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Multiple Principals and Collective Action: China's Rural Credit Cooperatives and Poor Households' Access to Credit

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Multiple Principals and Collective Action: China's Rural Credit Cooperatives and Poor Households' Access to Credit

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Ample empirical evidence suggests that Rural Credit Cooperatives (RCCs), which are the core credit institutions in rural China, are not accountable to their member households. This article argues that this conundrum can be explained by an institutional analysis of the credit cooperatives using the multiple principals–agent framework: the credit cooperatives as agents are accountable to multiple *heterogeneous* principals—with multiple *conflicting* objectives. The multiple principals are (1) the County RCC Unions, which exercise control using the evaluation criteria on which the remuneration of grassroots RCC officers is assessed; (2) local party secretaries, who exert influence through top personnel appointment and dismissal in the credit cooperatives; and (3) member households, which are a "collective" principal. In a multiple-principals scenario, the "collective" principal has weaker control over the agents due to the "collective action" problem.

KEYWORDS: Principal-agent, multiple principals, collective action, China's political economy, credit cooperatives

The Rural Credit Cooperatives (RCCs), or *nongcun xinyong hezuoshe*, which have been the core credit institutions in rural China since the Communist revolution in 1949, are hardly meeting the credit demands of the very constituencies they are supposed to serve. They are plagued with mountains of bad debt, which consists largely of non-performing loans to township and village enterprises (TVEs);[1] they have facilitated huge flows of financial resources from rural to urban areas and from agriculture to industry;[2] and poor households are increasingly left behind in credit access.[3]

As the only formal credit organizations with a network extending to the grassroots level (township), the RCCs are the major—and often the only—formal providers of credit to rural households in China.[4] At the end of 2002, there were 35,544 RCCs with legal entity status nationwide,[5] which was the widest network among all the financial institutions in China. The RCCs, collectively, had deposit savings of 1.98 trillion yuan and loans of 1.39 trillion yuan, which was the second highest level of individual savings deposits in the country and the fourth highest level in terms of the total amount of loans and deposits. Nonetheless, the RCCs are plagued with mountains of bad loans and suffer from chronic financial losses. According to official estimates, at the end of 2002, the nonperforming loans were 514.7 billion yuan, or 37 percent of total loans; the cumulative losses were 131.4 billion yuan; and 19,542 RCCs, or 55 percent of them, had a negative net worth or were technically bankrupt.[6]

Three-quarters of China's population still reside in the countryside, where the main source of income is agriculture. The Rural Credit Cooperatives have been a channel for reallocating capital from agricultural households to finance the development of local government-owned TVEs and state-owned enterprises (SOEs). As indicated in Table 1, households' savings accounted for more than 80 percent of total deposits but constituted only 37 percent of total loans. Aside from the small share of loans that go to agricultural households, the mounting bad debts (most of which are loans to the TVEs) also rob many credit cooperatives of the valuable funds they need to conduct lending activ-

Table 1 RCC Savings and Loans, Billion Yuan (2001)

	Total Savings	% share
Enterprise	58.9	3.4
Households	1,382.1	80.3
Agriculture	265.8	15.4
Others	14.3	0.8
TOTAL	1,721.1	100.0
	Total Loans	**% share**
Agriculture	442.8	37.3
TVEs	484.3	40.8
Others	259.7	21.9
TOTAL	1,186.8	100.0

Source: Almanac of China's Banking and Finance, 2002 (Zhongguo jinrong nianjian).

ities, which further reduces the credit supply to the very constituents they are supposed to serve.

Despite their importance in supporting the growth of the rural economy and in raising the living standards of agricultural households, there are to date few studies on the credit cooperatives, specifically on why they fail to provide credit access to households. Loren Brandt[7] examines the extent to which credit demands of poor households during the 1990s were met by the rural financial institutions. Andrew Watson[8] provides a historical account of the organizational transformation of the Rural Credit Cooperatives but falls short of providing a clear answer to the cause of the problem.

With this article, I aim to contribute to the existing paltry literature on the failure of the RCCs to meet the credit demands of poor member households, and on the cooperatives' patterns of resource allocations and their dismal financial performance. I adopt a different approach from the traditional methodologies and tools used to analyze rural credit institutions, such as the subsidy dependency index and measures of financial sustainability and outreach.[9] Instead, I analyze the credit cooperatives in an institutional context by examining their corporate governance to reveal the reasons they have failed to be accountable to member households.

The institutional analyses I use in this article are based on the multiple principals–agent framework, which has been drawn on extensively to explain the dynamics of bureaucratic control and coordination in US politics[10] and the complex web of political wrestling in the European Parliament.[11] I then bring the multiple principals–agent models one step further to incorporate a "collective" principal among the multiple principals. The concept of a collective principal has been applied to a large number of minority shareholders[12] to explain why they lack incentives to monitor the actions of managers.

I contend that the credit cooperatives are accountable to many principals, including their functional superiors, and the local Communist Party secretaries. I emphasize the importance of corporate governance—and politics—in understanding what has been largely perceived as an economic problem. Further, on the theoretical front, I seek to convey two important messages: (1) how applying theoretical models borrowed from the microeconomics of organizations and political accountability literature can help shed light on a problem that has thus far been studied by country specialists; and (2) how the ways the nature of principals are conceptualized can have important bearings on the outcome of the principal-agent relationships.

The empirical evidence presented in this article is based largely on primary data collected from fieldwork in rural Sichuan province during the summer of 2004. It is the product of interviews with half a dozen Rural Credit Cooperatives that have *not* undergone any recent institutional reforms and whose ownership rights and institutional structure are representative of the majority of the RCCs in rural China; interviews were also held with more than 200 RCC member households. Field study was conducted in several townships in rural Jiangsu province in the winter of 2005. Because the RCCs in rural Jiangsu were ahead of the rest of the country in their ownership reforms, only the evidence with respect to their institutional structure in the past is presented here. I then apply the principal-agent framework to the empirical findings to analyze the institutional nature of the credit cooperatives.

The rest of the article is organized as follows. The next section, which explores alternative causes of the problem, is followed by a brief historical overview of the RCCs' institutional changes. The remaining sections present, in turn, fieldwork findings on the existing corporate governance structure of the RCCs; a review of the theoretical literature on the multiple principals–agent models; an explanation of the concepts of multiple and collective principals; and an analysis of the empirics within the theoretical framework together with an explanation of why the RCCs have failed to meet the credit demands of member households.

Alternative Causes of the Problem

Causes for the failures of rural financial institutions in providing credit access to the poor have been an intense subject of debate among development specialists.[13] That said, empirical evidence from China has been relatively scarce.

