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Communist Party and Financial Institutions: Institutional Design of China's Post-Reform Rural Credit Cooperatives

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Introduction

Financial-sector reform is a cornerstone of economic restructuring in China. Described by Nicholas Lardy as the "Unfinished Economic Revolution,"[1] the path of reform followed by China's financial sector, which holds the country's enormous savings, has been a rocky one. It is widely recognized that the impediments to financial reforms stem in large part from the complex political-economic realities facing transitional China. Scholarship on the political economy of financial-sector reform has tended to examine it either from the angle of institutional politics at the central level (for example, Heilmann)[2] or from the perspective of elite politics (for example, Shih and Liew).[3]

What is largely missing from the literature is the configuration of the Communist Party's power in the financial organizations. Beset by lack of access to valuable data, a majority of researchers studying China's financial sector have tended to treat Communist Party institutions as non-existent or something exogenous to the system. Notable exceptions are Heilmann, who looks at policy making and institutional politics in Shanghai's financial

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1 Nicholas Lardy, *China's Unfinished Economic Revolution* (Washington, DC: Brookings Institution Press, 1998).

2 See Sebastian Heilmann, "Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry," *The China Quarterly*, vol. 181 (2005), pp. 1-21.

3 Victor Shih, "Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China," vol. 180 (2004), pp. 922-944; Leong H. Liew, "Policy Elites in the Political Economy of China's Exchange Rate Policymaking," *Journal of Contemporary China*, vol. 13, no. 38 (2004), pp. 21-51; Victor Shih, "Partial Reform Equilibrium, Chinese Style: Political Incentives and Reform Stagnation in Chinese Financial Policies," *Comparative Political Studies*, vol. 40 (2007), pp. 1238-1262.

industry,[4] and Shih, who deals with elite politics in the banking industry.[5] However, the party's influence over the financial organizations is so great that it must be a focus for analysis. Apart from some work on the party's influence on the corporate governance of state-holding corporations[6] and on cadre management,[7] how Party institutions operate and how they exert authority in financial organizations is almost a "black box" to the Western world. As this paper will establish, unraveling this "black box" is crucial in getting to the crux of the issue.

Scholars studying the former economic top performers such as Japan and the "Asian Tigers" will find much that is familiar in this paper's findings. Though China's Communist Party institutions are not replicated in other Asian countries, the hard lessons that the Asian neighbours learned from the Asian financial crisis—the problems caused by a politically cozy relationship between governments, banks and enterprises—are transferable.

The Rural Credit Cooperatives (RCCs), or *nongcun xinyong hezuoshe*, have been the core credit institutions in rural China, where three-quarters of the country's population still reside, since the Communist revolution in 1949. 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. However, the RCCs are not very effective in meeting the credit demands of the very constituencies that they are supposed to serve. Rural households consistently contribute more than 80 percent of total deposits,[8] but account for only one-third of total loans. Moreover, the RCCs are saddled with mountains of bad debt, much of which is nonperforming loans to township and village enterprises (TVEs).[9] This robs the credit cooperatives of valuable funds for lending, further reducing the supply of credit to rural households.

Reforms of the rural credit cooperatives epitomize the complexity of China's political economy and highlight the obstacles with regard to financial-

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[4] Sebastian Heilmann, "Policy-making and Political Supervision in Shanghai's Financial Industry," *Journal of Contemporary China*, vol. 14, no. 45 (2005), pp. 643-668.

[5] Victor Shih, *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge, New York: Cambridge University Press, 2008).

[6] See Christopher A. McNally, "Strange Bedfellows: Communist Party Institutions and New Governance Mechanisms in Chinese State Holding Corporations," *Business and Politics*, vol. 4, no. 1 (2002), pp. 91-115.

[7] For instance, see Susan Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* (New York: Cambridge University Press, 2001); Maria Edin, "Remaking the Communist Party-State: The Cadre Responsibility System at the Local Level in China," *China: An International Journal*, vol. 1, no. 1 (2003), pp. 1-15; John P. Burns, "Strengthening Central CCP Control of Leadership Selection: The 1990s Nomenklatura," *The China Quarterly*, vol. 138 (1994), pp. 458-491.

[8] *Zhongguo jinrong xuehui, Almanac of China's Finance and Banking [Zhongguo jinrong nianjian]* (Beijing: Almanac of China's Finance and Banking Editor Board, various years).

[9] Loren Brandt, Albert Park and Sangui Wang, "Are China Financial Reforms Leaving the Poor Behind?," in Yasheng Huang, T. Saich and E. Steinfeld, eds., *Financial Sector Reform in China* (Cambridge, Massachusetts: Harvard University Asia Center, 2005).

sector reforms.[10] Since the mid-1980s, the central government has planned new institutional design to make the credit organizations genuinely accountable to member households.[11] After separation from the state-owned bank in 1996 until 2003, the grassroots RCCs were loosely managed by central bank branches, predominantly at the provincial and county levels. The lack of strict vertical management structure made them easy targets for control by local governments. There was no substantial progress in reform until 2003, when the central government put the provincial governments in charge, introduced three institutional models—rural commercial banks, rural cooperative banks, and the original rural credit cooperatives—and implemented a pilot reform programme in eight provinces and municipalities.[12] After completion of the pilot programme, the reform was rolled out to the rest of the country, starting in 2004. As part of the reform effort, the central government also provided a range of financial subsidies to assist the RCCs in cleaning up their historical losses and balance sheets, including 170 billion *yuan* debt-for-bonds swaps, and earmarked central bank loans at a subsidized interest rate. This present study, based on fieldwork from 2004 to 2006, evaluates the institutional design of the post-reform rural credit organizations.

Despite being nominally "cooperatives," which implies organizations owned, managed and operated by members and designed to serve their needs, the RCCs were in fact managed as local branches of a state-owned bank from 1979. Since the RCCs were made independent of the state bank in 1996, central policy makers have been searching for an institutional model to improve the operation of the RCCs in serving the credit demands of member households.

In organizational analysis, "agency problems" are usually inevitable when there is a separation of ownership and management.[13] Since the principal (owner) and agent (manager) have divergent objectives, the agent will be investing effort in pursuing matters not necessarily in the inherent interests of the principal. With regard to the RCCs, since member households very rarely take part in member representative meetings, the manager holds an informational advantage that gives them enormous power over the credit organizations, resulting in insider control, an issue familiar in the literature on corporate governance.

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[10] For a historical account of the various phases of RCC development, see Andrew Watson, "Financing Farmers: The Reform of Rural Credit Cooperatives and Provision of Financial Services to Farmers," in Christopher Findlay, Andrew Watson, Enjiang Cheng and Gang Zhu, eds., *Rural Financial Markets in China* (Canberra: Asia-Pacific Press, 2003).

[11] Watson, "Financing Farmers."

[12] The eight provinces which were included in the pilot reforms included Zhejiang, Jiangsu, Shandong, Shaanxi, Shanxi, Guizhou and Chongqing.

[13] Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, vol. 3 (1976), pp. 305-360.

Furthermore, member households face the collective action problem in monitoring the agent's behaviour.[14] This is a problem recognized in studies of corporate governance: being part of a large number of dispersed corporate shareholders, individual members have little personal incentive to monitor the agent's actions. The large number of rural households or depositors in a township credit cooperative—from 5,000 to 25,000 in the areas where my field studies have been conducted—means that the gains resulting from any mobilized action will also accrue to those who do not invest any effort.

