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# Alienation of Rural Cooperative Finance and the Innovation of Financial Organization in China

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**Abstract** Based on the elaboration of the content and status of rural cooperative finance, rural cooperative finance—the alienation of rural credit cooperative is introduced from three aspects of the concept and objective of management, the organizational form and management mode, and the service object and business scope. Causes of alienation are analyzed. Firstly, change in the economic foundation of cooperative finance is the fundamental reasons for the alienation. Secondly, mandatory system change led by the government is an important reason for alienation. Thirdly, property and administration structure of rural credit cooperative are the internal reasons for alienation of agricultural support. To achieve the innovation of rural cooperative financial organization, the following aspects should be done: cultivating the basis for rural cooperative economy, further promoting the reform of rural credit cooperatives (innovating a variety of property rights modes; making clear definition of ownership; implementing the internal governance structure), introducing competition in the field of rural cooperative finance, and homing function of government and rural cooperative finance.

**Key words** Rural cooperative finance, Alienation, Rural credit cooperatives, Organization innovation, China

## 1 An overview of rural cooperative finance

As a cooperative economic organization in financial field, cooperative finance refers to a special credit organization mode and credit activity form with the combination of individual ownership and collective ownership during the economic activities and social life based on the principle of voluntary basis, democratic management, and mutual benefit, in order to improve the living and production conditions and to obtain low-cost financing services and other convenient services<sup>[1]</sup>. Rural cooperative finance is a credit cooperative finance sponsored by peasant households and the owners of rural enterprises in rural financial market, which has a high coverage and large scale in rural areas of China.

According to the forecasts of the National Statistical Bureau, the newly added financing demand during new countryside construction will reach about 15 trillion yuan<sup>[2]</sup>. And policy support is not enough for such a large-scale capital demand. What's more, capital "siphon" in rural areas becomes more serious. And how to establish a complete haematogenous mechanism is an immediate necessity for the development of rural finance.

The *Central Document No. 1* in the year 2006 has suggested to establish the community finance and the farmers' mutual-aid cooperative finance. Then, the National People's Congress has issued the *Law of Farmers' Specialized Cooperative* in China, offering new opportunities for the development of rural cooperative finance. During the development process of rural cooperative finance, there is the alienation of system, function

and organization form, which needs to be carefully analyzed.

## 2 Rural cooperative finance—the alienation of rural credit cooperative

Rural credit cooperative, as the formal form of cooperative financial organization, has gradually deviated from the direction of the initial cooperative after several institutional changes, and has become the subsidiary body to government departments or state banks. The mass character in organization, the democratic nature in management, and the sustainability of self-development gradually disappear, turning from the non-governmental into the governmental organizational system and showing the alienation in function.

### 2.1 The performance of alienation

**2.1.1** According to the concept and objective of management, mutual-aid cooperative spirit gradually weakens and the profit and competition awareness gradually strengthens. Traditional rural credit cooperative mainly offers services for its members and does not participate in market competition. However, with the development of rural commodity economy, the expansion of the operation scale of rural credit cooperative, and the weakening of government support, there is a significant change in the operating environment of rural credit cooperative. Facing with the special service object, anti-risk capabilities of peasant households, rural small and medium-sized enterprises, and cooperative economic organizations are far from enough. Therefore, the rural credit cooperative have to continuously expand the business space, improve the level of operating profit, and enhance its own strength and ability to withstand risks. The tendency of the pursuit of profit, as well as the behavior of commercialized management, is the necessary strategy adjustment under the unregulated market.

**2.1.2** According to the organizational form and management

mode, the traditional cooperative system has changed into stock cooperative system or stock system and the "one vote for one person" has turned into "one vote for one stock". Traditional rural credit cooperatives have small scale, usually using members to take the operation and management work. Major issues are discussed by all the members at the general meeting of members, adopting "one vote for one person", which reflects the democratic management and autonomy principle of cooperative finance. However, with the expansion of rural credit cooperatives and the increasingly fierce market competition, operation and management should realize the centralization and specialization. Thus, management of rural credit cooperative is concentrated to professional management staff and government officials. And the general meeting of members becomes a mere formality. With the separation of proprietary rights from management rights, the owners gradually lost their control of the property, while the professional management staffs actually control the property of rural credit cooperatives. Thus, the phenomenon of "Insider Control" appears.