Since the start of economic reforms in China, the central government has been using the financial system as a redistributional mechanism[14] to reallocate financial resources from the rural to the urban sector, and from agriculture to industry in order to gain political patronage from urban workers in the state-owned enterprises—its most important political constituency.[15] Intervention in the financial sector is one of the instruments used to achieve the central state's policy of favoring urban industry over rural agriculture; the others are extraction of taxes and fees, pricing policy, procurement quotas, and biased investment policy.[16] Indeed, China is no different from the other developing countries that have adopted redistributive "urban-biased" policies—despite its socialist facade or rhetoric. Nonetheless, since the mid-1990s, the central government has begun to realize that rural and agricultural development has been neglected. In 1996, in a financial sector restructuring, the RCCs were separated from the state-owned Agricultural Bank of China in order for the former to better serve the agricultural community's credit needs, rather than merely functioning as the state bank's grassroots branches. I argue in this article that despite the separation, financial capital continues to be siphoned from the RCCs to finance urban industrial investments due to the multiple principals–agent problem.

Jikun Huang, Scott Rozelle, and Honglin Wang (2003) suggest that between 1978 and 2000, a total of 1.15 trillion yuan of financial capital flowed from rural to urban China and 1.74 trillion yuan from agriculture to industry.[17] Despite this seemingly "urban-biased" policy at the national level, there is no evidence at the microlevel to illustrate how this has negatively affected credit access of the RCCs' poor member households, and neither has there been any study to establish the actual mechanisms through which some RCC borrowers have been deprived of credit access.[18]

The "imperfect information" school of economics argues that the rural credit market is characterized by high screening and monitoring costs—that is, the costs of acquiring information regarding the characteristics of loan applicants and of monitoring the applicants' use of funds. Because it is more difficult for lenders to obtain information about households than about enterprise borrowers, or about small borrowers than about large borrowers, lenders prefer to lend to those whose screening and monitoring costs are lower.[19] The extent to which this explains the lack of credit access by the poor in China is yet unexplained by empirical research, but some international organizations and government-linked organizations have established microfinance programs that employ various mechanisms to help circumvent these problems, and some of these programs have been reported to have reached a greater number of poor borrowers and to have shown higher repayment rates than the RCCs have. Many of these programs incorporate group-lending contracts to harness peer screening and monitoring and kinship as screening and enforcement devices in lieu of collateral. These programs are not, however, without problems: many report high dropout rates; some household borrowers have difficulties making weekly repayments given the seasonal nature of their predominantly agriculture-based income; and those borrowers who reside in remote and mountainous regions complain of the high costs of attending group meetings.[20]

Other studies suggest that crowding out poor borrowers is due to the poor performance of credit institutions in cash-strapped areas. Loren Brandt, Albert Park, and Sangui Wang find that the poor have been increasingly left behind in credit access because nonperforming loans are increasing more rapidly in poor than in rich areas, thereby constraining the lending ability of the credit institutions in the poor areas.[21]

A Brief Historical Overview of the Rural Credit Cooperatives

Although they are "cooperatives" in name, implying organizations that are democratically managed and operated by their members and designed to serve members' needs, the RCCs have gone through several institutional changes in the last fifty years and as a consequence have lost much of their cooperative nature. Their organizational transformations can be divided into five phases.

Phase I: 1949–1959

Until the collectivization of agriculture in 1959, the RCCs were largely grassroots cooperatives organized by the peasants. They had the basic characteristics of a "cooperative" system: the members contributed to the capital base, the members elected the personnel, and members were able to gain access to loans as a service provided by the credit cooperatives.[22]

Phase II: 1959–1979

After the collectivization movement in 1959, the RCCs were made subordinate arms of the communes, and the control rights were subsequently transferred downward to the local brigades or village cadres. The RCCs became a part of the brigades' finance bureaus (*caizhengbu*), underlining the fact that the peasants had lost control over the cooperatives and that key decisions were then being made at the collective level.

Phase III: 1979–1996

With the collapse of the commune system, which previously controlled the RCCs, the central government made the RCCs subordinate to the state-owned Agricultural Bank of China (ABC) in 1979. The RCCs functioned as branches of the ABC at the grassroots level and were managed simply as an extension of the bank's bureaucracy.[23]

The subordination of the RCCs to the ABC gave rise to various conflicts of interest between the two organizations, and these conflicts brought about various structural financial losses for the RCCs and financial gains for the ABC.[24] The financial aspect aside, the state-owned bank also intervened in the RCCs' operations. In terms of loan allocations, the state-owned ABC intervened by approving and directing the RCCs' loans to designated borrowers, including state-owned enterprises, township and village enterprises, and the state grain-marketing companies. The credit cooperatives had little control over the whole lending process other than assuming the role of cashier and involuntary supplier of funds for the ABC.[25]

Phase IV: 1996 Onward

The RCCs were formally delinked from the Agricultural Bank of China in 1996 after an overhaul of the ABC's operations. The role of the County RCC Unions was expanded to manage the RCCs at the grassroots level, despite the fact that many of the latter were independent legal entities. Grassroots or township RCCs were required to obtain authority for major loan decisions from the county unions and to accept supervision in terms of staff appointments, personnel management, and training. County RCC Unions also become centers for account clearance and fund transfers for the RCC establishments within the counties.[26]

Phase V: Recent Reform Experiments of the RCCs

Ahead of the rest of the country, pilot reforms to turn existing credit cooperatives into rural commercial banks were carried out in Jiangsu province in 2000. By early 2003, all township RCCs in Jiangsu had been merged into County RCC Unions and the provincial RCC federation had been established.[27] The RCCs in the rest of rural China remain independent township credit cooperatives.

The central government introduced some pilot reforms for the RCCs in August 2003 in eight provinces,[28] and these reforms have gradually been introduced in the rest of the country, starting in late 2004. Under these reforms, the management control rights of the RCCs are being transferred to the provincial governments, and various shareholding models are being tested in the RCCs.[29] The central government has also provided some financial support to reduce the historical debt burdens of the RCCs undergoing reforms.

The Existing Corporate Governance Structure of the RCCs

Because the fieldwork on which this article is based took place before the pilot reforms were implemented, the structure of the rural credit cooperatives examined here reflects the situation prior to 2003.

After separating from the state-owned bank in 1996, the RCCs adopted the corporate governance structure of cooperative financial organizations, though the substance of which is void of any cooperative element.[30] As Figure 1 shows, the highest governing body in a cooperative financial organization—the members' representative meeting—is made up of representatives of the members. In the case of the RCCs, however, the highest governing body consists of local government officials, who are the township and village cadres, instead of the fee-paying farmer members (*rugu huiyuan*). Out of my 200 interviews with RCC member households, fewer than 5 percent of fee-paying members have ever attended a members' representative meeting. Those who have attended are heads of household who happen to be village or township heads or party secretaries.

