutions – thus, if the institutional matrix creates piracy, then people will invest in becoming good pirates. In the case of China, the system called for organizations that governments and businesses could invest in and control. As a consequence, the law on farmer co-operatives was molded to provide just such opportunities. The structure of this law and the implications of this law for farmers are examined in the next chapter.
The Political Economy of Farmer Co-operative Development in China
Chapter 5

The Farmers Professional Co-operative Law

5.1 Introduction

As discussed above, agricultural productivity in China increased for a short period of time following the introduction of the HCRS in the 1980s. Shortly thereafter, small-holder farm productivity and incomes stagnated and farmers found it increasingly demanding to meet the standards of the modern supply chain that accompanied agricultural modernization. Policy makers began to prioritize strategies for increasing the organization of the farmers in order to address these needs. Policy makers understood that any strategy to develop modern agriculture in China must be compatible with the individualistic production system and small-scale agriculture that is pervasive in rural areas. These requirements made the rural co-operative a very attractive option for the state.

The experiences of western countries suggest that the creation of co-operatives was an important part of the development of agriculture. In these countries, co-operatives were typically formed by those experiencing difficulty dealing with economic change. Co-operatives were created because they offered a practical advantage in terms of economic ownership and a broader vision with a democratic framework.

This democratic aspect, however, was worrisome to Chinese officials. Since the People’s communes were disbanded in the early 1980s, the government has relaxed its economic control and given individuals, including farmers, more freedom to be creative and take initiatives that
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may reap economic benefits. Politics and political life, in contrast, are still banned. As a result, farmer organizations have been a sensitive topic for a number of years (CIDA [2008]).

Chinese small farmers are facing the same problems as their counterparts in Europe and North America did when these economies were being transformed into a capitalist production system. Research conducted in China suggested there be a strong justification for allowing farmer co-operatives to emerge and function within a formal legal framework. For example, this research suggests that when a co-operative lacks legal status its members are deterred from committing their resources to the organization (Chen [1970]) and it impedes the implementation of international co-operative principles (Feng [2004]).

The absence of co-operative law is also thought to result in a lack of clarity as to the rights and obligations of the organization’s members, which restricts the co-operative’s ability to engage in a number of activities. In addition, it is widely believed that legislation confirming the independence of farmer professional associations (FPAs) is necessary to protect them from undue interference in their operation by local authorities, enterprises or traders (World Bank [2006b]). Policy makers in China are good at researching the best practices of other countries and knowledge of co-operatives has been well circulated among the policy community.

However, laws express the outcome of political processes; in this broad bargain among the major players, some interest groups can impose their preferences on others and aggregate them into laws and policy outcomes (Gourevitch and Shinn [2005]). In Chapters 2 and 3, it was argued that there is an uneven allocation of political authority to elites and small farmers. The elites, including business owners and local government officials, want to use their social and political power to reinforce and consolidate their economic and political advantages. As a consequence, one of the key reasons for the FPCL is to provide the legitimacy that is needed for dragonheads and government officials to take control of these organizations. In short, the FPCL was introduced precisely so that these interest groups can retain their power – i.e., the FPCL is an endogenous outcome to the need by the powerful interest groups to further strengthen and legitimize their power.
Chapter 5. Farmers Professional Co-operative Law

The purpose of this chapter is to examine the structure and features of the FPCL that came into force in 2007 and to reflect how the law is a reflection of the existing institutions and power structure within Chinese agriculture and society.

5.2 Structure and Key Features of the FPCL

There are nine parts to the FPCL. Part I lays out the fundamental elements of a co-operative, including the purpose, definition and principles. Part II provides the details on what is required for an organization to be registered as a co-operative, including the bylaws and the documentation required. Part III encompasses membership regulations, eligibility for membership, and members’ rights and obligations. Part IV deals with the structure of co-operative governance, including general meetings and the Board of Directors (BOD). Part V outlines the financial management of a co-operative, including equity contributions of members and how the surplus of operations is distributed. Part VI stipulates the rules regarding merging, splitting, dissolution and liquidation of a co-operative. Part VII describes government support policy measures such as direct fiscal support, tax breaks, and other privileges provided for co-operatives. Part VIII is concerned with legal liabilities, including punishment for those who break the law. Part IX states when the law comes into effect.

Part I of the law is entitled Interpretation and Application. It stipulates that this law is the principal law with which all other co-operative legislation or regulations made by sub-national governments must comply. This part defines the farmer co-operative as a voluntary and self-controlled organization of agricultural producers. Farmer co-operatives are focused on satisfying the needs of their members. In addition, this part states that co-operatives must follow government directions concerning industrial policies.

Farmer domination of co-operatives is quoted as one of the co-operative principles. Other principles laid down in law include: the purpose of the co-operative is to serve the common interests of members; members should join and exit the co-operative voluntarily; all members are equal and the co-operative should be democratically controlled; and surpluses should be distributed on the basis of patronage.
Other persons and institutions who use and provide services and products from the same agricultural business operation can join the co-operative, but their numbers have to remain a minority. The FPCL allowed co-operatives to receive government grants to be used as reserve funds or for equity. Members’ liability is limited to their financial stake in the co-operative, which includes their equity contributions and reserves credited to their personal account. All equity and reserves are divided and kept under each member’s account.

The FPCL states that all government agencies are to protect the lawful rights and interests of farmer co-operatives. Furthermore, agencies are expected to assist co-operatives in accessing funds, banking services, technical assistance, and programs for human development. The government agencies must provide directions on the industrial polices that co-operatives need to follow. The law also stipulates that agricultural bureaus and line agencies should provide support and services for the formation and development of farmers co-operatives.

Part II of the FPCL is entitled Incorporation and Registration. This part outlines the requirements for organizations to register as a co-operative, and details the documents that should be provided to the registrar. This part states that the minimum number of founding members to begin a co-operative is five. The requirements that must be included in the bylaws of a new farmer co-operative are articulated and include membership, members’ rights and obligations, and the redistribution of operation surplus.

Part III of the FPCL is entitled Members. This part begins by stipulating who is eligible for membership in a farmer co-operative. A broad spectrum of persons and institutions engaged in various activities can be members, provided that they can use the services offered by the co-operative. Agencies with public administration functions are prohibited from membership. The law also stipulates that at least 80 percent of the co-operative members should be farmers, a clause which guarantees the predominance of farmers in all professional co-operatives. Restrictions on the number of institutional members is calculated based on the size of total membership in the co-operative. In addition, lists of member obligations and rights are made. In a provision dedicated to voting rights, it is stipulated that members with the largest share of patronage and capital contributions can have as much as 20 percent of the vote.
Part IV of the FPCL is entitled Organizational Structure. This part outlines how decisions are made within the co-operative. The general meeting is where the top decisions are made. A general meeting agenda is provided in this part for co-operatives to follow. In order for decisions to be made, a quorum must exist at the general meetings, which is fixed in the law as the presence of two thirds of all members. The voting process is also stipulated. In order for an election or a resolution to be made, half of the votes cast must be in favour. Co-operatives with more than 150 members may call delegate meetings instead of general meetings of all members.

This part also deals with the election of the board of directors (BOD) and the supervision committee (SC) and clarifies their relationship to one another. The members of the BOD and SC are elected at a general meeting. Part IV stipulates that the board of directors can hire managers to run the business of co-operative. It also provides a list of acts the board of directors and managers must not undertake, including fraud, breaches of trust, and conflicts of interest. It also outlines how funds cannot be used and which property cannot be disposed. It is made clear that government officials cannot be members of the board of directors or supervision committee at the same time as they hold a management position in the co-operative.

Part V of the FPCL is entitled Financial Management. This section states that the Finance Department of the State Council will develop the accounting practices for co-operatives. At the individual level, the board of directors from each co-operative should prepare the financial statements and create the plans for the allocation of surpluses and are responsible to present these to their co-operative at a general meeting.

The allocation of surplus is outlined as follows. The first use of a surplus is to immediately pay off deficits. Some of the surplus can be retained as a reserve, while up to 60 percent of the remaining surplus can be allocated to members on the basis of patronage. The rest of the surplus can be credited to each member’s account by computing the proportion of each member’s capital contribution, reserves, government subsidies and other grants. This part also stipulates the purpose of the reserves, emphasizing that they should be credited to each member’s account. According to the FPCL, each member’s account should include their equity contribution, reserves, and patronage of services and goods. This part of the law also states that an internal audit should be conducted, and that external auditing is optional.
Part VI of the FPCL is entitled Merging, Split, Dissolution and Liquidation. This section states the reasons that a co-operative may be dissolved. It also stipulates how the liquidator should be appointed and the rights that the liquidator can exert, in particular, regarding the disposal of assets. It also clarifies how leftover government grants and other support should be dealt with.

Part VII of the FPCL is entitled Support Policy. It states that the state entrusts the farmer co-operatives to implement rural and agricultural development projects. Central and local government are asked to provide support to co-operatives to help them gain access to funding, services, markets, knowledge, and new technologies.

This part urges state banks to provide credit to co-operatives and encourages commercial financial institutions to provide various financial services to them. In the law, farmer co-operatives can receive tax exemptions on agricultural production, processing, marketing services, and other farming activities.

Part VIII of the FPCL is entitled Legal Liabilities. This section deals with the people and the activities that violate the interests of co-operative. It also stipulates how fraudulent behaviours during the incorporation of the co-operative should be dealt with.

Part IX of the FPCL is entitled General. The section indicates when the FPCL comes into effect.

5.2.1 Co-operative Law Comparison

The structure of the FPCL is similar to the co-operative law in other countries, and particularly those in the West. For example, Canadian co-operative law the following parts: Part 1 – Interpretation and Application; Part 2 – Incorporation; Part 3 – Membership and Voting; Part 4 – Finance; Part 5 – Association Alternations; Part 6 – Management; Part 7 – Auditors; Part 8 – Records; Part 9 – Court Proceedings and Investigations; Part 10 – Dissent; Part 11 – Special Purpose Association; Part 12 – Extraprovincial Associations; Part 13 – Continuation, Amalgamation; Part 14 – Winding up, Dissolution and Restoration; Part 15 – Offenses and Penalties; and Part 16 – Administration (Government of Canada [1999]). These parts correspond very closely to those in the FPCL.
5.3 Development of the FPCL

The co-operative law contains elements of agricultural policy to foster the agricultural and rural economy (Part VII, Part I sections 1, 8, and 9). Farmers co-operatives are legislated to be controlled by producers, service providers, and agribusiness operation users (Part I.1). This legislation omits the possibility for small farmers to empower themselves and control a co-operative for their mutual advantage.

It appears that legislators were not concerned that the heterogeneity of co-operative members would perpetuate imbalances of power and conflicts of interest that distribute the burdens and benefits of collective decisions unequally amongst members. This inequality can be evidenced by the differing effects that decisions have on members that occupy different stages of the supply chain.

Most of China’s national-level policies are devised by an educated and well-informed group of policy makers at the central level with exposure to international concepts such as farmer co-operatives and their role in agricultural production and marketing. And, as discussed earlier, many policies are rolled out in selective areas on a trial basis; if the policy is successful, it is then applied to the whole country.

In the case of the national co-operative law, the policy makers were very cautious about allowing farmers to organize themselves collectively. Heavy pressure to restrict collective action came from both central and local officials that were concerned that farmer groups may become a political force that could threaten their authority. Hence, only two provinces (Liaoning and Zhejiang) were asked to act as provincial pilot projects to test farmer co-operative legislation. Several drafts of the farmer co-operative law were prepared and circulated among governments at the national and sub-national levels. The China’s Farmers Professional Co-operative Law (FPCL) was passed in November of 2006 and was enacted in July of 2007.

When the new law on farmer professional co-operatives came into effect it provided a legal basis for much of the group action that farmers were already taking either informally or under various, often local, regulations. Most of these groups were in the habit of providing documentation and registering with various authorities according to local regulations. The agricultural
bureau, the Science and Technology Association, and the Civil Affairs Bureau all acted as registrar’s offices, and had their own regulations based on their interpretation of the distinct features of each co-operative organization. Legally, however, the formation of these earlier co-operatives occurred in a vacuum. The FPCL now designates the Industry and Commerce Bureau as the sole registrar’s office.

A history of policy pronouncements advocating support for farmer associations dates back to the early years of the economic reforms. A Central Committee document, entitled Several Questions of the Current Rural Economic Policies from January 1983, proposed that various forms of co-operative economic organizations should be developed to meet the needs of agricultural production (Chen [1970]). This position was further elaborated in another Central Committee document of January 1984 that urged the supply and marketing co-operative system be reformed into co-operative entities owned by farmers.

The document, Deepening Rural Reform, issued by the Central Committee in January 1987, stated that supply and marketing co-operatives should organize with producers to establish professional production associations on the principle of voluntary participation and to set up specialized co-operatives according to the principles of co-operative business (Chen [1970]). Finally, The Standing Committee of the 10th National People’s Congress (NPC) formally accepted the drafting of a “Law of Farmers Co-operative Economic Organizations” into the agenda for drafting legislation in December 2003. The law was under preparation since 2004 and was finally passed by the NPC in November of 2006.

Co-operative legislation provides the legal framework for collective action to occur. It is important for a number of reasons. First, a formal legal structure provides associations with the ability to enter into contracts and to borrow money. Second, by determining the basic organizational features of producer associations in legislation, the legal framework can ensure that agricultural producers are provided with ownership and control. Third, the presence of a legal framework also provides legitimacy to producer associations as bona fide organizations. Fourth, legislation sets out the fundamental elements of a co-operative association that distinguish it from a profit making company (Ish [2005]).
The lack of a legislative framework before 2006 gave room for actors to behave opportunistically, basing their actions on their interpretation of the farmer co-operative and their own interests. As Bardhan [1989] has suggested, the situation appears to be one where the bureaucracy wanted a secure flow of rental income they formed a pressure group, with much narrower goals than the state elites, to get it. Generally, the bureaucracy is more concerned about their own authority, budget, and workforce and how they may be affected by a policy change. In China, where the government has formidable power in allocating resources, these concerns are particularly true.

At the central government level, various departments, such as the Ministry of Agriculture (MOA), Ministry of Civil Administration, State Administration for Industry and Commerce, Science and Technology Association, and the All China Federation of Supply and Marketing Co-operatives (ACFSMC) have all been involved in the administration and support of farmer organizations. It is a competition between departments for the allocation of regulating power and related resources from the central government. Organizations such as the Women’s Federation and Technical Association have taken initiatives to establish and support farmer organizations and to secure bilateral and multilateral donors. Farmer associations that are responsible for managing natural resources, some of which may also undertake economic activities, come under the jurisdiction of agencies such as the Water Resource Bureau and Forestry Bureau.

The two major departmental rivals competing for the opportunity to be the co-operative regulatory body are the ACFSMC and MOA. For ACFSMC, this assignment is crucial to its legitimacy and its survival.

In the 1950s, Supply and Marketing Co-operatives (SMCs) were formed to provide services to farmers, allowing farmers to make joint input purchases and better market their produce. The SMCs were owned and controlled by farmer members. However, the SMCs were overwhelmed by the collectivization drive of the late 1950s and were subsequently subsumed into the People’s communes. During the collectivization period, the status of SMCs as farmer-owned and -operated organizations was lost. They came to be considered simply as another branch of government in which decision making and provision of services was highly centralized and hierarchical. More recently, with market deregulation, many SMCs are vanishing.
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It is common that organizations created by social movements persist longer than the movements themselves, and gradually grow to take on a life of their own. As the vision and praxis of the movement fades, the organization will continue and become increasingly concerned with organizational self-interest (Develtere [1992]). Such seems to be the fate of the SMCs.

To entrench its interests, between 1995 and 1997 the ACFSMC proposed drafting a “Law of Supply and Marketing Co-operatives,” but this attempt was abandoned when the ACFSMC system began a process of internal reforms. In 1999 the ACFSMC again submitted an application to the State Council requesting that legislation be drafted to cover supply and marketing co-operatives, and in 2002 the request was broadened to involve a more general “Law of Co-operative Economic Organizations.”

China’s MOA’s mission statement deems it the sole government body authorized by the State Council (i.e., central government) for governing rural and agricultural development. It was natural that MOA wanted to be the sole regulating body of farmer co-operatives. In particular it was MOA’s Department of Co-operative Economy Management and Guidance (DCEMG) that used to administer the Rural Economy Management Stations at the township level across the country. However, with the collapse of the extension system, including the township stations, the DCEMG was looking for new business to conduct under its umbrella.

The FPCL is the result of internal debates, negotiations and comprises made between ministries and sub-national governments. The infighting between MOA and the ACFSMC penetrated the legislative process, and resulted in a prolonged process and with many resources distracted from their target. Departments skewed studies by recommending their own best samples of farmer co-operatives to be examined by the legislative teams. Furthermore, attempts were made by departments to influence legislative team members into writing clauses that would bolster their own interests.

When the law was eventually passed, the registrar for farmer professional co-operatives was located in the Industry and Commercial Bureau. As well, the State Council did not clarify which government body would be the regulating body for farmer co-operatives.
5.4 The Endogeneity of FPCL

As outlined in Chapter 3, the experience of other countries has shown that the development of a legal framework for co-operatives has followed two quite separate paths in the developed world and in developing countries (Su [1989]). In developed countries, co-operative legislation was introduced to allow the formation of organizations that had the potential to alter social and economic power relations. In developing countries, legislation was often introduced to allow existing groups, and most often the state, to exert additional control over a particular group of people.

The legislative process that the FPCL took falls into the experience exhibited by many developing countries. Since “institution winners” are in a position to impose rules on others, institutions, and the employment of power for which they allow, are self-reinforcing through the persistence of rules, beliefs, and norms. The direction of institutional change is thus path-dependent (Greif and Latin [2004]), with the institutional elements that prevailed prior to the introduction of a new institution being incorporated into the new institution.

The development of a legal framework in China for the formation and operation of farmer co-operatives is, in this sense, an endogenous response. The form and nature of co-operative legislation is a reflection of the institutions and power structure that was in place. In addition, the form and nature of the legislation is also a response to the problems that need to be addressed in agriculture, namely the industrialization and modernization of this sector. The co-operative sector is thus considered part of an overall agricultural development strategy, and part of a planned process by the state. Indeed, co-operatives have gained governmental support because of their potential use for, and the international merit associated with, organizing agricultural production and developing markets.

Although the FPCL has a structure similar to that of the co-operative law in western countries, the way in which this structure is used is very different. For instance, one of the FPCL’s purposes was to ensure that previously developed structures, like the C+H model, would be continued. The FPCL also had to foster agricultural industrialization.
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To achieve these goals, the law allowed co-operative membership to be open to citizens, firms, government-affiliated agencies, or any entity that is engaged in an activity associated with a farmer co-operative (see Part I, 2 and Part III, section 14). By allowing for a heterogeneous membership, the FPCL allows the co-operative structure to be used as a way of integrating the dragonheads and the farmers à la the C+H model.

As expected, the ownership form that is taken is that of blockholding rather than diffused ownership. As discussed in Chapter 4, diffused ownership emerges in a situation where there is strong protection of minority shareholders and effective rules for product-market competition (Gourevitch and Shinn [2005]). Thus, it is to be expected that western-style farmer co-operatives have been strong in countries that have strong minority shareholder protection and are characterized by liberal market economies (LMEs) – e.g., United States and Canada. Co-operatives have also been strong in countries characterized by centralized market economies (CMEs), providing the economic and political system is one that allows farmer groups to participate as one of the major blockholders – e.g., as in Denmark and Sweden.

In contrast to countries like Denmark and Sweden, however, the blockholding found in co-operatives in China does not allow farmers to participate as one of the major blockholders. Instead, the blockholders are those found in other business enterprises – namely government and business leaders with strong links to the CPC and the state.

5.4.1 Maintaining Social and Political Control

In the West, agricultural co-operatives were typically formed by farmers as self-help groups to further their own interests. In China, in contrast, co-operatives developed with a strong governmental presence. The FCPL legislation was deliberately scripted to provide an organizational form that would support the government’s agricultural policy goals. The government also built in a role for itself to provide direction and support to co-operatives, and also to retain capacity for regulation. The command and control, or top-down, approach adopted by the state is evidenced in the development of farmer co-operatives.

It first must be noted that the FPCL has a structure similar to that of the co-operative law in western countries. Indeed, national-level agricultural policy advisors expressed the intention
to establish Chinese co-operatives in accordance with international norms. The FPCL formally
ergonized the legal status of farmer co-operatives and is in some ways consistent with the
internationally recognized co-operative principles of the International Co-operative Alliance
(ICA) (Munkner [2006]).

But a study of the FPCL indicates that the state has deliberately imposed organizational
blueprints on the co-operatives that subsume classic co-operative ideology and visioning. First
off, the FPCL can be viewed as an agricultural policy document. For instance, the FPCL indicates
that the purpose of the legislation is “…to foster the agricultural and rural economy” (see Part
I, section 1). The FPCL also indicates that government will provide support for co-operative
development – e.g., “The state will provide financial support, tax breaks …human resources …”
(Part I, section 8) and “The central and local government should provide funding to co-operatives
…. ” (Part VII, section 49).

These policy directives result in sanctioned government involvement in the promotion, di-
rection, and control of farmer co-operatives. It is stipulated that co-operatives should follow
government industrial policies to achieve agricultural industrialization and modernization. In
contrast, the traditional purpose of co-operatives, to promote the social and economic interests
of its membership, is not defined or made explicit.

The FPCL states that the government entrusts farmer co-operatives to implement the state’s
rural and agricultural development projects (Part VII). Experience in many countries has in-
dicated that it is often a mistake to use the co-operative model as an instrument for policy
implementation. Once the government has taken the initiative to establish, fund, and support
coop-operatives, it has an incentive to guide and intervene in their management and operation. The
end result is that co-operatives will grow dependent on government intervention.

Co-operatives in China are not independent, nor do they operate as voluntary self-help orga-
nizations controlled by their members. These factors directly undermines their business viability
and the members’ sense of ownership and commitment. Moreover, state control may result in
resources being turned over to privileged business interests as a result of both political and tech-
nical factors. In this way, the distribution of credit, agricultural extension services, access to
markets, and land are heavily biased against small farmers.
Due to the lack of checks and balances at the local level, the patronage system is pervasive in the countryside. Public funds are diverted from their ostensibly intended purposes to be used for lubricating the patron-client structure. Corruption occurs at all levels. The shift of the taxation base from farmers to businesses has increased the need for local government officials to build close ties with businesses to demonstrate their superior performance and gain government support. Some local officials have direct or indirect ownership of these businesses, as discussed previously.

Various government measures were taken to protect and promote the growth of agro-businesses because of their potential to contribute to GDP growth and tax revenues. Co-operatives are a reliable taxation base that can provide an increasing income for businesses and local leaders, and solidify their market position. Local elites often force small producers to be members of co-operatives, since once a majority of small farmers have joined, the agro-processors have a monopoly position and can then establish barriers for new and potential competitors. This advantageous position allows the business to earn and secure greater profits due to lack of competition. In other words, a monopolitistic processor will generate a more reliable tax income for the local government, as well as greater opportunities for the collection of bribes.

Officials responsible for co-operative policy implementation often work with a limited understanding of the principles of co-operatives; they also work within traditional government structures where “instructing farmers what to do” is the norm. In the eyes of the government, farmers lack capital, business knowledge, and experience. Farmers are poorly educated and hopelessly backward, and because their land is small and fragmented, it is very hard for them to adopt innovative measures.

