

The Political Economy of Reform in China
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INTRODUCTION

In the decade from 1979 to 1988, China embarked on what appeared to most observers as by far the most ambitious and far-reaching attempt at economic reform undertaken by a communist state. Some viewed the reform as the beginning of a process that would eventually lead to the creation of a market system with private property relations.² Others characterized it as an open-ended reform, where the ultimate goal of reform was never clearly explicated and where a comprehensive reform plan was never formulated.³ There were of course intense debates about the goals of reform and the appropriate measures to attain them. Publicly the Chinese maintained the position of building socialism with Chinese characteristics. This was of course neither policy nor program, but it did signaled a readiness to experiment with and adopt new ideas.

Since no communist state has ever succeeded at reforming its economic system one could hardly be optimistic about its prospects in China. The transformation of a planned economy into a market economy meant a fundamental change in the way a society is organized.

¹ The author is Director of the Hong Kong Centre for Economic Research. The paper was researched while the author was a Visiting Scholar at the Hoover Institution, Stanford University. I am indebted to George Hicks and Ramon Myers for comments and discussions. Cait Murphy provided excellent editorial suggestions.

² See Cheung (1982).

³ See Lin (1988).

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Instead of organizing society from top down it has to be bottom up. If this were to happen then it would inevitably necessitate an ideological break with Marxism-Leninism and Mao Zedong Thought. The Chinese Communist Party's monopoly hold on political power would be threatened. From the very outset it was clear that the Chinese Communist Party had no intention of relinquishing such power. In 1984 the CCP Central Committee endorsed the establishment of a "planned commodity economy, not a market economy that is entirely subject to market regulation". It was asserted that the state would regulate and control the market, while the market controls the economy. This vague formulation, reflecting the lack of consensus of the ultimate objectives of economic reform in China, reveals the limiting boundaries that had been prescribed for the reform.

The most intriguing issue was whether authoritarian control could be maintained while permitting a decentralized market economy to emerge. There is little doubt that over the long run a competitive market economy must be paired with a pluralistic political system. Between 1979 and 1988, the progressive adoption of what appeared to be increasingly market oriented policies in China led many observers to believe that economic pragmatism had triumphed. As the amorphous concept of socialism with Chinese characteristics was being fleshed out and reinterpreted to justify the economic reforms, even early skeptics began to believe that the economic reforms could not be reversed regardless of political developments.

This view was rudely discredited by the tragedy at Tiananmen Square. To be sure China's economy was evidently in trouble by the fall of 1988 and the decision to halt further economic reform had already been taken. The tragedy at Tiananmen Square and the events in Eastern Europe was widely believed to have accelerated the turn away from reform. To many

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observers the political repression at Tiananmen Square and throughout China dramatized the ending of the economic reform period. Those who had all along argued that economic reform could not succeed without changes in the political system appeared to be correct. There is undoubtedly much truth in all this.

My view is that in view of the developments in the three years after Tiananmen Square the end of the reform is far from being a foregone conclusion. While the pace of reform has not moved as quickly as the first decade, the issues continue to be debated, and practical reforms measures are still being implemented in a number of areas despite the appearance of increasing centralization in official documents. That the economic reform is not dead bespeaks of changes that have occurred in Chinese society. These changes are of great importance in understanding the impact of the first decade of economic reform on Chinese society on which the future of economic reform in China will ultimately depend.

RAPID INDUSTRIALIZATION AS A GOAL

When the Chinese Communists came to power they adopted the Stalinist model of economic development. A command system emphasizing the development of heavy industry was the centerpiece of the strategy. The origins of the command economy can be traced to policy measures adopted by the Northeast Administrative Region during 1950-51. Prior to the Communist takeover in 1948, the Japanese had implemented two five-year plans between 1937 and 1946. A form of state capitalism based on a "contract-oriented planning system" prevailed. The Communists maintained that system until 1953, when the transition to a command economy based on a "target-oriented planning system" was made.