In a cooperative model, members of the boards of directors and supervisors are nominated by the members and elected in the members' representative meetings. The supervisory board plays a supervisory role over the board of directors, and the head of the board of directors in turn becomes the key decisionmaker for the cooperative financial organization. For the RCCs, the board of directors *(lishihui)* is headed by the RCC managers; and the board members consist of RCC officers,[31] while the board of supervisors *(jianshihui)* of the RCCs is led by the township party secretaries, and the board members consist of township cadres.[32]

The implications of the existing corporate governance structure on the distribution of power and on the decisionmaking process in the RCCs are as follows:

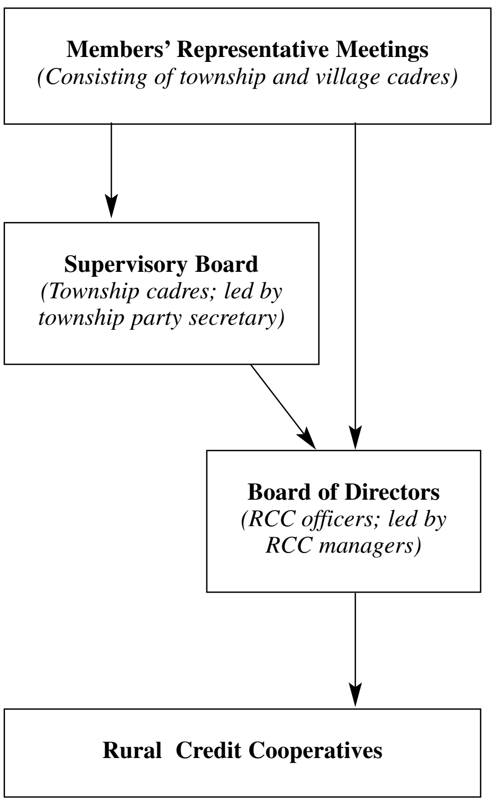
1. The members' representatives meeting, the channel through which the interests of agricultural member households are supposed to be represented, has become a venue for local governments or Communist Party committees to nominate and appoint their choice of candidates for the high-ranking positions in the credit cooperatives.

2. The RCC manager wields significant power over the credit cooperatives. In theory, the RCC manager is supposed to be accountable to the head of the board of directors, but since he holds both positions, he has unparalleled power over the financial organizations.

3. The township party secretary who heads the supervisory board is the only check on the power of the RCC manager.

In essence, in the lexicon of corporate governance, the RCCs suffer from an extreme case of "insider control"—the RCC managers (the insiders) are the key decisionmakers for the organizations and are accountable to no one but themselves—which renders the function of the board of directors hollow and insignificant. The local party committees—or, specifically, the local party secretaries, who may have different objec-

Figure 1 The Existing Corporate Governance Structure of the RCCs



tives from the managers—are the only oversight institutions for the credit cooperatives. Using their political pressure at the local level, they are able to influence the decisions of the managers to allocate loans in a certain manner. Member households have no representation in the current corporate governance structure, and therefore their interests are not reflected in the formal channels.

The Principal-Agent Model and the Problem of Multiple Principals

The principal-agent model, the dominant framework for the formal analysis of hierarchy, is a vital component in organizational theories and essential to understanding the ways in which organizations work. Its quintessence is one of delegation of authority from the principal to the agent. Agents may not behave in the way the principal envisages or desires, because they act in a manner to pursue their own interests, subject only to the constraints imposed by their relationship with the principals.

The RCCs, as agents, are accountable to multiple heterogeneous principals—with multiple conflicting objectives—who compete for control over the agents. Further, one of the principals—the rural member household—is a "collective" principal, which is a collection of individuals whose interests are commonly represented and collectively advocated. In this article, I argue that in a multiple-principals scenario where there is a collective principal, that person has considerably less control over the agent than do the other principals.

Multiple Principals

The most straightforward principal-agent (PA) relationship is a single principal delegating authority to a single agent. The relationship becomes more complex when the number of principals and agents increases, thereby increasing the number of delegation contracts. Here we are concerned with the situation of a multiple principals–agent relationship—more than one organizationally distinct principal delegating authority to a single agent.[33] Two elements set the multiple PA relationship apart from the single PA relationship. First, given that each principal has his or her own distinct goals and preferences, the nature of a contract the agent has with a principal is different from that with another principal. Second, each principal can negotiate a contract with the agent independently and without consultation with the other principal(s).[34]

Multiple principals–agent relationships have numerous applications in contemporary politics. In US politics, Roderick Kiewert and Mathew McCubbins propose that any given bureau is likely to have multiple principals and be subject to direct oversight by the president at the federal level and by several congressional committees, each comprising many politicians.[35] The president struggles with Congress over control of the bureaucracy; and within the Congress, House committees struggle with Senate committees to exert control over the bureaucrats.[36] The essence is, as Terry Moe notes,

> Each principal is effectively in competition with the others in his efforts to exert control, while the bureau, on the receiving end of all this, finds it must contend with uncoordinated and often conflicting demands, requirements, and incentives . . . bureaus are "partial agents" of various governmental parties, without being under the complete authority of any one in particular, and without any common understanding of how authority is legitimately divided among the competing principals.[37]

Similar multiple-principal analytics have been applied to European Union politics. The European Commission is responsible to both the Council of Ministers and the European Parliament. But neither body requires the consent of the other to recontract with the European Commission.[38]

A "Collective" Principal and the "Collective Action" Problem

A particular type of single principal—the "collective" principal, which consists of a collection of individuals—should be differentiated from multiple principals. Following Kiewert and McCubbins' definition, in a collective principal–agent relationship, more than one individual enters into a common contract with the agent. One critical difference between collective principal–agent relationships and multiple principals–agent relationships is the *number* and *nature* of contracts between the principal(s) and the agent: the former has one identical contract, while the latter has multiple dissimilar contracts. The other crucial differentiating factor is that each individual within the collective principal is *not* able to negotiate a contract individually with the agent; the individuals function as a group and they must reach an agreement before dealing with the agent. In other words, they are a collection of individuals whose interests are commonly represented and collectively advocated.[39]

In a multiple-principals scenario, as we have seen in the competing control of the bureaucracy by the president and the Congress, each principal has a distinct contract with the agents, and neither of them requires the consent of the other to recontract with the agents. In a collective-principal situation, however, no individual is able to unilaterally renegotiate the contract with the agent without the consent of the other members of the group. Examples of collective-principal scenarios that are common in a democracy are a voters' (collective-principal) delegation to politicians (agents), or a legislators' (collective-principal) delegation to party leaders (agents).[40]

A problem that persists with a collective principal is that large numbers of individuals are mobilized to monitor the behavior of agents. This is the familiar "collective action" or "free-rider" problem.[41] Since everyone in the monitoring group—even those who have contributed nothing to the monitoring effort—receives the same amount from any gains realized, a rational individual would have no incentive to exert any effort.