With this perspective in place, small farmers become objects that the government uses to manage, transform, and implement their plans. To manage the farmers, the government needs to take over the responsibilities of promoting and supervising the co-operatives, registering them, supervising their operations, and guiding their formation and organization. According to a survey by Shen, Rozelle, and Zhang [2005], 84 percent of farmer organizations were formed as a requirement of higher-level officials (see table 5.1).
Officials, eager to capitalize on the government’s formidable power to allocate resources, promote their farmer organizations with official documents and other support and intervention measures. These practices, facilitated by the co-operative law, are a source of funds, services, markets, knowledge and new technologies to farmer organizations (Part VII, section 50). Furthermore, state banks and commercial banks are encouraged to provide credit to these organizations (Part VII, section 51).

Experience in many countries, especially in developing countries, has shown that direct financial support from public funds can do more harm to co-operatives than good (Munkner [2006]). In China, due to imbalances of power, the bulk of the benefits available to co-operatives are being annexed by the more influential and powerful groups. Many “false” co-operatives are formed to take advantage of government support measures and end up becoming the major recipients of financial and other supports, leaving legitimate small farmer self-help groups excluded.

Farmers, with no tradition of democratic decision making, limited education, and a habit of submissively complying with instructions issued by the government, often become passive participants in the process of creating farmer co-operatives. Co-operatives formed by government agencies cannot become self-reliant, self-help organizations. Their situation of dependency is not replaced by self-reliance, and their dependence on others is perpetuated by the new organizational frameworks offered by the co-operatives.

Moreover, to prevent the farmers from organizing to gain political power, the government strictly limits the activities of farmers groups to economic functions. The function of co-operatives for claim and advocacy activities is totally ignored in the Law (see Part I, section
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1). It is believed that it is impossible for farmer groups to be engaged in social and political participation or the allocation of public resources. Many local officials see farmers organizations as a threat to their authority, and fear that, once organized, farmers will immediately fall into an antagonistic relationship with local authorities (CIDA [2008]).

The FPCL only deals with primary co-operatives (part I, section 2). There is no mention of the power of co-operatives to federate according to the principle of co-operation among co-operatives. Apex co-operative organizations play key roles in the sustainable and healthy development of co-operatives. According to MacPherson [2007] their key roles include preserving and enhancing identify, education and training, information provision, government relations, movement expansion, strategic development, business development and association with like-minded organizations.

5.4.2 The Continuation of Agricultural Industrialization

From top state leaders to local officials, government has given overwhelming attention to fostering and accelerating the industrialization and modernization of agriculture. The development of farmer co-operatives is one of the measures intended to foster the vertical coordination of the agri-food production system using China’s existing farming system. Co-operatives are viewed as one way to coordinate the production efforts of many small producers, and to ensure a consistent supply of quality products to agro-processors.

In the name of agricultural modernization and industrialization, local governments work closely with business groups to pressure farmers to form co-operatives. In particular, the company + co-operative + households (C+C+H) model is promoted. The C+C+H model is a farmers’ association in which the leading company, who is usually a processor, plays a central role in forming a co-operative, and small households become members by signing contracts to sell their produce to the company.

There are two key implications of the FPCL for agricultural industrialization. On the one hand, the FPCL provides a legal framework for the formation and operation of farmer co-operatives, thereby creating the opportunity for farmers to improve their income earning potential. Since a farmer self-help group is recognized as a legal business entity, it is thus able to perform basic...
representative tasks, like signing contracts and handling financial accounts (Part I, section 4). Thus, if business opportunities are available that farmers could collectively benefit from (e.g., from pooling resources or engaging in value-added operations), then the co-operative provides a structure whereby such activity could be undertaken. The financial role of co-operatives in channeling funds to members on the basis of use is also recognized in the context of taxation and prevents the double taxation of proceeds (Part VII, section 52). However, when farmers decide to work together and form a democratically controlled self-help groups, there is little guidance and information available to them that identifies the best practices that will ensure their interests are realized.

On the other hand, the FPCL allows different forms of organizations to be registered as co-operatives (Part III, sections 14, 15, 17). Some of these organizations strategically carry the name of co-operative and do not adhere to the key principles of co-operatives. Thus, these co-operatives need not be owned and controlled by farmers; instead, they are often being hijacked or captured by the business elites.

Government officials often have a limited understanding of co-operative principles and how co-operatives are distinct from other forms of business. Therefore, the term “farmers organization” is used in common parlance to describe a variety of organizations with different organizational arrangements, including organizations led by the government, those created by dragonhead enterprises, and those practicing “order form farming” (World Bank [2006b]). Co-operatives in these latter groups were established to maintain existing economic and social relations and structures, and to introduce farmers into the vertically coordinated supply chain controlled by business groups.

When the state legislated the FPCL it adopted a flexible – even lenient – definition of co-operatives. As a consequence, an opening was left for opportunists to exploit the organizational form by promoting the development of what could be termed “false co-operatives.” Under the FPCL, a broad spectrum of persons and institutions engaged in activities associated with co-operatives can become members, provided they can use the services offered by the co-operative.

The heterogeneous membership of co-operatives allowed for in the FPCL is an endogenous structural response used by the government to ensure that the historically developed C+H struc-
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ture for agricultural production continues. It is an endogenous response because the terms of the FPCL appear to be have been specifically developed in response to pressures from within the agricultural system and the larger political system. These terms also allowed existing practices and power relations to be continued.

Armed with the new FPCL, profit-seeking entrepreneurs are able to adopt the title of “farmers co-operative” and use it as a “flag of convenience” to help ensure a reliable supply of raw materials. Particularly when financial incentives by way of government grants or tax exemptions are available, it can be expected that innovative and pragmatic designs for farmer organizations will be devised by profit seekers.

A diversity of membership is common. In most organizations members include individual farmers, representatives from enterprises, government agencies, people from research institutes, traders, and others within a single co-operative or association. Moreover, it is not uncommon for non-farmers to lead farmer organizations. In fact, small farmers do not play any leadership role in professional farmers’ associations.

The control that small farmers and producers should have on account of their majority membership in the co-operative is being marginalized. Although the FPCL states that no less than 80 percent of the members should be farmers (Part III, section 15), the law cannot guarantee the predominance of farmers in the decision making process due to the imbalances of power that persist. Indeed, directly to the disadvantage of small farmers, the law stipulates that members holding a larger share of capital contribution and patronage can claim as much as 20 percent of the votes (Part III, section 17). This clause makes it possible for a minority of investors to control the whole co-operative.

While some Chinese commentators note that the interests of farmer members should be at the heart of farmer co-operatives and that they should promote the principles of democratic control, equal economic participation, and the redistribution of benefits in proportion to patronage, these commentators also suggest that there is a need for a variety of organizational structures to be developed. Indeed, they argue that a one-size-fits-all approach should not be followed during a period of transition (Zheng [2006]).
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Commonly, it is local enterprises that take the initiative to create farmers organizations, and then utilize their enterprise managers or company staff to sit on the management board. The FPCL approved the legal status of co-operatives with multi-stakeholder structures such as the company + households model. However, the procedure of allotting votes to classes of members is not clearly spelled out (Munkner [2006]).

Leading enterprises that ran a C+H model of production were strategically positioned to take advantage of the opportunity to institutionalize their power by transforming into a C+C+H model. Under the C+C+H model, the co-operative is initiated by the company who looks to ensure a consistent supply of quality products, reduce costs, build linked markets to appropriate profits, acquire farmers’ land, and take advantage of various government grants and support programs.

While they could achieve these objectives as a C+H entity, with the introduction of the FPCL there is now a legal framework for their operation as a C+C+H organization, and they can register as a legal entity. Since the introduction of the FPCL, government granting privileges have been linked to legalized farmer co-operatives (Part VII). This has lead to the development of false co-operatives, formed exclusively for the purposes of benefiting from such privileges including grants, subsidies, tax exemptions, access to markets, and technical information and training.

Although small producers account for the vast majority of co-operative membership, real control rests with the company that provides most of the capital investment and operating expenses. The president of the company usually assumes the post of co-operative director. One of the most common ways of exercising control over the farmer co-operative is for the director to replace the general meeting of members with a meeting of delegates.

As the law stipulates, a co-operative with more than 150 members may introduce meetings of delegates to replace the general meeting of members (Part IV, section 25). This number appears to be low compared with the co-operative laws of other countries, for example in Germany a minimum of 1,500 members is required to move to a meeting of delegates.

In China, this clause deprives the majority of members of their main membership right – the right to have direct participation in the management and the key decision-making processes of their co-operative. Furthermore, the selection process of delegates is not transparent and is
usually manipulated to the company’s advantage. Usually the delegates are those who have close ties with the management of the company and are appointed by them directly.

Another deficit of the FPCL is that it under-regulates transactions between members and non-members. The law only goes so far as to stipulate that co-operative managers must keep separate accounts for transactions with members and with non-members (Part V.34). However, the volume of business with non-members is not restricted as it is in other countries like the United States where business with non-members cannot outweigh business conducted with members. Undoubtedly, this leniency in China makes exploitation easier for C+C+H co-operatives.

A further deficit of the FPCL is that it does not require the appointment of an external auditor for the auditing of the co-operative. External auditing is only an option rather than an obligation. According to Munkner (2006), in co-operative law it is international standard practice to define the powers and duties of external auditors, as well as the scope of the audit and the minimum contents of the audit report. In particular, the external audit should assess the performance of the Board of Directors and management in meeting the objectives of the co-operative and their member-oriented effectiveness. An external audit is critical to ensure that the co-operative is acting in the best interests of its membership.

In addition, co-operative values and principles are under-regulated by the FPCL and the government registrar’s office. It is common for a local authority to play a strong role in the formation of a C+C+H organization. Local authorities typically have little if any knowledge of co-operative principles and values, and thus are not in a position, even if they were so inclined, to insist on these principles being followed.

5.5 Concluding Comments

In summary, the purpose of the farmer co-operative legislation is to legitimize organizations created by agribusiness to foster agricultural industrialization and coordinate the supply chain. Although the structure of FPCL is similar to co-operative laws in other countries, including the West, co-operative values and principles which distinguish co-operatives from other forms of business are under regulated. Moreover, the flexible legal framework for farmer co-operatives
allows for a heterogeneity in membership, giving room for enterprises and local authorities to manipulate the structure to their advantage at the expense of small farmers.

The result is that the FPCL fails to provide an enabling environment for the development and success of co-operatives owned and controlled by farmers themselves. On the contrary, as the examples of co-operatives examined in the next chapter suggest, small farmers are under represented, the burdens and benefits of decisions are shared unequally, and conflicts of interest constantly arise among the different membership groups. Consequently, co-operatives initiated and controlled by agribusiness (C+H) and big households dominate the co-operative sector. In these organizations, due to various constraints, asset-poor farmers are in a disadvantaged position to make the necessary moves to exert their governance rights.
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Chapter 6

Forms of Farmer Co-operatives

6.1 Introduction

Previous chapters of this thesis have reviewed the historical development of co-operatives in both China and elsewhere in the world. The particular concern of this chapter is to understand the philosophies and practices of contemporary Chinese farmer co-operatives by drawing on primary and secondary research. The structure of power within co-operatives that determine who owns and controls the organization is illuminated based on a number of co-operative examples.

This chapter is organized into two parts. The first part examines the two general forms of development that farmer co-operatives have taken. The first form of co-operative is the spontaneous or self-help group created by farmers to meet their common needs. This form of co-operative, while similar to the co-operatives typically formed in the West, has been largely marginalized in China. The second form has evolved from the company + households (C+H) model of the co-operative. These are initiated and controlled by a privileged group and favoured by the local authorities. These two types exemplify the dichotomous development paths that farmer’s organizations have taken in China. It is expected that they can also provide a lens for viewing the role of the co-operative in the vertical integration of agricultural production in China, and the balance of power between supply chain members.

The second part of the chapter presents a series of examples to illustrate the diversity of farmer co-operatives that exist under the C+H model. Representative co-operatives are examined
to show their business purposes, governance strategies, and benefit structures. These examples demonstrate graphically the similarities and differences among co-operatives.

The C+H co-operative model can be divided into various sub-models. These include: big households, leading enterprise + households, company + co-operative + households, and investor-owned firm (IOF) + co-operative. Privileged groups choose to form co-operatives to exploit them for personal ends if they know they can take advantage of local variations in the competency and organizational capacity of competitor companies (defined by size, market power, political power, market structure, ties with government, and available capital). Advantages can be gained by creating a co-operative to help vertically integrate, maximize their own values, and increase or institutionalize power.

### 6.2 The Dual Development Path of Farmer Co-operatives

The Chinese government holds formidable power over the social and economic life of its citizens. The emergence and survival of any organization is determined largely by the support and encouragement of the government. In China, the development of co-operatives has taken a divided path, in part due to mixed support from government officials. On one path, the C+H models of co-operatives have become local authority favourites and are predominantly the major recipients of government support and programs. On the other path, the self-help farmer groups have been stifled by local authorities and continue to struggle with enormous obstacles that marginalize them. The first part of this section discusses farmers’ self-help group actions by reviewing the developmental progress of several farmer groups. The second part examines the purposes, strategies, and structures of several C+H co-operative sub-models.

#### 6.2.1 Self-Help Farmer Co-operatives

Although the discussion to this point has focused on co-operatives derived from the C+H model, there are some self-help co-operatives that have been organized. These associations, however, are small and generally exhibit a low degree of formal organization. A rough estimate, based on a large village survey (Shen et al. [2005], 2004), suggests that the average membership of an independent association is less than 50 households. Furthermore, they are based on informal
co-operation. This informality reveals that members try to avoid and minimize the costs of ownership, such as internal governance and bureaucratic red tape.

Two examples provide a sense of the form that these associations take. The first example is of a group of green onion growers in Yuanmou, Yunnan Province that formed a Green Onion Association, headed by a technically competent farmer. The association’s only activity is to send their leader to visit the vegetable wholesale market, study the market trends, and inform the members as to the most profitable varieties of green onions to grow. There are no membership fees, no bylaws, and no board of directors (BOD). The head of the association pays his own traveling costs, and in exchange the members go to his field and take care of his crops. This co-operative is in a primitive stage of development, but it works for the members. The number of farmers that are members of the Green Onion Association is expanding, as is the amount of area dedicated to growing green onions.

Another example of a self-help group is a group of chicken farmers in Gannan, Jiangxi Province that formed what could be called an informal bargaining association. Before the association was formed, the chickens were purchased by traveling traders who usually forced down the price and under-graded the chickens. Furthermore the unreliable nature of the market prevented farmers from expanding their production. These farmers then formed a Chicken Producers Association (CPA). Instead of using joint marketing, the CPA signed a contract with a trader. The contract stipulated that the trader could not sell the chickens at the wholesale market in Guangzhou for more than RMB 0.6 per kg more than he purchased them for from the CPA. The director of the CPA had the job of monitoring the wholesale price of chickens in Guangzhou to ensure that the trader complied with the contract. Although the work of the association is modest, it appears to function well.

There are a number of reasons why these self-help associations are small and have a low level of organization. One reason is that Chinese farmers lack a history and culture of working together voluntarily to grow and market their products. The small scale of farm operations and a tradition of subsistence agriculture have led to most produce being grown for self consumption. Small amounts of marketable surplus are sold at nearby on-the-spot markets. This means that coordination of production and marketing are not necessary and should even be avoided.
Small-holder farmers give top priority to security, and manage their own risks by diversifying production.

For individual Chinese farmer households, agricultural co-operation means sacrificing some of their managerial sovereignty over their farming operations in favour of collective management. The sacrifice can be justified as a way to promote the common well-being amongst the group of farmers (Dore [1971]) or to generate benefits for the individual that would not otherwise be attainable if farmers were to act on their own. But many small farmers in China are very reluctant to sacrifice their sovereignty. This may be due to the prosaic but persistent struggle between the peasantry and those who seek to extract labour, food, taxes, rents, and interest from them (Scott [1985]). This legacy of appropriation and exploitation generates distrust and fear among the small farmers who usually cannot exert their economic, political, or civil rights (World Bank [2007] and CIDA [2008]).

When the patron-client structure is used to analyze farmer co-operatives, it becomes clear why these organizations, in many instances, do not follow generally accepted co-operative principles and practices. The structure of village power and the pre-existing social stratification imposed by the patron-client networks influences co-operative development. As a result, farmer groups are predominantly controlled by the rural elite instead of being democratically controlled by small producers.

The existence of a patron-client structure provides a partial explanation for the very modest and low-level co-operation among small farmers. Local authoritarian leaders have suppressed group life in order to maintain social order. These restrictions led to the rise of powerful clans and groups that dominate the social structure. Farmer co-operatives have the potential to provide a new structure of leadership to rival clan dominance, ultimately leading to losses in power and prestige (Faki and Taha [2009]). However, in reality this outcome does not occur; instead, farmer groups are frequently initiated and controlled by powerful clans or by village or township leaders.

Government and other power holders view organized farmers as a threat to their authority and thus are often unwilling to let farmer groups operate independently (CIDA [2008]). As a result, leaders of farmer self-help groups typically wish to keep their co-operation informal.
Chapter 6. Forms of Farmer Co-operatives

The leaders of informal groups understand that their investments in the group are vulnerable to appropriation and control by the power holders; as a result, they keep their investments opaque, work the system to minimize the risks, and lower the profile and visibility of their group’s activity. Otherwise, their groups would be in the radar of power holders, who either will work out ways to appropriate the small farmers’ wealth or to block the group’s activity, so that even the space for information co-operation is removed. As an example of the tactics used, when a farmer credit co-operative wanted to register in the registrar office, the local police station asked it to install security system in its office, the cost of which outweighed the total equity contribution made by the members.

Market factor is crucial to farmers co-operation as well. As a result of the changes underway in the modern supply chain, farmers are no longer in a position to choose the attributes of the farm products they produce, nor can they act as the residual claimant. Instead, the input suppliers and processors that are providing market outlets, monitoring production, and supplying key inputs are the residual claimants (Fulton [1995] and Hobbs and Young [2001]). This need for control is a further reason why these other participants in the supply chain often form and control farmer co-operatives.

The small size of farmers relative to the size of the market is an additional factor in the absence of farmer-led agricultural co-operatives. At present, there are some NGOs actively promoting farmer co-operatives and associations in China. The leading one is Yanyangchu Rural Reconstruction College (YRRC). YRRC organizes training courses for farmers who are interested in forming farmer groups, and may provide start-up funds or loans to newly-formed groups. YRRC focuses on the social development aspect of farmer co-operatives and on farmer mobilization. One consequence of this focus is that the business and strategic aspects requirements that farmer co-operatives must meet has been largely neglected.

An example involving YRRC provides some insights into the difficulties that farmer self-help groups face, and why China’s agricultural sector is experiencing a trend toward closer vertical coordination. One of YRRC’s trainers, a professor from China Agricultural University, assisted a group of farmers from Lankao, Henan Province, to form a co-operative to grow organic rice. The co-operative obtained start-up funding from the government. However, after the organic rice
was produced, the co-operative found it difficult to sell the product. The supermarket required
the produce to be certified organic, and rents had to be paid for the shelf space required to sell
the rice. In addition payment for the produce would be made to the co-operative only every three
months. These conditions were not affordable to the co-operative, so it explored other options.
However, they found that when they tried to sell the rice to the wholesale market, they could not
obtain a price premium for the organic produce. The wholesalers would only buy the rice at the
regular price. When they went directly to urban dwellers, nobody trusted them enough to buy
their rice.

The trend towards vertical coordination has many impacts on small farmer groups. New
relationships with downstream product handlers and traders raise questions about who controls
the farm management practices, and who can access the markets. Closer vertical coordination
means that open spot market transactions are being replaced by contracts. It is becoming more
difficult for small producer groups to obtain a good price as the market becomes “thinner” and
under greater control by large vertically integrated businesses. Small farmers groups are finding
that the supply chain is closed to them, and new constraints are arising due to their inability to
meet product standards and provide sufficient output to meet market demand (Hodgson [1998],
Teece, Rumelt, and Winter [1994]).

Given these barriers, farmers are cautious to form groups in which there is a possibility that
the substantial costs of operation may outweigh the benefits of group action. Formal co-operative
institutions entail democratic governance, adequate accounting, and an audit system which all
require funds. This is particularly true when taking into account groups with small scales of
operation. Therefore, small farmers often limit their joint action to the extent that no substantial
governance costs are incurred, but this caution comes at the expense of potential benefits from
horizontal coordination and co-operation.

It is widely believed that farmer co-operatives should integrate vertically, provide value-
added services to members, and try to gain greater shares of the supply chain. On the other hand
there is merit in the way that groups like the CPA function. The members of that association do
not want to sacrifice their rights or put control in the hands of the association, nor do they want
to bear the costs of democratic governance and management.
Other countries’ experiences suggest that development of independent and voluntary self-help groups evolve from the solitary nature of traditional communities. In China, during decades of life in communes, the autonomy, independence, and institutions of small farmers were dismantled. Life and production in the commune tended to diminish the skill, agility, initiative, and morale of their intended beneficiaries, and consequently the “human capital” of the work force was reduced. Authoritarian social engineering and social control measures damaged earlier social structures based on mutuality and social ties, and they undermined individual capacities for autonomous self-governance.

After the communes were disbanded, market orientation and the deregulation of the economy have changed the dynamics of rural life. Huge numbers of small farmers are migrating to the cities to take off-farm jobs, and the difference between urban and rural household incomes is increasing. The new economy has led to a reduction in face-to-face communication, which is diminishing the trust and sense of community among the villagers. Social ties and interdependence are weakened by the development of commercial services as well. Both informal and formal co-operation occurs less, social capital is decreasing, and the villagers’ solidarity is further broken.

Moreover, as outlined in chapter 2, the structure of the HCRS means that farmers are inherently individualistic, which in turn reduces the ability to co-operate. Relatedly, strong co-operatives have developed where social movements have succeeded in creating a sense of obligation for people to support the co-operative (Fairbairn [1994]). In China, such social movements are not common, so instead farmers evaluate the costs and benefits of a potential collective action to determine their support. As will be discussed in the next section, relying on personal benefit-cost calculations is often not sufficient to support co-operative formation.

Generally, the spontaneous self-help groups are small, and organized generally within the boundary of a single village or township, rather than along commodity lines. Consequently, these groups are unable to achieve more orderly forms of marketing, or to guarantee a market and capture value-added opportunities.
6.2.2 C+H Co-operatives

There has been a strong state governmental presence during the development of farmer co-operatives. The government plays a role in selecting sample co-operatives that exemplify its own understanding of co-operative principles and functions. These co-operatives are used as demonstration projects for the further development of co-operatives to be replicated throughout the country. The central government encourages all levels of government to provide various supports to these organizations to encourage their formation.

As shown in the previous chapter, the majority of farmer co-operatives in China are initiated and dominated by agri-business companies and big households. Various studies (Shen et al. [2005], World Bank [2007], CIDA [2008]) indicate that local government also plays an important role in the formation and operation of these types of farmer co-operatives. The aim of local government officials is often to generate higher GDP and improve their performance indicators rather than to improve the welfare of their constituents. This is increasingly the case as local governments come to rely more and more on business-related taxes to generate their revenues.

There is also a possibility that an element of coercion may be involved in co-operative development, as county and township officials seek to attract investment into their areas of jurisdiction. Furthermore, as the analysis earlier in the thesis suggests, entrepreneurs have little choice but play to the system and work with local government when they lease or acquire land, because rural land must be acquired by the government before it is resold for development.