**2.1.3** Both of the service object and business scope have shown a growing trend. The traditional rural credit cooperative mainly offers financial service for the members based on mutual benefit. However, this situation is gradually replaced by the commercial principle. For the convenience of deposits, more branches should be established, and financial products should be updated in order to attract more deposits by high interest rates. Besides, the loans should mainly support the peasant household and invest in the private enterprises, joint ventures, township enterprises, and leading enterprises of agricultural industrialization with good operating efficiencies, as well as the stocks, bonds, real estate, and other high-risk investment business, in order to obtain the maximum profit.

## 2.2 Causes of alienation

**2.2.1** Change in the economic foundation of cooperative finance is the fundamental reasons for the alienation. Economy determines the finance; while finance reacts up on economy. During the development of rural credit cooperative, cooperative economy, which is the economic foundation for cooperative finance, has changed. After the establishment of people's commune system and the Great Leap Forward in the year 1958, rural collective economy has taken the place of rural cooperative economy. The people's commune is more than a rural economic organization, it is also a mixed organization of national grassroots power and rural economic cooperation, playing the functions of national grassroots management. After the implementation of household contract responsibility system, the people's commune system is completely abolished. Thus, rural individual economy and township enterprises have grown more vigorously than ever before, gradually forming a new situation of rural economic development with the coexistence of public ownership and other forms of ownership. At present, under the support of the state, farmers' specialized cooperative organizations will achieve a significant advance; and the economic base for rural cooperative finance will vary continuously. Thus, the rural credit cooperative will face a new round of reform.

**2.2.2** Mandatory system change led by the government is an important reason for alienation. Rural cooperative financial system in China has been a mandatory change led by the government. Rural credit cooperative has changed from a cooperative organization, a sector of the people's commune, a grassroots agency of state-owned agricultural bank of China, to a sector severing ties with agricultural bank, which all adopt the top-down mandatory change mode led by the government<sup>[3]</sup>. This mode is totally different from the induced change of cooperative financial system in western countries. Rural credit cooperative is the requirements of government during the planned economy and transition economy. It also brings along some negative effects. Operating mechanism of rural credit cooperative is strictly in accordance with state-owned banks, deplorably loses touch with the masses, makes democratic management turn out to be a mere formality, and does not reflect the voluntary nature of corporative finance. For instance, in the new round of reform' the *Several Opinions on Regulating the Rural Cooperative Financial Institutions Becoming Shareholders* points out that the share can be divided into investment share and qualification share. Qualification share can be sold only when a series of conditions are met; while the investment share of members can not be sold.

**2.2.3** Property and administration structure of rural credit cooperative are the internal reasons for alienation of agricultural support. Clear property rights and protection system can reduce the transaction costs and improve the efficiency. After the several changes, rural credit cooperative in China still has the problems, such as unclear property rights, absence of owners, and imperfect governance structure. They are mainly shown in several aspects. Firstly, governmental credit is the members' motivation of buying a share. Members do not really care about the survival and development of rural credit cooperative. They take the share capital as the deposit to obtain interest, so that the government ultimately bears the risk and the risk-sharing mechanism of credit cooperative can not be implemented. And rural credit cooperative has vague definitions of the rights and responsibilities of shareholders at the beginning. Secondly, the decentralized ownership structure of rural credit cooperative leads to the common phenomena of free ride and cheap vote. The owners can not effectively supervise the cooperative. The general meeting of representative members, which is the highest authority, can hardly constraint the board of directors. During actual operation, the board of directors and supervisors are mostly the managers. Shareholders can not carry out effective supervision and restriction. Thus, the democracy, flexibility and mass character of credit cooperative are completely lost.