Those problems aside, the RCCs, like other government or quasi-government organizations in China, are heavily influenced by Communist Party institutions at the local level. Local Party committees frequently interfere in credit institutions' loan allocations to favour their enterprises and projects, in order to promote the local economic growth on which their political careers depend. Local Party committees influence the operation of rural credit organizations by exercising influence over cadre management or the *nomenklatura* system to which RCC senior management belong.[15]

Extending this line of analysis, this paper examines *the extent* to which the most recent institutional reforms have addressed the effects of insider control, the problem of collective action for member households, and the influence of the local Party on the operations of the rural credit organizations. The interference of local government in the allocation of loans has significant implications for how the literature has traditionally perceived the role of local government. Scholars have seen this role as positive in regard to the country's economic development, describing the local states as "corporatist" (Oi),[16] "entrepreneurial" (Duckett)[17] and "developmental" (Blecher and Shue).[18] To varying degrees, these studies have applauded local states for their interventionist and instrumental roles in rural industrialization. They see this activity as underpinning the wider economic expansion, on the grounds that fiscal decentralization, in giving local states an incentive to retain revenue, has prompted them to engage vigorously in income-generating business activities—put simply, to behave like "corporations" and "entrepreneurs." Evidence presented in this paper, however, presses for a fundamental rethinking of the role of local states. The mounting problem

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14 Lynette Ong, "Multiple Principals and Collective Action: China's Rural Credit Cooperatives and Poor Households' Access to Credit," *Journal of East Asian Studies*, vol. 6, no. 2 (2006), pp. 177-204.

15 Jean C. Oi, *Rural China Takes Off* (Berkeley: University of California Press, 1999); Lynette Ong, "The Political Economy of Credit in Rural China: The Rural Credit Cooperatives," Australian National University, Ph.D. thesis; Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* .

16 Oi, *Rural China Takes Off* ; Jean C. Oi, "Fiscal Reform and the Economic Foundations of Local State Corporatism in China," *World Politics*, vol. 45, no. 1 (1992), pp. 99-126.

17 Jane Duckett, *The Entrepreneurial State in China: Real Estate and Commerce Departments in Reform-era Tianjin* (London and New York: Routledge, 1998).

18 Marc Blecher and Vivienne Shue, *Tethered Deer: Government and Economy in a Chinese County* (Stanford, California: Stanford University Press, 1996).

of the non-performing assets of rural credit cooperatives resulting from massive loans to local government-owned TVEs shows clearly the need to reassess the effects of local government business-like behaviour.

This study aims to contribute to the literature in the following ways. First, by analyzing the configuration of Communist Party institutions, it shows that the institutional design of the post-reform rural credit cooperatives and banks is still fundamentally incompatible with effective corporate governance. Second, it adds to the literature explaining why the problem of local Party interference in the allocation of loans has *persisted* in China's financial sector. The consequences of this local government interference suggest that a reappraisal of the role of local states in China's economic development is overdue.

Empirical data for this study was collected from more than 120 semi-structured interviews with persons involved with the rural credit cooperatives from 2004 to 2006 in seven provinces and municipalities: Zhejiang, Jiangsu and Shandong (three of the eight provinces which have undergone pilot reforms) during August-December 2005; Sichuan and Hebei (where no reforms have been undertaken) during June-August 2004 and in July 2005, respectively; and Beijing and Shanghai municipalities, where financial-sector reforms are ahead of the rest of the country. This paper has also benefited tremendously from a rural credit survey of about 300 households which I conducted, and many discussions with Chinese academics and policymakers specializing in this area.

This paper is structured as follows. The next section describes the rationale for the RCCs' reforms. Section 3 briefly reviews the two fields of literature which this paper addresses: the political economy of China's financial reforms, and insider control and the problem of collective action in corporate governance. Sections 4 and 5 present key empirical findings and analyses: section 4 sets out the institutional structure of the provincial unions, and various post-reform models; and section 5 examines the institutional design of the post-reform credit organizations: the corporate governance structure and internal party institutions. Section 6 places the issues discussed in the broader context of China's financial institutions and its relation with the Communist Party's control system. The last section concludes this study.

Rationale for the Rural Credit Cooperatives' (RCCs) Institutional Reforms

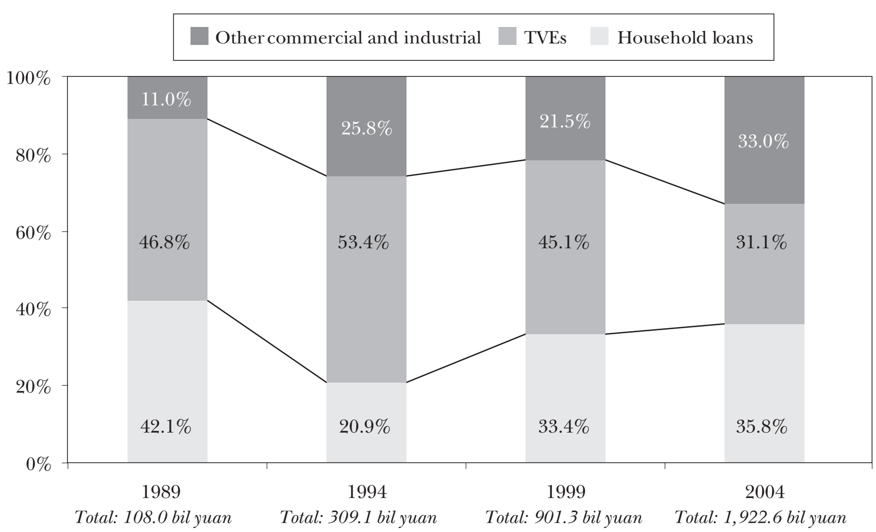
Three-quarters of China's population still resides in the countryside. Poor rural residents in China depend critically on their access to the formal credit market to maintain basic livelihoods, while those in peri-urban areas rely on credit access to improve their living standards.[19] Since the early 1980s, the

[19] In some parts of rural China where private enterprises are vibrant, such as Wenzhou prefecture in Zhejiang province, informal finance plays a greater role in supplying rural residents

central government in China has been trying to reform 35,000 Rural Credit Cooperatives (RCCs) nationwide—the mainstay of formal credit throughout rural China—to make them better able to meet the credit needs and demands of local communities. Despite various government policies to improve households' access to credit, a consistent feature of the RCCs is that their loans are often allocated to local government-owned enterprises and projects, rather than to rural households involved in either farming or small trading. Throughout the 1980s and 1990s, loans to local government-owned collective enterprises consistently accounted for about *half* of the RCC loans, leaving the rural households with *a quarter or less*, despite the fact that more than 80 percent of the RCCs' capital has consistently come from the savings of rural households, as indicated in the Almanac of China's Finance and Banking (*Zhongguo Jinrong Nianjian*) (see figures 1 and 2 for details).

Because local government-related borrowers typically have higher default rates than household borrowers, the RCCs suffer chronic financial losses, and are saddled with mountains of bad debt; the non-performing loan (NPL) rate nationwide was estimated at 50 percent in the late 1990s.[20] The immense

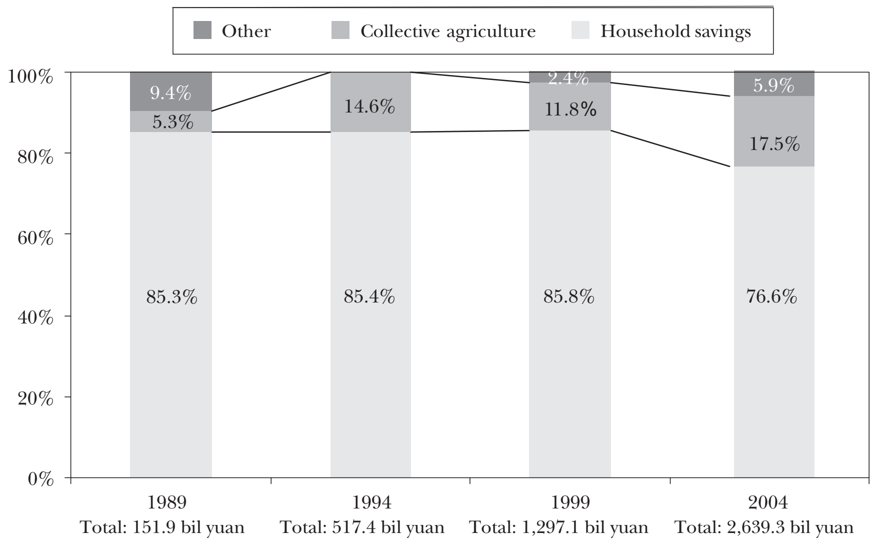
Figure 1
Composition of RCCs' Loans Nationwide (Various Years)



with much-needed capital financing. For further information, see Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Ithaca, New York: Cornell University Press, 2002).