The top-down approach determines that central government policies have been widely emulated and followed by the provinces. At the beginning of 2006, 27 provinces had issued circulars giving instructions on how to support farmer professional co-operative organizations. Suggested policies include reducing or eliminating taxes and fees, providing exemption from highway tolls, providing rural investment funds, providing land and utilities, and streamlining registration procedures (Zheng [2006]). The traditional approach of local government officials to achieve policy objectives is to set quantifiable targets, issue instructions, and assign responsibilities to relevant government agencies in order to meet the targets (World Bank [2006b]). Hence, the development of farmer organizations has been added to the local government’s list of performance indicators.
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At the local level, the officials responsible for co-operative policy implementation are often working with a limited understanding of the principles of co-operatives, and generally work within traditional government structures where “instructing farmers what to do” is the norm. According to research done by Shen et al. [2005], “84 percent of farmers co-operatives/associations are in villages in which upper-level officials either sent an official document to or held a meeting (or both) with village leaders urging them to start co-operatives/associations” (p. 203). Thus, government officials often push to start up co-operatives and associations and then dominate them.

Local authorities are also skeptical and cautious of the risks that arise from allowing farmers to organize independently (RAF [2004]). There is a tendency for village officials and extension staff to hold key management positions in associations to avoid any transference of power to farmers (Sun [2007]). This is acceptable to local government officials who know and trust these local elites. Local government officials always give top priority to social stability, since their job depends on it, rather than economic development or the reduction of social inequality. As such they worry that independent farmers organizations will challenge them and undermine social stability.

The elites running farmers co-operatives take their positions in them as an additional task. As a result, they often do not have any motivation to explore the economic and social viability of options for operating them more successfully.

The following example illustrates the points made above. In Santai, Sichuan Province, a Rice Producers Association was formed by the township government. A technician of the township extension office was appointed as director of the BOD. Other members of the BOD included party secretaries from all the administrative villages. The only activity carried out by the association was to purchase chemical fertilizer.

The farmers that were members of the association could buy a 50 kg bag of fertilizer at RMB 1 less than the regular price. There was no incentive for farmer participation in the running of this association. There were no membership fees and no equity capital contributions required. No general meeting was ever held. As a result, farmers understood that this kind of co-operative
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is an extension of government. It is likely that most co-operatives and associations of this type will shortly cease to operate and will exist only on paper.

The following section analyzes the different purposes that co-operatives, controlled and owned by various elites, serve. These co-operative variations of the company + household model can be grouped into several classifications: big households, leading enterprise + households, company + co-operative + households, and investor-owned firm (IOF) + co-operative.

### 6.3 Variations of the Company+Household Model

The company + household model is the agricultural industrialization model promoted by China’s state government since the 1990s (Fulton and Zhao [2009]). The contracts signed between the company — often an agri-processor — and small producers and households were expected by policy makers to help accelerate the vertical coordination of the agri-food production industry. However, due to high transaction costs, this kind of vertical coordination has proven unsuccessful (Fulton and Zhao [2009]).

The agri-food sectors of Canada and the United States started to move closer toward vertical coordination in the 1950s (Hobbs and Young [2001]), and farmers there had been organizing themselves since the 1880s and 1890s (Fairbairn [1994]). Producers co-operatives in North America had the advantage of making the first moves in the transformative process from impersonal markets to contract coordination (Boehlje and Schrader [1998]). However, Chinese small farmers only gained a formal allowance to organize their own business groups in 2007. As a consequence, the agri-business companies were much better prepared to take advantage of this new organizational form and translate the C+H contract into a C+H co-operative or association. This transformation was made to minimize the sum of production and transaction costs, and gain a competitive advantage.

As a result of this development support, the C+H co-operative is the dominant form of co-operative in China today. In this organization, the company, often an agro-processor, plays a leading role in coordinating the stages of the food supply chain, which is increasingly characterized less by open spot markets and more by negotiated contracts and managerial orders.
The efficient use of plant capacity, stringent quality requirements for processing, reliable market outlets, and stable prices are the main advantages of close vertical relations.

In the C+H co-operatives, different classes of membership are designated. Ownership and control of the co-operative is concentrated in the hands of core members – or blockholders – who are the owners of the main companies or an organized coalition of them. The blockholders exploit the co-operative for their own ends. Small producer members are usually peripheral members. They do not, or are not allowed to, contribute any capital to the co-operative. They do not have any formal means to hold the block holders accountable. In such co-operatives, the consensus-building process is usually replaced by the command and control directives of the dominant companies, although the degrees of control vary with the relative power held by each company.

The C+H co-operative model can be classified into co-operatives dominated by big households, leading enterprise + households, company + co-operative + households, and investor-owned firm (IOF) + co-operative. Although these organizations have some commonalties, like their investors holding control, they are different in terms of the specific purposes they are built to achieve. Some are organized to achieve vertical coordination, others to control small producers, acquire farmland, or to increase their own bargaining power.

6.3.1 Co-operatives Dominated by Big Households

Thirty years of economic reform and development has produced inequalities between urban and rural China, as well as significant inequalities between and within rural areas. The term "da hu" or "big households" is used to designate a wealthier rural household. The "da hu" not only have more physical assets, but are usually also better endowed with education, experience, and social capital. The term "xiao nong" or "small farmer" is used to designate an average to poor household that continues to farm on a small scale (CIDA [2008]).

One of the most defining characteristics of successful development is the transformation from a rural to urban based society based on industry rather than on agriculture (CCICED [2005]). Local governments are fully aware of this trend and help to foster this trend by promoting the concentration of productive resources, including land, in the hands of big households.
The importance of rural stratification is found in the writings of Lenin and Marx. Lenin [1967] and Marx and Engels [1992] discussed at length the process they called the “differentiation of the peasantry.” Lenin expanded on Marx’s notion that rural capitalism led to increasing class stratification in the countryside. Like Marx, he argued that petty producers would either rise into the ranks of the capitalist farmers by competing successfully and expanding their production to the point of requiring wage labour, or conversely they would fail in competition and fall into the ranks of the proletariat. This differentiation left the countryside tiered into three analytically distinct social stratas – the rich, the middle class peasantry, and the poor peasantry. The middle peasants or family labour enterprises were the strata destined to disappear (Mann [1990]).

Many rural development policies, including training, subsidies, loans, and government programs, have targeted the “big households.” One government policy, for instance, aims to increase the organizational capacity of big farmers by providing them with direct fiscal support.

Field studies indicate that many of these big household heads are relatively better educated and connected with local power holders; some used to be local elementary school teachers or are village CPC branch secretaries or village chiefs. Meanwhile, many of them are producers, traders, or transporters and they intentionally use the co-operative to expand their scale of operations and increase their bargaining power with other actors in the supply chain. Small producers share the benefit from such actions, as they gain a more reliable marketing outlet and access to consumer information; at the same time they are also exploited in some way.

Research conducted in Zhejiang province by Hu, Huang, Hendrikse, and Xu [2007] indicated that large farmers play a major role in co-operatives. They often make up the largest number of shareholders, have representation on the board of directors, and they are the major users of co-operative services.

There are generally two groups of co-operatives. In the first group only a small number of “core” members are shareholders in the co-operative and common members are users only. In the second group, most of the members have shares in the co-operative, but the rights and interests associated with ownership of shares is restricted, and the largest shareholders still play a dominant role. The relationship and connection between the core members and common members are shaped and permeated by traditional power structures (Hu et al. [2007]).
In another study, Zhang and Zhang [2007] suggest that among the 4,375 co-operatives and associations in Hubei Province, 95 percent of them were founded by “big men” in the village who were strong in farming, processing, and trading. The co-operatives under the control of big men do not take on any of the formal elements of modern co-operatives, such as auditing, and the supervision and control of managers. Instead members of these type of co-operatives are concerned with the kind of services and benefits they can receive from the leaders.

The following three examples illustrate that the big households play a dominant role in both the formation and operation of this extension of the C+H co-operative.

**Yushu Pig Producers Co-operative**

An example of the co-operative dominated by big households is the Yushu Pig Producers Co-operative (YPPC) in Jilin Province. This co-operative was initiated by Madam Zhang, a local elementary teacher and intellectual who gradually became a large pig producer. At the outset Zhang attempted to get a preferential state bank loan by forming a co-operative group to meet the thresholds of the program. The group was comprised of her close friends and kin. Later, in order to get more government grants for equipment and working capital, she recruited more villagers to become members. The feed mill of the YPPC, which was financed by a government grant, is run and controlled by Zhang and her de facto husband. To ensure her control and authority in the co-operative, all member representatives that can attend the general meeting must be recommended by her.

Zhang derives her power from allocating goods and services. The “key members” can always buy feed on credit. Ordinary members behave strategically when they are seeking help from the big households. For example, they will sell their pigs and buy feed through Zhang’s co-operative if they can get government-subsidized credit and other agricultural inputs from Zhang, even if the price offered by the co-operative is a little lower than prevailing market price. Otherwise, they will give their business to the traders. If they succeed in getting credit and inputs they will also show their support to the big household leaders in the form of speaking highly of Zhang before government officials and other visitors.
The relationship between key members and ordinary members is unequal in status, wealth, and influence, creating a “lopsided friendship.” The terms of exchange in such relationships depend upon the relative bargaining power of the two parties. Obviously, the more the key members want support from ordinary members, the more the members can receive and vice versa.

Wanzhou Peach Growers Co-operative

The Wanzhou Peach Growers Co-operative in Chongqing has about 20 members. Membership is limited, since only producers with orchards of more than 100 mu are eligible for membership and each member needs to contribute RMB 5,000 as an equity contribution to the co-operative.

Several years prior to the development of the co-operative, a peach grower association was formed. The small growers, however, were not making a commitment to the collective action of the association. For example, they would not agree to the joint marketing of their peaches at the price set by the association. According to the director, small producers were only growing small peaches and the quantity of marketable surplus was small. As a result small farmers did not have a strong need for a reliable marketing outlet or the sense of support they could gain from a co-operative. Many small farmers sell their peaches nearby in on-the-spot markets, and much of their cash income is generated from off-farm jobs.

However, the larger peach producers are dependent on peach production and require a reliable marketing outlet. As a result, the services that can be offered by a co-operative are critical to their incomes and livelihoods. They have the need and motivation to co-operate with each other. As a result, they formed the Wanzhou Peach Growers Co-operative.

After the co-operative was formed, the marketing division began to target high-end markets in the big cities. Once the co-operative receives an order, it circulates it among members and the members voluntarily decide how much they want to sell at the stipulated price. Since farmers are not pooling their products, the sacrifice of sovereignty in marketing members’ products is greatly reduced; governance costs are also reduced.

Most of the government subsidies given to the association went to the co-operative, and were used to register a trademark and brand name, finance the rental cost of supermarket counters in the
big cities, and to hire technicians to provide training and advisory field services. These benefits were largely reaped by the members of the co-operative, rather than by the small producers that make up the membership of the association and that are the majority of the peach growers.

The Wanzhou Peach Growers Co-operative has some characteristics of North America’s new generation co-operatives in that membership is linked to the contribution of equity capital. It also exhibits closed membership designed to keep out free riders.

**K Dairy Farmers Association**

The K Dairy Farmers Association (KDFA) is located in a suburb of Beijing. This association was initiated by a big dairy farm owner. He invested RMB 4.7 million to build the farm in 2003. The relatively small scale of his operation led to the price of his milk being forced down by the large dairy companies. In response the dairy owner co-founded the KDFA with the owners of three dairy farms and ten dairy households.

A general meeting was held once by the KDFA when the association was formed. The BOD and members of the supervision committee are paid by the director who is the owner of the dairy farm. All equity was contributed by the owners of the founding dairy farms and no dairy household made any contributions. Therefore, these households are not eligible to receive returns on capital investment, and they do not participate in the decision-making process. The services the households receive include a supply of feed and the purchase of the milk that they produce. A minimum price is not available and profits are not returned to members based on patronage. Today the number of household members has increased to almost 100.

**6.3.2 Leading Enterprise + Household Model**

The leading enterprise+household (LE+H) co-operative is usually established by a leading enterprise in order to achieve vertical integration. Local authorities will often provide strong support to the enterprise. The framework of the FPCL enables the enterprise to develop relational contracting with small producers, which in turn allows small farmers to invest in assets and transactions with the enterprise. The transactions look like resource-providing contracts in which the enterprise provides a market outlet, supervision of production practices, and key inputs (Hobbs and Young [2001]), while the small farmers end up taking on most of the risks.
The following examples provide some illustrations of co-operatives that fit this model. These cases illustrate how this co-operative structure is used to collect information and to ensure a consistent supply of quality products. The leading enterprises that establish the co-operatives are able to capture more surplus from the supply chain by linking markets and to construct barriers that prevent competitors from entering the market. When most of the producers in one defined county or township are members of one co-operative or association, there is no space for a new entrant since there are not products available to it. Such a strategy is particularly effective when specific products can only be grown in certain micro-climates or where the soil has specific characteristics.

**W Broiler and Hog Company**

The W Broiler and Hog Company (WBHC) was established in 1983 in Guangdong Province. The company began its co-operation with small producers under the flag of a C+H association. Today, WBHC is accredited by local, provincial, and national governments as a key dragonhead company. This accreditation allows it to receive subsidized government loans and taxation breaks. The government encourages the emergence and expansion of these type of companies because it believes that dragonheads generate local business-related revenues and provide a reliable marketing outlet for the produce of local small farmers. Hence, the development of dragonheads is deemed to be a win-win situation.

When a farmer wants to become a supplier to WBHC, he/she makes an application to the co-operative. WBHC sends a technician to inspect the farmer’s barn to ensure that it can hold at least 2,000 chickens. The farmer then signs an agreement and WBHC opens an account for this farmer. WBHC claims that it provides chickens and piglets to small farmers on a credit basis, but usually the farmer needs to make a down payment of RMB 3-5 per chicken. A farmer also needs to sign contracts with WBHC for the sale of the finished products. These contracts include a fixed price and the specification of the quantity of feed and the vaccinations and animal drugs they need to purchase from the company. WBHC’s technicians will inspect a farmer’s chicken barns periodically, and provide vaccinations and other technical advice.
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When WBHC’s database shows that a farmer’s chickens are mature, it will advise the farmer to deliver them to its marketing unit. The chicken will be weighted and graded. After the costs of the chickens, vaccinations, drugs, feed, and other inputs have been deducted, the residual amount is paid to the farmer.

Several issues have arisen for farmers that deal with the WBHC. Farmers complain that WBHC’s chickens, piglets, and feed are more expensive than other suppliers. Sometimes during a market downturn WBHC has refused to buy farmers’ produce, which breaches the contract. WBHC has also asked small farmers to keep the chickens and pigs longer on the farm, explaining that they are short of weight. This means that farmers have to feed the chickens and pigs for longer, thereby reducing their rate of return.

The surplus of operations is not distributed to farmers on the basis of patronage. Roughly 40 percent of the revenue goes to staff as remuneration, 40 percent is given to shareholders as dividends, and the remainder is distributed to the staff as a bonus. The seven founding families hold 70 percent of the co-operative shares, with the rest being owned by staff.

Some farmers wanted to form an independent producers’ association to negotiate with WBHC regarding the price of chickens, piglets, and other inputs. The purpose of the association was to increase the farmers’ bargaining power when they sign contracts with WBHC. However, few producers wanted to join the association because they were afraid that this attempt to gain power would anger WBHC and no contracts would be awarded to them.

Under this co-operative model, WBHC achieved remarkable growth. When it was founded in 1983, the seven founding families each contributed RMB 8,000. In 2008, the WBHC sold 690 million broilers and 2.54 million hogs. Sales in 2008 amounted to RMB 16.1 billion. The WBHC now owns 30 branches in 20 provinces and its business scope has expanded into dairy production, livestock health, and food processing. The current number of employees working for WBHC is 23,000. The president of WBHC has been elected as a congressman for four consecutive terms. On the WBHC website you will find many photos of senior leaders visiting the company, such as the national agricultural minister, the party secretary, and the governor of the province.
Yili Dairy Farmers Co-operative

With the aid of local government, some large agri-businesses soon began to employ the framework of the farmer co-operative as an instrument for vertical coordination. The dairy farmer cooperatives and associations established by the giant dairy processors are a typical case. Yili Dairy Farmers Co-operative (YDFC) was formed in December of 2007 in a county village located in Inner Mongolia Autonomous Region (IMAR).

The founding members included the county agricultural bureau, the Yili group (one of the two or three largest dairy companies in China), the township government and three dairy farmers. The county agricultural bureau invested RMB 1 million to build the dairy farm. This investment was accounted for as 20 shares in the co-operative. The Yili group contributed the milking equipment and its investment was given 20 shares. The township government contributed the administration service and were given no shares. The three dairy farmers owned 10 shares, 8 shares, and 6 shares respectively. Each share required the investment of five cows plus RMB 1,000 cash. The county agricultural bureau, township government and Yili group participated in the management and policy making but they did not receive dividends. On average, the Yili group was paid a RMB 0.26 management fee per kg of milk purchased from the co-operative.

Lishu Slaughterhouse

Another example of a leading enterprise + household co-operative is the slaughterhouse in Lishu, Jinlin. As with other co-operatives of this type, this co-operative is engaged in high-value and capital-intensive farm produce processing. The Lishu Slaughterhouse (LS) was organized as an association. The company provided the official space and appointed the director. An advisory committee was established, comprised of retired senior officials from commercial agricultural bureaus and state banks. The county government provided agricultural subsidies for purchasing piglets and improving pig barns to the association, and only members of the association were eligible for receiving such subsidies.

Producer members were requested to buy feed, additives, and piglets through the association. The association sourced these products from the feed mill and breeding farms owned by the
company. Pig vaccination was performed by the association, and the hogs of association members could only be sold to the association. Members could not defect because the association retained an updated database on each member’s pigs, including their number and age.

**Santai Pig Producers’ Association**

In Santai, Sichuan, a slaughterhouse transformed itself into an association with the aid of the township government. A local extension officer was appointed as director of the Santai Pig Producers’ Association. Membership was limited to farmers that raised more than 20 pigs. The township government provided subsidies via the association for members to expand their barns. The association established some requirements for its members, including the need for members to purchase feed, vaccinations and marketing services through the association.

### 6.3.3 Company + Co-operative + Households Model

The company + co-operative + households (C+C+H) model originated from the C+H model in the early 1990s when the government focused on promoting agricultural industrialization and modernization. To ensure the local dragonheads had a consistent supply of quality products, the local government encouraged local companies to sign contracts with small producers. The companies, mostly agro-processors, faced problems with cost control due to ineffective flow scheduling and poor capacity utilization. To meet the specific quality and food product safety standards demanded by consumers, product conformance needed to be guaranteed. Although some of the food standards required can be achieved through processing, others must happen during production, hence the need arose for closer coordination.

International experience defines the two systems that have been used to coordinate production – the contract-coordinated system and the ownership-coordinated system. Chinese agro-processors have found the contract-coordinated system does not work well when dealing with thousands of small producers. For contracts to work, both parties must see an advantage to making the commitment to each other. Small farmers will generally not make such a commitment because it takes away the opportunity to earn a higher price from someone else. More often than not, the farmers would sell their products to a trader at the expense of the agro-processor if they
offered a better deal. Because the litigation and contract enforcement costs are too high for the processor to bear, agro-processors are leery to contract or trust farmers in this system.

The company + co-operative + households (C+C+H) model is similar to the LE+H model in that it links small producers to a agribusiness company in an effort to achieve the goals of vertical coordination and to increase the company’s bargaining and lobbying power in government. However, while E+H co-operatives are initiated by very large companies (typically operating all over China), C+C+H co-operatives are usually initiated by medium and small agro-businesses. The co-operative is established with small producers along a particular product line.

In contrast to the LE+H model, in the C+C+H co-operative there is a bargaining process that occurs when the agro-business negotiates, monitors, and enforces their contracts with small producers. Bargaining occurs because the company in the C+C+H model does not have complete power. As a consequence, more attention is given to the allocation of costs and benefits in the co-operative. Payoffs are often awarded to individual members to prevent their defection from the company. Although the bargaining process may not be formalized to the extent that it can hold the elected board of directors accountable, members and households can use the threat of defection as a means of disciplining the management.

The C+C+H model attempts to solve the vertical coordination problem by internalizing transactions within the organization, which helps to cut transaction costs. With more face-to-face communication, trust can also be established to some extent, and a sense of community can be created. The C+C+H model is effective because small producers can identify to a certain extent with the big household producers that sit on the BOD, giving them a feeling of representation that they do not get dealing directly with investors.

Small producers that defect from the co-operative are more effectively punished because of their relationship with the big households. The agro-processors rely on big households to collect producer information and to provide the attributes of farm produce and other production insights.

The following examples show some of the ways that C+C+H co-operatives have developed.
Shenglin Pear Growers’ Co-operative

The Shenglin Pear Growers’ Co-operative (SPGC) was established by Mr. C, the owner of S Pear Company Ltd., in January of 2006 in a suburb of Beijing. Previously, Mr. C managed a state-owned company in another province, but moved to Beijing to start up S Pear Company Ltd (SPC) after the company went bankrupt.

Mr. C bought a 30-year lease for a 200 mu orchard from the township government in 2001. He invested RMB 2 million in the land to grow pears, and in 2003 the orchard started bearing fruit. SPC signed a contract with a local supermarket to sell its pears but, with the increasing consumer demand for pears, the company could not produce enough fruit with just one orchard. The SPC adopted a company + households model and began to sign contracts with local pear growers to purchase their produce. At the beginning, less than 20 households signed contracts with the SPC, but the numbers increased gradually and by 2005 there were approximately 140 contracted households.

The SPC found the pitfalls and weaknesses of the C+H model soon after it was adopted. In 2004, some of the SPC contracted growers sold their high-quality pears first through other channels to get a price premium, leaving their inferior produce for the company to purchase. During this production season the SPC lost about RMB 20,000.

Another key issue for the SPC was quality assurance. To get a higher price, the growers mixed their high quality pears with ones of inferior quality, even when the boxes with grade labels were distributed to them by the company. In addition, to cut costs, pear growers used low quality plastic bags which resulted in a shorter shelf life for the pears.

The SPC stipulated that farmers could not irrigate the pear orchards in the last 20 days before harvest, in order to protect the sugar content and the taste of the pears. However, growers often irrigated during this period to increase the weight of the pears. The SPC had to spend a lot of time and energy monitoring the growers and testing the sugar content of the pears, but these efforts were ineffective.

A third issue for the SPC was in bargaining for the pear price. Household growers were only concerned about the price they could receive for their pears, the quality did not matter. In
The contrast, the SPC had the opposite interests in mind; they gave a great deal of attention to the quality of pears, and not much to the price paid to growers. This conflict of interest made it difficult for growers to trust the SPC; the fact that the owner of the SPC was not native to the area made things even worse.

To mitigate the above problems, the SPC, with the support of local government, transformed itself from a C+H model into a C+C+H model at the end of 2005. The SPGC was registered in January of 2006 by the SPC and 230 pear growers from 15 towns. The equity investment, amounting to RMB 50,000, was contributed by the SPC. In November of 2007, the SPGC started to receive equity contributions in cash from its members. And it was formally registered as a farmers professional co-operative under the new co-operative law.

The membership fee for an ordinary member to join the SPGC is RMB 100, but these members are ineligible to receive returns on their capital investment. Only members who make an equity investment can receive returns. The SPC remains as an institutional member of the co-operative. The equity contributions from its owner and management team account for more than half of the SPGC’s total equity.

Although each member has one vote, each member with an equity investment can have as much as 20 percent of the voting rights. Top policy decisions are made by a representative group of 29 members, most of them big pear growers or village leaders, at representatives meetings rather than at general meetings of the members. The representatives meetings are held once or twice a year and include seven members on the board of directors, four pear growers, and three members from the SPC. The director of the SPGC is the owner of SPC and the deputy director is a party secretary from the village.