Collective principals and the challenge of mobilizing a large group of individuals to monitor the behavior of agents are particularly relevant in the study of corporate governance. In corporate governance, a familiar problem is the lack of incentives for a large number of dispersed shareholders of corporations to monitor the actions of managers. Peter Gourevitch has skillfully elucidated the Enron case using the following concept: Fragmentation of ownership—the fact that no one (not even the pension funds or institutional investors) owns a large enough share of the company to have an incentive to pay the transaction costs required to monitor the managers—creates the need for external monitors, who are the "reputational intermediaries" (accountants, stocks and bonds analysts, banks, and lawyers). When these "reputational intermediaries" collude, the interests of shareholders are significantly compromised.[42]

This article takes the existing theoretical models on principal-agent relationships one step further, by combining multiple principals and collective principals. Critically, in a multiple-principals scenario, if one of the principals is a collective principal, that person's monitoring of the agent's behavior, or relative control over the agent, is considerably *weaker* than that of the other principals.

The various conceptual forms of principal-agent relationships are depicted in Figures 2, 3, and 4. It should be noted in Figure 3 that the outcome of the PA relationships is indeterminate, given the multiple principals. However, in Figure 4, where one of the principals consists of a large group of individuals who must agree before contracting with the agents, thereby forming a collective principal by definition, we have good reason to believe that the principal's control over the agent is *relatively weaker* than that of the other two principals.

The various principal-agent relationships can be depicted as follows:

Figure 2 Single Principal–Agent

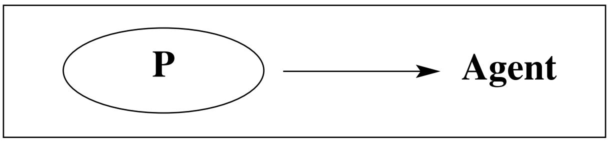


Figure 3 Multiple Principals–Agent

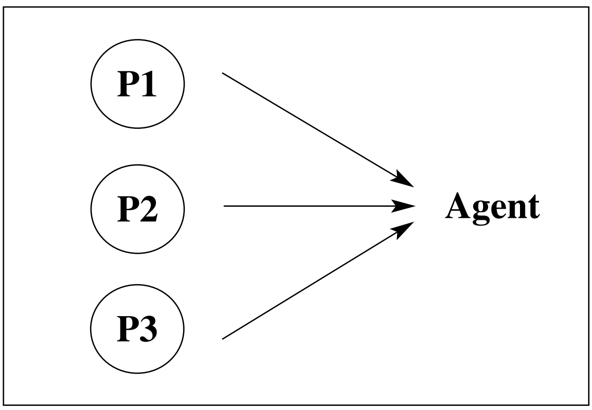
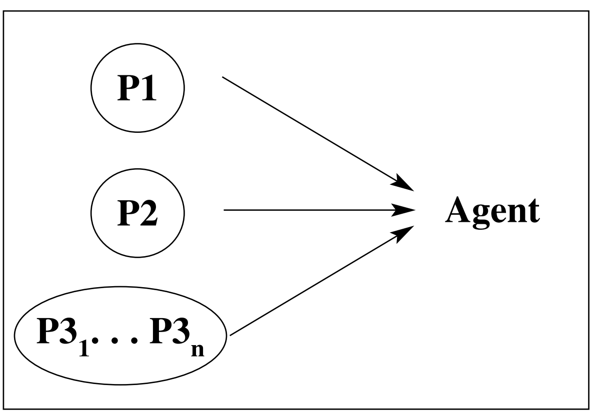


Figure 4 Multiple Principals (with a collective principal)–Agent



Some may question the validity of the "collective action" problem—that is, question whether, in the tradition of Elinor Ostrom,[43] there is any social norm or mechanism that encourages "conditional cooperative" behavior.[44] I argue that the RCCs' member households fit more into Mancur Olson's "rational self-interested individuals (who) will not act to achieve their common or group interests,"[45] than Ostrom's "conditional cooperators." A few contextual elements contribute to this: the large size of the groups, the small marginal benefit of a collective action; and, most important, the perception that the RCCs, like the other state-owned banks, are backed by the central government, and hence that the central government will act as lender of last resort should the credit cooperatives collapse.[46] Empirical evidence presented in the next section provides further support for this point.

RCCs' Multiple Principals–Agent Relationships

After the severing of ties with the state-owned Agricultural Bank of China, the management role was taken over by the County RCC Unions. Currently, the RCCs' multiple principals–agent relationships and the respective contracts take the following forms:

County RCC Unions—Township or Grassroots RCCs

Township RCCs are the most grassroots-level credit cooperatives in rural China. Though the great majority of them are independent legal entities (*dulifaren*) responsible for their own profits and losses (*zifuyingkui*), they are under the management of the County RCC Unions in terms of operations, staff appointments, account clearance, and loan requirements. The County RCC Unions are largely local credit organizations and are independent to a great extent. They are responsible for all management decisions and are only guided—not managed—by the higher-level RCCs.[47]

In the principal-agent context, the County RCC Unions are independent principals, to whom townships or grassroots RCCs are, as agents, accountable. The County RCC Unions control the agents by formulating and assessing the agents' remuneration criteria. The grassroots RCC officers' remuneration scheme consists of basic and variable components.[48] The variable components, which account for as much as three-quarters of officers' total compensation, are assessed by their functional superiors at the county level. The assessment is done according to two sets of criteria. First, the grassroots credit cooperative for which an officer works is given a rating from 1 (worst) to 5 (best), according to the following set of criteria related to the cooperative's financial performance and efficiency:[49]

- Quality of assets (*zichan zhiliang*), measured by the ratio of nonperforming loans to total loans
- Deposit/loan ratio per employee
- Average profit per employee
- Average expense per employee (administrative and operational expenses)

At year's end, the grassroots credit cooperative is subject to another set of evaluation criteria, which in combination with the previous determine the total compensation of the officer:

- Deposit growth
- Reduction of nonperforming loans (NPLs)
- Expansion of agricultural loans (*zhinong daikuan guimo de kuada*) with at least 75 percent of the newly disbursed loans in that particular year being designated for agricultural purposes only
- Collection of interest income
- Internal security (*neibu anquan*)—for instance, robbery cases, illegal behavior of officers, corruption (*weifa, weigui, lianzheng*)

The weight of financial performance indicators in the evaluation criteria strongly suggests that the County RCC Unions are primarily concerned with profit maximization and efficiency of capital; the other secondary considerations include supporting the credit needs of the agricultural sector and internal security of the financial organizations.

What are the implications of the County Unions' management for the grassroots credit cooperatives' resource allocations? First, the grassroots RCCs are profit-driven, given the overwhelming weight of economic performance-oriented indicators in the evaluation criteria. This implies that the RCC officers are more likely to allocate loans based on improving financial returns than on assisting the poor member households in their credit access in accordance with a primary goal of cooperative organizations. Second, since the County Unions now become the account clearance center for the credit cooperatives within the county, I found in my field study that in some townships where there was a lack of vibrant enterprise activities and the grassroots RCCs deemed it unprofitable to lend to these townships, the RCCs deposited the savings collected from the townships into the County RCC Union, and the County Unions in turn deposited the funds in the Central Bank to earn interest. Transferring the savings collected from the townships to the County Unions has reduced the funds available to lend to households.[50]

Local Governments or Local Communist Party Committees—Township RCCs

The local Communist Party committees or local government officials[51] have different objectives from those of the County RCC Unions. The primary objective of the local party committee, led by the local party secretary, is to promote economic growth of the local economies. Local economic growth is a critical factor in determining the function of the local government units or the sheer survival of the revenue-strapped ones, as well as political promotions of the local party cadres.