[20] Xiaochuan Zhou, "The Central Bank's Role in the Rural Credit Cooperatives' Reforms" [*Zhongyang yinhang zai Nongxinshe gaige zhong de jueshe*], *21 Century Economic Report [21 shiji jingji baoda]*, 23 August 2004.

Figure 2
Composition of RCCs' Savings Nationwide (Various Years)



Source: China's Almanac of Finance and Banking (*Zhongguo Jinrong Nianjian*), various years.

financial burdens have also drained the liquidity of these small credit organizations and constrained their ability to lend to households.

After the launch of Deng Xiaoping's market reforms in 1979, the central government made the RCCs, which were previously subordinated to the rural communes, report to a state-owned bank, the Agricultural Bank of China (ABC). For one-and-a-half decades, the RCCs functioned as grassroots branches of the state-owned bank, though they kept separate accounts, and their employees were subject to a different compensation system, which usually paled in comparison to their state-owned bank colleagues.[21]

The RCCs formally severed their relationship with the Agricultural Bank of China in 1996 following an overhaul of the state-owned bank's operations. Instead, the central bank set up more county credit unions to manage grassroots cooperatives.[22] Since then central policymakers have been looking for a suitable institutional model for the RCCs to make them "truly

[21] From the author's field interviews with retired RCC officers.
[22] The county credit unions in turn had to report to the central bank's offices at the local level.

accountable to member households" and to become "commercially sustainable."[23]

In June 2003, the central government implemented pilot reform in eight places, which included Zhejiang, Jiangsu, Shandong, Jiangxi, Shaanxi, Guizhou and Jilin provinces, and Chongqing municipality. The major contents of the reforms included:

(a) Transfer of management rights (*guanli quan*) of the RCCs to the provincial governments, which are responsible for overseeing the RCC management, and are not to be involved directly in detailed operations.

(b The RCCs can adopt an institutional model from a choice of three, including the rural commercial banks, the rural cooperative banks and the original rural credit cooperatives. Localities with a higher degree of industrialization and a lesser need to support agricultural households can adopt the profit-maximizing commercial banking model. Localities that still have disproportionately large numbers of subsistent households are to retain the original cooperative model, while the cooperative banks are suitable for those locales that are neither highly developed nor poor and subsistent. The qualifying criteria for the models also differ in terms of financial performance of credit organizations, with the commercial banking model requiring the best performance, followed by the cooperative banking and the credit cooperative models, respectively.[24] We will return to the specifics of the models later.

To relieve the RCCs of their financial burdens, the central bank implemented a variety of policies to make them financially viable. The biggest ongoing aid programme is an interest-rate subsidy, under which the RCCs can borrow funds from the central bank at around 2 percent and yield a handsome profit when the money is lent to farmers at market interest rates. In addition, the central bank also provided 30 billion *yuan* worth of subsidies to those credit cooperatives that suffered losses due to the central government's interest-guarantee policy in the period from 1994 to 1997.[25] The central government also reduced business tax (*yingyeshui*) and fully exempted the credit cooperatives, in the relatively poor central and western regions, from paying corporate income tax.

The non-performing loans (NPLs) of the RCCs are largely made up of non-recovered loans to local government-related enterprises and projects.

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[23] Ping Xie, "Debates on the Reforms of China's Rural Credit Cooperatives' System" [*Zhongguo Nongcun Xingyonghezoushe Tizhi Gaige de Zhenglun*], *Jinrong Yanjiu* [Journal of Financial Research], vol. 1 (2001), pp. 1-13.

[24] Ning Yu, "An Investigation of the Repayment Situations of the Central Bank's On-lending" [*Yanghang zaidaikuan changhuan qingkuang diaocha*], *Finance and Economics [Caijin]*, (5 August 2003).

[25] During the years of high inflation, in order to guarantee positive savings rates to the savers, some of the RCCs were forced to pay out such high savings rates that it ate into their profitability.

From the borrowers' perspective, the mirror image of the NPLs is the mounting local government debt, primarily from township authorities which have relied on lending from the RCCs the most. Official figures suggest that at least half of the RCCs' aggregate NPLs of 515 billion yuan in 2002 were owed by local governments. The likelihood of local governments repaying these loans is slim, particularly in capital-strapped localities. My field study data in two poor counties in Sichuan suggests that township debts owed to RCCs range from 1.4 to 40 times the townships' annual fiscal revenues.[26] Hence, the central government's financial subsidies forming part of the recent reform package—168 billion *yuan* debt-for-bonds swaps and 930 million *yuan* earmarked central bank loans[27]—and having the effects of not only assisting the RCCs to dispose of their bad assets and historical losses, but also bailing out local governments.[28] Further, according to the central bank's policy, the respective provincial governments are supposed to match the central government's 168 billion *yuan* contribution to clean up the RCCs' balance sheets.[29]

Literature Review

To evaluate the rural credit cooperatives' institutional reforms, this paper addresses two bodies of literature: the politics of China's financial-sector reform and the problems of insider control and collective action in corporate governance.

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[26] Lynette Ong, "The Political Economy of Township Government Debt, Township Enterprises and Rural Financial Institutions in China," *The China Quarterly*, vol. 186 (2006), pp. 377-400.

[27] In Chinese language, they are known as "*zhuangxiang zhongyang yinhang piaoju"* (earmarked central bank bill) and "*zhuangxiang zhongyang yinhang daikuan*" (earmarked central bank loans). All the provinces undergoing reforms have chosen to have the earmarked central bank bills, with the exception of Jilin and Shaanxi, that opted for the earmarked central bank lending. Those poor-performing RCCs that have an excess of liabilities over assets (*zibudizhai*) based on their financial figures in 2002 year-end were qualified to apply for the earmarked central bank's bills or earmarked central bank's lending. The excess is calculated based on a formula taking into account the value of non-performing loans, and liability-offsetting assets (*dizhaizhichan*). Sources: China Banking Regulatory Authority, "Operation of the Central Bank's Earmarked Bills for the RCCs in Pilot Reform Areas," *Document No. 181* (3 September 2003), China Banking Regulatory Authority, "Management of the Rural Credit Cooperatives' Earmarked Lending in Pilot Reform Areas" [*Nongcun xinyongshe gaige shidian zhuanxiang jiekuan guanli banfa*]. *Document No. 181* (3 September 2003). The bonds pay an annual interest rate of 1.89 percent, and cashing-out of the bonds are conditional upon the RCCs meeting requirements on capital adequacy ratios, and certain nominal changes in corporate governance structure. Further, the earmarked Central Bank's loans came with a low annual interest rate of 0.945 percent.

[28] Lynette Ong, "Local Government Debt: Another Bail-Out Job," *China Economic Quarterly*, vol. 1 (2006), pp. 48-52.

[29] That said, the author has seen little evidence that the provincial governments have matched the central government's contribution. According to some rural finance specialists in China, local government's matching is spotty; rich provinces typically contribute more than poorer ones do.

Politics of Financial-Sector Reforms in China

It is widely recognized that financial-sector reforms in China face complex political and economic realities. Analyzing the central party's supervision of the financial sector, Heilmann[30] expounds that central political leaders have centralized financial-market supervision starting from 1998 using the party's control over senior financial executives and party-sponsored institutional reorganization. However, the rigid and hierarchical party institutions have caused frictions with emerging forms of corporate governance, and have failed to suppress financial mismanagement and corruption.

From the angle of elite politics, Shih argues that financial reform outcomes are a result of "a series of short-term political calculations aimed at strengthening the power of individual leaders."[31] He reasons that the financial reform pushed by Zhu Rongji's administration was incomplete because "the technocrat's concern for political survival [had] produced a bundle of financial policies [that] maximize[d] his financial control, bolster[ed] his administrative accomplishments, and minimize[d] policy risks."[32]

These studies aside, there is a dearth of studies that explain financial sector outcomes from the perspective of controls over financial institutions. Few studies exist to account for *why* local government interference is persistent in the financial sector, despite numerous reform attempts to tackle this very issue. A notable exception is Heilmann, who illustrates the party's role in policy making and supervision of Shanghai's financial industry.[33]

The Problems of "Insider Control" and "Collective Action" in Corporate Governance

In any organization not managed directly by the owner, a familiar "principal-agent" problem exists where managers, as agents, may not act in the interests of the owner or principal.[34] A key agency cost is insider control, where managers gain control of the organizations at the expense of the owner's interests.[35]

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[30] Heilmann, "Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry," pp. 1-21.