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The planners in the Northeast Administrative Region subsequently joined the planning apparatus and economic ministries of the State Council; they included Gao Gang, Li Fuchun, and Chen Yun. Top leaders in the planning and managerial sections of the state apparatus were literally "colonized" by the group from the Northeast and their proteges. Some 6000 students and 7000 workers were sent to the Soviet Union to be trained. This generation duly returned to China and took up positions in the economic ministries and state enterprises. When the central economic bureaucracy was established after 1953, the most able cadres were recruited into the heavy industrial ministries. The Northeast China team provided the blueprint and the top leadership for China's industrial management. The continuity of this network sheds considerable light on the perpetuation of the administrative approach in China. Initial privileges secured by the heavy industrial enterprises were capitalized upon and flourished in a bureaucratic environment.

The decision to adopt a heavy industry based development strategy provides another explanation for the rather sudden termination of the "new democracy" period. Before the Communist takeover, Mao had envisaged that the process of economic development that would transform China from an agricultural to an industrial country would be a lengthy one and would involve the development of indigenous capitalism.

In the brief period between 1949 and 1953, the number of privately owned industrial establishments increased from 123,000 to 150,000 and the number of workers in private industry increased from 1,644,000 to 2,231,000, accounting for approximately 37 percent of China's industrial output. This was the peak development of indigenous capitalism. It soon declined rapidly thereafter to accommodate the demands of heavy industry in the First Five-Year Plan.

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The Chinese First Five-Year Plan was closely patterned on the Soviet First Five-Year Plan (1928-32), but the emphasis on heavy industry was even greater. There was an enormous sense of urgency among the top leadership to pull China out of its backwardness. Industrialization had to be hurried. When it did begin to occur, the process was accomplished largely by exploiting the countryside. The number of unemployed workers in the cities and underemployed workers in the countryside swelled. Poor peasants sold their land and flocked to the cities. Income disparities among individuals, across regions, and between social groups widened.

The command economy also created an elitist bureaucracy whose increasing power and influence troubled Mao. In his search for a solution to the problems created by the Stalinist approach, Mao began to outline an alternative approach in the article, "On the Ten Great Relationships". The Second Five-Year Plan (1958-62) was replaced by Maos' new revolutionary solution of speeding up agricultural collectivization, decentralizing economic decision making, and increasing enterprise autonomy. He believed that these new institutional arrangements would unleash the revolutionary zeal of the masses. In moving rapidly towards socialism, agricultural productivity could be raised by the creation of communes, and industrial output could be increased at little cost through the creation of small- and medium-scale industries that required little capital investment, but relied on the maximum utilization of labor. The era of the Great Leap Forward (1958-60) had arrived. It is important to note that although Mao had misgivings about the Soviet strategy of putting emphasis on heavy industry, his strategy was premised on the idea that the development of heavy industry did not have to be compromised because revolutionary zeal of the masses translated into increased productivity.

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The state did not have to abandon its goal of promoting heavy industry and certainly not to relinquish control over key state enterprises. It merely called for a smaller, centrally planned sector that would still include the key industries.

The economic crisis in the early 1960's following the Great Leap Forward was managed by reestablishing central planning and the introduction of limited market incentives outside the planned sector, especially in agriculture. Economic direction over the economy in general was returned to the economic ministries and the architects of the First Five-Year Plan were restored to prominence. Mao subsequently purged Liu Shaoqi and many of those who were responsible for these policies as “capitalist-roaders”. The main thrust of Liu's initiatives was also a reaction to the Stalinist system by softening it with material incentives. The guiding principle is best characterized by Chen Yun's theory of the bird in a cage.

During the Great Proletarian Cultural Revolution (1966-76) that followed, the bureaucrats and the planners were once again in retreat as Mao implemented his socialist vision. After the initial euphoria had subsided, reforms were instituted in the Fourth Five-Year Plan to decentralize control over industry to the local level. The State Council and the State Planning Commission assumed a drastically reduced role, but was able to retain control over key state enterprises, due in a large measure to the personal intervention of Zhou Enlai. But the central authorities now had to deal with local authorities whose powers were enhanced. Mao's development strategy embraced a vision of economic decentralization with more decision-making power being granted to the provinces, localities, and enterprises.

In the absence of an effective and viable mechanism for coordinating economic activity, the shift towards local self-sufficiency accelerated with decentralization of the administered

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economy. Inefficiency increased as transactions costs rose and resource misallocation worsened. The cellular or fragmented nature of the Chinese economy is as much a Maoist legacy as it is a product of the command system.⁴

During the brief period 1977-78 under Hua Guofeng after the Cultural Revolution ended, China mounted another drive to develop heavy industry. Exports were promoted through administrative means to finance massive plant imports to support a Stalinist development strategy.