There is extensive evidence to support the economic growth orientation of the local governments. Local party officials whom I have interviewed spoke of the need to look for sources of revenue, without which the functioning of the local governments and the ability of those governments to provide basic services will be compromised, and without which the political future of party officials will be at stake. The series of fiscal reforms introduced by the central government in the early 1980s, which were aimed at improving tax-revenue generation at the local level, stimulated tremendous growth of township and village enterprises, whose de facto owners were the township and village governments, because those governments were allowed to retain a certain proportion of the revenue collected from the enterprises.[52] Since the mid-1990s, the township and village enterprises that used to contribute a significant proportion of local government revenue have largely failed or have been transformed into private enterprises.

The means and degree of interference by the local governments in the grassroots RCCs have changed over the years. Between the mid-1980s and the mid-1990s, when development of township and village enterprises was at its peak and nearly every township had its own enterprises, the grassroots RCCs with whom the grassroots governments had intimate relationships became a convenient source of capital financing for enterprise development. At that time, local governments played a critical role in securing loans from the RCCs for the enterprises by acting as the guarantors for loans, by using community assets as collateral, or by applying sheer political pressure on the RCC managers to allocate loans to preferred enterprises. The latter measure, which is known as "administrative interference" (*xingzheng ganyu*) in the Chinese literature, is common in the banking sector in China.[53]

The principal-agent relationship between the local government units and the grassroots RCCs has changed accordingly since the mid-1990s. The previous relationship was more direct—the local government units interfered in the loan allocation process explicitly. In contrast, the current relationship is more tacit—the local government units influence the decisions of RCC managers through various means. As the RCCs' corporate governance structure illuminates, the local Communist Party secretary, acting as the head of the supervisory board, supervises the conduct of the RCC manager. Therefore, the local Communist Party secretary is able to influence the decisionmaking of the RCC manager and becomes a principal to the agent in that respect.

Influence through the corporate governance structure aside, I also find extensive evidence that local party secretaries have appointed senior RCC personnel. Like all the administrative units (*shiye danwei*) in China, there are Communist Party committees *within* the RCCs, which report to the Communist Party committee in the locality. For instance, the Communist Party committee or secretary of the RCC in township X reports to the Communist Party committee or secretary of that township. Put simply, the party machinery in the locality exerts influence on the RCC's loan allocations through personnel appointments—having the final say over who is to become the manager of each of the grassroots credit cooperatives. In short, the local party secretary is still a principal to the grassroots RCCs, though the principal-agent relationship has evolved over time from directly interfering in operational decisions to influencing loan allocations by determining who the RCC decisionmakers are and by supervising the actions of those decisionmakers.

What are the implications of local party influence on the RCCs? All the RCC managers I have interviewed spoke of the need for political pressure before the mid-1990s to "support" the enterprises or business projects initiated by the local governments, though they often knew that the favored enterprises or projects were not able to repay loans and did not make any business sense. Nonperforming loans to township and village enterprises are the single largest source of bad debt for credit cooperatives throughout China. In the poor townships where my field study was conducted, nonperforming loans by the township and village enterprises accounted for as high as 60–70 percent of all nonperforming assets, and this has deprived the credit cooperatives of scarce funds to conduct lending activities, especially in the poor areas where savings are stagnated or grow only gradually.

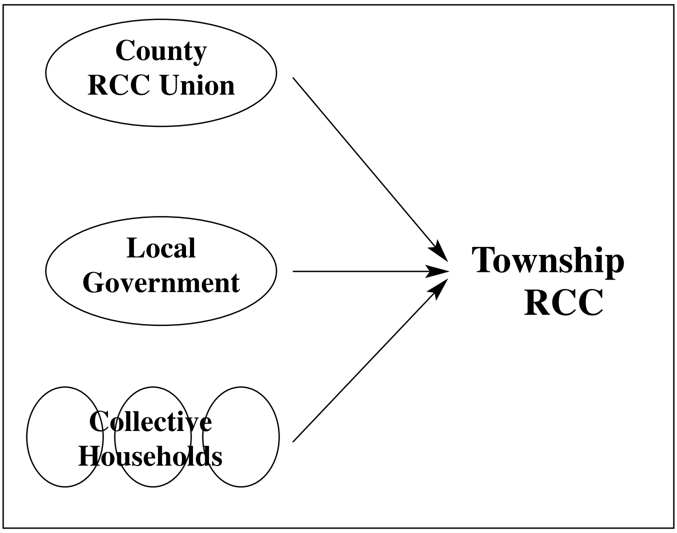
Member Households—RCCs

Member households are ultimate principals to the RCCs because the equity of the credit cooperatives is made up of member household shares.[54] However, as illustrated in the corporate governance structure, member households have no formal representation in the system. The formal channel of participation aside, there has been no incidence where member households have attempted to organize themselves to exert influence over the decisionmaking process of the credit cooperatives.[55] This is not to say that the rural community in China has not mobilized itself to protest against the authorities. Indeed, peasant resistance, including demonstrations and violent protests, has become increasingly common in rural China and has been staged for the causes of resisting the imposition of unjustified taxes and fees, cadre corruption, and confiscation of farmland with unjustified payments.[56] In the present context, member households, who are the ultimate stakeholders of the financial organizations whose aim is to maximize return on their assets or, more fundamentally, to have the safety of their savings guaranteed, have been left out of the decisionmaking process and have thus far made no effort to improve their participation.

I contend that member households as a collective principal suffer from the "collective action" problem: any potential gain from mobilized actions is too small to justify the cost of participation. This is due to the large number of households or depositors in a township RCC—the number of households ranges from 5,000 to 17,000 in the four townships where fieldwork was conducted, almost all of which have deposit accounts at the RCCs, given that the credit cooperatives are the only financial institutions at the township level. Any mobilized action will necessarily involve a large number of households, and the gains from such actions will accrue to those who do not exert any effort. Some may argue that, along with the state-owned banks, the RCCs are perceived by depositors as having an implicit deposit guarantee by the central government, and they do not need to monitor the actions of agents. For the purpose of this study, it just goes to show that the *perceived* risks of potential loss of savings are so low that the high costs of monitoring or participation are not justified.[57] Following this logic, member households as a collective principal, have weak control over the agents and weak incentive to monitor the actions of agents.