[31] Victor Shih, "Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China," vol. 180 (2004), pp. 922-944.

[32] Shih, "Partial Reform Equilibrium, Chinese Style: Political Incentives and Reform Stagnation in Chinese Financial Policies," pp. 1238-1262.

[33] He notes that "as long as local Party Committees control executive appointments, local financial institutions will serve as a policy tool for politicians that are eager to support economic growth in their jurisdiction, or their personal prestige projects, by pumping money into the economy while ignoring the inherent risks to the financial system." Heilmann, "Policy-making and Political Supervision in Shanghai's Financial Industry," p. 666.

[34] Jensen and Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," pp. 305-360.

[35] Terry Moe, "The New Economics Of Organization," *American Journal of Political Science*, vol. 28, no. 4 (1984), pp. 739-777.

Moreover, the RCCs' member households also face the collective action problem in monitoring agents' behaviour, as I have argued in my earlier work.[36] The problem arises from the challenge of mobilizing a large group of dispersed members to monitor an agent's actions. Since monitoring is costly, if any gain goes to everyone in the group, those who contribute nothing to the monitoring effort will benefit as much as those who have contributed, any rational individual will have no incentive to exert any effort.

The collective action problem has many applications in the corporate governance of modern enterprises. As Gourevitch[37] has argued, collective action is a major cause of the Enron case: the fact that no one (not even the pension funds, and 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, bond and stock analysts, banks and lawyers). When these "reputational intermediaries" collude, the interests of shareholders are significantly compromised.

This study evaluates the recent institutional reform of the RCCs on the basis of whether the recent reform has addressed the problems of insider control, collective action and control by local Communist Party committees. Given that most provinces only began implementing the RCC reforms in 2006 and 2007, it is still too early to draw any firm conclusions from their financial performance. Therefore, this study is based on evaluation of the corporate governance of the post-reform credit institutions.

Provincial RCC Union and Various Post-Reform RCC Models

Provincial RCC Union

All provinces undergoing reform have formed RCC unions at the provincial level. The provincial unions perform several functions: managing industry (*hangye guanli*); making personnel appointments, appraisals and dismissals; setting province-wide remuneration systems; vetoing large loans; approving major capital expenditures; auditing (technical investigations of financial misconduct),[38] and providing services such as province-wide management and support of IT systems and professional personnel training.[39]

It is noteworthy that, unlike the grassroots RCCs, the provincial unions do *not* accept savings or issue loans. They are purely administrative

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36 Ong, "Multiple Principals and Collective Action: China's Rural Credit Cooperatives and Poor Households' Access to Credit," pp. 177-204.

37 Peter Gourevitch, "Collective Action Problems in Monitoring Managers: The Enron Case as a Systemic Problem," *Economic Sociology, European Electronic Newsletter*, vol. 3, no. 3 (2002), pp. 3-16.

38 This function is called *shencha* or *jihe* in Chinese. Auditing that is technical in nature should be differentiated from the role of the Party's disciplinary committee, which is in charge of disciplinary actions on Party members who have been found guilty of financial misconduct.

39 From the author's interview with a senior official from a provincial union.

organizations (*xingzheng jiguan*) that represent the interests of the provincial Party committees or governments in the RCC reform. The provincial unions are headed by senior provincial government officials who used to hold finance or economic-related portfolios.[40] A provincial union's Party committee that I have investigated consists of four members: the Party secretary, who heads the committee, is also the head of the board of directors (*dongshizhang*); the assistant Party secretary, who is the union director (*zhuren*); and two members, who have no effective professional functions in the union. One of the two members has actually failed the professional assessments by the banking sector watchdog, the China Banking and Regulatory Committee (CBRC), and therefore does not qualify to perform any banking function. The other member serves as the Party disciplinary committee member (*dangjilv jiancha weiyuan*).[41]

Rural Credit Cooperatives

There are two types of post-reform rural credit cooperatives: one with a county union as a unified legal entity (while township RCCs in the county are merely branches); and the other involves each township RCC as a first-tier legal entity, with the county union being a second-tier legal entity. The credit cooperatives that retain the original multi-tier legal entity structures are those with very poor financial performance that have been denied the reform opportunity.[42]

Rural Cooperative Banks

A majority of the RCCs adopt the rural cooperative banking model. When this happens, the previous legal entity status of township RCCs is abolished

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[40] In the case of Shandong province, the head of the Shandong provincial union was previously a secretary to the deputy provincial head in charge of economic affairs. His previous portfolio was related to finance and economics, and his move to head the Shandong provincial union is a promotion from a deputy provincial administrative rank (*futingji*) to a main provincial administrative rank (*zhengtingji*). From the author's interview with a senior official from the Shandong provincial RCC union.

[41] Some observers have criticized the formation of provincial RCC unions in all the reform provinces. Shen argues that the province-wide unions create monopolies in the rural credit sector. Since a provincial RCC union is formed on the basis of all county unions in the province (no county union can opt out of the provincial union), and since the county unions are aggregations of all grassroots or township credit cooperatives in a province (no township credit cooperative can opt out of a county union), a provincial union has monopoly powers to set the rules for all the credit cooperatives in a province. As a result, there is little room for local institutional innovation to tailor to the specific credit needs of the localities. For further details, see Minggao Shen, "Monopoly by Provincial Unions Creates Moral Hazards" [*Shenglianshe Longduan Yunniang Daode Fengxian*], *Caijing [Finance and Economics]*, (January 2004).

[42] I am puzzled as to why poorly performing local credit cooperatives are denied the reform opportunity when they are supposed to be the financial organizations that need the most assistance. Given that the financial assistance given by the central government comes with some conditions, such as improved performance indicators, the restriction may have been imposed by provincial unions to ensure that those undergoing reform will qualify for the financial subsidies.

and the county union becomes a rural cooperative bank, and the united legal entity in the counties. This means if a county has ten township RCCs, in the previous system, there would be 11 RCC legal entities (ten at township level, and one at county level), while in the current system, there is only one legal entity at the county level. A united legal entity reduces duplicated administrative functions performed by each of the legal entities, and brings some savings in tax expenses.[43]

Rural Commercial Banks

Only a handful of rural credit cooperatives in industrialized southern Jiangsu have adopted this model. The criteria for becoming rural commercial banks are more stringent than for the other two models, including a higher capital adequacy and lower nonperforming loan ratios.[44] Similar to the case of rural cooperative banks, a county union becomes a rural commercial bank, while township RCCs become branches of the united legal entity.

Figure 3 represents the institutional hierarchy of the post-reform RCC models. Provincial unions that were previously non-existent now become provincial-wide administrative organizations. With the exception of a few in the poor central and western regions, the independent legal entity status of most township RCCs has been abolished. As a consequence, they become branches of the county unions. With the change in legal status, most township RCCs lose their power to make loan decisions, particularly those involving large sums, and the power becomes centralized at the county level.

At this juncture, one may wonder whether the centralization effort has made the RCCs the financing machinery of the county, instead of the township government. This is not at all impossible since county credit unions are still accountable to local party committees. Yet, compared to the pre-reform situation, local government interference has been curbed to some extent by the establishment of provincial unions and the accompanying rules and procedures which the credit cooperatives have to observe. This is not to say that local government interference has been eliminated entirely, but the vertical management control has made it harder than before for interference to occur.