The co-operative has taken on many important roles. It has set a single standard for growing and purchasing pears. All the pears purchased by the co-operative are graded and sold under the brand name SPC. The co-operative uses joint purchasing to buy inputs, such as chemicals and plastic bags, and organizes technical training for members. With the support of grants provided by the Ministry of Agriculture, the co-operative was able to build two more cold storages in addition the one previously built by the SPC.
The co-operative pays 10 percent of its sales income to the SPC as a commission and to cover staff salaries; the rest of the income is treated as operational income for the co-operative. After the cost of operations has been covered, the income surplus is returned to management members based on patronage and the amount of equity invested. At the end of this business year, the returns based on patronage amounted to RMB 214,000, accounting for 80 percent of the total surplus of operations.

In the first year of SPGC operation, the pear grower members proposed that a minimum price for pears should be set to protect themselves. The amount suggested was to be 10 percent higher than the price received in 2005. The management members (investors) suggested the price be kept at the same level as the previous year. The grower members won and voted that the co-operative should set the minimum price. The reason the growers won was that the investors realized that it was important to attract more farmer members so that they had enough pears to meet the needs of the contracts they had signed with the supermarket.

In 2007, the following year, when the representatives meeting was held to discuss the purchase of pears, the management members refused to set a minimum price for pears. They argued that setting a minimum price would allow the rivals to act opportunistically, but the real reason was they had a better understanding of how traders would react to a minimum price, and how many pears they could purchase at a set price. The management was now able to obtain a much larger share of the operation surplus.

Bage Rabbit Growers Co-operative

The Bage Rabbit Growers Co-operative (BRGC) is located in Sichuan. In 2003, four growers who raised rabbits on a relatively large scale met to discuss the possibility of working together to solve their common problems. First, as relatively large producers they needed a reliable market outlet and other technical services. Second, they faced credit constraints which prohibited them from further expanding their production. At that time Mr. Rong, who had previously acted as village party secretary, was a successful businessman who had invested in rabbit processing. He founded a firm named H Rabbit Company Ltd. When the four large rabbit raisers exchanged views with Mr. Rong about the formation of a rabbit co-operative, he spoke highly of the initiative
and indicated that if they organized farmers to raise rabbits, he would purchase all of them for processing at his plant.

Encouraged by this positive response the four growers consulted several government agencies including Animal Husbandry, the Science and Technology Commission, and the Ministry of Agriculture. All agencies supported the proposal. The rabbit growers then conducted a survey which determined that there were 200 to 300 households willing to work together. They drafted a constitution for the co-operative and received comments on it from line government agencies.

After all the preparation work was done, H Company agreed that the co-operative could use its name, so the four founders went to the Industry and Commerce Administration and registered their co-operative as a shareholder company. H Company invested RMB 2 million worth of fixed assets as equity in the co-operative; however, this equity did not give it access to the distribution of surplus. The growers, however, could invest rabbits as equity. Twenty breeding rabbits were calculated as one share, and equivalent to RMB 500. By the end of 2004, the equity of members had reached RMB 3.23 million contributed by 16,000 shares.

The distribution of the co-operative surplus is carried out as follows. Five percent of the surplus is retained as reserves, five percent is kept as an educational fund and 15 percent is maintained as a contingency fund. The remaining surplus is distributed to members based on their shares; for each rabbit produced, farmers were paid RMB 0.1-0.5. The bonuses were distributed according to the number of rabbits the members sold to the co-operative, an incentive for members to patronize it.

The co-operative headquarters is based at the county level, and a further 38 branches with 3,000 members are based at the various villages. The co-operative has a number of key operating bodies, including a president, board of directors (BOD), and a supervision commission (SC). The president of the H Company was elected as the vice president of the BRGC. The SC, made up of government officials from line agencies, operates as a check and balance to the BOD on behalf of all members. At the local level, each village has a Party Branch from which members are appointed to the local BOD or SC for their branch co-operative. The Party Branch of H company also holds joint meetings with the Party Branches from the 38 villages where co-operative branches are located.
Property rights to the rabbits, used by members as their equity payment, are not clearly defined. Although the rabbits are deemed to be assets in the co-operative, it is impossible for the co-operative to use them to meet its investment needs since the rabbits are kept by the members.

One of the major functions of the co-operative is to mobilize farmer resources for productive use. However, with the equity structure outlined above, the co-operative does not have sufficient equity to finance its business and to invest in other operations that could generate value-added income. Another effect of this equity structure is that members are not required to make a strong financial commitment to the co-operative and thus they do not feel a strong sense of ownership. When some of the members were interviewed they did not even realize that they were members and had an obligation to sell their rabbits to the co-operative.

The H Rabbit Company is a very successful private processing company. It has built its own sales teams and has 80 sales people promoting its products in more than 20 cities. The H Rabbit Company provides the following items and services to the co-operative:

- Offices for the co-operative.
- Processing contracts with BRGC members. The annual processing capacity of the company is 5 million rabbits, and of this amount, 2.5-3.0 million are supplied by the co-operative.
- Price floor for rabbits. In 2003, the price floor was RMB 6 per kg; in 2004, the price floor was RMB 8 per kg. H Rabbit Company monitors the market price and if the market price is higher than the price floor, the company matches the market price.
- Bonuses to the co-operative for each rabbit they send to the processor. The bonuses range from Y 0.1 to Y 0.5 per rabbit. In 2003, the total bonus was RMB 266,000 and in 2004 it was RMB 398,000.
- Credit to the co-operative. The company has provided two lump sums of credit: RMB 56,000 and RMB 160,000.

BRGC employs eight full-time technicians to provide services to its members. The provisions of breeding rabbits, feed, vaccines and drugs have been centralized. The co-operative has also
developed a quality assurance system for rabbits; by controlling the inputs the co-operative attempts to control the production process to ensure that rabbit growers are complying with the standard operating procedures set.

The co-operative helps to facilitate access to credit for members. BRGC and Rabbit Company jointly pledged RMB 2 million in collateral at the Rural Credit Union for members to obtain credit; RMB 9.1 million has been channeled to members in this way. Furthermore, RMB 900,000 worth of drugs and feed were provided by the co-operative to members as credit.

H Rabbit Company plays a large role in the co-operative by providing a market outlet, by supervising production practices, and by supplying key inputs including credit. By doing so, H Rabbit Company retains the marketing rights of the rabbits while assuming a smaller proportion of the risks, and reducing the need for working capital since the ownership of rabbits is still retained by the small producers. Small producer members in the co-operative have been able to expand their rabbit production through increasing investments in rabbits and facilities. This increases their frequency of transactions with the processor and increases their investment in specific asset; thus they are technically investing their resources in a relationship with H Rabbit Company. The greater investment makes it costly for farmers to break away. As a result of these investments, H Rabbit Company can ensure a consistent supply of rabbits to market, stabilize volume processing, meet its flow scheduling, and utilize its processing capacity, which are all essential to controlling costs. At the same time, the greater investment creates a greater opportunity for opportunist behaviour on the part of H Rabbit Company.

6.3.4 Investor-Owned Firms + Co-operative

According to the study conducted by Liao [2009], 20-40 percent of farmer co-operatives are actually private firms using the term farmer co-operative as a flag of convenience. These private firms are engaged in agro-processing, trading, and transporting produce. To take advantage of government support programs targeted at co-operatives, these firms register themselves as co-operatives. They are termed “rolling-plate co-operatives” because they prepare many different nameplates to show their visitors depending on who is visiting. It is easy for these firms to win the support of local leaders because they often own a production base, such as orchards or
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farmland. In addition, they have professional managers armed with marketing and management knowledge, they occupy fancy buildings, and usually have a registered brand for the products they have developed.

**Zhongmou Dairy Farmers Co-operative**

The Zhongmou Dairy Farmers Co-operative (ZDFC) was established in Henan Province. Zhongmou acquired the land of 100 farmers plus some land owned by the village which he transformed into a dairy farm and registered as a dairy farmer co-operative. Zhongmou financed and built the animal sheds, silage pits, a feed mill, waste treatment facilities, water tap, and a sewage system. The local government provided some subsidies for the waste treatment facilities. The farmers whose land was acquired by Zhongmou can use the animal sheds free of charge and are responsible for caring for the cows. In return for the use of the land, the farmers need to purchase feed from the ZDFC and all milk produced by the farmers needs to be sold solely through ZDFC. The dairy processor pays Zhongmou RMB 50 for each ton of milk processed as a management fee. Co-operative members can also receive veterinary services from local government veterinary officers.

For Zhongmou, the “co-operative” is a great investment in many ways. First, the dairy industry is very labour-intensive, and on his farm the farmers are non-wage labourers, so he is saving the expense of paying them. In addition the cows are bought by the farmers themselves, which is a RMB 5,000-8,000 investment per cow. With over 1,000 cows on the farm, this saves Zhongmou from making a substantial initial investment. Moreover, Zhongmou’s risk of dealing with animal health diseases is reduced because he is not the owner of the cows. The feed mill and the cow manure sold to mushroom growers also generate cash flow. Zhongmou is very ambitious and indicated that he was going to build another co-operative of this type in another locality.

**T Chicken Farmers’ Co-operative**

The T Chicken Farm Co-operative (TCFC) is located in Shandong Province. The TCFC evolved from the C+H model, and was already accustomed to signing contracts with small farmers for the purchase of chickens. According to T Company contracts, the company provided the chickens, feed, and vaccinations and the farmers were obligated to sell their chickens back to the company.
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However, T Company found that some farmers were selling their chickens to other traders offering a slightly higher price. Worse was that some farmers were overdosing their chickens with anti-bacterias because they were worried about the chicken’s health and potential losses. Even if only 3 of the 5,000 chicken farmers had over-dosed their chickens, the whole order of chickens would be refused by the buyer due to the antibacterial residues in them.

Farmers chose to sell their chicken to other traders for two main reasons. First, T company refused to buy any chickens from a farmer if any of the farmer’s chickens were in poor condition. Second, other traders would come to collect the chickens at the farmers gate, which saved transportation costs and potential losses during transportation.

To meet the stringent sanitary and phyto-sanitary standards of the export market and the needs of flow scheduling, T Company decided to take on the name of a co-operative and lease land from the farmers. The co-operative paid rents to the farmers because land was not allowed to be acquired by private companies under the Land Law. Some farmers were recruited as workers and received three months of training before starting to work on the chicken farm. T Company built 33 fenced chicken farms. Only the chickens, feed, and vaccines provided by the company were allowed to enter onto the farms. Two thousand university graduates were recruited as technicians to guide workers on how to raise chickens.

6.3.5 Livestock Production Parks

In many rural areas the livestock industry is emerging as a pillar of industry and is receiving an increasing amount of support from rural governments. Due to its capital and labour-intensive nature, livestock production is also contributing a large amount in taxes.

China is unique in that while one-third of livestock production is conducted by large intensified operations, two-thirds of the livestock produced comes from a large number of dispersed households (Wang [2009]). This contrasts with most other countries where the majority of livestock production is conducted by large intensified operations with only a small amount of livestock being produced by households or lifestyle farms (MWH [2009]).

Given the rapidly increasing number of animals being produced in China, there is a growing concern about the pollution generated from animal waste. For dispersed households the
only feasible solution to deal with waste is to rely on low-technology, low cost systems that are applicable at a small scale (MWH [2009]). Moreover, the concern that epidemics will be transmitted between animals and people is much higher when production is spread out among small producers and courtyard livestock production. These two concerns give local governments a strong incentive to encourage scaled up operations in livestock production. Further, it is costly for governments to monitor whether the animal waste management practices of small producers are in compliance with laws and regulations.

The Province of Henan is one of the biggest livestock producers in China. Henan is requesting the World Bank’s support to “provide expertise and share experiences on how to manage livestock waste, and facilitate transfer of national and international best practices and technological alternatives and innovations in waste management” (World Bank [2009], p. 1) with China. The World Bank has agreed to provide Henan with a $US 80 million loan if China’s sub-national governments provide matched funding.

The World Bank requests that most of the livestock farms that will participate in the project should be already existing. Only new farmers co-operatives formed by small producers can be funded by the new livestock farms because the project is not meant to be a production expansion project; rather it is a waste management project. As a consequence the Henan government submitted to the World Bank project proposals for farmer co-operatives called livestock production parks.

Two livestock parks were proposed by Henan to be funded by the World Bank project: a 500 dairy cow park and a 500 beef cattle park. According to these two project proposals, the production parks will have the following features. First, these parks will acquire land to hold animal sheds, fodder and grain warehouses, workshops, milking stations, waste treatment facilities, and offices. Various pieces of equipment will be purchased, and all of these investments totaling several million RMB will be funded by the project. Second, these farms will employ 30 to 40 staff including managers (general manager, operation manager, accountant, etc), technicians, production staff, and supportive staff.

These parks will be operated like an investor-owned farm rather than being operated individually by member households. For instance the day-to-day decisions will be made by the
management, and financial management will be controlled by the financial staff. Farm investment will be funded by the project in 30 to 40 counties of Henan province. The investments made on these farms are expected to account for the vast majority of the total project costs.

6.4 Concluding Comments

The case studies of farmer co-operatives analyzed in this chapter demonstrate that co-operatives have followed two distinct developmental trajectories. One group of co-operatives is defined by self-reliance, self-help, and spontaneous action taken by small farmers. These co-operatives have been much less successful due to various constraints including lack of assets, unequal rights, changing markets, and poor networks.

The other group of co-operatives – those based on the C+H model – are those initiated and controlled by government officials, rural elites (including big farmers) and investor-owned companies. This group is favoured by the government, and receives the lion’s share of government funding targeted at the co-operative sector.

The C+H co-operatives are the most successful co-operative model. The C+H model represents a greater level of control for the lead company and is a form of quasi-vertical integration. The companies and households are generally able to establish and enforce a particular set of rights to meet each of their interests, even though the two parties lack equality. Indeed, the contractual arrangements are made in favour of the investors. The investors design the governance system in their best interest, leaving the vast majority of small producer members excluded from the policy-making process and often with very little benefit.

The next chapter of the thesis provides an in-depth analysis of the nature of these organizations, including an exploration of their ownership and control, and the reasons behind the domination of C+H model co-operatives. The analysis is based on institutional analysis and a modeling of their role in vertical integration, competitiveness, and the institutionalization of power.
Chapter 7

Analysis of the Company + Households Model

The previous chapter distinguished between several types of the company + households (C+H) model of co-operatives. These C+H models appear to be dominating the developmental path of farmer co-operatives in China. They are favoured by local authorities and are often the major recipients of various government support programs targeted at the co-operative sector. This support builds momentum for their further development. In contrast, farmer self-help groups remain marginalized.

This chapter explores the basic nature of the C+H model and examines how ownership rights are defined and how control of these enterprises is assigned to economic agents. It explores the implications of ownership and control for key players in the co-operative, including farmer members and companies. Co-operative theory and property rights theory provide useful analytic tools for designating the boundaries between C+H co-operatives and western co-operatives. It is critical to understand that the organizational structure of companies and organizations is a result of the larger institutional structure in which they are located. We will see that institutional economics, industrial organization, political theories, and strategic management literature provide theoretical foundations on which to base our understanding and analysis of the relationships between companies and small producers in the C+H co-operative model.

Moreover, the concepts of endogenous institutions and path dependence remind us that in our search for explanations we need to think about causes and effects that are often separated in time, rather than focusing exclusively on synchronic explanations, like the legislative process of the FPCL.
Chapter 7. Analysis of the Company + Households Model

This chapter is divided into three parts. The first part of the chapter analyzes the nature and roles of C+H co-operatives. With the aid of co-operative principles, the C+H model co-operatives are compared to western co-operatives. This part also examines the corporate governance of C+H co-operatives, including the structure of power within the organization that determines the allocation of resources and distribution of risks. Drawing on theories of corporate governance and property rights, and the concepts of residual claims and control rights, this part argues that investors and elites are the ones that own, control, and bear the risks associated with operating these organizations.

The second part of the chapter examines the reasons why companies make the institutional choice to become a C+H model co-operative. The theories of endogenous institutional change and path dependency provide a basis to analyze how an institution can persist, and become self-enforcing as a result of pre-existing political, social, and economic structures. Institutions tend to be reproduced and reinforced within structures. Industrial organization theory helps to explore the concept of transaction costs. The strategic management literature provides the perspective from which to view the C+H model co-operatives as a result of strategic planning choices. The final section of this part is dedicated to understanding how decisions are made within co-operatives.

The third part of this chapter builds a model of the C+H co-operative based on the discourse surrounding industrial organization, transaction theory, and strategic management theories. C+H co-operatives are viewed in four ways. First, as a form of achieving vertical integration for companies. Second, as a collation of a company and small producers. Third, as an independent business enterprise that can be analyzed as a investor-owned firm. Forth, as a means of strengthening the power of interests group. One of the conclusions of this section is that the co-operative model has been captured by the emerging elites to institutionalize their power, and by traditional elites to reinforce their existing institutions.
7.1 The Nature of the C+H Model Co-operatives

7.1.1 Co-operative Principles

As elaborated previously, one of the distinctive features of the co-operative is the promotion of, and adherence to, a set of principles. Principles play a central role in co-operative culture and help to define their nature and role in society by distinguishing them from other forms of business, especially investor-owned firms (IOFs) (Barton [1989]).

No modern farmer co-operative follows all the Rochdale principles, but many of the fundamental principles and essential characteristics of these original principles persist. Enduring principles include: (1) democratic ownership and control by users; (2) limited returns on capital; (3) return of benefits or margins to users on the basis of use; and (4) the obligation of user-owner financing to ensure that farmers can indeed exert jurisdiction over those aspects of their life they wish to control (Fairbairn [1994] and USDA [1995]). This list of obligatory principles makes up the minimum features necessary to be considered a co-operative (Fairbairn [1994]). These principles reflect the presence of a community of members interested in the idea that as a group they can work collectively to address their common challenges (Uphoff [1993] and MacPherson [1972]).

For the purpose of this thesis, a farmer co-operative is defined as a form of economic organization with the following characteristics (Staatz [1987b] and Cotterill [1987]):

- Equity investment should be contributed by each member and there is a strict limitation on the proportion of one member’s contribution, including institutional members. For example, no member can own more than 5 percent of the shares in the co-operative.

- The formal governance of the business by the stockholders is structured “democratically” in the sense that:

  - Voting rights are not proportional to equity investment. The limitation to “voting one’s equity” may be in the form of a one-member, one-vote rule. Voting may be proportional to patronage or stock ownership if it is also subject to some limit, such as restricting any member from having more than five percent of total votes.
Chapter 7. Analysis of the Company + Households Model

– There are strict limitations on the number of non-members who may serve on the board of directors, and farmer (user) board members should make up the majority.

– A general meeting, where all members are invited, must be the top decision-making body. There is a strict limit that prohibits general meetings from being replaced by meetings of representatives.

• The benefits a member receives from committing capital to a co-operative is tied largely to patronage. There are three reasons for this:

  – Each patron member is eligible to receive patronage payments and to vote.
  – The business pays a strictly limited dividend on equity capital invested in the organization.
  – Net margins are distributed among stockholders in proportion to their patronage with the business rather than in proportion to their equity ownership in the organization.

As the right column of Table 7.1 indicates, the C+H model does not follow the key co-operative principles or characteristics. Most of the equity contributed to the C+H co-operatives comes from the owners of agro-processing companies and small producers are either not willing or not allowed to make an investment. The vast majority of small producers are treated as peripheral members that receive marginal benefits, or none at all because the distribution of surplus is based on shares of contribution capital, rather than patronage. Furthermore, small producer members cannot elect people to the board of directors and cannot hold the co-operative accountable.

The preceding analysis suggests C+H co-operatives are not real co-operatives. They are not owned and controlled by small producer members, and the benefits do not directly accrue to them. Instead, C+H co-operatives are monopolized by a small number of investors and their allies for their own ends.

Of course, whether any given organization is a co-operative or not is not a legalistic, black-and-white question. Rather, the co-operative is defined by its strategy, its purpose, the control structure it holds, and its connections to a defined community of people (Fairbairn [2004]). An
Table 7.1: Co-operative Principles compared to Company+Households Co-operatives in China.

<table>
<thead>
<tr>
<th>Co-operative Principles</th>
<th>C+H Co-operatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity is contributed by each member. Limits to each member’s contribution to prevent capital domination</td>
<td>Some members are not allowed to make an equity investment. Company members can contribute more than 50 and up to 100 percent of the equity. Domination of capital by a small number of investors</td>
</tr>
<tr>
<td>Each patron member has voting rights. One-member-one-vote or voting is proportional to patronage</td>
<td>Some members don’t have voting rights. Each member of management can have as much as 20 percent of the voting rights</td>
</tr>
<tr>
<td>Voting rights are not proportional to equity investment</td>
<td>Voting rights are proportional to equity investment</td>
</tr>
<tr>
<td>Strict limits on the number of non-members that serve on the BOD</td>
<td>Company management and government officials occupy most of the BOD seats</td>
</tr>
<tr>
<td>Net margin is distributed in proportion to patronage</td>
<td>40 percent or more of the net margin is distributed in proportion to equity investment.</td>
</tr>
<tr>
<td>There are strict limitations on how a general meeting can be replaced by a representative meeting</td>
<td>Representative meetings are often the top decision making body instead of a general meeting</td>
</tr>
<tr>
<td>Co-operatives grow through horizontal coordination and vertical integration</td>
<td>Co-operatives grow through vertical coordination</td>
</tr>
<tr>
<td>Co-operatives control their own marketing facilities</td>
<td>Leading enterprises control and own marketing facilities</td>
</tr>
<tr>
<td>Management and control of production rests with individual farmer</td>
<td>Management and control of production rests with a small number of investors</td>
</tr>
</tbody>
</table>

analysis of the structure of co-operative principles is not sufficient to understand the economic nature and other key aspects of these organizations. One must also know something about their organizational behaviour; their objectives, ownership and control structure; and how to interpret the acts of different agents in these organizations. This analysis will be carried out in the following section.
7.1.2 Property Rights to Ownership and Control of Resources in C+H Co-operatives

To analyze, understand, and predict the emergence and development of C+H co-operatives, it is critical to have an in-depth understanding of who owns and controls these organizations, who benefits from them, and whether these structures differ from IOFs.

An economic organization is viewed by agency theorists as a nexus of contracts among various participants who provide the organization with inputs including labour, managerial talent, and capital, and who purchase its outputs. Each participant, or “agent,” seeks to maximize his or her own welfare. Agency theorists stress the importance of two types of contracts within economic organizations. The first contract specifies the nature of the residual claims in the organization, while the second defines the allocation of the decision making process among agents (Vitaliano [1983]). Understanding these two contracts, and how they apply to co-operatives, is crucial to determining the degree of member control and the goals that co-operative is set up to achieve.

The residual claimants are agents who receive a share of the difference between the organization’s gross revenue and the payments promised under fixed claim contracts. The decision process of an organization can be divided into two general categories – decision management and decision control (Fama and Jensen [1983]). Decision management includes the right to initiate and implement approved decisions, while decision control includes the right to ratify or make the decision that is to be implemented, the right to measure performance, and the right to set the reward for decision makers (Condon [1987]).