After Deng Xiaoping regained power, the planners were once again reinstated. Between 1977 and 1980, economic policy was primarily oriented towards recovery and the command system was relied upon to redress economic imbalances. In industry, state ownership and central planning were consolidated through the implementation of a pragmatic policy for enterprise management based on the greater use of material incentives. In agriculture, private incentives were reintroduced and decollectivization was resumed. It was in many ways a continuation and development of the policies initiated by Liu Shaoqi during the period of economic adjustment after the Great Leap Forward.

Although there were improvements in economic performance with the introduction of material incentives, especially in agriculture, the problems associated with the command system remained. It became increasingly apparent to many in China that the problem was not merely a question of the proper allocation of power at various levels within the bureaucracy, but how to move away from the framework of the state-administered economy. The process of de-

⁴ See Donnithorne (1972) and Lyons (1986).

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Stalinization, this time under Deng Xiaoping, was soon to begin again. Unlike Mao it did not proceed from an overall vision, but there was a willingness to experiment with new ideas.

Despite Mao's initiatives, the two centerpieces of the Stalinist model - the command system and the emphasis on heavy industry - were never abandoned even during the Great Leap Forward and the Cultural Revolution when Mao's influence on economic policy was dominant. The economic consequences of these Maoist adventures were tragic. The Great Leap Forward forced the economy into total collapse and the Cultural Revolution ushered in an era of autarkic stagnation. Each episode was ended by reasserting central control over economic decisions in industry, reversing the pace of agricultural collectivization, and reintroducing material incentives.

In China, the experience with the Stalinist strategy was not entirely negative because of Maoism. The Maoist episodes were associated with political chaos and economic disruption, while the Stalinist periods were identified with political order and economic stability. Despite its shortcomings, the command system was perceived as a reliable instrument to manage economic chaos caused by Maoist excesses. Before the decade of economic reform, the worst economic mistakes in China were not committed by those who implemented Stalinist policies but those who opposed them.

THE CONSEQUENCES OF RAPID INDUSTRIALIZATION

The emphasis on heavy industry at the expense of light industry and agriculture was criticized from time to time. But the dominant role of the heavy industrial ministries was never effectively challenged. The central planners were able to protect them even at the height of the Cultural Revolution when the state bureaucracy was under severe pressure from leftist

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ideologues. The prolonged emphasis on heavy industry from 1949 to 1978 may well have been the single most important policy decision, whose consequences continue to play havoc with the development of the Chinese economy. Such a developmental strategy required resource allocations to be deliberately distorted and could only be achieved through administrative means. Planning was an indispensable tool. State ownership of resources became a convenient necessity. Resource misallocation was accommodated by distorting the price structure and through a system of rationing. Attempts to decentralize decision-making and reduce central planning were never complete and heavy industries always remained within the central plan. They symbolized the planned sector and became an institutionalized feature of the command economy.

In an impoverished, capital scarce country, putting emphasis on heavy industry meant working against the economic principles of comparative advantage. One had to lower the cost of using capital by suppressing the interest rate. The cost of foreign exchange had to be depressed in order to protect these industries from foreign competition. This would also lower the cost of importing essential facilities and equipment used by heavy industry.

Since the return from investing in heavy industry could only be realized after a long time, a rapid rate of accumulation can only be assured by forced up profits. To do this, a policy to guarantee low wage rates and low raw material prices became an integral part of the strategy. For wage rates to remain low it was important to provide essential items, like food, housing, medical care, education and other social services at very low prices.

The result of all these policies to foster the growth of heavy industry was to generate a serious imbalance in the supply and demand of capital, foreign exchange, raw materials, various

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agricultural products, and essential goods and services. Economic shortage became a general and pervasive phenomenon.⁵

On the other hand, there was still no guarantee that resources would voluntarily flow to those industries to which the state had set a high priority. To ensure that it took place, a system of centralized planning and management became imperative; an extreme but not unnatural solution for permanent economic shortages and distorted prices. Ironically, the value of a command economy is best appreciated when the policy objective aims to deliberately contradict the principles of comparative advantage.