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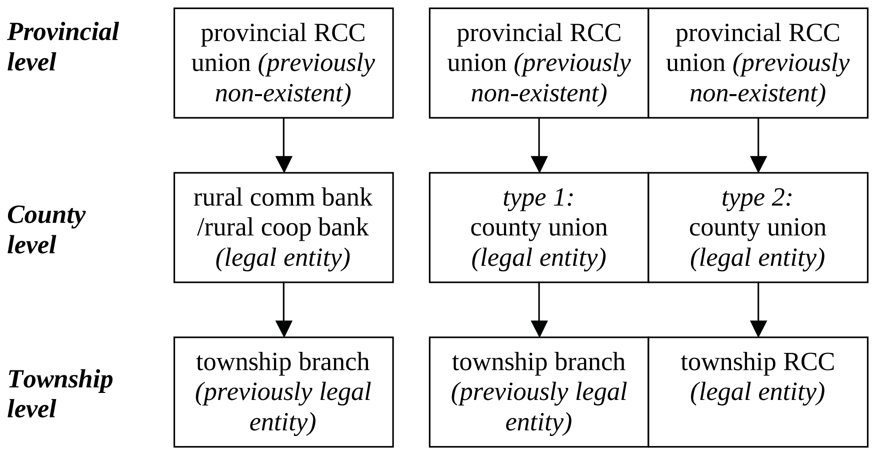
[43] Because each legal entity was responsible for its own profits and losses (*zifuyingkui*), and liable for company income tax (*qiye suodeshui*), the RCCs as a whole had paid more taxes and incurred larger expenses than a unified county RCC union in this new model does. Furthermore, since county unions have now become the clearing houses for funds, flows of funds across townships that may have been previously impeded by legally specified loan-to-deposit requirements can take place across townships to reflect market supply and demand for credit.

[44] The financial conditions for commercial banks are: no less than one billion *yuan* in total capital size, less than 15 percent non-performing loan rate, at least 8 percent of capital adequacy ratio, and at least 50 million *yuan* in equity after restructuring.

Figure 3
Schematic Representation of Post-Reform RCC Models



Institutional Design of the Post-Reform Rural Credit Organizations

Corporate Governance Structure

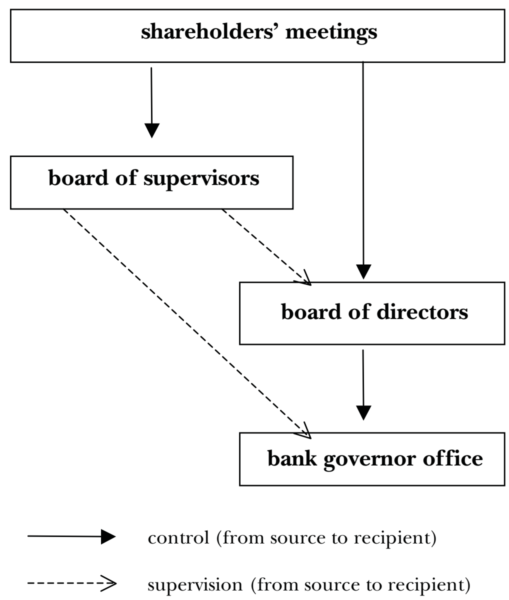
In a cooperative credit organization, the member representative meeting, made up of the ordinary members, is the highest governing body. In theory, members nominate and elect those who sit on the board of directors and board of supervisors; the supervisory board supervises the board of directors; and the head of the board of directors becomes the key decision maker.[45]

Nonetheless, in the case of pre-reform RCCs, the member representative meeting (*huiyuan daibiao dahui*) consists of township- and village-leading cadres (*lingdao ganbu*), instead of the fee-paying members (*rugu huiyuan*). Out of a sample of about 300 member households, only 12 percent had ever attended a member representative meeting; these people, or their spouses, were, at that time, either township or village heads or secretaries.[46] The board of directors typically comprises only RCC officers, and is headed by the RCC manager. While the township Party secretary typically leads the board of supervisors, the supervisory board comprises township cadres exclusively.

[45] The co-existence of the board of directors and board of supervisors is unique to China. The idea of a supervisory board is borrowed from Germany. Cooperatives in other countries may not have a supervisory board. However, the central idea of the corporate governance of cooperative organizations remains the same—the members' representative meeting is the highest decision-making body where nominations and decisions for the people who sit on the board of directors are made.

[46] From the author's rural credit survey, see Ong, "The Political Economy of Credit in Rural China: The Rural Credit Cooperatives," pp. 105-138.

Figure 4
Corporate governance structure of post-reform rural cooperative banks and rural commercial banks



How has the corporate governance structure changed as a result of the institutional reform? As illustrated in figure 4, the corporate governance structure of the post-reform credit organizations consists of the board of directors, bank governor's office, board of supervisors and the shareholders' meeting.

Board of Directors (Dongshi hui)

The composition of the post-reform BOD differs among the three models. Typically, the head of the BOD is both the credit organization's legal representative (*faren daibiao*) and the internal Party committee's secretary. The RCCs that have retained the original cooperative model have little change in their BOD, which is made up of RCC employees, whereas the BOD in rural cooperative banks consists of employee and non-employee member shareholders, with the number of the non-employees usually exceeding that of employees. The non-employee shareholders can be individual shareholders (*geren gudong*) or representatives of company shareholders (*qiye gudong*). Comparing the BOD of the rural cooperative banks with that of the original cooperatives, the monopoly power of the credit organizations' employees, or insider control, has diminished considerably.

In addition to having employee and non-employee shareholders, rural commercial banks have a number of independent directors on their BOD. Independent directors—who have no stake in the financial organizations—are supposed to be impartial, and have a long-term-oriented outlook. Independent directors are usually economics professors, successful entrepreneurs, or retired government officials familiar with banking operations who are invited to sit on the board to balance against the interests of those who hold shares in the organizations. Independent directors are appointed by the head of the BOD.[47]

Bank Governor's Office (Hangzhang shi)

The bank governor's office is a newly set-up institution in the rural cooperative banks and rural commercial banks, which is not found in the original RCCs. The BOD delegates (*weituo*) the rights to make daily operational decisions to the bank governor's office. Prior to the reforms, the head of the BOD used to perform the function of both decision maker for strategic issues and day-to-day operations. Because the charters (*zhangcheng*) of the rural commercial banks and rural cooperative banks specify that the same individual *cannot* fill both the positions of head of the BOD and bank governor, which has been strictly followed, the previous over-concentration of power in the hands of a single person has been curbed in the new structure.

With the separation of functions between the head of the BOD and bank governor, loan approval decisions are also subject to more stringent procedures. A loan approval committee, operating under the bank governor's office and BOD, now makes decisions on big loans that fall outside the purview of branch managers.[48] It is noteworthy that these decisions used to be the exclusive prerogative of the head of the BOD. Further, various committees have been established under the BOD and the bank governor's office to institutionalize various decision-making processes. For the rural cooperative banks, there are three committees operating under the BOD: a risk management, personnel wage and audit committee. A rural commercial

[47] From the author's interviews with a number of members of BODs, including independent directors from rural commercial banks.

[48] In the case of a rural cooperative bank in Zhejiang, the loan approval committee, made up of the bank governor, assistant governor, chief accountant, and several department heads, has the right to make decisions on any loan to an individual borrower exceeding five million *yuan*, or any loan to an enterprise borrower exceeding 10 million *yuan*. Any loans exceeding those amounts have to be submitted for consideration to a risk management committee (*fengxian guanli weiyuanhui*), a committee under the BOD. While the committee does not approve loans, it assesses the risk profiles of the borrowers and the projects, and subsequently passes the information to the BOD for decision making. The BOD makes decisions on a simple-majority vote based on the total number of board members.

bank has an internal transaction committee in addition to these other three. All these committees report directly to the board of directors.[49]

Nonetheless, the effectiveness of such micro-organizations is far from clear at this stage, but the creation of audit committees is welcome because it represents an attempt to take financial misconduct seriously. The audit committees in some rural commercial banks are increasingly playing a more prominent role, which is reflected in the fact that the banks have discovered some cases of fraud and financial crime through internal audits.[50] However, it is important to draw the differences in functions between the audit committee and the Party disciplinary committee (*dangjilv jiancha weiyuan hui* or *jijianwei*). The audit function is technical in nature, as it investigates the professional aspect of financial misconduct. Upon discovering misbehaviour, the audit committee hands the relevant personnel over to the Party disciplinary committee for action. If the individuals are Party members, the committee takes action against them based on Party disciplinary rules.[51] Hence, though the existence of an audit committee means enhanced vigilance against financial misconduct, the power of investigation still lies with the disciplinary committee, subject to the rules of the Communist Party.