Using this framework, Condon [1987] summarizes the key difference between a co-operative and an IOF:

“In an IOF, control over how resources are used and the rights to residuals ultimately rest in the hands of the owners of common stock in the organization. Decision control is based on the share of capital invested, and decisions are presumed to be judged on the merits of the returns generated by that capital. In a co-operative, the basic property rights governing ownership and control are structured so that decision control and the rights to residuals rest solely in the hands of those who patronize the firm as members …. Ancillary to this restructuring of rights is the
The Political Economy of Farmer Co-operative Development in China

fact that co-operative firm control is generally based on one-member, one-vote terms and not by the share of capital invested” (Condon [1987], p. 24-25).

Since co-operative members receive benefits in proportion to their use of the co-operative, members have little incentive to invest money in the enterprise. A common way of addressing this problem is to have members provide capital in proportion to their use of the co-operative. This can be done up-front (i.e., when the members first join), as is the case in the New Generation Co-operatives, or as the members go along by having the members contribute capital in proportion to their patronage. Such practices help solve the problem of the under-financing of farmer co-operatives.

In China, one of the reasons that more western-style co-operatives are not present is that Chinese farmers typically have little ability to contribute capital, which in turn would provide them with control. Farmers’ ability to contribute capital is largely a result of the small size of Chinese farms and the resulting lack of capital to invest. The lack of a well-functioning credit market or set of credit policies that would allow farmers to obtain loans to finance their co-operative shares is also a factor in the lack of capital contribution.

According to Gourevitch and Shinn [2005], ownership in a firm can be divided into two models: a diffuse shareholder model and a concentrated blockholder model. In the diffuse shareholder model, a diffuse set of shareholders owns the firm. In this model, managers are supervised by a shareholder-elected board of directors that holds the managers accountable to the investors. The board members hold relatively small portions of the total stock, but their vote is required on major decisions, and they are supposed to discipline and reward the managers. In contrast, the blockholder model tightly links ownership and control. Managers are supervised by a concentrated group of blockholders. In the blockholder approach large shareholder blocks are either held by big businesses like firms, controlled through a family or ethnic network, or controlled by public authorities through a variety of instruments. The board of directors is made up of representatives from these various blockholders.

Within each of these models, the role of management can vary. In some instances, management holds effective control – as is the case in the so-called managerial firms (Monsen and Downs [1965]). In other instances, the investors (or in some cases the workers) are able to exer-
cise control (Gourevitch and Shinn [2005]). Different models of corporate governance provide different minority shareholder protections, low shareholder protection will lead to concentration of ownership (Gourevitch and Shinn [2005]).

With the aid of previously explained theories including property rights, governance structures, dominant institutional structures of power and authority, and firm-ownership and control (residual claimant and decision control), it is possible to analyze how C+H co-operatives fundamentally differ from those of the West. By examining the economic nature and governance structure of Chinese co-operatives we can interpret the relationships among investors, patron members, and management.

Table 7.2: A Structural Comparison of IOF, Company+Households Co-operatives and Co-operatives.

<table>
<thead>
<tr>
<th>Structure of organization</th>
<th>IOF</th>
<th>Co-operatives</th>
<th>C+H Co-operatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance structure</td>
<td>Shareholding or blockholding</td>
<td>Shareholding</td>
<td>Blockholding</td>
</tr>
<tr>
<td>Capital contributors</td>
<td>Investors</td>
<td>Patron members</td>
<td>Mostly investors</td>
</tr>
<tr>
<td>Residual claimants (risk bearers)</td>
<td>Investors</td>
<td>Patron members</td>
<td>Investors</td>
</tr>
<tr>
<td>Control</td>
<td>Investors or management hired by them</td>
<td>Patron members or management hired by them</td>
<td>Investors or management hired by them</td>
</tr>
</tbody>
</table>

As Table 7.2 illustrates, in an IOF, the governance structure is either shareholding or blockholding. Owner-investors contribute the capital and are the residual claimants. The profits are distributed in proportion to the amount of capital contributed by each owner-investor. The decision control and management of the companies officially rests in the hands of the owners, via the board of directors. However, in practice the managers may hold effective control of the organization.

In co-operatives, the governance structure is diffused shareholding. The co-operative is owned by its members, who provide the capital investment and are the residual claimants of the organization. The control of the co-operative officially rests in the hand of a member-elected BOD that
is accountable to the membership. However, as with IOFs, the managers may effectively control the organization in some instances.

The governance structure of the C+H co-operatives is blockholding. The ownership of these organizations is concentrated in profit-oriented businesses and/or rent-seeking government officials. Indeed, it is common for a small number of favoured investors or organized coalitions of investors to own these co-operatives. Control of these organizations may rest with managers. However, given the power that the major blockholders can typically exert, managers may have little effective power to control the organization. The C+H co-operatives are also marked by efforts to restrict and limit competition. Co-operative laws are not enforced, or if they are enforced their interpretation has altered their meaning substantially. There is little protection provided to minority shareholders, and their are no rules on accountability for the corporate board (or the rules are not enforced).

In the C+H co-operative, patron members produce an intermediate output and pay a nominal membership fee. Patron members are not eligible to receive returns on equity capital. In the cases where patron members can receive a return, based on their use of co-operative services, from the operation surplus, the investor decides how much to allocate based on the incentives for members to deliver better quality inputs. In other words, the residual claimant is the investor.

The above comparative study of the structure of IOFs, co-operatives, and C+H co-operatives indicates that the C+H co-operative is, in everything but name, a private-owned firm. It features the concentrated blockholding ownership of an IOF rather than co-operative ownership, use, and democratic control by patron members. As a consequence, the investor is the residual claimant and the holder of control. The investors and/or their allies are the agents responsible for making the decisions that determine how resources will be used, and these parties assume most of the risks associated with those decisions.

The examples of C+H co-operatives provided in the last chapter suggest that the board is not elected by the members and that producers cannot hold the board accountable, in part because no information is provided by the board through disclosure, auditing, and oversight. Investors or organized associations of investors assume almost all of the management positions in the co-operative. Further, the owner of the company usually assumes the position of director of the
co-operative and director of the BOD. Other BOD members come from the same company or are favoured local elites with business or political ties to the company. Consequently, decision control rests in the hands of the investor(s) and they assume most of the risks associated with the decisions.

7.2 Explanations for the Domination of the C+H Co-operative

The C+H model of co-operatives has developed a blockholding governance structure as it passed through the filters of dominant institutions in China, such as crony capitalism and the patronage system. While defining property rights can help us understand the nature of the residual claimant and who controls the decision making process, corporate governance is useful to help understand the structure of power within each firm. Corporate governance determines who has claim to the firm’s cash flow, who has a say in the firm’s strategy and allocation of resources (Gourevitch and Shinn [2005]). At the core both concepts help to explain the power structure within a firm.

7.2.1 Endogenous Institutional Change and Path Dependency

Organizations are a structure of roles (Janvry et al. [1993]). The roles are recognized and accepted by members of these organizations. They are purposive entities designed by their creators to maximize wealth, income, or other objectives defined by the opportunities afforded by the institutional structures of society (North [1990]). Corporate governance is the authority structure that decides who has claim to the revenues created by an organization; it is the structure that indicates who has a say in an organization’s strategy and allocation of resources (Gourevitch and Shinn [2005]).

The theory of property rights argues that property rights are social institutions that evolve to meet the interests of the segment of society that has the power to establish and enforce them (Hite [1979]). They are expressed as legal restrictions and are devised to place constraints on how the resources available in an economy may be allocated and used (Condon [1987]). Therefore, property must be an enforceable claim, and the legal right must be justified by a public belief that it is morally right (MacPherson [1978]).

This view of property rights claims is consistent with the social development perspective of co-operatives analyzed in Chapter 2 that argued that co-operatives were developed within social
movements and in relation to time- and place-specific social, political and economic forces (Dervelere [1992]). In North America, co-operatives became more organized and systematic in the twentieth century alongside democratic politics and the modern state (Fairbairn [2004]).

Corporate governance structures reflect public policy choices which are fundamentally the result of political decisions (Gourevitch and Shinn [2005]). Corporate governance systems are shaped by the larger institutional environment defined by the set of fundamental political, social, and legal ground rules that establish the basis for production, exchange and distribution, rules governing property rights, and rights of contract (Williamson [1993]). Institutions contain historically determined sets of rules – some stable, others abstract and impersonal – which are crystallized in traditions, customs, and laws so as to implement and enforce patterns of behaviour governing the relationships between separate social constituencies (Menard [1995]). Therefore, understanding institutional change, such as that exemplified by co-operative development in China and other countries, must involve an understanding of the underlying political power and conflicts (Evans [2004]).

Interest groups work within the political sphere to create public policy regimes that reflect their preferences for corporate governance systems. Interests groups support institutions that will provide them with the most benefit, and hurt them least, because once institutions take hold, they are likely to endure even if they have a long-run negative effect on development and limit the likelihood that more efficacious institutions will emerge (Greif [1994]).

The interest groups that become “institutional winners” gain political power along with economic benefits (Evans [2004]). As a consequence, they are less likely to support institutional changes that will diminish their gains relative to other participants, even if the change would result in greater productivity that would increase their returns in absolute terms (Bardhan [2001]). Not only do interest groups want to protect their investments by controlling and influencing their political environment to ensure favourable regulatory treatment (e.g., restricting markets for control, limiting competition, allowing pyramid leveraging and cross-shareholding (Staatz [1987a] and Gourevitch and Shinn [2005]), they also want to control the authority structure of firms.
Chapter 7. Analysis of the Company + Households Model

The political differences among countries lead to different corporate governance structures. Democratic, transparent, and accountable governments develop institutions that reflect and are shaped by shareholders. The more authoritarian the political system, the more likely it is to develop a blockholding pattern of ownership (Gourevitch and Shinn [2005]). The absence of a system of checks and balances allows institutional winners to gain and to retain unchallenged political and economic control. Authoritarian systems lack democratic pluralism, a political and legal system that allows citizens to assemble, speak against, and remove governments from office that do not serve the interests of the people. More importantly, democratic pluralism protects the human and civil rights of citizens so that they can perform these responsibilities (Rausser and Johnson [1993]).

In Chapter Two the social, political, and economic forces specific to China were analyzed. The exploration in Chapter 4 of crony capitalism and the patronage system in China indicated that resulting vertical patron-client dyad is permeating the country’s political, economic, and social life. These institutions promote blockholding patterns of ownership rather than diffuse shareholding ownership, since blockholding ownership allows the groups with power to retain this power.

The analysis in previous chapters has also suggested that the early Chinese state did not establish a constitution that clearly defined and secured basic political, civil, and economic freedoms, nor did it design a legal and regulatory infrastructure (LRI) that would create a fertile environment for a vibrant market economy, which make up important steps for future democratic development (Rausser and Johnson [1993]). Instead, the influence of various bureaucratic interest groups are prominent features of the political-economic landscape. One of the striking features in China’s institutional landscape are the LRI mechanisms that are designed to protect monopoly, inefficiency, and corruption.

Elite bureaucrats wish to concentrate wealth in the hands of a small number of investors. Since the small holders are too difficult to tax, bureaucrats are intent on designing organizations that are taxable and from which they could collect rent (e.g., the Commune). Investors, for their part, want both personal protection and access to more resources, both of which are controlled by the government. Thus, investors established strong ties with the government in order to grow
bigger and gain more bargaining power. As a result, adjudication of commercial disputes and allocation of resources are generally made on the basis of association rather than economic values – indeed, this type of behaviour is common among the blockholding structure that has emerged in China. Decisions favour those who have close relationships with political leaders and government officials.

Cronyistic supports provided by the government to investors include privatization giveaways to relatives and political cronies, granting of artificial monopoly rights, credit given to political allies, and government bail-outs of politically connected enterprises. Cronyistic supports were provided under the guise of an industrial policy in which the government explicitly and implicitly underwrites investments, restricts markets for control, limits competition, and offers weak protection to other social groups.

As discussed in Chapter 4, institutions and policies are often hard to change due to path dependency (Arthur [1994] and Pierson [2004]). As “institutional winners”, the elites (both bureaucrats and investors) are in a position to impose rules on others and shift the rules in their favour while diminishing the position of their rivals. This strategic behaviour results in self-enforcing beliefs and associated behaviours that determine policy, laws, and institutions (Janvry et al. [1993], Greif and Latin [2004]).

Undoubtedly, farmer organizations adhering to western co-operative principles would be a new institution in China, since if they were effective they would represent a new relationship between farmer groups, business and government. Put somewhat differently, a co-operative which is owned, used and controlled by the small farmers would not be regarded as part of what North calls “the interdependence web of an institutional matrix” (North [1990], p. 95).

However, a C+H style co-operative does benefit the dominant interest groups in a way that reinforces their own capacities and diminish those of their rivals. It is for this reason that although the FPCL theoretically allows for a western-style co-operative, the outcome has been very different. As the cases presented in the previous chapter underscore, the ruling elites have interpreted the law in a way that perpetuates their power and influence.

The making and the enforcement of the FPCL echoes Hoff and Stiglitz’s argument that imposing new sets of formal rules without simultaneously reshaping the distribution of power
that underlies prior institutional arrangements is a dubious strategy from the perspective of political economy (Hoff and Stiglitz [2001]). Instead, the social filters derived from dominant institutional norms will be applied to the emergence of new social norms.

Figure 7.1: Institutional Filters

Source: The Author

Figure 7.1 shows that any proposed new institution or governance structure will be filtered through the structural biases of existing dominant institutions that were introduced and are maintained to serve the interests of a specific group that has the power to impose its own sets of preferences upon the structure (Elliott [1975]). Gourevitch and Shinn [2005] argue that policy is the output of preferences and power resources mediated by political institutions. Interest groups apply dominant institutions as filters in order to strengthen their power and defend themselves from downward mobility (Rausser and Johnson [1993] and Elliott [1975]). As a result, the
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policies and structures that benefit these interest groups are kept and passed on, and those that will hurt them are removed.

Western-style co-operatives are a threat to the elites in rural China because they decentralize decision making and they generate and distribute wealth locally. Put more generally, their very nature empowers rural people and their communities (Torgerson et al. [1998]). In contrast, the dominant institutions and structures in which the C+H co-operative is embedded promotes blockholding patterns of ownership and the concentration of wealth in a small number of interest groups.

Figure 7.1 illustrates the existence of two dynamic feedback loops that determine the political-economic feedback effects within a dynamic, closed loop framework. The dominant institutional filter is viewed as a multi-phase process. The interest groups that are institutional winners benefit from the existing institution because it is biased in their favour. They have a vested interest in continuance and reinforcement of these institutions, and will apply their political leverage based on their newly acquired economic power to make sure it continues. Thus, the institutions and associated behaviours become self-enforcing. Meanwhile, the institutional winners will impose their private preferences and vested interests on development programs, thereby blocking any enrichment attempts made by other groups. This is the reason why there are two feedback loops – one is an outcome of interest groups and the other is a dominant institution filter.

Interest groups and elites, afraid that co-operatives would undermine their institutionalized processes and power structures, co-opted them to serve their own purposes. The key economic goals of co-operatives were also successfully filtered by elites to allow and even reinforce the existence of monopolies and retain inequalities between farmers and business. As the positive feedback effects accumulate, they generate a powerful cycle of self-reinforcing activity that over time increase the asymmetrical power structure.

As a consequence of these two feedback loops, it is harder for developmental trajectories to be reversed. Over time Chinese co-operatives have ended up functioning as instruments for overcoming the technical and managerial problems of agricultural industrialization rather than being a new form of participation available to free citizens in a free society (Fairbairn [2004]). Taking into account that causes and effects are separated in time, the explanation for the pattern
of farmer co-operative development in today’s China date back to high modernism, crony capitalism, patron-client structures and even previous monarchies as indicated in Chapter 3 of the thesis. Farmers were never treated as equal partners of the state in these institutions. Instead, they were forced into an institutional straitjacket devised by the state and made subjects of claims from outsiders. The self-reinforcing processes, which are a key factors in path dependency, make reversals increasingly impossible over time.

7.2.2 Lack of an Enabling Environment for Farmer Co-operatives

The endogeneity of institutions leads individuals to act in a manner that reproduces and reinforces associated beliefs and behaviours (Janvry et al. [1993] and Greif and Latin [2004]). As a result, the more privileged groups want to defend these institutions to perpetuate their wealth and power and block the enrichment of other groups. In contrast, the subordinate classes are far less interested in changing the larger structures of the state and the law than they are interested in working the system to their minimum disadvantage (Scott [1985]). The resulting diffusion of interests and free-riding makes the formation of broad coalitions difficult (Janvry et al. [1993]).

Researchers have identified a number of other internal and external obstacles that farmers confront. Internal obstacles include the free-rider problems, horizon problems, portfolio problems, control problems, and decision-making problems. External obstacles include information, resources, political environment, culture and Porter’s five forces (Egerstrom [2004]). A number of these external obstacles can be linked to the nature of the institutional environment in which co-operatives find themselves.

**Dominant institutions reinforce social stratification and imbalances of power**

Contrary to the traditional view of rural communities as systems of communal solidarity, most rural villages are highly stratified by economic class and power, and the gap between the haves and have-nots is growing. One reason is that market orientation and the deregulation of the economy have changed the dynamics of rural life. Huge numbers of small farmers are migrating to the cities to take off-farm jobs. The result is a reduction in face-to-face communication between those that remain behind, which in turn diminishes the trust and sense of community among the villagers. As well, social ties and interdependence are weakened by the development
of commercial services. Both informal and formal co-operation occurs less, social capital is decreasing, and the villagers’ solidarity is further broken.

Furthermore, the economic and social lives of citizens in rural communities are dominated by rural elites – e.g., local party branch and village leaders, and those with strong ties to power holders. Since the elites earn most of their income by appropriation, they receive the lion’s share of fertile land, agricultural inputs, and credit provided by the government. Local authorities fail to dispense justice and are non-responsive to local farmers’ hardships. Further, their strong ties with local elites, and their lack of accountability and political transparency have resulted in public funds being used to support the patronage system rather than the overall development goals.

For small farmers, co-operation gives them hope for empowerment and reduced dependence and susceptibility to appropriation. For these reasons, rural elites and local authorities are motivated to frustrate and repress voluntary co-operation. As a result, the FPCL, the only legal document to support small farmer co-operation, is either not enforced or has its meaning altered to meet the goals of the elites.

During decades of Commune life, the autonomy, independence, and institutions of small farmers were dismantled. Farmers were forced into an institutional straitjacket devised by the government and elites to make them subordinate recipients of government programs and subjects of claims from outsiders. As a result small farmers are far less interested in changing the larger structures of the state and the law. Their motivation is to work the system to their minimum disadvantage. For example, during the years of the People’s Commune, shirking and free riding was rampant (Lin [1988]). In much the same way, farmers today “choose” to join and become members of C+H co-operatives – i.e., doing so is a way of working the system.

In addition farmers are pressured to join C+H co-operatives through a number of other mechanisms:

1. Co-operatives become channels of government funds and support programs – thus, farmers are deprived of certain economic benefits (e.g., subsidized credit and agricultural inputs) if they decide to stay out of the co-operative;
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2. Only C+H co-operatives and their members are allowed to engage in the production of some products (e.g., pigs and cattle), since individual household production is banned in the name of animal and public health;

3. Some agribusinesses are monopolies/monopsonies, and farmers have to be members of co-operatives controlled by them if they want to do business with these businesses;

4. Some farmers are members of C+H co-operatives because it is dangerous economically and socially to not participate with the local elites.

Even though C+H co-operatives are not owned and controlled by small farmers, they are nevertheless important as a means of providing a marketing outlet for agricultural production, introducing high-quality breeding stock and crop seeds, circulating market information, improving the quality, quantity and consistency of agricultural production to meet consumers’ needs, and assisting small farmers to develop more sophisticated skills and adopt best practices. The fact that many farmers have voluntarily participated in the C+H co-operatives indicates that farmers are receiving some benefit from these organizations. Thus, C+H co-operatives do contribute to the development of a modern supply chain and ensure that small farmers have access to this chain in a way that appears to be at least somewhat beneficial.

**Tangible benefits from group actions are marginal**

The principal economic motivations for forming a farmer co-operative are to increase bargaining power and to develop a competitive yardstick. However, the small scale of operations means that Chinese small farmers cannot generate substantial economic benefits from their collective actions. The average size of farmland for each household is less than half a hectare, a size which prevents small farmer groups from engaging in capital and management intensive operations where the profit level is higher.

For example, taking into account the small size of land per household (less than half a hectare), even with 1,000 to 2,000 households engaging in collective action to pool their production, the group would still be unable to reach a scale of production that is cost competitive and
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economically viable. On top of this farmers must add the costs and risks associated with operating a self-help group.

Most co-operatives pay off only after a considerable amount of time and effort. To organize and operate a farmers’ group and become the residual claimants, farmer members have to exert their control. But doing so comes at a cost. If the members do not have the financial and management skills to operate the co-operative, they would need to rely on expensive professional services, such as accountants and lawyers. In addition, there are costs associated with controlling managers and monitoring the board to hold it accountable (Hansmann [1996]).

When many persons share ownership of a group, the collective decision making process is costly, as there are likely to be differing opinions, preferences, and vested interests among the members of the group. It can take a long time to reach an agreement on the shared goals the group is to pursue and to resolve the conflicts among members. These are the costs of collective decision making (Hansmann [1996]).

When joining a co-operative, farmer members pledge many of their assets, both farm and personal, in order to participate. As a result, they face far greater risks than they would if they were to continue to contract with a private firm. In the event that the co-operative fails, they stand the risk of losing a substantial portion of their personal wealth. Small farmers are also forced to operate in terms of short-term interests due to the scarcity of resources and low income potential. The resulting horizon problem also discourages co-operation (Vitaliano [1983]).

These forces can be seen to be at work in some of the examples presented in the previous chapter. For example, the Green Onion Association in Yuammou, Yunnan does not require member capital contributions, and they are not democratically controlled. Another example is the Chicken Growers Association in Gannan, Jiangxi which chose not to engage in more advanced levels of processing and distribution, which have higher profit levels, due to the costs to farmers.

Lack of leadership

Since the authoritarian government never allows organizations to be operated independent of government control (CIDA [2008]), there are no organizations which can take a lead in coordinat-
ing farmers actions and in representing them in the policy-making process. In contrast, external agents and organizations play (and played) a key role in fostering rural reforms and policy making in North America, Europe and some developing countries. As Harris, Fulton, Stefanson, and Lysyshyn [1998] say, the roles played by the external agent include: (1) mobilizing stakeholders; (2) helping farmers develop institutional arrangements which can address assurance and credible commitment issues; (3) identifying the problems and needs faced by farmer groups; (4) developing strategies to address these problems and needs; and (5) mobilizing resources both from within and outside the groups.

Although some NGOs are attempting to assist farmers in China in forming their own groups, they do not have the knowledge and skills required to be effective facilitators. These include: a solid knowledge of the agri-food industry, the ability to link this knowledge with an appropriate organizational arrangement, and the ability to foster mutual trust and interdependence among stakeholders (Harris et al. [1998]).

Individual leaders are also important. The most important attribute of a successful co-operative leader is his or her vision of a business opportunity and the ability to motivate members to take advantage of it (Baker and Soren [2004]). However, most of the better-educated farmers with entrepreneurial skills have moved to the cities to take jobs. Those staying in the villages have been thoroughly socialized by dominant institutional norms, making it difficult for them to understand the nature of the co-operative opportunity – the ability to work together for mutual benefit and to determine their own destinies democratically.