Another natural outcome is the emergence of state ownership of enterprises. Heavily regulated private enterprises would still be a threat to the central plan, because there would be little incentive for owners to reinvest their profits in low profit industries considered to be of high priority by the state. If the right to reinvest profits elsewhere is denied then private ownership of enterprises ceases to exist for all practical purposes.

The establishment of a compulsory system of state procurement of agricultural products to depress prices was an integral part of the development strategy. It kept wages and various raw materials prices low. The system practically eliminated the operation of agricultural markets. As agricultural incentives were curtailed, productivity sagged. By the mid-1950's many poor peasants fell heavily into debt, some sold their land, while others migrated to the cities. The collectivization of agriculture became a necessary step to strengthen the state's

⁵ Kornai (1980) interprets general shortage in socialist economies as an outcome of soft budgets in the planning process. The explanation is useful for understanding problems created by central planning and state ownership of resources. Our interest, however, is in explaining why central planning and state ownership of resources became necessary. See also Wong (1986) who applies the Kornai model to China.

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control over peasant decisions in production, consumption, distribution and migration. Excess demand for grain and other agricultural products was also brought about by their depressed prices. Rationing of these products became necessary in the urban areas.

The system of agricultural collectives and of rationing essential consumption goods also serves as effective devices for preventing the rural population from migrating into the urban areas. Keeping the peasants in agriculture was necessary for the fulfillment of state agricultural procurement plan. But an immobile labor force, both within the rural sector and between the rural and urban sectors fostered more misallocation of resources.

Within the urban sector, labor mobility was also restricted. Labor markets were eliminated in favor of central allocation to ensure that state enterprises were assured of needed manpower. Labor mobility was further discouraged by tying a substantial fraction of a worker's remuneration package to benefits - education, housing, medical care, childcare - provided by the enterprise.

Housing was by far the most important item provided by the state enterprises. If housing were to be provided through the market, it would be difficult to prevent the housing industry from becoming a major competitor for resources that could be used for industrialization. The housing market, therefore, could not be allowed to function. The state had to ration housing, a practice that became acceptable to workers only because of the low rent. Enterprises became the only institutions, which had a direct incentive to provide workers with living quarters. But they often had to draw on their own limited funds and were subject to restrictions imposed by the state. Retired workers had no alternative but to try to hang on to their living quarters. Jobs became hereditary in order for the system to perpetuate itself.

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The workplace also became the focal point of a worker's social life. The enterprise emerged as a self-contained and self-perpetuating entity, and labor markets became unnecessary. The enterprise was burdened with administering and providing various services that are not related to production, such as, education, medical care, and distribution of various retail commodities. These arrangements are not only inefficient to begin with, but difficult to get rid off once they are in place.

Since the price of capital funds, foreign exchange, labor services, raw materials and output were all severely distorted, the market became superfluous. Prices became units of accounting. Information costs were prohibitive; planners planned in ignorance; resource misallocation was guaranteed. Even worse, without a market, resources were largely allocated through bureaucratic bargaining. This was not only socially inefficient, but also provided numerous opportunities for corruption and abuse of privilege. Barriers to entry were everywhere as essential materials were rationed.

The creation of an elaborate system for allocating resources in all kinds of activities through administrative channels was essentially dictated by a development strategy that was predicated on an erroneous conception of the economic process. Comparative advantage was totally ignored and rapid industrialization was pursued as a goal in itself. A highly coercive system was indispensable to achieve the goal. Political and economic spheres of life, and sometimes even social spheres, became perfectly merged. In all spheres of life, the freedom to choose was severely limited.

As a method of social control the system was profound. The various parts of the system depended on each other. It was almost impossible to change or eliminate any component

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without severe repercussions throughout the system. The perpetuation of a highly inefficient economic system was also guaranteed.

A different development strategy emphasizing comparative advantage rather than rapid industrialization would probably have meant a very different outcome. While it is conceivable that such a strategy might still be based on a command system, but it would have been obvious from the very beginning that the informational advantages of the market would clearly dominate any central plan and administrative mechanism. The role of the state in such a system would be drastically different and reduced. Economic decisions would be essentially decentralized and state ownership of resources would be unnecessary.