Board of Supervisors (Jianshi hui)

The function of the BOS is different in practice from what is stated in the organization charter. In theory, members of the board of supervisors (BOS) are supposed to be appointed in the shareholders' meetings, and the BOS supervises the BOD and the bank governor. In practice, the effectiveness of the BOS is very limited, more so in the case of the RCCs and rural cooperative banks than in the rural commercial banks.[52]

Interestingly, among the post-reform rural credit organizations that I have interviewed, the bank executives are the same people as those before the reform. Usually the head of the BOD was the previous director of the county union (*zhuren*) , the deputy head of the BOD was the deputy director (*fu zhuren*), and the head of the BOS was the office manager. Rarely is there any

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[49] Further, there are eight departments operating under the bank governor office: security, audit, technology, finance and accounts, business expansion, human resources and general administration. All departments report directly to the bank governor office. This information was obtained during the author's conversations with high-ranking banking officers during dinner or other informal events.

[50] This information was obtained during the author's conversations with high-ranking banking officers during dinner or other informal events.

[51] If it is a major crime, the committee hands the individual over to the police. Source: the author's interviews with a few party committee members in credit cooperatives and banks.

[52] The senior management of the rural commercial banks has been able to tell me what the heads of the BOS have done, such as monitor whether the BOD decisions abide by the banks' charters. Most of the rural cooperative bank and RCC managers openly admit that the BOS exists only in nominal terms.

injection of new blood into the top management after reforms. That said, this may be a reflection of the lack of qualified banking personnel in the localities and new qualified banking practitioners may be employed as the banks develop over time.[53]

The Collective Action Problem and Insider Control

One of the persistent corporate governance problems with the original RCCs is the collective action problem. As a large and dispersed group, the RCCs' member households have little incentive to organize themselves to pay for the costs of monitoring managers. This results in relatively weaker control of member households over the RCCs' officers.[54] It is interesting to see how credit cooperative senior management perceives this problem. An internal document prepared by the head of the BOS[55] in a Zhejiang RCC notes that "because of the small number of shares owned by member households and members of the BOD and the BOS, they do no more than raise their hands and eat buns (*jujuquantou, chichimantou*) during meetings!"

The relevant question here is the extent to which this problem has been addressed by the institutional transformation. The RCCs that retain the original model have had little change in their share structures, even though the size of their capital base has expanded. Here, we compare the share structures of a pre- and post-reform rural cooperative bank and those of a rural commercial bank.[56] Generally, shares of rural cooperative banks are divided into "natural person" shares, (*ziran rengu*) owned by individuals including employees, and "legal person" shares (*faren gu*), owned by companies. Each type of share has a basic "eligibility threshold"[57] (*zige gu*), and the rest are "investment shares" (*touzi gu*).

The collective action problem still exists in the post-reform rural cooperative bank, though its degree may have diminished somewhat. Table 1 suggests that the number of shareholders has reduced from 60,000 to 13,500, the shares are still rather thinly spread, with the top ten shareholders holding only slightly over 10 percent of total shares collectively. The largest

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[53] The Shanghai City Commercial Bank was previously the Shanghai Urban Credit Cooperatives. When the commercial bank was first established, the top management consisted of the same people as those in the urban credit cooperatives. However, there was a gradual replacement in top management by recruiting qualified banking professionals from the industry as the bank grows over time. Source: Author's interview with a senior officer from the Shanghai City Commercial Bank.

[54] See Ong, "Multiple Principals and Collective Action: China's Rural Credit Cooperatives and Poor Households' Access to Credit," pp. 177-204.

[55] The internal document was made available to the author.

[56] All comparisons in this paper are done using one example from each institutional model because I have discovered little difference in rural cooperative banks or rural credit cooperatives between different provinces. And in the case of rural commercial banks, there were only a handful in southern Jiangsu, the institutional designs of which hardly differ.

[57] The "eligibility threshold" that is equivalent to one vote is 1,000 shares for a "natural person" and 10,000 shares for a "legal person."

shareholders are bank employees, with the single largest owning 1.5 percent of total shares. In fact, the banks' charters have imposed restrictions on maximum share ownership. A corporation and its related companies or the "legal person" can only hold a maximum of 0.5 percent of total shares, while bank employees and other "natural persons" can hold 1.5 and 0.5 percent, respectively. It is noteworthy that these restrictions are established by the provincial unions to preclude domination by any large shareholders in order for them to exert control over the RCCs.[58]

Table 1

Comparison of share structures between a pre- and post-reform rural cooperative bank

	Rural Cooperative Bank	Previously RCC
Number of members/ shareholders	13,567	60,000
Total members'/ shareholders' equity *(yuan)*	200 million, of which 155 million are "natural person" shares (55 million of which are held by employees) and 45 million are "legal person" shares	24.6 million
Shares held by employees *(% of total)*	50 million *(25%)*	N.A.
Voting rights	In addition to an "eligibility threshold" that is equivalent to one vote, for a "natural person" every additional 2,000 investment shares provides one extra vote; for a "legal person" every additional 20,000 shares provides one extra vote	One-person-one-vote
Maximum shares held *(% of total shares)*	"Natural person," including employees: 301,000 *yuan (1.5%)* "Legal person": 1.01 million *(0.5%)*	N.A.
Shares held by top 10 shareholders *(% of total shares)*	11.3%	N.A.
Number of representatives in members' representative meetings *(% of total share)*	75: 19 are employees (*25%*), 39 other "natural person" (*52%*), 17 "legal person" (*23%*)	N.A.

N.A.: not available or not applicable
Source: the rural cooperative bank's charter

58 From the author's interview with a retired official from a provincial office of the People's Bank of China. This was later confirmed by an interview with an economics professor who has been an advisor to the provincial government on RCC reforms.

With respect to insider control, despite the absence of pre-reform comparative data, employees, as a group, own a sizeable one-quarter share of the post-reform rural cooperative bank, as indicated in table 1. Given the large and dispersed nature of the bank's shareholders, bank employees are by far the single largest group of shareholders, indicating that insider control is still a thorny issue in the post-reform rural cooperative bank.

Turning to the rural commercial bank, the collective action problem has diminished by a large extent after the institutional reform. As table 2 indicates, the number of shareholders fell from 120,000 to 1,656, and the top ten shareholders now hold more than one-third share in the rural

Table 2
Comparison of share structures between a pre- and post-reform rural commercial bank

	Rural Commercial Bank	Previously RCC
Number of members/ shareholders	1,656, consisting of 1,545 "natural persons" of whom 797 are employees and 111 are "legal persons"	120,000
Total members'/ shareholders' equity *(yuan)*	315 million	14 million
Composition of shares *(% of total shares)*	"Natural persons": 161.9 million (*51.4%*) of which employees are 50.9 million (*16.95%*) "Legal persons": 153.1 million (*48.6%*)	"Employee": 7.9 million (*56.6%*) "Natural person": 2.9 million (*20.9%*) "Legal person": 3.2 million (*22.5%*)
Shares held by employees *(% of total shares)*	16.9%	56.6%
Minimum and maximum shares	Min: 1,000 *yuan* Max: 20,000 *yuan*	Min: 10 *yuan* (1 share) Max: 20,000 *yuan* (2,000 shares)
Voting rights	One-share-one-vote	One-member-one-vote
Max shares held *(% of total)*	"Natural person": 0.5% "Legal person": 10%	N.A.
Shares held by top 10 shareholders *(% of total shares)*	34.7%	N.A.

N.A.: not applicable or not available
Source: the rural commercial bank's charter

commercial bank. Having a bigger stake in the commercial bank provides large shareholders greater incentive to monitor the manager's actions. Hence, everything else being equal, the collective action problem has been curtailed to a greater extent in the rural commercial bank than in the rural cooperative bank. Some may argue that dominance by large shareholders will hinder participation by small shareholders, but the amount of shares held by the top ten shareholders in the rural commercial bank (only one-third of the total) does not seem to be large enough to preclude participation by others.

The problem of insider control has also been attenuated significantly, as indicated by the fall in magnitude of employee-held shares from 56.6 to 16.9 percent. This means that in the previous system, the employees used to have a majority in the member representatives meeting. But, as a group, they now account for less than one-fifth of total shareholders' votes. Further, given the fact that shareholders are more dispersed in the rural cooperative bank than in the rural commercial bank, insider control is more of a problem in the former than in the latter.