Co-operators that believe in and understand collective action often have great difficulty communicating their paradigm to a community permeated by the traditional power structure. Even when a co-operative is started, it is not easy to translate the vision into practice because there are few real world examples that can be emulated. As a result of dominant institutions, co-operative organizations inevitably lose many of the properties that made them unique. In particular, farmers with an entrepreneurial drive are more inclined to run their own business since the direct economic returns on their investments of capital, time, and effort are limited in co-operatives due to ill-defined property rates.
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In addition, those leaders dedicated to co-operation and community development may find themselves being pushed out of the co-operative if their organization threatens the power base of local elites or if they were to compete seriously with established private interests.

Lack of a Business-Friendly Environment

The participation of government officials in business activities for their own interests is a serious obstacle to the development of competitive markets (Rausser and Johnson [1993]). The authoritarian political system encourages blockholding by restricting markets for control, limiting competition, and offering weak protection to investors of small and medium enterprises (SMEs). SMEs are also vulnerable to manipulation and control by local elites and special groups. Business owners that feel insecure resort to seeking protection from power holders, thereby reinforcing the establishment of the patron-client network.

Farmers groups face the same risks as other members of the rural business community that have to deal with authoritarian government interference. The government imposes unreasonable burdens on SMEs such as interfering with their markets, and providing little information or technical assistance. The fact that the institutions of the market-economy are not fully implemented or enforced, including the rule of law, gives these organizations no recourse.

Small farmers’ self-help groups are confronting internal and external obstacles that marginalize them in the co-operative sector. In contrast, C+H co-operatives are being venerated as the best examples of agricultural modernization, and are favoured by local authorities. The next section of this chapter is devoted to examining the basis of the relationship of unequal power and status that exists between the company and households in the C+H co-operative model.

7.3 Modeling the C+H Co-operative

A C+H co-operative is an organization jointly owned by a dominant company (agro-processor) that acts in its own best interests, and numerous small producers who do not have a voice in decision-making. Most of the returns from co-operative investments accrue to the company.

In Chapter Six various examples were given to help illustrate the practices of C+H co-operatives. Earlier in this chapter a theoretical analysis was also provided to give a better understanding of their economic nature, looking particularly at ownership and control. Now it is time
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to generalize their behaviours and find out what drives the emergence of investor-dominated and investor-manipulated co-operatives, which are fundamentally different from both western co-operatives and even IOFs.

Based on their main purposes and governance structures, a C+H co-operative can be viewed in four distinct ways. First, as a form of vertical integration for companies. Second, as an investor-owned company which carries the title of co-operative as a flag of convenience. Third, as a strategic management tool to perpetuate the power and wealth of local elites. Fourth, as a coalition that provides a bargaining process to deal with co-operative and conflictual behaviours between the company and small producers. Each of these views will be discussed in turn.

7.3.1 C+H Co-operative as a Form of Vertical Integration
Industrial organization theory suggests that the main driving forces for the vertical coordination of the agri-food sectors are flow scheduling, capacity utilization, and new consumer demands for products that meet specified quantity, quality, and safety standards. As a result of these forces, greater coordination among the stages of the food chain is becoming necessary, resulting in the movement towards negotiated contracts and away from spot markets (Boehlje and Schrader [1998] and Hobbs and Young [2001]). In China, many agro-processors saw the potential economic rewards from the vertical coordination of the agri-food system through contracts or full vertical integration and have used the co-operative model to help them achieve it.

As argued previously, integrating backwards into farm production is not a viable option for most agri-business companies in China due to high production costs and legal obstacles. A viable method for processors to achieve vertical coordination is through the use of detailed contracts that require farmers to follow specific production practices.

According to Mighell and Jones [1963], contracts can be classified into three broad groups. Market-specification contracts stipulate that the sellers must sell their products to the buyer at a specified time – these contracts allow the farmer to retain control over production. Production-management contracts allow the buyer to specify and/or monitor the farmers’ production practices including input usage – these contracts entail more buyer control than the market-specification contracts. Resource-providing contracts stipulate that the buyer provides a market outlet, super-
vises production practices, and supplies key inputs to the farmer – these contracts allow the
buyers a great deal of control over the farmer.

The examples of the Shenglin Peach Growers Co-op and Bage Rabbit Producers Co-op in
chapter six illustrate that market-specification and production-management contracts can have
high contract enforcement costs due to a lack of trust and imbalances in power. High transaction
costs occur because of the difficulties the company and small producers have in coming to an
agreement on acceptable contract terms that shares the risks and rewards fairly between them.
Transaction costs include the costs of gathering and processing the information necessary to carry
out a transaction, reaching decisions within the organization, negotiating contracts with other
parties, identifying and specifying future contingencies, and policing and enforcing contracts
(Staatz [1987a]). If the transaction costs of contracting become too high, coordination is unlikely
to occur (Boehlje and Schrader [1998]).

The transaction approach suggests that an organization will develop its form and gover-
nance structure to minimize the sum of the production and transactions costs that dominate
the organization’s activities, in this case the activities associated with agricultural production.
C+H co-operatives like W Broiler and Hog Company and Lishu Slaughterhouse chose to utilize
resource-providing contracts, albeit with some differences in characteristics, in order to mini-
mize their transaction costs. These two companies both supplied key inputs to contracted small
producers, including piglets, vaccines, feed, and additives. They also monitored the farmers pro-
duction practices using veterinarians, technicians, and associated staff. Finally, they retained
the ownership or marketing rights of the finished products.

The C+H co-operative model represented the greatest level of control for these companies
as buyers. C+H co-operatives differ from resource-providing contracts in that the companies, as
buyers, are able to assume a smaller proportion of the risk, while appropriating a higher surplus
from operations and retaining ownership of product. Farmers must transfer control over certain
aspects of production and marketing, but fail to receive much greater assurance of access to
market, inputs, and lower risk.

Property rights theories (e.g., Barzel [1989] and Fulton [1995]) can be used to analyze the
structure of ownership and control in the C+H co-operatives in relation to the residual claimant.
According to this theory, farmers were made the residual claimant so that they would take appropriate action to operate efficiently and effectively. When the quality of the product can be effectively determined through the provision of the key inputs, it is no longer necessary for the farmer to be made the residual claimant. Consequently this opens the door for the agro-processor to obtain greater control over the entire production process.

Williamson’s work (Williamson [1979, 1985, 1989]) also provides a theoretical framework from which we can obtain empirical answers and make concrete predictions about C+H co-operatives. Williamson considers the transaction as the basic unit for the analysis of governance systems. Hence, the dimensions of a transaction will determine the governance structure an organization chooses.

Under the C+H co-operative model, companies are designing their governance structure in order to shape their transactions, giving them the necessary dimensions to meet their need to vertically coordinate. Therefore, C+H co-operative is a governance structure, not only for economizing transaction costs, but also for shaping transactions so that they can be sustained.

Table 7.3 illustrates that, based on the critical dimensions of transactions, there are four types of governance structures and three associated forms of contracting that may result. The critical dimensions of transactions include the frequency with which they recur, the degree and type of uncertainty to which they are subject, and the condition of asset specificity. The four governance structures and their related contracting forms are: (1) a market structure with classical contracting; (2) a trilateral structure with neoclassical contracting; (3) a bilateral structure with relational contracting; and (4) a unified structure with relational contracting.

The market governance structure is the main structure for non-specific transactions of both occasional and recurrent contracting (Williamson [1989]). A third party is needed to address the limits of classical contract law by resolving disputes and evaluating performance. The trilateral governance structure is applied to transactions involving both mixed and idiosyncratic assets that occur with occasional frequency. The bilateral and unified governance structures are both relation contracting forms. They occur when transactions are recurrent and involve mixed or idiosyncratic assets. While the autonomy of the parties is maintained in the bilateral governance
form, transactions are organized within the firm (or are vertically integrated) when the structure takes a unified governance form.

<table>
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<tr>
<th>Frequency</th>
<th>Conflict</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Nonspecific</td>
<td>Mixed</td>
</tr>
<tr>
<td>Occasional</td>
<td>Market governance</td>
<td>Trilateral governance</td>
<td>Bilateral governance</td>
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<td>Recurrent</td>
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Sources: Williamson [1979].

Historically, small producers in China usually did not specialize in the production of one specific product; thus they did not have frequent transactions with a single company nor did they make large investments in specific assets. As a result the market governance structure has been the main structure for vertical transactions. However with changes in the agricultural economy, many agro-processors are looking for a governance structure that helps them deal with recurrent vertical transactions involving idiosyncratic assets.

An agro-processor wishes to develop a form of relational contracting with small producers to encourage them to engage in transactions that are recurrent and involve mixed or idiosyncratic assets. In addition to providing a market outlet, monitoring farmers’ production practices, and supplying key inputs, the companies encourage a sustained relationship by having farmers invest resources in the relationship.

Farmers associations have gradually evolved into an organization that is able to incorporate this quasi-vertical integration. Furthermore, there is much government support available to companies using the guise of farmer associations, including providing resources, maintaining legitimacy, and providing a reputation for fairness. For this kind of association, membership is usually selective and a minimum threshold is established for potential members; this threshold might specify the size of farmland a member owns, or the number of animals they raise.

The stories of W Broiler and Hog Company (W) and Lishu Slaughterhouse (Lishu) reflect the tendency for C+H co-operatives to choose a governance structure for economizing transaction costs, and sustaining transactions with desirable dimensions such as recurrence and the involvement of idiosyncratic assets.
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In the C+H co-operatives established by W and Lishu, the producers with relatively large scales of production are usually treated as core members of the association. The company makes substantial investments in the association to make sure these members make binding commitments to honouring and sustaining their relationship. After the co-operative is established, the first order of business for the company is to pour sufficient resources into it to avoid potential defection and to enforce contracts. For example the co-operative can force producers to provide deposits to ensure they honour their contracts. Co-operatives will also hire a large number of staff to monitor the contracted producers to ensure they buy inputs and other supplies from the company, and that they sell their output to the company.

The company then starts to require its contracted producers to make relatively large investments in specific assets, such as animal sheds, choppers, and other machinery which are later set as preconditions for membership in the association. When transaction-specific assets become more idiosyncratic, the producers have a strong incentive to sustain the relationship.

Local authorities will usually provide assistance to companies to develop and enforce their contracts. For example, they might provide subsidies to encourage small producers to sign contracts with the company, and help them to invest in production facilities, or seek farmers compliance by coercion. Other types of services local authorities might provide include database technology and staff support to enhance the legitimacy and reputation of the co-operative. They may also reduce transaction costs by enforcing contracts. In particular, government has helped to cover shirking and cheating costs (the costs of using price-constraint systems plus the losses due to imperfect measurement) (Hennart [1993, 1994]).

The above analysis of C+H co-operatives indicates that their typical structure is a hybrid of vertical coordination with a strategically managed hierarchy and market governance. C+H co-operatives are shaped to allow transactions with desirable dimensions to reoccur on a sustained basis which helps companies tackle the uncertainties of the market and to receive benefits associated with a structured hierarchy of coordination and control. The presence of government in the organizational structure reduces the bureaucratic costs of such a hierarchy. Therefore, the choice of the organization’s structure is not only determined by cost considerations, but also by the existence of hierarchies and power relationships (Sauvee [1998]).
7.3.2 Co-operative as a Firm

The competency/capacity approach is a collection of work that focuses on the “core competencies” or “internal capacities” of firms as an explanation for the evolution of firms (Langlois and Foss [1997]). Based on this approach, the strategic management literature takes a pragmatic and functionalist view of the firm (Porter [1991]). Both of these approaches can be used to analyze the creation of C+H co-operatives.

The competency/capacity approach argues that the existence, structure, and boundaries of a firm can be explained by analyzing the individual or team competencies, such as skills and tacit knowledge, that are in some way fostered and maintained by that organization (Hodgson [1998]). A firm’s competence is determined by its set of technological skills, complementary assets, organizational routines, and its competitive capacities in one or more businesses (Teece et al. [1994]). A firm’s core competencies influence the scope of the firm’s activities and provide motivations for vertical relations that can help to maximize or expand output capabilities through co-operation or integration.

Agri-business companies in China emerged early in the 1990s when agricultural industrialization was undergoing a shift from impersonal markets to contract and ownership coordination. Agri-businesses acquired knowledge and information on the coordination of key players in the food supply chain and the role of government. After 2000, when farmers organizations were allowed to be established, these companies already had the information and knowledge they needed to increase their power and control, capture profits, and transfer risk to others with less power (Boehlje and Schrader [1998]). The capacities and competences of these companies determined that by using the C+H co-operative model their boundaries and limitations were far fewer and they could engage in a full range of activities including the supply of key inputs, the control of production practices, and the marketing of products.

For example, W Boiler and Hog Company, Lishu Slaughterhouse, and Yili Dairy Farmers Co-operative all established C+H co-operatives so that they could control product safety and quality. These companies provide young animals (chicks/piglets), feed, vaccines, and technical services at pre-agreed prices to their farmers. The price of inputs are set by the dragonhead and
include the company’s profit margin. In most cases these inputs are provided on a credit basis and the final accounts are settled when the finished products are sold to the dragonhead for processing.

This arrangement mitigates the member producers’ cash problem somewhat, but usually the company still requests that producers make a down payment when the contracts are signed. The down payment not only provides the company with collateral, but it also creates a pool of working capital. Agri-businesses generally own their own feed mills and licenses for trading vaccines. To some extent, these linked markets provide secure outlets for the company’s own products and become a profitable enterprise for the company. This is supported by the finances which show that most of a company’s profits are generated from the supply of these inputs to members, since most still contract out the marketing of their finished products.

The strategic management literature suggests that a company’s strategic considerations are the desire to create barriers to entry and to raise rivals’ costs. Thus companies tend to engage in closer vertical relations in order to enhance their competitive advantage in respect to actual or potential rivals (Mahoney [1992]).

For example, the Shenglin Peach Company and the Bage Rabbit Company used the C+H co-operative model to cope with both rival companies and potential rivals such as producer self-help groups. These companies made preemptive moves early in the transformation from open markets to a closed system in order to retain their prominence in the sector. They developed into C+H co-operative organizations so they could coordinate vertically and provide value-added services, while restricting ownerships to large investors. This model is in sharp contrast to the growth of co-operative enterprises in North America, which redesigned co-operative boundaries to embrace capital while protecting their co-operative values and property rights (Cook and Chaddad [2004] and Harris et al. [1996]).

Some C+H co-operatives have sufficient market presence to move price levels closer to those under monopoly/monopsonistic conditions, thereby capturing higher profits and transferring risk to farmers. Furthermore, these co-operatives actively try to protect their investments by influencing their political environment to ensure favourable regulatory treatment, and building entry barriers.
Strategic risk reduction

Farming is a business with high levels of risk and uncertainty (Hansmann [1996], Boehlje and Schrader [1998], Hobbs and Young [2001]). Many agri-business firms in China use the C+H co-operative model as a business strategy to reduce their risks. Companies that obtain their produce from a large number of farmers can expect small losses with some certainty. In many cases they are using the co-operative to shift risk to small producers.

One risk for companies is price fluctuation on the cost of inputs and products. One common business strategy used by agri-businesses to reduce the risk of high prices for inputs and low prices for products is to sign contracts with small farmers. For example, contracts signed between W Broiler and Hog Company (W) and the farmers include the price of the finished products and price of inputs. When the market for finished products is in a downturn, W may find an excuse to refuse to purchase the finished products from farmers, or shed this risk by making raw product prices contingent on prices received for finished products. Input prices are also sometimes adjusted to match market price fluctuations. Through these methods the risks are shifted to the farm members, and the company can still make profits from its operations.

Conceptually, farmers have taken on what can be called a relationship risk (Boehlje [1998]). Specifically, by signing a contract, the farmers are opening themselves to the risk that the company might renege on the relationship that was been established.

A second source of risk is related to quantity and quality features. To ensure a consistent supply of quality products, the company needs to manage the coordination of production quantities, quality, and timing features with small farmers. To be cost competitive, the plant should be operated at full capacity at all times. As analyzed in the previous section of this chapter, to reduce risks in quantity and quality, companies like W, Lishu Slaughterhouse and Yili Dairy Co-operative designed a unified governance structure under the C+H co-operative model to ensure that their desired transactions were sustained.

The third source of risk is high levels of disease and animal mortality. The company asks small producers to make a down payment for the young animals it provides. This downpayment
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means that the company is able to pass on the risks of animal disease and mortality to the small producers.

**Increased bargaining power and visibility**

The scale of operations of some big households and private farms is much larger than that of the small producer; therefore, the risks they are exposed to are much bigger. However, even these large households and firms are not big enough to exert market power when dealing with other players in the food supply chain, such as the input providers and processors.

To increase their bargaining power and manage their risk, big households have strong incentives to form representative associations to negotiate better contract terms with larger players. For example, Yushu Pig Producers Co-operative, Wanzhou Peach Growers Co-operative, K Dairy Farmers Association, and Shenglin Peach Growers Co-operative were all established by big households. These co-operatives or associations usually recruit small producers as peripheral members that do not contribute capital. The most important role small producer members play in the association is to inflate the membership. The control and ownership still rest in the hands of a small number of big households or private farms.

As a consequence, the goal of such a co-operative is to maximize the personal value of the big households that own it, rather than the welfare of the total membership. The co-operative’s investments, contributed by the big households, are returned to them through improved cash flow. Big households receive returns in the form of more favourable prices, subsidies, grants and commissions given by the processors. For example, the big households that were the founding members of Yushu, Wanzhou, K, and Shenglin all received better prices for their products and substantial grants from local authorities. The small farmers members also received more favourable prices for their products, but other benefits were marginal or non-existent.

**Strengthening their dominant position and making entry difficult**

The modern agro-processor owns and runs a capital-intensive operating facility with a large production capacity to absorb the raw agricultural products from the county. When it is the only buyer, it is considered a monopsony. There are several ways in which a firm may become and remain a monopsony. It may have a knowledge advantage as an early entrant to a specific
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Having learned by experience, the firm may have lower costs. Experience may include specific agri-product knowledge on quantity and quality features or about its producers. When a producer’s association or co-operative is controlled by a firm, it allows the firm to collect and process such information, gain insights, and extract other reliable information to which the rivals do not have access.

The local government may protect the incumbent firm by providing a favourable environment for its success. A government might protect the firm by designating territory for it that restricts the entry of other firms, – e.g., dairy farmers might be restricted to selling their milk to a particular company’s milking stations. This favouritism is usually provided to firms that have strong personal ties with local leaders. The relationship is mutually beneficial since the local government also relies on the VAT contributed by the firm to create a stable taxation base. In the name of supporting farmers organizations, local governments are actually providing support to firms under the guise of industrial policy and farmer co-operatives.

The dominant position of incumbent firms is strengthened by the huge capital investment required for a modern agri-processing firm to enter the field (Sutton [1991] and Fulton and Giannakas [2001]). Sunk costs and asset specificity are critical barriers for the entry of competing firms and reduce the amount of competition. An incumbent firm can further increase the difficulty that potential competitors have in entering the market by establishing producer associations or co-operatives that control the market for their product. An existing firm will try to control most of a specific agricultural product in a county through such organizations.

Several of the examples exemplify this approach. W Broiler and Hog Company controls the piglet and hog production in a number of counties in Guangdong province, Lishu Slaughterhouse controls the hog production in Lishu county of Jilin, and Santai Pig Producers Association controls the pig production in Santai county. Producers in these counties are restricted from selling their products to anyone but the associated firm, even if the firm has set a lower price than the producers can get elsewhere.

Usually, these restrictions are aided by the presence of a strong local government. The government will give a production quota for a specific product to each town or village, and
checkpoints are established at the borders with other counties to prevent small farmers from selling their products to others who can offer a higher purchase price.

**Acquiring farmland**

Many investors are starting co-operatives so they can obtain the benefits associated with the development of livestock parks. The co-operative model helps new firms enter the livestock industry because the complicated review and clearance processes for land development are not applied to farmer co-operatives. Further, World Bank project financing can only be applied to new livestock parks which are established by producer co-operatives or associations (World Bank [2009]).

The government tightly controls farmland acquisitions, which in turn limits large scale farming. However, through the use of co-operatives, companies have found ways to overcome this barrier.

It is very difficult to obtain the land required to run a livestock operation in China due to the household farm system which has divided up the land among a very large number of farmers. A standard 500-cow dairy farm requires 50,000 square meters of land, and a standard 500-head beef cattle farm requires 33,000 square meters of land. In China the average household leases two to four mu land (One mu equals 660 square meters). If we take the mean of the farmland to be three mu per household, then in order to develop a dairy farm an investor would need to acquire the land of 26 households; a beef cattle farm requires the land of 15 households.

Negotiations with such a large number of households are difficult and costly, especially because most farmer households depend on their land for their livelihood and security, so even a high price may not be enough to convince them to rent out their plot of land. To overcome this barrier firms use the co-operative model to encourage farmers to participate in their livestock development. The investors may offer farmers contracts that stipulate that the household will have a lifetime access to one of the firm’s barns in order to get farmers to sign over their land. Local authorities have also threatened to ban the production of livestock in a household’s backyard in order to stifle small production. These threats are executed under the guise of the need to
control environmental contamination from animal waste and the spread of diseases. The latter has proven to be an effective method for forcing small farmers off their land.

The “co-operative” method for acquiring land through contracts has proven unfair to small farmers due to the imbalance of power that is apparent in the contracting. For example, farmers have to rent equipment and buy all of their inputs (e.g., feed, additives, and animal drugs) from the livestock park. The livestock park has sole purchasing rights of the products (milk, meat) produced on the land. For a dairy park most of the profits made by the investors come from the management fees paid by dairy processors who buy milk from the farm. The surplus of operations from the collection of management fees, sale of manure, and governance subsides are not distributed to the small farmers.

### 7.3.3 The Co-operative as a Coalition

The preceding parts of this chapter examined the nature of the C+H model co-operative and the interaction between the key agents within the co-operative. This section explores the existence of co-operative and conflictual behaviours within these organizations.

The co-operative can be viewed as a coalition of participants – e.g., the company, small producers, big households, government officials – that each have their own objectives and will participate in the organization as long as the benefits outweigh the costs. The resulting actions and behaviours of the co-operative result from the power struggle between participants during the bargaining process. The participants have enough relative power to have a say in the co-operative bargain amongst themselves to agree on courses of action that allow each to achieve at least some of their objectives (Staatz [1987a]).

The above framework indicates that the companies who own and control these organizations can exert differing degrees of power relative to their bargaining power with small producers and other co-operative members. The resulting choice of an organization structure reflects the existence of these power relationships (Sauvee [1998]). Different internal incentive structures will be created by the organization to benefit the dominant agent.

Some C+H co-operatives, such as those in which the company is a medium or small processor, have more common interests with the small producers and will depend on them more due to
lesser market power. For these reasons the company will have a greater incentive to work with small producers through the bargaining process. In these cases the bargaining process is often more institutionalized, and the level of trust between the company and the small producers is relative high. In the examples of the Shenglin Peach Company, K Dairy Farm, and Ms. Zhang of Yushu Pig Producers Co-operative, the company owners are producers that share the same problems as other producers, and their scale of operation determines that they must work together to deal effectively with other members of the supply chain.

The level of trust between contracting parties is important (Staatz [1987b]). According to Casson [1991], the institutional and legal systems in the western world help to monitor performance and penalize parties that do not fulfill their negotiated commitments. These institutional and legal systems are fundamental to creating trust in contracts, but they do not exist or work in China. As a result, C+H co-operatives are being used as an alternative approach to engineering trust.