Some may question why the County RCC Unions and local governments, which are both made up of groups of individuals, are not considered collective principals. As discussed earlier, for a group of individuals to become a collective principal, each individual within the group is *not* able to unilaterally negotiate a contract with the agent, and the group must agree among themselves before recontracting with the agent. The manager of the County RCC Union, the decisionmaker, does *not* need the consent of all the union's staff members before contracting with the agents. Similarly, the local party secretary has the final say in the local party committee and does *not* need the agreement of all party committee members before negotiating a contract with the agent. The multiple principals–agent relationships of the RCCs are shown in Figure 5.

Figure 5 RCCs' Multiple Principals–Agent Relationships



RCC's Corporate Governance: A Collective Principal and Multiple Principals–Agent Relationships

The preceding analysis contends that as agents, the grassroots RCCs are accountable to multiple principals with sharply conflicting objectives: (1) County RCC Unions, which are their functional superiors and interested in maximizing profits and returns on financial assets; (2)

local party or government officials, whose priorities are to promote the growth of local economies on which their political careers and the basic functions of local government units depend; and (3) member households, collectively a principal to the RCCs, who are concerned with having access to loans and with safeguarding the value of and maximizing the returns on their precious savings. The three principals have diverging interests, and each of them exerts control over the agents using differing means. The County RCC Unions manage by formulating a set of evaluation criteria strongly weighted on economic returns on which remuneration of grassroots RCC employees is based. On the one hand, local party officials rule by determining the people who fill the top posts in the RCCs and by influencing the decisions of the RCC managers to direct loans toward their favored enterprises or projects, using their local political authority. On the other hand, member households as a "fragmented" principal face an insurmountable task of mobilizing the entire group to monitor and supervise the actions of the agents. I contend that as a large group, member households face a "collective action" problem: each of the member households has no incentive to pay for the monitoring costs. The implication of such complex relationships between the RCCs and the principals is that the interests of member households are significantly compromised. Furthermore, loans are often siphoned off to local government-preferred projects or enterprises due to political persuasion.

Given the RCC's institutional changes over the years (though the post-2003 changes are not considered here), have the dynamics of the principal-agent relationships changed? Put simply, do the nature and structure of PA relationships differ between the management of the state-owned Agricultural Bank of China and the County Union? What is the extent of the local party committee's control over the two relative periods?

Both primary and secondary evidence suggest that in the latter period, the County Union replaces the state-owned banks in managing the township RCCs, while the local party committee's control remains pervasive throughout. This is evidenced in the fact that the local party committee has control over appointments and dismissals of high-ranking personnel throughout the two periods. In short, the RCCs were accountable to multiple principals in both periods, which were the local party committees, member households as a collective principal, and the state-owned Agricultural Bank of China prior to 1996 and the County Union after 1996.

Conclusion

By studying the corporate governance or power distribution within the organization, this article contributes to the scanty literature on the RCCs, addressing why they are saddled with mountains of bad debt, most of which are loans to township and village enterprises; why they suffer chronic financial losses; and why they have failed to be accountable to the member households.

Scholars studying China's Rural Credit Cooperatives may not expect to see in this article the nature and array of analyses presented. Nonetheless, it is for this very reason that this study aims to make its mark. Studies on rural financial institutions have traditionally been the realm of economists using tools to measure subsidy dependency and outreach in such organizations. This study underscores the importance of politics in explaining what has been predominantly seen as an economic puzzle.[58] Further, this article demonstrates that using theoretical models from the microeconomics of organizations and political accountability literature can help inform on a problem examined by country specialists.[59] For those scholars working on principal-agent relationships, this analysis makes clear that the manner in which the nature of principals is conceptualized has profound bearings on the strengths of the delegation of authority from the principal to the agent. Critically, when one of the multiple principals is a "collective" principal, we have good reason to believe that the control of that principal over the agents is considerably weaker than that of the other principals.

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Notes

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Chinese University of Hong Kong in January 2005. All remaining errors remain those of the author.

1. Loren Brandt, Albert Park, and Sangui Wang, "Are China's Financial Reforms Leaving the Poor Behind?" paper presented at the conference "Financial Sector Reform in China," JFK School of Government, Harvard University, September 11–13, 2003.

2. Jikun Huang, Scott Rozelle, and Honglin Wang, "Fostering or Stripping Rural China: Modernizing Agriculture and Rural to Urban Capital Flows," paper presented at the 40th Anniversary Conference at the University of Hong Kong, December 2003.

3. Brandt, Park, and Wang, "Are China's Financial Reforms Leaving the Poor Behind?"

4. The Rural Cooperative Foundations (RCFs) that existed between the mid-1980s and late-1990s offered an alternative source of credit to the RCCs during that time frame. They were initiatives by township authorities to absorb rural households' savings and make loans to rural enterprises, households, and governments. But due to inadequate management and corporate governance, and misallocation of funds, they were shut down by the central government in 1999. For further details, see L. Ong, "The Political Economy of Township Government Debt, Township Enterprises, and Rural Financial Institutions in China," *China Quarterly* 186 (2006).

5. The number multiplies if the RCC branches at the village level are included.

6. Xianqun Yu, "Nongxinshe gaige ying quanti tuijin" [Reforms of the RCCs should be pushed forward], *Zhongguo Jingji Shibao* [China Economic Times], August 6, 2003.

7. Brandt, Park, and Wang, "Are China's Financial Reforms Leaving the Poor Behind?"

8. Andrew Watson, "Financing Farmers: The Reform of Rural Credit Cooperatives and Provision of Financial Services to Farmers." In C. Findlay, A. Watson, E. Cheng, and G. Zhu, eds., *Rural Financial Markets in China* (Canberra: Asia-Pacific Press, 2003).

9. Timothy Besley, "How Do Market Failures Justify Interventions in Rural Credit Markets?" *World Bank Research Observer* 9, no. 1 (1994); Jacob Yaron, "What Makes Rural Financial Institutions Successful?" *World Bank Research Observer* 9, no. 1 (1994); Jacob Yaron, McDonald P. Benjamin Jr., and Gerda L. Piprek, "Rural Finance: Issues, Designs, and Best Practices," *Environmentally and Socially Sustainable Development Studies and Monographs Series,* No. 14 (Washington, DC: World Bank, 1997).

10. See, for example, D. Roderick Kiewert and Mathew D. McCubbins, *The Logic of Delegation: Congressional Parties and the Appropriations Process* (Chicago: University of Chicago Press, 1991).

11. See, for example, Mark Pollack, *The Engines of European Integration: Delegation, Agency, and Agenda-Setting in the European Union* (New York: Oxford University Press, 2002).

12. Peter Gourevitch, "Collective Action Problems in Monitoring Managers: The Enron Case as a Systemic Problem," *Economic Sociology: European Electronic Newsletter* 3, no. 3 (2002).