THE DECADE OF REFORM

Between 1979 and 1988 China captured the imagination of many observers by the boldness of its reforms. To begin with it is useful to make clear what is meant by progress in economic reform. Economic reform can be defined in terms of changes in the planning process. In the Chinese context, this means decentralizing decision-making process. By this criterion, reform has been widespread throughout China since 1979, however, a system which is capable of coordinating decentralized decision making did not emerge.

An alternative definition of economic reform focuses on the avowed objectives of the reformers to improve economic efficiency and enhance productivity. During most of the pre-reform period, productivity growth in the years 1957-78 was nearly stagnant.⁶ By this criterion, the reforms in China have been a great success in agriculture, but the evidence for industry is

⁶ Even the revisionist study by Chen, Wang, Zheng, Jefferson and Rawski (1988) finds support for this view. Their study also surveys earlier findings which reveal not only stagnation but also decline.

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mixed. While both agricultural and industrial output grew at impressive rates during the decade of reform, various estimates of productivity growth revealed significant progress only for agriculture.⁷

In actual fact, the reforms had a rather modest aim in the beginning. The purpose of the initial policy measures was to correct the serious imbalances in the economy after the Cultural Revolution and further exacerbated by Hua Guofeng's misconceived policies. Material incentives that were social taboo in the decade of leftist idealism were restored. It is worth noting that in 1979, Deng Xiaoping laid down the limits of the reforms in a speech entitled, "Insist on the Four Basic Principles". It was clear at the outset that Marxism, Leninism, and Mao Zedong Thought were to continue as the guiding principles in the building of socialism under the leadership of the Communist Party. The initial policy measures that were adopted in agriculture and industry were not novel. They were used by Liu Shaoqi at the end of the Great Leap Forward to revive the shattered economy. The same team of economic architects - Deng Xiaoping, Li Xiannian, Chen Yun, and Bo Yibo - was brought in to design and implement these policies. The new leadership was able to move swiftly because they were on familiar ground. With Mao and the Gang of Four out of the picture they could now implement the same policies that were abandoned almost 20 years earlier without interference.

In agriculture, the restoration of individual economic incentives through policy adjustments, primarily by increasing state procurement prices for agricultural products, led to

⁷ Chen, Wang, Zheng, Jefferson and Rawski (1988) using revised figures showed that industrial productivity increased at an annual rate of 5 percent or more during 1978-85. Their result differs from most other findings of no growth. But since the various estimates all work with faulty figures to some extent, the question remains an open one.

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significant and immediate increases in agricultural output. The gross value of agricultural output increased at 6.5 percent per annum over the 1978-87 period, compared to an average annual growth of 2.6 percent in the 26 years preceding 1978. Economic success encouraged the leadership to pursue further reforms to restructure property rights in agriculture. Partial decollectivization of the farm sector and the emergence of a system of family tenant farming with extensive rights to the use of land and to own productive factors soon followed. Markets in agricultural products were revived. The scope of the reforms expanded beyond its original boundaries. This was possible because Party policy had shifted towards economic modernization and the fall of the Gang of Four had created a more relaxed political environment where controversial policies and unorthodox experiments can be tolerated. Deng had paved the way for this by proclaiming that "practice is the only standard by which truth can be ascertained".

Agricultural reform achieved better results not only because the economic relationships there were simpler than in industry, but also because political opposition to the reform was weaker there. The presence of severe competition made it difficult for special interest groups to protect their rights. Peasants welcomed deregulation and privatization because perceived benefits were obvious and immediate. Disgruntled rural cadres, who had misgivings about the reforms, were a relatively ineffective and diffuse political force. Geographically they were widely dispersed and economically they had different interests. Both factors made it costly for them to organize themselves into an effective political coalition.

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Economic reform of industry was much less successful because the institutional interests of enterprise managers, party cadres and bureaucrats in the central administration and those in the provinces and localities were interrelated in complex ways.