C+H co-operatives like Shenglin and Wanzhou Pear Growers Association engineer trust by manipulating the incentive structures so that small producer members fulfill their commitments based on potential rewards they will receive or penalties they will incur. Member incentives can be either economic or emotional. Economic incentives include supply of cheaper inputs, better prices for finished products, and access to a portion of the operation surplus. Emotional incentives include an opportunity to personally negotiate transactions with the co-operative, guilt for cheating, and satisfaction for performing according to expectations. Emotional incentives are particularly affective when a peer group is present. Higher levels of trust can help to facilitate the reaching of a consensus during bargaining processes.

Some C+H co-operatives, dominated by large agro-processors, such as W Broiler and Hog Company and Lishu Slaughterhouse, have the monopolistic/monopsonistic power to design a unified governance structure that manipulates small farmer members. The interests of large agro-processors are often in conflict with the interests of small producers, leading to confrontations and control being exerted by the contracting firm. Individual choice is limited for small producers, but they can use the threat of exit, or not fulfilling the contract, as a means of disciplining the company.
Agro-processors need to make large investments in the infrastructure of modern large-scale production. Consequently, small producers also need to invest in highly specific assets to provide standardized products to the processor. This asset fixity and frequency of transactions requires a minimum level of trust between small producers and the company, so that the farmers believe the company will not act opportunistically (and vice versa).

In the long run, these companies use relational contracting that promotes a general understanding that disputes will be settled amicably to preserve a long-term relationship (Williamson [1985]). To prevent small producers from breaking away, attention is given to the payoffs from co-operation. A stable equilibria can emerge from the above two bargaining processes.

<table>
<thead>
<tr>
<th>Table 7.4: Relationship Between Co-operation and Conflict</th>
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<tr>
<td><strong>Conflict</strong></td>
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<tr>
<td><strong>Co-operation</strong></td>
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<tr>
<td>Low</td>
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<td>High</td>
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<td>Low</td>
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Source: Craig [1993]

According to Craig [1993], conflict is not always in opposition to co-operation. In fact, conflict may be an integral part of inducing and sustaining co-operative behaviour. Table 7.4 presents four logical combinations of co-operation and conflict in a social group. A low level of conflict may be matched by a low level of co-operation. In these groups there is little intra-group action. Sometimes there will be intense conflict between people, but when it comes to achieving some mutual objectives the co-operation between them can be intense as well. In these groups there may be strong disagreement over precise definitions for goals or the means of achieving them. When a group of people experience low conflict and high co-operation, it is easy for them to define common goals and take collective actions to achieve them. When high conflict is matched with low co-operation, the intra-group relationship is unstable.

Craig’s theory can be illuminated by the conflict and co-operation processes that occur within C+H co-operatives.

As Table 7.5 illustrates, Craig’s theory for modeling co-operation and conflict can be applied to the various co-operative models to gain insights into their nature. Co-operatives dominated by
Chapter 7. Analysis of the Company + Households Model

Table 7.5: Co-operation and Conflict occurs in C+H co-operatives

<table>
<thead>
<tr>
<th>Co-operation</th>
<th>Low</th>
<th>High</th>
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<tbody>
<tr>
<td>Low</td>
<td>Co-op dominated by big household</td>
<td>Leading Enterprises + Households</td>
</tr>
<tr>
<td>High</td>
<td>Company + Co-op + Households</td>
<td>IOF in name of co-op</td>
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</table>

big households (C+B model) – e.g., the Yushu Pig Producer Co-operative initiated by Ms. Zhang – experience low conflict and low co-operation. Both the big household and small households are producers and as a result there is little competition, but they don’t have strong incentives to work together.

The experiences of the company + co-operative + households (C+C+H) model are typified by low conflict and high co-operation. Companies like Shenglin Pear Company, Wanzhou Peach Company, and K Dairy Farm may have different objectives from those of the small producers and big households, but there is bargaining amongst the co-operative members over courses of action. These companies are usually a small or medium trader, transporter, or producer that faces competition from other rival companies. They do not have a monopoly or monopsony position that they can use; instead small producers can threaten to refuse to sell products to the co-operative as a means of disciplining the management. Therefore, the company is more willing to negotiate and make compromises in the sharing of costs and benefits.

The leading enterprise+households (L+H) co-operative model is typified by high conflict and low co-operation. The leading enterprise, such as W Broiler and Hog company or Lishu Slaughterhouse, will abuse their monopolistic or monopsonistic power over the households to extract profits. The leading enterprise is usually a buyer of agri-products with the desire to force down product purchase prices and maximize profits. The imbalance of power negates the necessity to negotiate with small producers.

Private firms (P+C) carrying the title of farmer co-operatives as a flag of convenience may experience either high conflict and high co-operation types of behaviours or high conflict and low co-operation depending on their interaction with farmers. When a firm acquires land from farmers, if they can offer reasonable compensation or share the benefits with small producers
in a reasonable manner, a creative relationship can be established between investors. However, most of the time the contracts signed between the investor and small producers are biased in favour of the investor leading to a high conflict and low co-operation relationship.

7.3.4 Strengthening the Power of Interest Groups

No amount of tinkering with the institutional framework of co-operatives is likely to change the social structure in which co-operatives are embedded (see Janvry et al. [1993] and Attwood and Baviskar [1993] for a general discussion of how institutions are exogenous to certain organizations and activities). The co-operative model was introduced to developing countries like China as a borrowed institution with many remarkable and grave distortions (Hunter [1969]). In China, the state has formidable power to control economic development and the allocation of resources (Bandyopadhyay and Eschen [1993]). As a consequence, co-operatives have been created as institutional forms and production units for monitoring, managing, appropriating, and controlling individual households from above. They are also expected to help overcome the technical and managerial problems of vertical coordination.

More privileged groups are well positioned to capture the opportunities brought about by co-operatives. For example, co-operatives are being used as an institutional base for local interest groups to lobby government officials. Co-operatives can provide additional power and new opportunities for elites to use in their own best interests, thereby obstructing the attempts of small farmer self help groups. The co-operative is also a means of strengthening an elite’s position and reinforcing the institutions that are beneficial to them (Enriquez [1986]).

Captures additional power and resources

The introduction of the market economy has resulted in widespread differentiation in the wealth, status, and power of Chinese citizens. A large number of the better-offs are the private business owners who have strong ties with local authorities. They want to protect their investments by controlling their environment and influencing the local authority to ensure favourable regulatory treatment and access to productive resources. Co-operatives provide these more privileged groups with additional power and new opportunities to strengthen their positions. Further, the govern-
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ment believes that farmer co-operatives are a better institutional arrangement and production unit for organizing, monitoring, controlled, taxing, and appropriating small farmers.

Few authoritarian regimes can maintain power through coercion alone. Most mix coercion with patronage to secure support from key constituencies. Each year in China, central and local authorities provide direct fiscal grants to those elite or company run co-operatives that set the best example. Higher-level government will ask lower-level governments to recommend a number of co-operatives in accordance with the performance indicators established by the higher-level government. As a consequence, the most common motivation for investors to establish a co-operative is to take advantage of various government support programs targeted to them. Such behaviour is found in all types of co-operatives, including C+B, C+C+H, L+H and P+C.

The agricultural bureaus and other line bureaus are providing funding and in-kind support to locally selected co-operatives. For example, some livestock co-operatives (e.g. Zhongmou Dairy Farmers Co-op and many livestock parks) receive subsidies to buy breeding animals; simultaneously, they may also receive grants from environmental protection bureaus to build biogas digesters. Some companies, like the Shenglin Pear Company, have used the funding to purchase equipment and build workshops. Although it is claimed that the co-operative owns the infrastructure built with government subsidy, it is the companies that operate them that are making the profits from them.

Co-operatives also are given better access to loans and extended credit by state banks. In some cases, the interest owed on a loan is also subsidized by the government. In addition, co-operatives receive tax breaks and the income from a co-operative is not taxable.

Some big companies – e.g., W Broiler and Hog Company and Lishu Slaughter House – that have strong ties with local officials and make large, stable tax contributions to the local fiscal income are targeted as major recipients of agricultural support programs. Even though these programs are supposed to target small producers, the local government’s priority is to expand the local taxation base. Therefore, government funding is transferred to these big companies that take on the co-operative name.

Some local governments want to promote large-scale farming operations. They encourage the big households to merge land with their neighbours and to take on the title of a co-operative.
The Political Economy of Farmer Co-operative Development in China

The objective is to have land concentrated in the hands of big households, so that other capacity building programs like technical training, assistance and new technology transfer can be targeted to these “demonstration households.” As leaders of the co-operatives, the big households quickly learn to exploit their new position for personal ends only.

Institutionalization of power

Economic development has provided the opportunity for a group of new better-offs to emerge. Individuals that were better prepared for the economic development process through education, skills, entrepreneurial drive, or connections are able to obtain a larger share of the economic growth and become early beneficiaries of modernization. These better-offs tend to use the co-operative as leverage to gain better access to resources, and to differentiate themselves from the masses. They are politically motivated and their ultimate goal is to use the co-operative as an instrument for legitimating and institutionalizing their power and control.

Traditional elites and interest groups take advantage of the opportunity to exploit and manipulate the new better-offs to reinforce their power. Due to a lack of political transparency and weak public regulation, the system helps the traditional elite to protect their wealth and achieve more business growth. In this inegalitarian socioeconomic setting, the new better-offs have to become members of existing privileged groups. Within these groups, decisions are made on the adjudication of commercial disputes and the allocation of resources which are ultimately made to favour those with already privileged status. The distribution of credit, agricultural extension services, access to markets, and the benefits of agricultural research and land reform are heavily biased against the excluded.

These new better-off groups tend to use co-operatives as avenues of upward mobility to access government support. The government has delegated to co-operatives the economic administration for control and appropriation. Through a process of inter-group competition and selection based on social-economic status, the government and the traditional elites determine how resources are divided between groups. For example, Ms. Zhang, the director of Yushu Pig Producers Co-operative, Mr. C the director of Shenglin Pear Co-operative, and the founders of Wanzhou Peach Co-operative gained their legitimacy from their leadership position in the co-operative.
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that includes them in a closed system that provides access to inside information, builds networks with policy makers, and creates a voice in the policy making process.

Perpetuates and reinforces power structure

New economic opportunities tend to weaken the power of traditional elites since they earn their income in large part by appropriation. If the creation of a co-operative succeeds in raising the living standards of the local villagers then their dependence on the elites and susceptibility to appropriation will be reduced. Likewise, if traditional elites choose to share power with the new better-offs they would be losing some of their power. Therefore, traditional elites strategically maneuver themselves to monopolize the co-operative business for their own benefit and to ensure co-operative development is a process of impoverishment rather than enrichment.

To limit the risk of downward mobility and to defend existing institutions in favour of themselves, the traditional elites (party officials, village officials and other rural elites) form groups to acquire control over resources. They are well connected and have insider insights that can help them to win this inter-group competition. For example, the owner of Bage Rabbit Company, and the owners of many livestock parks are, or used to be, village party secretaries. They initiated the co-operative or association and control it by appointing themselves as director, or appointing their representatives as leaders. Through the co-operative they are provided with additional power and more opportunities to use it, thus strengthening their position. Further, to reinforce their power, they tend to frustrate and repress other organizations of voluntary co-operation by removing or co-opting their leaders, thus eliminating the opportunity for the development of independent power bases for emerging leaders.

The traditional elites earn much of their income by appropriation. Through the village committee and the government suppliers, inputs such as irrigation, chemical fertilizers, loans and land contracts are appropriated by elite run co-operatives. Thus they tend to confine their co-operatives membership to kin and close friends who are worthy of a share in the fruits of appropriation. In turn, these core members must be loyal and supportive. To the majority of members the benefits of appropriation will be non-existent or marginal.
As a consequence, these co-operatives reinforce pre-existing socio-economic inequalities and fail to provide the vast majority of farmers with access to resources or a sustainable livelihood. Thus, social stratification is reinforced.

### 7.4 Summary

In summary, the examination of farmer co-operatives provides us with a lens through which we can understand the sector and the institutional structures of which it is a part. While co-operatives have achieved a number of economic and social goals in other countries, in China they have been appropriated by more privileged groups to help perpetuate their wealth and power.

This outcome is the consequence of endogenous institutional change. All stable social systems, including political systems, have self-reinforcing beliefs and associated behaviours. The preferences of elite interest groups are aggregated over time and reflected in the resulting political institutions. These political institutions continue to dictate and refract policy outcomes and the manner in which resources are distributed. Dominant institutions act as filters through which new institutions and social norms must emerge. New institutions which are thought to diminish the power of an elite interest group will not pass through. Therefore, without a reshaping of the distribution of power, the ordinary people will not have the power to impose their own sets of preferences (social justice, decentralized wealth, decision making power, and equal opportunity) upon the structure.

Co-operatives in China have failed to live up to their expectations of achieving just economic and social change. They did not increase the transparency or balance of power between members of the agricultural supply chain, nor did they help reduce poverty and inequality. Moreover, the obstacles to co-operative development are the same ones that exclude the vast majority of small farmers from economic and democratic participation.

Although the state has formidable power, it has not used the co-operative model as a developmental tool to overcome inequality. Instead, co-operatives were introduced as a means to overcome the technical and managerial problems associated with vertically coordination of the supply chain. There is no political will to implement the necessary checks and balances that would limit any single faction from gaining and retaining unchallenged political and economic
control. Nor is there political will to change the existing distribution of power. As a result, democratic pluralism in which citizens have economic, political, and civil freedoms is still absent from the economy.
Chapter 8

Summary, Conclusions and Implications for Further Research

8.1 Summary and Conclusion

Corporate governance structures – i.e., the way in which business entities are structured and controlled – reflect public policy choices. These policy choices are fundamentally the result of political decisions, decisions that are heavily influenced by the preferences and power resources of different groups in a society, as well as by the existing political and economic institutions.

This thesis considered a specific example of corporate governance – namely that of agricultural co-operatives in contemporary China. The China Farmers Professional Co-operative Law (FPCL) was passed in November 2006 and was enacted in July 2007. Since then, farmer co-operatives have developed rapidly. Unlike their counterparts in western democratic capitalist systems, however, farmer co-operatives in China are owned and controlled by individuals and groups other than farmers – the resulting structure is referred to as the Company+Household (C+H) co-operative. As a result, the small farmers who make up the majority of members have very little participation or control in these organizations.

The thesis began with the proposition that the FPCL, and the resulting pattern of co-operative development, is the expected outcome given the challenges that China is facing in its agricultural sector, China’s economic development goals, and the political economy of the country. A corollary of this proposition is that the structure of China’s agricultural sector is likely to evolve in a different fashion than did the agricultural sectors in western capitalist economies. Thus, instead
of farmer co-operatives emerging to increase competition and limit opportunism as they did in the West, they are likely to contribute to a concentrated and monopolistic system.

The conclusion of this thesis is that the proposition stated at the outset is correct – the political economy of Chinese agriculture and of China more generally is such that the observed pattern of co-operative development is to be expected. The reasons for this conclusion are multiple and multi-layered.

At the corporate governance level, China’s political economy provides an environment in which farmer co-operatives that are owned and operated by small farmers, and in which the state and large private interests are largely absent, would be very unlikely to exist. China's economic system can be described as “capitalism with Chinese characteristics.” In terms of corporate governance, the Chinese characteristics include a dominant role played by the state and a reliance on personal relationships.

Both of these features have developed to provide the trust required for the effective coordination of an economic system. As Hall and Soskice [2001] argue, all capitalist systems require mechanisms that coordinate decisions and expectations. Due to a lack of institutionalized trust (e.g., trust created by reliance on the rule of law and independent judiciaries), China relies on other mechanisms for this coordination. Having the state involved as a major shareholder in corporations serves as an important way of ensuring that the state will not act opportunistically and change the rules and regulations in a way that is detrimental to the firm in question. Similarly, relying on personal relationships is critical in ensuring effective management of a firm when minority shareholder protections (e.g., auditing and disclosure rules) are virtually absent.

The outcome is an economic system in which a blockholder ownership pattern emerges as the most effective governance structure, with the state and large investors (both of which have close personal ties to other investors and other state officials) as the blockholders. Within this system, there is little room for the small investors, since they have little confidence that their investment will be effectively managed and they have little if any power to influence the decisions made by the firm (if a manager is not performing well, a large blockholder can simply request the manager’s removal, while a small investor has no such recourse).
Western-style co-operatives are, of course, a form of enterprise in which small investors (i.e., the members) do make an investment and do have power. For western-style co-operatives to work, the members must have access to strong minority shareholder protection. Given the lack of this protection in China, western-style co-operatives would be at a severe disadvantage. Instead, what can be expected to occur is the emergence of large blockholders that are able to provide effective governance to the co-operatives.

The emergence of large blockholders can be expected for another reason. In addition to their governance advantage, the large blockholding structure also allows the existing groups with economic and political power to perpetuate and strengthen their power. C+H co-operatives, for instance, are favoured by local authorities because these organizations have become major recipients of various support programs targeted toward agriculture.

Furthermore, C+H co-operatives have been promoted by local government officials as a way of generating tax revenue, revenue that is badly needed as a result of a lack of an effective mechanism of transferring government revenue from the federal and state governments to local governments, and the concomitant need for local governments to raise their own revenue to meet programs and provide services that have been mandated by higher level governments.

C+H co-operatives have also emerged as the most likely organizational structure for reasons unique to the agricultural sector. Specifically, the industrialization that has occurred in agriculture around the world during the last two decades has created a need for much greater coordination within agricultural supply chains as companies within this chain attempt to provide a rapidly increasing range of products that must meet increasingly higher standards of consistency, quality and safety. This higher degree of coordination requires a different industry structure than traditionally existed in the past, one in which more or less independent farmers sold their undifferentiated products to spot markets.

The new structure is one in which agro-processors increasingly specify the type and quality of product produced by farmers, who are often contractually required to buy inputs from and to sell output to a particular processor. This new structure is well adapted to the Chinese political economy described above. Specifically, the C+H co-operatives not only have a governance
structure that fits into the blockholding model, but they provide a large degree of control by the company (i.e., the agro-processor) over the decisions made by farmers.

Thus, as a consequence of both China’s larger political economy and conditions specific to agriculture, it is to be expected that the C+H model of a co-operative would emerge as the dominant organizational form for co-operatives in China. Thus, although the FPCL has all the attributes of co-operative law found in western countries, the implementation of this law has taken a very different form.

The conclusion is that the political and economic institutions in China today do not provide an enabling environment for the establishment and the success of farmer self-help groups. The result is that the historical place of peasants and farmers in Chinese society is unlikely to change. As this thesis outlines, for at least the last century, the state-peasant relationship has been characterized by a struggle between the peasantry and the state who seeks to extract labour, food, and taxes from them. As a subordinate class, farmers have rarely been afforded the luxury of open and organized political activity.

The development of co-operatives has thus been heavily influenced by what have so far remained the dominant institutions of China. Today, as historically has been the case, powerful interest groups and elites are afraid of developments in which those without power will act in a manner that does not reproduce the associated structures, beliefs and institutions that provide power to those with power. Co-operatives are one such development.

### 8.2 Policy Recommendations

A central argument of this thesis is that unequal power leads to the formation of institutions that perpetuate inequalities in power, status, and wealth. What was not investigated in this thesis was the question of whether these structures are also bad for the investment, innovation, and risk-sharing that underpin long-term growth. However, there is an argument that good economic institutions should be equitable in a fundamental way: to prosper, a society must create incentives for the vast majority of the population to invest and innovate. Such an equitable set of economic institutions can emerge only when the distribution of power is not highly unequal and in situations in which there are constraints on the exercise of power by officeholders (World Bank [2008]).

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Based on the evidence gathered from an examination of farmer co-operatives, the conclusion of this thesis is that the conditions are not yet present for the emergence in China of a set of economic institutions built around self-help and farmer ownership and control. Nevertheless, the FPCL provides a legal framework for small farmers, business groups and other key players to take collective action. Even though C+H co-operatives are not owned and controlled by small farmers, in many instances they are important as a means of providing marketing outlets, market information, technology and quality inputs to an otherwise isolated rural population, and that in this way they contribute to the development of agriculture and China’s economy.

Although they lack equality in the C+H cooperatives, small farmers possess some advantages that allow them to bargain with more privileged groups. For example, by lowering costs and reducing risk, farmers’ labour and farmland are crucial to the operation of the leading enterprises. Farmers’ participation in these organizations is also critical, since without this participation the leading enterprises would be unlikely to obtain the support of the local leaders, who are likely to prefer options that have at least some benefits for farmers. If these advantages can be leveraged, small farmers may be able over time to have more control and participation in co-operatives. Thus, while the current situation is not advantageous for farmer ownership and control, the possibility exists that greater ownership and control could be forthcoming.

If institutions that promote equity are also required to promote long-term economic health, then China’s economic future may be in some jeopardy unless a way is found to introduce some more fundamental institutional changes.

While it is easy to say that more fundamental institutional changes are required, in practice this is very difficult to do. Institutions, by their very nature, are slow to change. And, as was discussed in the earlier chapters, there is a strong path dependency at work with institutions – as supporting organizations develop and as the benefits of staying on a particular institutional path appear large relative to those of alternative paths (particularly in the short run), there is a strong momentum at work to retain existing institutions. Given that the focus of this thesis was on farmer co-operatives, and not specifically on the China’s political economy institutions, it is not appropriate to suggest how these institutions might be altered to better support co-operatives.
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What can be concluded, however, is that changes in the more general corporate governance structure in China are likely required before any success can be achieved with the formation of member-owned and controlled farmer co-operatives. Specifically, the emergence of stronger minority shareholder protections would appear to be a necessary condition for the eventual appearance of western-style farmer co-operatives, since such protections would signal both a change in the underlying power structure in the economy and a change in the power of small investors at the firm level. These changes, of course, will require more fundamental changes in the institutional underpinnings of China’s society and economy.

The importance of the larger institutional environment for the success of farmer co-operatives suggests that the success of co-operatives in other countries besides China is likely dependent on the institutions present in those countries. Specifically, the research in this thesis suggests that NGOs and development agencies such as the World Bank that are promoting co-operative development need to clearly understand the institutional environment into which co-operatives are being introduced.

Since the success of co-operatives in providing significant benefits to small farmers is greatly reduced if the institutional environment and the overall corporate governance structure is not conducive to the development of farmer-owned and controlled co-operatives, the efficacy of attempting to introduce co-operatives in such environments must be questioned. As the results of this thesis suggest, introducing co-operatives into situations where their desired outcomes will not be realized can have the effect of further exacerbating the unequal power relationships that the co-operatives were designed to address.

8.3 Implications for Further Research

Due to space limitations, this thesis is necessarily limited in scope. There are thus many opportunities for additional research.

First, as outlined in the previous section, the analysis in this thesis takes the institutional environment as fixed. One area of research would be to examine in more depth the ways in which the institutional environment in China has been shaped, and the likelihood of it changing (albeit very slowly).
Second, while the thesis suggests some interesting connections between the broader corporate governance structure and the governance structure of farmer co-operatives, little is known about how this relationship has evolved over time in the western democracies. The investigation of this relationship is of particular importance since it is known (see Gourevitch and Shinn [2005]) that major shifts have occurred in the corporate governance structures in the advanced democracies. For instance, the structure in the United States has moved from a strong blockholding model in the late 1800s to a strong diffused shareholder model today. Why did this change occur, and how did this change influence the structure and actions of co-operatives? For instance, were co-operatives able, at earlier points in time, to operate and prosper in an environment that would appear to be hostile to their operation? If they were, how was this possible and what lessons, if any, does this have for understanding how western-style co-operatives might emerge in China?