## 3 Innovation of rural cooperative financial organization and its homing function in China

### 3.1 Cultivating the basis for rural cooperative economy

Economy is the basis of finance. For a long time, peasant households in China have been in the highly decentralized state with high risks and little information, which leads to the extremely high transaction cost of rural financial services. Thus,

many rural credit cooperatives break away from the "agriculture, farmer and rural area". Due to the lack of funds and guarantees, peasant households can hardly form the scale economy and industrial development. The fundamental reason for the difficult investigation on capitals of both parties is the high transaction costs, which is also a problems needs to be solved during the rural financial reform. According to the analysis on the alienation of rural credit cooperative, it is believed that one of the methods to reduce the cost of rural financial transaction, to solve the information asymmetry, and to create a positive interaction between rural economy and finance is to encourage and support the development of the peasant economic cooperative organization and to cultivate the basis for rural cooperative economy. Development of cooperative economy is an objective requirement of the further development of market economy. Cooperation at different layers can turn the small capital into large capital, and the small-scale production into large-scale production. Thus, the scale economy is formed in order to solve the conflicts between big market and small-scale production.

**3.2 Further promoting the reform of rural credit cooperatives** The following aspects should be paid attention to during the new round of reform of rural credit cooperatives:

**3.2.1 Innovating a variety of property rights modes.** According to the international experiences, rural cooperative financial organization in the United States is a multiple compound cooperative financial system with "deficiency in the upper and excess in the lower". In France and Japan, it is a semi-official and semi-public cooperative financial system and a cooperative financial system in the rural cooperative organization. China has massive land and the regional productive force and market economy are extremely unbalanced. Even in the same region, development level varies due to the accumulation level, educational level and operation ability of peasant households. Economic subjects have different demands for the services of financial institutes. Whether the regional rural credit cooperative develops into a bank or cooperative is a problem should be treated differently in different regions. During the reform, property rights reform of rural credit cooperative in China basically shows three modes. The first is the shareholding mode represented by Beijing Rural Commercial Bank. The second is the joint-stock system mode represented by Tianjin Rural Cooperative Bank. And the third is the provincial credit cooperative mode represented by Jiangsu Provincial Credit Cooperative with the coexistence of secondary legal person and tertiary legal person. According to the development status of credit cooperatives, the integration process of urban and rural areas, and the macro-economic environment in different areas, rural credit cooperative should determine its own organization form. In the aspect of property right, government should guide but not determine the development of rural credit cooperative. Thus, the cooperative finance can truly turn back to the farmers<sup>[2]</sup>.

**3.2.2 Making clear definition of ownership; implementing the internal governance structure.** Rural cooperative finance in China needs to be further improved in the aspect of corporate gov-

ernance and property ownership structure. The principle-agent relationship should be carefully treated. Otherwise, the rural credit cooperative is still a subsidiary organ of government, the willingness of the peasants can not be expressed and government will get half the results with twice the effort. During the reform, we should firstly improve the ownership structure, realize the diversified ownership structure fundamentally, and ensure the large scale of equity capital. Secondly, we should rationalize the internal organizational structure, improve the general meeting of the representatives, the board of directors and the board of supervisors, ensure their independent characters, and achieve the separation of decision-making power, supervisory power, and management power. Thirdly, both of the information disclosure system and the incentive and restraint mechanism should be enhanced.