Between 1979 and 1983, economic reform of industry began with the reform of state enterprises. By 1980, special autonomy in fiscal matters and in trade and investment was given to the provinces of Fujian and Guangdong, the three municipalities of Beijing, Tianjin, and Shanghai, and four special economic zones were established. But the momentum of the reforms slowed down from December 1980 onwards as Chen Yun pressed for adjustment of the economy using orthodox administrative measures, which would strengthen central control over economic decision making. He was opposed by a loose group of central administrators, local officials, enterprise managers, and academics that promoted economic reform to expand enterprise autonomy. One may choose to call this group the reform coalition.⁸ Local cadres were eager to preserve and expand the power they had acquired during the Maoist era. The coastal provinces perceived correctly that increased autonomy worked in their favor. They were in a better position to take advantage of emerging new opportunities, especially in the area of foreign trade and investment. It is worth noting that enterprise autonomy was also promoted by Mao.

Nevertheless, the severity of the economic imbalance and the state's budget deficit in 1979, caused by the uncontrolled expansion of capital investment promoted by the localities and the enterprises in the previous year, forced a decision in favor of economic adjustment. The

⁸ The term is used in the same sense by Shirk (1985), who also identified a Communist coalition, comprising the heavy industry ministries, central bureaucracy, and inland provinces.

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decision was supported by Deng Xiaoping. Economic reform of industry became official policy in 1984. By then even those who had previously supported adjustment now came out in support of reform.

Several important factors shaped the process and nature of the reform. First, a loose coalition in favor of reform was emerging even before industry reform was on the agenda. For them reform meant primarily greater autonomy from the central plan. The reform coalition welcomed market-oriented reforms that freed them from the discipline of the central plan. This did not necessarily translated into support for a complete transition to a competitive market economy. They were less keen about having to comply with the discipline of the market.

Second, market reforms were threatening to inefficient state enterprises and their employees. The list includes banking, foreign exchange, international trade, steel, petroleum, heavy machinery, drugs, silk, utilities, public transportation, mining, public communication, and others. Most would not survive the market test in a competitive environment. The early emphasis on heavy industry had created numerous monopolistic state enterprises with supporting institutions under the direct management of the economic ministries. The interests of these enterprises were tied initially to the strategy of rapid industrialization against the dictates of the laws of comparative advantage. Over time their interests became institutionalized in the command economy. Market reforms that promised improved allocative efficiency were frowned upon.

Third, the ideological and political consequences of a transition from a centrally planned command economy to a decentralized market economy had to be squarely faced. It is inconceivable that the transition could be achieved without a fundamental change in the role of

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the state in the economy. In a market economy, decentralized decision making is coordinated through the price system on the basis of well-defined property rights. Under such a system many of the existing functions of the state would wither away. In a Marxist-Leninist state, the devolution of power not only threatened the bureaucrats but the legitimacy of the Communist state. The old guard and Deng were not willing to let this happen. The extent to which the Four Basic Principles could be watered down was limited.

Fourth, in the more relaxed political environment it was possible for policy makers and economists to debate and explore more openly alternatives to the command economy. New studies appeared and provided some theoretical basis for a more fundamental rethinking of the problems with China's economic system.

These factors determined the specific policy measures that were adopted and the general nature of the reforms. The leadership was willing to experiment with the reforms for two simple reasons. First, industrial productivity was stagnant in China throughout the period between 1957 to 1978. The superficially impressive rate of growth of industrial output at the rate of 10 percent per annum was achieved by allocating increasingly more resources to industry. Economic efficiency was low. Technological innovation was almost absent. Capital equipment was miserably outdated. Second, the success of the bold measures taken in agriculture was a major source of encouragement.

In 1984, the Party Central Committee decided to build a planned commodity economy. The role of the market in building a socialist economy was officially given the seal of approval. In 1987, the 13th Party Congress approved the development of an economic system where the state would regulate the market, and the market would control the economy. The state was

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given a new role but it remained at the center of the economic system. The market was to operate under the control of the state.