13. See, for example, Dale W. Adams, Douglas H. Graham, and J. D. Von Pischke, *Undermining Rural Development with Cheap Credit* (Boulder: Westview Press, 1984); Avishay Braverman and J. Luis Guasch, "Rural Credit Markets and Institutions in Developing Countries: Lessons for Policy Analysis from Practice and Modern Theory," *World Development* 14, no. 10/11 (1986): 1253–1267; Marguerite S. Robinson, *The Microfinance Revolution,* vol. 2: *Lessons from Indonesia* (Washington, DC: World Bank, 2002).

14. Kaja Sehrt, "Banks Versus Budgets: China's Financial Reforms, 1978–1996" (Ph.D. diss., Department of Political Science, University of Michigan, 1999).

15. Loren Brandt and Xiaodong Zhu, "Redistribution in a Decentralizing Economy: Growth and Inflation in China Under Reform," *Journal of Political Economy* 108, no. 2 (2000): 422–439.

16. Al Nyberg and Scott Rozelle, *Accelerating China's Rural Transformation* (Washington, DC: World Bank, 1999).

17. The estimations were made by calculating the differences between savings by farmers and enterprises and the loans to farmers and enterprises. For further details, see Huang, Rozelle, and Wang, "Fostering or Stripping Rural China."

18. Through various interviews with Chinese academics and policymakers, I have gathered that the RCCs were required to place reserves at the Agricultural Bank of China when they were part of the state-owned banking system. The credit cooperatives are also required by the central government to place transfer deposits with the Central Bank, the People's Bank of China. This may suggest that the reserves and transfer deposits were then made available to the state-owned bank and the Central Bank to lend to urban enterprises. However, there has been no formal study to put this in context.

19. Karla Hoff and Joseph E. Stiglitz, "Imperfect Information and Rural Credit Markets: Puzzles and Policy Perspectives." In K. Hoff and J. E. Stiglitz, eds., *The Economics of Rural Organization: Theory, Practice and Policy* (Oxford: Oxford University Press, for the World Bank, 1993).

20. See Albert Park and Changqing Ren, "Microfinance with Chinese Characteristics," *World Development* 29, no. 1 (2001): 39–62.

21. Brandt, Park, and Wang, "Are China Financial Reforms Leaving the Poor Behind?"

22. "Nongcun xingyong hezuoshe wushi nian fazhan licheng" [50 years history of the rural credit cooperatives], *Zhongguo Jingji Shibao* [China Economic Times], July 8, 2003.

23. On-Kit Tam, "Rural Finance in China," *China Quarterly* 113 (1988): 60–76; Andrew Watson, "Financing Farmers: The Reform of Rural Credit Cooperatives and Provision of Financial Services to Farmers." In Findlay, Watson, Cheng, and Zhu, *Rural Financial Markets in China*.

24. Structural losses for the RCCs were caused by several factors. First were the high interest rate differentials between loans and deposits. In the early 1980s, the RCCs paid rates of between 7.2 and 9.4 percent on farmers' deposits, most of which were fixed term; they were required to place 20–30 percent of their deposits with the ABC as reserve, but obtained only 4.3 percent interest returns on capital (Tam, "Rural Finance in China"). The negative margins between the interest rate received on the reserve and those paid to depositors were a major source of structural losses for the credit cooperatives (Watson, "Financing Farmers"). A second factor was low capital utilization rates. The reserve deposit requirement substantially reduced the amount of capital the RCCs had available to lend out to earn returns with which to pay their depositors. Aside from the 30 percent reserve required to be placed at the ABC, the RCCs were also required to retain 15 percent of their deposits as operational reserves, and therefore only about half of their deposits were available for intermediation (Watson, "Financing Farmers"; Tam, "Rural Finance in China"). A third factor was that deposits became a major source of capital for the ABC. Reserve deposits by the RCCs were the single largest source of funds for the ABC, accounting for nearly half of ABC's total deposits.

25. Tam, "Rural Finance in China," p. 74.

26. Watson, "Financing Farmers."

27. The RCC unions of Changshu, Jiangyin, and Zhangjiangang counties in Jiangsu province were converted into rural commercial banks. The PBC provided interest-free on-lending to the RCCs in Jiangsu for five years to help reduce their historical debt burdens. Enjiang Cheng and Zhong Xu, "New Developments in China's Rural Financial Markets: Since the Middle 1990s," paper presented at the China Brown Bag Seminar, Asian Development Bank, Manila, February 28, 2003.

28. The eight provinces are Zhejiang, Shandong, Jiangxi, Guizhou, Jilin, Chongqing, Shaanxi, and Jiangsu.

29. The different shareholding models include cooperative systems, shareholding systems, and commercial banking. In relatively developed areas with vibrant commercial activities and less need for supporting agricultural households, commercial banking models are being tested. The actual conditions for commercial banks are as follows: the total capital value of the RCC is no less than 1 billion yuan, the nonperforming loan ratio is lower than 15 percent, equity after restructuring is no less than 50 million yuan, and the capital adequacy ratio is at least 8 percent (Ning Yu, "Nongxinshe youxian gaige" [Limited reforms of the RCCs], *Caijing Magazine*, no. 15, 2003, pp. 27–36).

30. For a theoretical discussion of the corporate governance structure of cooperative financial organizations, see Guangwen He, *Hezuo jinrong fazhan moshi ji yunxing jizhi yanjiu* [Research of developmental models and operating mechanisms of cooperative finance] (Beijing: Zhongguo Jinrong Chubanshe, 2001).

31. Personal interviews with RCC managers.

32. Personal interviews with RCC managers; the Sichuan Ministry of Agriculture, which was the base of the former Sichuan Rural Cooperative Management Station; and some township officials.

33. Though there is more than one individual or employee with each rural credit cooperative, we perceive them as a single agent having the same interests.

34. Kiewert and McCubbins, *The Logic of Delegation.*

35. Ibid.

36. For other applications of the multiple principals–agent model in US politics, see Thomas H. Hammond and Jack H. Knott, "Who Controls the Bureaucracy? Presidential Power, Congressional Dominance, Legal Constraints, and Bureaucratic Autonomy in a Model of Multiinstitutional Policy-making," *Journal of Law Economics and Organization* 12, no. 1 (1996): 119–166; Susan K. Snyder and Barry R. Weingast, "The American System of Shared Powers: The President, Congress, and the NLRB," *Journal of Law Economics and Organization* 16, no. 2 (2000): 269–305; William F. West and Joseph Cooper, "Legislative Influence v. Presidential Dominance: Competing Models of Bureaucratic Control," *Political Science Quarterly* 104, no. 4 (1989/90): 581–606.

37. Terry M. Moe, "The New Economics of Organization," *American Journal of Political Science* 28, no. 4 (1984): 739–777.

38. Both the parliament and the Council of Ministers have the formal authority to monitor, reward, or sanction the European Commission, even though the council has more tools than the parliament. See Pollack, *The Engines of European Integration*.

39. It is important to note that if these two elements are not present, a collective principal will then become multiple principals. This may be a tautology, but it is sometimes easy to overlook the obvious.