**3.3 Introducing competition in the field of rural cooperative finance** Monopoly certainly leads to low efficiency and corruption, which is also an important reason for the excessive administrative intervention in the financial cooperation. In order to break the monopoly, competition should be introduced. In December 22, 2006, China Banking Regulatory Commission issued the *Some Opinions on Adjusting the Access Policies of Banking Financial Institutions in Rural Areas and Better Supporting the New Countryside Construction*, which allows the industrial capital and private capital to establish banks in rural areas, and sets up more township banks, community-based credit cooperatives and other banking financial institutions. The society warmly responded to this policy. Wen Tiejun, an expert in the Three Agricultural Problems, hopes that this policy will resolve the plight of rural finance. He also points out that institutional barriers still exist due to the interests of the official sectors. Besides, China Banking Regulatory Commission only reduces the thresholds of community finance and farmers' cooperative finance in a smaller part of rural areas. There is still a long way to go to achieve the objectives of the comprehensive reform of rural finance and the relative system construction<sup>[2]</sup>. An important content is to break through the monopoly in market access and public fund<sup>[4]</sup>. In the aspect of market access, new cooperative financial organization should be allowed to enter into the rural financial market and improve the main body of market supply during rural financial service together with rural credit cooperatives, the bank, postal savings and other rural financial mechanisms. In the use of public funds, government service of agricultural support policies and meeting the farmers' financing needs are taken as the evaluation indices, so as to break through the executive monopoly of rural credit cooperative in the Three Agricultural Problems and the specific protection for rural credit cooperative. In the aspect of market exit, exit mechanism should be improved including the rural credit cooperative, so as to allow the transfer or exit of rural credit cooperatives.

**3.4 Homing function of government and rural cooperative finance** Administrative intervention of government is an important factor causing the alienation of cooperative finance. At present, with the gradual establishment and further develop-

ment of rural market economic system, government and rural cooperative financial institution should return to their own positions.

Government should firstly establish and improve the basis and security system of market economy, further enhance its property right and protection system, encourage the development of rural cooperative economy, support the development of cooperative finance, establish information platform of farmers' credit system, consolidate the construction of relevant laws and regulations, and improve the system, legal and information security of market economy. Secondly, means and methods of government intervention should be reformed. Direct intervention in administrative enforcement by government should be changed into indirect intervention by laws, public funds and other means. For instance, evaluation index system for public funds should be changed, taking the effects on the Three Agricultural Problems as the judgment criteria for public funds utilization. Behaviors going against the utilization principles of public funds or causing loss and waste should be given legal sanctions. Thirdly, supervision should be strengthened. Introduction of competition will inevitably bring about new risks. Government should effectively perform its functions in supervision, punish the non-standard pseudo-cooperative economic organizations, and provide protection for the development of rural cooperative economic organizations and rural financial institutions. Fourthly, education and training should be strengthened. Farmers' quality plays a crucial role in constraining the development of cooperative economy and the reform of rural finance. In order to awake the farmers' awareness of property rights and to enhance their ability of self-management, government should offer more education and training for the farmers.

As for the rural cooperative financial organizations, rural credit cooperative should firstly definite the obligations of agricultural support, further clarify the property rights, improve their corporate governance, gradually reduce the support from government, and realize the transformation from mandatory institutional change led by the government into the bottom-up induced institutional change. As for the new rural cooperative finance,



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circular agricultural products and give the safety guarantee to consumers. In the second place, the market of agricultural products should be further expanded and the plan of the marketing of agricultural products should be strengthened. The large demand of market on ecological agro-products means the huge potential of agricultural products. The government should implement the marketing strategy of famous brand; establish the brand of ecological economy of circular economy; strengthen the promotion of products and accelerate the market pace of agricultural products, so as to better facilitate the development of agricultural circular economy.

cooperative financial organization at village level with small peasant household as the main body should be reconstructed, so as to further deepen the reform of rural financial system. Facts prove that commercial credit and insurance without the mutual aid of farmers or the cooperative financial organization at village level can not survive in the rural areas. Only when the farmers' mutual-aid organization, which is supported national policy, develops, funds withdrawn can turn back to the rural areas. Besides, based on the rational division and close cooperation with policy or commercial finance, rural cooperative financial organizations should develop the mutual insurance and guarantee business guided by the government, and promote the cooperation between the commercial credit and insurance institutions and the farmers' specialized cooperatives and farmers mutual-aid capital organizations<sup>[5]</sup>.

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