Third, the thesis suggests that western-style co-operatives do not suit China’s political economy and the conditions specific to agriculture. Given that China is undergoing rapid social and economic development, what is the nature of the changes in institutions (e.g. political economy) and farming features (e.g. distribution of farmland) that would be necessary to provide the conditions for western-style co-operatives to function in China? For instance, supposing stronger minority shareholder protections were in place, what is the scale of farming operations required for the formation of member-owned and controlled farmer co-operatives? What changes in society’s values are required? Given that individualism makes co-operation more difficult, how likely is it that a social movement could arise that would create a sense of obligation for farmers to support co-operatives?

Fourth, the thesis focuses primarily on farmer co-operatives in China. A number of interesting questions could be addressed by expanding the analysis to examine farmer co-operatives in other parts of Asia, and in particular Japan and South Korea, areas where farmer co-operatives are very successful. Both of these countries have a blockholding pattern of ownership, albeit with much higher levels of minority right protections than in China. South Korea is particularly interesting, since its business system is the closest to that of China’s (Redding and Witt [2009]). Moreover, farming in both Japan and South Korea is characterized by small land-holdings and scattered
plots. Finally, the government in both countries is strong and willing to limit individual liberties in the name of the collective.

According to Su [1989], there are a number of areas for further work. These areas include how the government worked together with farmers and their organizations to provide services to farmers which enabled small producers to be included in economic growth; and how group action by farmers has been a response to problems associated with rural-to-urban migration.

In addition, a comparison of cooperative development across the three countries provides an opportunity to examine the impact of different institutional environments on the cooperative development process. Was, for instance, the growth of co-operatives in South Korea and Japan associated with changes in the overall corporate governance structure? If not, then what was the mechanism by which farmer co-operatives were able to develop and operate effectively?

Until these questions are answered, the precise mechanisms by which institutional features such as corporate governance structures affect cooperative development cannot be fully understood. However, the results of this thesis suggest that there are important linkages and that understanding them is likely critical to understanding how co-operatives develop and operate.
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Appendix A

The Farmers Professional Co-operatives Law, 2006

Passed by the 24th Sessions of the 10th National People’s Congress on October 31, 2006

Unofficial translation by Zhao Jun and Achim Fock

Table of Contents

- Part I  Interpretation and Application
- Part II  Incorporation and Registration
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Part I. Interpretation and Application

1. The Farmers Professional Co-operatives Law, 2006 addresses all legislative areas concerning farmers professional co-operatives (hereinafter referred to as ‘Co-operatives’). Its purpose is to facilitate and direct the development of farmers Co-operatives, standardize organization and behaviors of them, protect legal interests of Co-operatives and members, and foster growth of agricultural and rural economy.

2. Co-operatives are self-help organizations which are associated voluntarily and controlled by producers of same agricultural products or service providers and users of same agricultural business operations. The farmers Co-operatives are based on the rural household contract system. Farmers Co-operatives focus on the needs of their members, which includes the purchase of agricultural inputs, marketing, processing, transportation, storage of agricultural products and provision of information and technologies.

3. The Farmers Co-operative shall comply with the following principles:
   
   (a) farmers play the dominant role among its members;
   (b) the key purpose is to serve members and act in the common interests of all members;
   (c) the members shall join and exit voluntarily;
   (d) all members are equal and Co-operatives are democratically controlled;
   (e) surplus should be redistributed based on the volume of members’ patronage.

4. Registration shall be made by the farmers Co-operatives; then the status of legal entities will be granted to them. The farmers Co-operatives’ assets include capital raised by members, accumulated surplus, government direct financial support, grants from other parties and other sources; the Co-operatives have the right to own, use and dispose of them and take liabilities for debts with such assets.

5. Liabilities of members of Co-operatives are limited to their contribution and shares of the accumulated surplus in their personal accounts.
6. The state protects all legal interests of farmers Co-operatives and their members, any individuals and agencies are not allowed to violate them.

7. Running and operation of farmers Co-operatives shall comply with laws, regulations, social norms, and business ethics and be undertaken in an honest and credible manner.

8. The level of government that is at county and higher level should organize local agricultural bureaus and line agencies to provide support and services to formation and development of farmers Co-operative within their jurisdictions pursuant to the Law.

Part II. Incorporation and Registration

9. A farmers Co-operative can be incorporated when it meets the following conditions:

(a) subject to sections 14 and 15, a minimum of 5 persons are required to apply for incorporation;

(b) a bylaw pursuant to the Law;

(c) a organization structure pursuant to the Law;

(d) a registered office pursuant to legal, regulatory and bylaws;

(e) share capitals contributed by members pursuant to the bylaws.

10. The first meeting of the founding members should be held with the participation of all founding members. When the Co-operative is incorporated, persons who want to be members voluntarily will be founding members. The agenda of the founding members’ meeting must include:

(a) the adoption of the bylaws prescribing the rules of administration of the Co-operative;

(b) the election of members of the Board of Directors, of the Director of the Board of Directors, and of executive members or members of the Supervision Committee;

(c) the review of other key issues.

11. A Co-operatives should include bylaws relating to:
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(a) name and address of office;

(b) business activities;

(c) the qualifications, withdraw, cease and termination of membership;

(d) members’ right and obligations;

(e) organization structure and origination of it, authority, terms of office and rules of decision-making;

(f) amount of membership fees and way of contributing;

(g) financial management, allocation of surplus and pay-off of deficits;

(h) procedures to amend the bylaws;

(i) application of dissolution and methods of liquidation;

(j) public disclosures and ways;

(k) others need to be specified.

12. The incorporators shall apply for incorporation by sending to the registrar- Industry and Commerce Bureau:

(a) the articles of incorporation in the prescribed form;

(b) minute of founding members’ meeting which are signed and sealed by all the founding members;

(c) the bylaws signed and sealed by all founding members;

(d) office and identification documents of legal first Director and other Directors;

(e) the prescribed fees signed and sealed by members;

(f) other documents requested by government agencies;

(g) other papers pursuant to legal and regulatory documents.

The registrar will complete the process within 20 days of the application and issue certificate of incorporation to the incorporators who meet relevant conditions.
The Co-operative shall send articles of amendment in the prescribed form to the registrar.

The regulation on Registration of farmers Co-operative will be made by the State Council.
There are no registration fees.

Part III. Members

13. Every citizen with capacity for civil conduct, and firm, government-affiliated agency & civil society organization who is engaged in activities associated with co-operatives and who can make use of services provided by the Co-operative, subscribe to the articles of incorporation and has agreed to abide by the bylaws and other procedures is deemed to have agreed to become a member of the Co-operative and, on incorporation of the Co-operative, is to be entered on the Co-operative’s register of members. However, agency that have public administration function shall not become a member of Co-operative.

A name list of members shall be prepared by the Co-operative and sent to the registrar.

14. No less than eighty percent of a Co-operative’s members should be farmers. For Co-operatives whose number of members are less than 20, one company or government-affiliated agency or civil society organization can become a member of it; for those whose number exceeds 20, the number of companies, government-affiliated agencies and civil society organization(legal entities) cannot exceed five percent of the total number of members.

15. A member of a Co-operative is entitled to exercise the following rights:

(a) is entitled to control the Co-operative democratically by voting at the General Meeting, and is eligible to be a Director;

(b) makes use of services and facilities provided by the Co-operative;

(c) is entitled to receive surplus pursuant to the bylaws or decisions made by the General Meeting;
(d) has access to the bylaws, name list, meeting minutes of the General Meeting or delegates meeting, decisions made by the Board of Directors and Supervision Committee, financial statements and book-keepings;

(e) other rights pursuant to the bylaws.

16. No member or delegate is entitled to more than one vote in the General Meeting. A Co-operative may provide in its bylaws for classes of members whose share of patronage or capital contribution are relatively bigger can vote separately. Votes they cast cannot exceed twenty percent of the total. The number of members of this class should be disclosed to other members when each General Meeting is held. The bylaws can have restriction on areas of vote entitled to this class of members.

17. Members shall take the following obligations:

(a) comply with decisions made by the General Meeting, delegates meeting and Board of Directors;

(b) contribute capital pursuant to the bylaws;

(c) make transaction with the Co-operative pursuant to the bylaws;

(d) pay-off deficits pursuant to the bylaws;

(e) other obligations laid down in the bylaws.

18. A member may withdraw from a Co-operative by making an application three months before the end of a fiscal year; whereas, the member who is company, government-affiliated agency or civil society organization, their application for withdrawal should be made six months before the end of a fiscal year; a member also may withdraw from a Co-operative on any terms and conditions provided in the bylaws. A membership is terminated at the end of a fiscal year.
19. A member shall continue to enforce contract with a Co-operative before termination of membership; or on any terms and conditions provided in the bylaws or separate arrangement made with a Co-operative.

20. A membership is terminated, the Co-operative shall: within a period of time provided in the bylaw, purchase from member at par value all shares in the capital stock of Co-operative held by the member; and pay to the member all amount held to the member’s credit; subject to 37 (b), pay dividends to the member before membership is terminated. The member whose membership is terminated shall shoulder deficits and debt obligations before the termination comes into effect.

**Part IV. Organizational Structure**

21. The General Meeting is presented by all the members of a Co-operative, it is the governing body of a Co-operative; the agenda of a General Meeting must include:

   (a) the adoption and amendment to the bylaws;

   (b) the election of members and first Director of Board of Directors, acting supervision members or member of Supervision Committee;

   (c) a sale, lease or exchange of all or substantially all of the property of a Co-operative, investment, pledge creates security interests in all or any property of the Co-operative, and other key decisions;

   (d) approve annual work report, scheme of allocation of surplus and deficits;

   (e) resolution on amalgamation, split, dissolution and liquidation;

   (f) number, qualification and term of office of the management;

   (g) report made by Director of the Board of Directors or the Board of Directors about changing of its members;

   (h) others provided in the bylaws.

22. When the General Meeting of a Co-operative is held, the number of members who are present should be more than two thirds of the total of it. Election and resolution shall be
made and approved by half of votes cast at a General Meeting; amendment to the bylaws or amalgamation, split, dissolution shall be approved by two thirds of votes cast at a General Meeting. Or otherwise provide in the bylaws which specifies higher percentage of member approval.

23. At minimum a General Meeting of a Co-operative shall be held once a year, the call of meeting is provided at the bylaws. In any of following cases, a special meeting should be called:

(a) receipt of request made by thirty percent of members;

(b) called by acting Supervision Committee member or Supervision Committee;

(c) others provided at the bylaws.

24. A structure of delegation can be used for Co-operatives whose number of members exceed 150, subject to the bylaws. The meeting of delegates can exert part or all rights of the General Meeting as provided in the bylaws.

25. A Co-operative shall appoint a Director or Board of Directors and other members of the Board of Directors. The Director is the legal representative of the Co-operative. A Co-operative may appoint an executive supervisor or a Supervision Committee. The Director, members of the Board of Directors and management may not assume the role of Supervision Committee member. The Director and members of Board of Directors, and the executive supervisor or members of the Supervision Committee who are elected by the General Meeting, subject to this Law and the bylaws, to exercise powers are accountable to the General Meeting. For decisions made by Board of Directors and Supervision Committee, no member is entitled to more than one vote.

26. Minutes are to be kept of: all resolutions and proceedings at General Meetings, Board of Directors and Supervision Committee with seals of all members, Board of Directors members and Supervision Committee members.
27. Subject to the decisions made by the General Meetings, the Board of Directors may, from time to time: hire managers and accountants, who can also assume management positions. Subject to the bylaws or decisions made by Board of Directors, manager can hire other staffs. Subject to the bylaws or delegated power of the Board of Directors, manager manages business and affairs of the Co-operative.

28. The Board of Directors and management of a Co-operative shall not:

(a) appropriate, use or allocate property of a Co-operative without authorization of members;

(b) without authorization of members and not pursuant to the bylaws, lend money on the debit of the Co-operative or hypothecate and pledge create a security interest in all or any of property of the Co-operative, owned or subsequently acquired, to secure any debt obligation of the Co-operative;

(c) receive and retain commissions of transactions with the Co-operative;

(d) undertake activities contrary to the interests.

Members of Board of Directors and management’s incomes generated from the above activities will be confiscated by the Co-operative; loss-making from such activities will be made up by them.

29. Members of Board of Directors and the management of a Co-operative shall not assume positions of members of Board of Directors and management of other Co-operatives that are undertaking similar business.

30. Civil servants who are engaged in the operation of a Co-operative shall not assume such positions as members of Board of Directors, members of Supervision Committee, management or accountants.

Part V. Financial Management
31. Subject to relevant laws and regulations, the Finance Department of the State Council shall develop accounting practice for farmers professional Co-operatives. The Co-operatives should undertake book keeping in compliance with such accounting practice.

32. Subject to the bylaws, Board of Directors shall prepare an annual work report, a plan for allocating of surplus or paying off deficits incurred, and financial statements; these documents should be ready for inspection by members 15 days before the General Meeting takes place.

33. A Co-operative shall keep separate accounts for transactions with members and non-members.

34. Subject to the bylaws or decisions made by the General Meeting, the Co-operative may set aside any part of surplus in reserves. The reserves may be used to pay off deficits incurred, to expand business or to credit to members’ capital contribution. Subject to the bylaws, reserves shall be credited to the members’ accounts.

35. Co-operatives shall open an account for each member, which includes:

(a) the member’s capital contribution;
(b) the member’s amount of reserves;
(c) the member’s patronage or business volume with the Co-operative.

36. Where a Co-operative has a surplus in a fiscal year, before it allocates the surplus among or credits it to members, the Directors should use any part of the surplus to pay off deficits incurred previously and for any reserve it is required to maintain.

Subject to the bylaws or resolutions made by the General Meeting, the Directors may allocate and credit or pay to members the remains after making provision for the matters described in the preceding paragraph:

(a) in proportion to the business done by the members with or through the Co-operative in that fiscal year, total patronage dividends may not be less than 60 percent of the remain of surplus;
(b) the surplus after making payment of patronage dividend shall be allocated to members by computing the proportions of each member’s capital contribution, reserves, government subsidies and other grants.

37. Executive supervisors or Supervision Committee who are elected by members of co-operatives shall conduct internal audit of their own co-operatives, the results of such audit will be reported to the General Meeting.

The General Meeting may make resolutions to contract auditors to audit the financial statements.

**Part VI. Merging, Split, Dissolution and Liquidation**

38. Merging of Co-operatives. Within 10 days of merging decision is made, a written notice shall be sent to each known creditor. The merged Co-operative will inherit all assets and liabilities of each of the merging Co-operatives.

39. When a Co-operative is split, its assets shall be split as well, and a written notice shall be sent to each known creditor. The splitting Co-operatives will take joint obligations for paying liabilities as they become due, unless a written agreement is entered into with creditors for liabilities.

40. A Co-operative may be dissolved for the following reasons:

   (a) in such cases as specified by the bylaws;
   
   (b) through a dissolution resolution made by the General Meeting;
   
   (c) a dissolution due to merger or split,

41. if its business license is terminated or removed by the court. When a Co-operative is dissolved pursuant to sub-section (a) (b) or (d), liquidators shall be appointed by the General Meeting within 15 days after the special resolution of dissolution. When no liquidators are appointed within the time span specified, members and creditors can make an application to the court to appoint liquidators, the court shall make an order to appoint liquidators.
42. On the appointment of liquidators, all the powers of Directors vest in the liquidators, carry on the business of the Co-operative as required as for an orderly liquidation, settle or compromise any claims by or against the Co-operatives, distribute the remains of assets after paying for all claims against the Co-operative, bring, defend and take part in any civil, criminal and administrative action or proceeding in the name and on behalf of the Co-operative. After paying or making adequate provision for all claims against the Co-operative, the liquidator shall apply to the registrar for approval of the final accounts and issuing a certificate of dissolution.

43. Liquidators shall give notice of appointment within 10 days it is made to all members and each claimant and creditor and publish notice of appointment in the Gazette within 60 days it is made. Any person who has a claim against the Co-operative is required to present details of the claim in writing to the liquidators not later than 30 days after receipt of notice or no later than 45 days after the first publication of the notice. If all members and creditors receive the notice within specified period of time, liquidators dont need to publish notice.

Any person who has a claim against the Co-operative is required to present particulars of the claim in writing to the liquidators. The liquidators shall maintain separate list of creditors. The liquidators shall not pay for the discharge of its obligations during the notice.

44. When a Co-operative is dissolved for the reason described in 41(a), or when it is brought to the court for bankruptcy, the members shall not apply for withdrawal from the Co-operative.

45. Subject to approval of the General Meeting or court order, the liquidators can work out scheme for paying for staffs’ salaries and insurances, settling or compromising any claims by or against the Co-operative. Where at anytime the liquidators determine that the Co-operative is unable to pay or adequately provide for the discharge of its obligations, the liquidators shall apply to the court for bankruptcy.
46. The government’s direct financial support shall not be allocated to members as property left after liquidation. How to allocate the kind of property will be stated in Regulation of the State Council.

47. Liquidators shall be accountable and carry out liquidation pursuant to the law. The liquidators shall pay compensation to the members and creditors for the mistakes they make on purpose or unintended.

48. The Bankruptcy Law applies to Co-operatives. After paying the cost of liquidation and claim against a Co-operative, the remaining money shall be used to pay unsettled bills of transactions with farmers members.

**Part VII. Support Policy**

49. The State can entrust farmers Co-operative to implement rural and agricultural development projects.

50. The central and local governments shall provide funding to support Co-operative’s activities such as information, training, quality standard and certification of agri-products, agricultural facilities, marketing and extension. Preferential treatment will be given to Co-operatives who are running in ethnic minorities’ area, remote area and poor area and those who are producing products which are urgently needed by the state and civil society.

51. The State policy financial institutions shall provide various source of funding to farmers Co-operatives. The specific polices will be made by the State Council. The State encourages commercial financial institutions to provide various financial services to Co-operatives.

52. Co-operatives qualify for tax breaks in agricultural production, processing, marketing services and other farming activities as stipulated by the government.

Other tax breaks designated for Co-operatives will be made by the State Council.

**Part VIII. Legal Liabilities**
53. Any person who has concealed, misappropriated or withheld any property of a Co-operative, or any person who has made unlawful intervention of operation of Co-operative, or any person who has levied unlawful fees to a Co-operative, or any person who has forced a Co-operative to pay for some services and make them lose money, will be brought to the court.

54. If a Co-operative has obtained its incorporation by fraud, the registrar will order it to make corrections within a specified time span; for cases of severe violations, it will be ordered to be dissolved.

55. A Co-operative that provides fake or false facts in its financial statements will be brought before the court.

**Part IX. General**

56. This Law will come into force on July 1, 2007.
Appendix B

Co-operatives Interviewed, Provinces Where They Are Located and Major Crops Grown
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<table>
<thead>
<tr>
<th>Co-operative interviewed</th>
<th>Provinces</th>
<th>Major Crops Grown Around the Co-operative</th>
</tr>
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<tbody>
<tr>
<td>Yuanmou Green Onion Association</td>
<td>Yunnan</td>
<td>Vegetables</td>
</tr>
<tr>
<td>Yushu Pig Producers’ Co-operative</td>
<td>Jilin</td>
<td>Corn, pig</td>
</tr>
<tr>
<td>Gannan Chicken Growers’ Association</td>
<td>Jiangxi</td>
<td>Chicken, vegetables, fruits</td>
</tr>
<tr>
<td>Wanzhou Peach Growers Co-operative</td>
<td>Chongqing</td>
<td>Vegetables</td>
</tr>
<tr>
<td>K Dairy Farmers Association</td>
<td>Beijing</td>
<td>Corn, wheat</td>
</tr>
<tr>
<td>Shenglin Pear Growers’ Co-operative</td>
<td>Beijing</td>
<td>Fruits</td>
</tr>
<tr>
<td>Daxing Y Pig Producers’ Association</td>
<td>Beijing</td>
<td>Wheat, vegetables</td>
</tr>
<tr>
<td>Santai Pig Producers’ Association</td>
<td>Sichuan</td>
<td>Pig, vegetables</td>
</tr>
<tr>
<td>Bage Rabbit Growers Co-operative</td>
<td>Sichuan</td>
<td>Rabbit, vegetables</td>
</tr>
<tr>
<td>Pengzhou Vegetable Producers’ Association</td>
<td>Sichuan</td>
<td>Vegetables</td>
</tr>
<tr>
<td>Pengzhou Pig Growers’ Co-operative</td>
<td>Sichuan</td>
<td>Pig, vegetables</td>
</tr>
<tr>
<td>W Broiler and Hog Company</td>
<td>Guangdong</td>
<td>Chicken, rice</td>
</tr>
<tr>
<td>Yili Dairy Farmers Co-operative</td>
<td>Inner Mongolia</td>
<td>Wheat, cows, corn</td>
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<tr>
<td>Lishu Slaughter house</td>
<td>Jilin</td>
<td>Corn, wheat, pig</td>
</tr>
<tr>
<td>Pucheng Peach Growers’ Association</td>
<td>Shaanxi</td>
<td>Wheat, peach</td>
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<tr>
<td>Livestock Production Parks</td>
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<td>Wheat, pig</td>
</tr>
<tr>
<td>T Chicken Farmers’ Co-operative</td>
<td>Shandong</td>
<td>Vegetables, wheat, chicken</td>
</tr>
<tr>
<td>Liangzhou Beef Cattle Producers’ Association</td>
<td>Gansu</td>
<td>Potato, cattle</td>
</tr>
<tr>
<td>Zhongmou Dairy Farmers Co-operative</td>
<td>Henan</td>
<td>Wheat, vegetables, cows</td>
</tr>
<tr>
<td>Zhongmou Beef Cattle Producers Association</td>
<td>Henan</td>
<td>Wheat, cattle</td>
</tr>
</tbody>
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Appendix C

List of Interview Questions

The following questions identify the areas that the researcher intends to explore through the personal interviews. The questions are intended to guide the participants. It is expected that in some cases, depending on the nature of the response, that the discussion might go outside the expected scope of the interview. The respondents will be allowed and encouraged to tell the stories they think are most important.

Draft Questions for Discussion with Interview Participants:

Describe your community?

What are the major social events in the community?

How do you get information about what goes on in your community?

Do people in this community work well together? If so, on what activities?

Is there a high degree of trust in this community?

Do you think you have influence in your community? If yes, what are the instruments and how do you make use of them?

Do you think there are power holders in your community? How did they gain their power? Are they are appointed or natural leaders)?

Do the leaders in your community listen to the community members? Do they answer to the community members?

How do you assess your status in your village? In economic, social and political terms.

Do you think there are layers in the community?

Do you have a plan to migrate out? How about others?
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Would you like your children to stay in the community or to go to the city when they grow up?

What are the major challenges that are facing your community?
How do you see the co-operative/farmer association dealing with these challenges?
How was the co-operative formed? Who initiated the discussion of forming the organization?
What kind of services do you receive from the co-op?
How much do you contribute to the co-op?
How do you benefit from the operation of the co-op?
How often you use the service provided by the co-op? Have you tried the service provided by competitors?
Do you think the members are loyal to the co-op? Why or why not?
How does the government support the co-op?
How were leaders of the co-op elected? Do the leaders hold positions in other community organizations or businesses?
How do you evaluate the leadership of the leaders of the co-op?
Do you think you have means to hold the leaders accountable?
Do you trust the co-op to operate in your best interests?
What are the major things distinguishing a co-operative from other organizations?
How often do you attend the general meeting? Have you ever read the work report and financial statements? Are they produced and made available?
Do you think you and your neighbors are more influential in community development after the co-op was formed?
What other kinds of services and assistance you think the government should provide?
What is your ethic background? Your religion? Education level? Family size? Income level? Major income sources? Do you have relatives in the village? What access do you have to credit services (friends or financial institutions)?