40. For a more detailed explanation of the difference between multiple and collective principals, see Mona Lyne, Daniel Nielson, and Michael Tierney, "A Problem of Principals: Common Agency and Social Lending at the Multilateral Development Banks," paper presented at the USCD conference "Delegations to International Organizations," Del Mar, CA, September 19–20, 2003.

41. Mancur Olson, *The Logic of Collective Action* (Cambridge: Harvard University Press, 1965).

42. Gourevitch, "Collective Action Problems in Monitoring Managers." Gourevitch argues that since shareholders own small percentages of the corporation, no one has enough leverage over the whole to have much incentive to pay the costs of gathering substantial information (visiting factories, interviewing managers and employees). Instead they monitor through relative "cheap" (low search cost) information, which consists of annual reports produced by the auditors, ratings produced by the rating agencies, and stock analyses written by brokerage firms. The Enron case showed that these "reputational intermediaries" have a substantial interest in colluding with managers and each other, at the expense of shareholders: managers largely pick the board and reward them for compliance; audit committees of the board rely on the auditing firms, who

in turn derive income from consulting; the audit is paid by the firm, not the shareholders. It is designed to fit the strategy of the firm, not to provide investors and shareholders with independent information.

43. Elinor Ostrom, *Governing the Commons: The Evolution of Institutions for Collective Action* (Cambridge: Cambridge University Press, 1990).

44. "Conditional cooperators are individuals who are willing to initiate cooperative action when they estimate others will reciprocate and to repeat these actions as long as a sufficient proportion of the others involved reciprocate. . . . Conditional cooperators will tend to trust others and be trustworthy in sequential prisoner's dilemma games as long as the proportion of others who return trust is relatively high. Conditional cooperators tend to vary, however, in their tolerance for free riding. Some are easily disappointed if others do not contribute, so they begin to reduce their own contributions. As they reduce their contributions, they discourage other conditional cooperators from further contributions" (Elinor Ostrom, "Collective Action and the Evolution of Social Norms," *Journal of Economic Perspectives* 14, no. 3 [2000]: 137–148).

45. Olson, *The Logic of Collective Action*.

46. Ping Xie, "Zhongguo nongcun xingyonghezoushe tizhi gaige de zhenglun" [Debates on the reforms of China's rural credit cooperatives' system], *Jinrong Yanjiu* [Journal of Financial Research] 1 (2001).

47. The County Unions are guided (*zhidao*)—not managed—by the higher-level RCCs (prefectural and provincial) in terms of information provisions regarding government policy changes. For instance, to support the agricultural sector's credit demand, the central government has required that a certain proportion of RCC loans be given to agricultural households, and the provincial RCC unions are responsible for transmitting the required policy information to the lower units to help ensure that all the units operate in the direction of the central government's macroeconomic and financial policies (personal interview with a provincial RCC director).

48. Personal interviews with various RCC managers.

49. This suggests that the variable component of officers' remuneration is determined collectively at the unit, rather than at the individual level. If a township RCC performs well on these criteria, all the officers that work at the unit will receive the same compensations on the variable component. Similarly, if the unit does not perform well due to the action of an officer, the compensation of the other officers in the same unit will also be affected.

50. That said, this upward transfer of excess funds has been partly mitigated by the transfer from the County RCC Unions to townships where capital is in short supply, and some households have been able to obtain loans that they would not have otherwise. One of the functions of the County RCC Unions is to clear funds and accounts. When the RCC in township A has more savings than profitable lending opportunities, it cannot lend the funds to the RCC in township B that has an excess of lending opportunities over savings. However, the RCC in township A can transfer the funds to the County RCC Union, and the latter can then lend the funds to the RCC in township B to invest in profitable lending activities.

51. Like the Soviet system, China has parallel party and government administrative apparatuses at the national and subnational levels. The formal administrative levels below the center—province, prefecture, county, and township—are organized in basically the same way as the center, with government and party organizations paralleling one another. The Communist Party committee at each level, headed by the party secretary, is the primary point of authority coordinating the activities of the organizations within its geographical jurisdiction. The people's government is the administrative (executive) organ of the people's congress. In principle, the party is to make policy, and the government is to administer it. For the purpose of our analysis, we perceive the party apparatus and government administration at the same administrative level as a single entity. And the two terms are used interchangeably. For further details on the Chinese government and party systems, see K. G. Lieberthal and D. M. Lampton, *Bureaucracy, Politics and Decision-Making in Post-Mao China* (Berkeley: University of California Press, 1992); and Tony Saich, *Governance and Politics in China* (New York: Palgrave, 2001).

52. The local governments have direct control over two parts of after-tax profits from TVEs. The first part is that portion remitted directly to the government and known as "management fees." The second part is the profits retained by TVEs but earmarked for public expenditures. The local government decides on the use of those funds for supporting agriculture and providing community welfare—for example, for schools, roads, health care, pensions. In addition, it also has significant influence on the remaining after-tax profits, which are used for reinvestment. Jiahua Che and Yingyi Qian, "Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village Enterprises," *Journal of Law, Economics, and Organization* 14, no. 1 (1998): 1–23.

53. This concept has been explained in Watson, "Financing Farmers," and in various articles in Chinese. See for example, Xiaoming Guo, "Yi nongmin hezuo de mingyi: sichuansheng nongcun hezuo jijinghui qunwang licheng, 1986–1999" [In the name of farmers' cooperatives: Milestones of RCFs in Sichuan province, 1986–1999], University Service Centre Seminar Series No. 16, The Chinese University of Hong Kong (2001), available at www.usc.cuhk.edu.hk/wk_wzdetails.asp?id=920.

54. A distinction is made between "principals" and "clients." Depositors who are clients of a bank may not necessarily be the principals to the banks. But bank investors, like the member households, who contribute to the equity of the bank, are principals.

55. I have conducted a thorough search of the secondary literature, such as Chinese-language newspapers and academic papers, and have found no evidence of actions by member households.

56. For a literature review of peasant resistance in rural China, see Kevin O'Brien, "Collective Action in the Chinese Countryside," *China Journal* 48 (2002): 139–154.

57. Refer to Xie, "Zhongguo nongcun xingyonghezoushe tizhi gaige de zhenglun" for examples of the central government's bailouts of the RCCs.

58. Some political scientists have conducted excellent work on the political economy of rural China, such as Jean C. Oi, *Rural China Takes Off* (Berkeley: University of California Press, 1999); Susan Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* (New York: Cambridge University Press, 2001); and Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Ithaca: Cornell University Press, 2002). Some anthropologists have also ventured into explaining why rural finance has failed to meet the credit demands of the poor. For example, see Robinson, *The Microfinance Revolution.*

59. Here I refer to the China specialists, and the studies conducted by the China specialists are usually empirical and free of theoretical jargon or models, the merits (demerits) of which are, of course, a point of contention, which is beyond the scope of this article.