Internal Party Committees in the Credit Organizations

The most pivotal institution within the credit organizations—the internal party committee—does *not* exist on paper. Neither the charter of the credit cooperative nor of the bank mentions a "party committee," though it is the core decision-making body in these organizations.[59]

The RCC's Party committee is headed by the Party secretary, who is also the head of the board of directors. He is undoubtedly the top decision maker in the organization (*yibashou*). The Party committee usually comprises the deputy head of the BOD, who is the second in-charge; the bank governor (*hangzhang*, in the case of rural commercial banks and rural cooperative banks) or the bank director (*zhuren*, in the case of rural credit cooperatives); the head of the supervisory board, who is also the Party disciplinary committee member (*jilv weiyuanhui*); and assistant bank governors, or heads of key departments, such as credit.

It should be noted that some but *not* all of a bank's typical key executives are Party committee members. The Party committee members are the core decision makers who have major powers over personnel nominations, appointments and dismissals of branch managers. This implies that not every bank executive has substantive and equal power; only those selected into the Party committee are the core decision makers in the organization. Among

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[59] This conclusion is drawn from my previous work on the RCCs. The supreme power of the Party committee is also confirmed in scholarly work on state holding companies and other financial institutions in China, such as McNally, "Strange Bedfellows: Communist Party Institutions and New Governance Mechanisms in Chinese State Holding Corporations"; Heilmann, "Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry," pp. 1-21.

the banks I have interviewed, while the head of the BOD and bank governor are always in the Party committees, the other key executives, such as head of BOS and assistant bank governors, may or may not be Party committee members.

Interestingly, the executive appointment and appraisal system has an uncanny resemblance to the cadre evaluation system of the Communist Party. The Party committee members themselves—the first-tier personnel—are determined and appraised by the Party committee one level above them. The Party committee of a county union determines that of township RCCs, and the Party committee of a provincial union determines that of county RCCs. Second-tier and ordinary employees in the financial organizations are akin to the ordinary cadres (*yiban ganbu*) in the Party. Their personnel information, or dossiers, are held by the leadership group or leading cadres (*lingdao ganbu*) at the same level. Personnel information of the members of the leadership group—akin to leading cadres (*lingdao ganbu*) in the Party—are evaluated by the Party committee one level immediately above them.[60] The Communist Party's authority on personnel matters includes nominations, appointments, appraisals, reallocations and dismissals of individuals. Aside from personnel decisions, major capital expenditure is also a prerogative of the Party committee. For instance, if a credit cooperative needs to build a new building for one of its fast-growing branches, the decision needs to be studied and approved by the Party committee.[61]

With the exception of those grassroots RCCs that still retain their independent legal entity status, the power of the township Party committees over the post-reform township RCCs has diminished considerably.[62] The post-reform township RCC Party branches are now accountable to the county RCC unions' Party committees. This means that as Party members, they are now evaluated by the county unions' Party committees: township Party committees have no *formal* control rights over the grassroots RCC officials, though one could argue that *informal* rights to influence or sway their

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[60] For instance, see Hon S. Chan, "Cadre Personnel Management in China: The Nomenklatura System, 1990-1998," *The China Quarterly*, vol. 179, (2004), pp. 703-734; Edin, "Remaking the Communist Party-State: The Cadre Responsibility System at the Local Level in China"; John P. Burns, ""Downsizing" the Chinese State: Government Retrenchment in the 1990s," *The China Quarterly*, vol. 175 (2003), pp. 775-802.

[61] From the author's interviews with a few Party committee members, and high-ranking rural bank officers.

[62] Previously, each township RCC had a Party committee (*dangwei*): a Party unit containing a Party secretary leading a group of Party members. On the contrary, after the reforms, each township RCC only has a Party branch (*dangzhibu*), which is nothing more than a constellation of Party members (more than three), that has no decision-making power over major Party issues, such as utilization of funds or personnel appointments, management or dismissals. Local (township) Party committees should not be confused with Party committees in township RCCs. The former is the Party organization at the township administrative level, to which all Party units in local enterprises and units report; and the latter is the Party organization in the credit organization.

decisions still exist.[63] Most importantly, since loan decision-making power has been centralized at the county level, the county union's accountability to the local Party committee means that the post-reform credit organization still have to toe the local Party's lines.

In short, the collective action problem of member households and insider control have been attenuated to a greater extent in the post-reform rural commercial bank than in the rural cooperative bank. However, the Party's influence remains forceful in both post-reform credit organizations.

Reconciling Internal Party Institution with the Corporate Governance Structure?

After examining the corporate governance structure and Party institution, a logical question to ask is how could the Party's prerogatives be reconciled with those of the board of directors and members' representative meetings or shareholders' meetings?

The scope and strength of the power of these institutions differ between areas, and the division is by no means clear-cut. On personnel matters, including appointments, promotions and dismissals, the Party committee, irrevocably, has an upper hand. Furthermore, the Party committee also has prerogatives over major financial expenditures, such as employees' remuneration, and building renovation and construction expenditures. Personnel (*yongren)* and finance *(yongqian*) are clearly the two areas where the Party committee has power over the formal corporate governance bodies, namely the BOD, or members' representative meeting or shareholders' meeting.[64] As far as loan allocation decisions are concerned, it is far from clear whether the formal corporate governance bodies or Party committees dominate. All my interviewees have told me that the Party committees in the post-reform credit organizations are not involved in loan allocations. It is impossible to tell whether they were "toeing the official line" or speaking the truth. Nonetheless, it is inconceivable that the coterie that makes a range of decisions from personnel to expenditure can abstain from getting involved in the bank's core business: loan allocations.[65]

A conflict that has arisen in the post-reform corporate governance structure, due to the persistence of Party institutions, is the clashing of the

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[63] From the author's interview with a township RCC manager.

[64] This has been repeatedly confirmed by a dozen interviews with Party committee members and banking professionals.

[65] Interestingly, the provincial union in Zhejiang has formally reaffirmed the status of the Party committee as the supreme decision-making body in these credit organizations. The Zhejiang provincial union has issued a document instructing (*zhishi*) all rural credit cooperatives and rural cooperative banks in the province that all major decisions have to be studied (*yanjiu*) by the Party committees before they are broached for discussions at the shareholders' meetings or board meetings. See Fangyi Zhu, "Identify the Circumstances, Strengthen Leadership, Improve Implementations, Ensure Annual Work Objectives are Realized: Zhu Fangyi's Speech at the Inaugural Members' Representative Meeting at the Provincial Rural Credit Union" (2005).

heads of the BOD and the BOS, and the bank governor. In terms of professional functions, as set out in the charter, the head of the BOD is the bank's legal representative and strategic decision maker, while the bank governor, whose power is delegated by the BOD, makes decisions on day-to-day operations, and the head of the BOS plays a supervisory role over the other two. Hence, according to the formal corporate governance rules, there exists a separation of functions between these three positions, and checks and balances against each other's power. Yet, in terms of Party hierarchy or administrative ranking, the head of the BOD, who is also the Party secretary, clearly outranks the other two; and, as Party members, they have to report to the Party secretary. How could a subordinate supervise the Party superior when his performance is in fact evaluated by the superior? By the same token, how could a subordinate prevent the superior from intervening in his work when his failure to follow the superior's instructions will likely result in a dismissal?

The Communist Party and Corporate Governance: What Does it Imply for the Role of Local States in China?

Scholarly work that examines the nexus between politics and business in China has shed light on the fact that the Communist Party institutions are fundamentally incompatible with effective corporate governance structure.[66] Here, I highlight some issues pertinent to the financial institutions.

Matrix Muddle: Functional and Party Accountability

All financial institutions in China, including the rural credit organizations, are subject to two sets of accountability system: the functional/industry and the Communist Party. Figure 5 maps out the accountability system at various administrative levels.

It is exceedingly clear that the two sets of accountability systems are aimed at serving different goals and objectives. On the one hand, the local Party committee has its own interests and priorities, which differ from those of the provincial unions. Based on the Communist Party cadre evaluation system, the local Party committee is evaluated by the Party bosses one level above it. Studies on the Party cadre evaluation criteria show that local economic growth takes priority over other areas of development, such as the environment, education and healthcare.[67] Local economy needs finance to

[66] On the corporate governance of state holding companies, see McNally, "Strange Bedfellows"; on the financial sector reform in Shanghai, see Heilmann, "Policy-making and Political Supervision in Shanghai's Financial Industry," pp. 643-668.

[67] For instance, see Elizabeth Economy, *The Rivers Runs Black: The Environmental Challenge to China's Future* (Ithaca, NY: Cornell University Press, 2004); Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* .

fuel its growth, and the local Party committee uses its political tentacles to pressurize the local financial institutions to extend credit to favoured enterprises and projects. Local government interference in credit expansion has been blamed for the bouts of inflation between the late 1980s and early 1990s,[68] and the credit boom in China in the early 2008, despite a slowing down in the global economy.[69]

On the other hand, the interests of the provincial unions, which represent the provincial governments' stake in RCC reform, are not as clear-cut. Several points can be inferred from their operations thus far. Given that a key central government's objective in the reform is to transfer financial responsibility of the loss-making credit institutions to the provincial governments, the provincial unions have an inherent vested interest in the commercial sustainability of the RCCs.[70] This profit orientation is reflected in the professional evaluation criteria, to which RCC officers are subjected, and on which the magnitude of their bonuses depend. The RCC's professional evaluation criteria assess the employees based on an increase in savings, reduction in non-performing loan rates, collection of interest income, profitability and agricultural loan issuance.[71]

If RCC officers are to strictly follow their professional evaluation criteria, they will be allocating loans based on the expected returns of applications. This may not favour local government's enterprises and projects. If profit orientation is the ultimate criterion, RCC officers will favour lending to private enterprises and member households, given the historically high non-performing loan rates of local government-related loans. Hence, it is evident that the Communist Party accountability system is fundamentally incongruent with an effective corporate governance structure and efficient functioning of the financial system.

What does this imply for the role of local states in China? It is taken for granted that fiscal decentralization provides an enormous incentive for the local states to develop industries and promote industrialization. While this behaviour is seemingly "entrepreneurial" or "corporatist," it is noteworthy that enterprises need capital financing, and industries require capital

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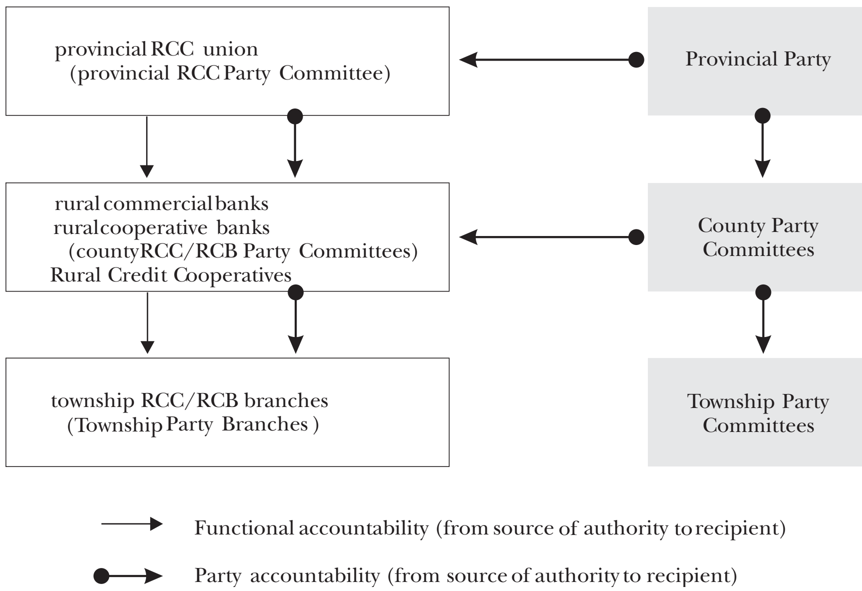
68 Yasheng Huang, *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations During the Reform Era* (Cambridge: Cambridge University Press, 1996).

69 Victor Shih, "China's Credit Boom," *Wall Street Journal*, 21 February 2008.

70 Ping Xie, Xu Zhong and Minggao Shen, "RCC Reforms: What Have We Done? What Do We Still Need to Do?," (2006). Since the provincial governments have taken over financial responsibility of the RCCs in their jurisdictions, any financial losses in the future will be, theoretically speaking, borne by the provincial authorities. That said, this remains a policy intention, as no provincial government has yet been put to test on this. On a related note, there is little sign that the respective provincial governments have matched the central government's 168 billion *yuan* debt-for-bonds swaps to help get rid of the RCCs' mounting bad debt. A number of Chinese scholars specializing in rural credit had indicated to the author that the matching of funds is sporadic, with wealthy provinces contributing more than poor provinces do.

71 From the author's interviews with RCC managers.

Figure 5
RCCs'/RCBs' Functional vs. Party Accountability



investment. Where is the money coming from? This is the question that the existing literature has often failed to ask. When a local government pressures the local credit cooperative to allocate loans to its township-and-village enterprises or industrial projects, the money must be redirected from somewhere else. The loans could have gone to private enterprises and rural households who consistently contribute 80 percent of the RCCs' savings base, and who require credit for a range of production and consumption activities. Further, the mountains of non-performing loans of the RCCs make it abundantly clear that a majority of the loans to local government-related enterprises and projects have gone sour. In short, when the costs of local industrialization are fully taken into consideration, the role of local states is far from "developmental," as the existing literature has depicted.

Conclusion

In this study, I have examined how far the recent institutional reforms have succeeded in improving the rural credit organizations' corporate governance and reducing local Party interference in their operation.

On the positive side, the post-reform rural cooperative banks and rural commercial banks have dispersed the power held by the head of the BOD by establishing the bank governor's office, which takes over the former's daily operational functions. The various committees and departments established under the BOD and the bank governor's office—especially audits to investigate financial misconduct and loan approval committees to strengthen loan approval procedures—are positive developments. Insider control and small shareholders' problems with regard to collective action in organizing themselves to monitor bank managers' behaviour has been improved more in rural commercial banks than in rural cooperative banks.

Nevertheless, many problems remain unresolved. Critically, the reforms have failed to eliminate the entrenched Party involvement in the financial organizations that is fundamentally inconsistent with effective corporate governance structure. The revamped board of directors, board of supervisors and bank governor's office still have limited powers compared to those of the internal Party committee and the provincial union. The checks and balances intended to operate between the heads of the BOD, the BOS and the bank governor are ineffective because the head of the BOD, who is also the Party secretary, clearly outranks the other two in the Party hierarchy. As a Party member, the head of the BOS could not supervise the head of the BOD effectively, since the latter is the Party secretary whose instructions the head of the BOS must follow. Appointments and appraisals of bank employees still uncannily resemble the Communist Party's cadre recruitment and evaluation system.

Despite various reforms, the Party is still *not* able to relinquish its power over credit institutions. This provides a powerful explanation for the stubborn *persistence* of local government interference in the credit sector, despite many attempts by central policy makers to tinker with the institutional configuration.

What does this imply for local state theories in China? The existing literature has correctly pointed out that fiscal decentralization has unleashed the entrepreneurial spirit of local government officials. However, when we take into account the financial costs of state involvement in businesses (specifically, how local government interference in loan allocations has resulted in mounting non-performing assets in the rural credit system and deprived rural households and private enterprises of access to credit), the role of the local states in the country's economic development is far less positive than is usually suggested. The studies that have described local governments as "corporatist" and "developmental" have tended to examine only the benefits of state involvement in businesses, such as the number of enterprises built and jobs created. By highlighting the massive indebtedness of the rural credit institutions and the persistence of Party interference, this paper has clarified the costs of such local state behaviour.

These costs should come as no surprise, however, to scholars familiar with corporate governance issues in the once economically vibrant "Asian Tigers." The nature of the micro-institutions may differ, since China is Communist while the other Asian countries are not, but the poignant lesson provided by the problems of ineffective corporate governance and soft lending to state-related enterprises, which led to the Asian Financial Crisis a decade ago, should not be forgotten.

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