In 1981, Premier Zhao Ziyang reformulated the policy of "enterprise autonomy" into the "industrial production economic responsibility system". The change was not rhetorical but substantive.⁹ The concept of "enterprise autonomy" was rooted in Mao's ideas of balancing the interests of the state, enterprises, and individual producers and encouraging activism at the grass roots level. It was an approach that permitted multilateral interaction by a large number of participants, each guided by its own economic interests. In contrast, the concept of "responsibility" implies principal-agent relationships between the state, enterprises, and individuals. The administrative framework through which subordinate agents would be held accountable could be preserved. From the economic point of view, the system was similar to the "contract oriented planning system" which existed in the Northeast provinces under Japanese rule before the Communist takeover. A system which Chen Yun was thoroughly familiar with and from which he probably took inspiration in the formulation of his own economic theory of the bird in the cage. According to Chen Yun, "Economic management is to be done within the framework of the state plan. The relationship between the two is like a bird in the cage. A bird should be allowed to fly. If the cage is too big the bird will fly away. If the cage is too confining the bird will be unable to fly." From the political point of view, Zhao's reformulated "industrial production economic responsibility system" probably represented a compromise between maintaining state power and market incentives.

⁹ See Lee (1987), pp. 181.

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Throughout the decade of reform the administrative approach was never abandoned. Whenever the economy became overheated and state budgets ran into deficit, administrative controls were reinstated. Its effectiveness in mobilizing resources and in securing state revenue during an economic crisis made it an attractive policy instrument. Although it was recognized that the administrative approach was a blunt instrument and lacked dexterity, it was never abandoned, probably out of fear that it would ultimately rock the whole system -- fear that was reinforced by the events in the Cultural Revolution. It was also a fear confirmed by the chaos that often appeared whenever decision-making power was decentralized. The market-oriented reform introduced in the post-Mao era was not intended by the leadership to replace administrative control, but to turn it into a sharp instrument of the State. This is not to imply that opinions about the nature of the reforms were unified. No doubt some policy makers and economists came to realize that for the reforms to succeed it had to go all the way, but this was never the adopted policy.

THE REFORM IN TROUBLE

Broadly speaking, economic reform had to deal with two problems. First, it had to improve economic performance by decentralizing decision making by deregulating industries and privatizing state enterprises. Second, it had to establish a price system capable of coordinating decentralized decision making. The reforms were more successful with the first task than with the second.

At the micro level, enterprises were given greater autonomy to provide incentives for reviving economic performance. These included the adoption of profit retention schemes, tax for profit schemes (to replace state appropriation of enterprise profits by taxes), various types of

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responsibility contracts, and shareholding schemes. At the macro level, the decision-making power of the local and provincial authorities and the economic ministries was expanded in an effort to encourage them to show more initiative. These included the right to extend loans and approve investments, and the adoption of foreign exchange retention schemes.

The most controversial scheme was the introduction of a dual-track price system. Under this system some prices were set by the state and some were allowed to be freely determined in the market. Most of the time this meant that the same commodity could be exchanged at two different prices. One set by the state and the other by the market. The market prices provided information based on which the state would adjust the administered prices from time to time. It was believed that in due course the amount of price distortion in the system would be reduced. It was hoped that this would cushion the economic impact when eventually all prices were allowed to be freely set in the market. The dual-track price system had the double purpose of facilitating the decentralization of decision making and coordinating those decisions.

These reform measures succeeded in restoring economic vitality in many enterprises, localities, and ministries. Resources began to flow into activities where economic gain could be obtained. The rapid growth of wage bonus schemes and numerous types of responsibility contracts are a reflection of the economic vitality they fostered. Unfortunately the pursuit of economic gain was based on distorted signals. Resource misallocation sometimes worsened rather than improved.

At the enterprise level, responsibility contracts vitalized economic activity. But the contracts often failed to specify clearly the financial responsibility for state owned assets. Short run opportunistic behavior became a universal phenomenon as enterprises race to expand output

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by running down state owned assets. This led to the rapid expansion of enterprise consumption funds and indiscriminate disbursement of wage bonuses.

In the localities and provinces, the newly acquired autonomy led to over investment and duplication. Local and provincial authorities raced to approve various projects, which they then forced the banks to finance. When these projects failed the state ended up with bad loans. It was the best of all worlds for these enterprises because the state assumed responsibility for the losses while the enterprises and local and provincial governments get to keep the profits.¹⁰ Many local industries and capital construction projects were initiated with no regard for comparative advantage. To protect their own interests local and provincial governments engaged in mercantilist practices to secure and protect their own markets against competition from enterprises in other localities and provinces, as well as those belonging to the central economic ministries. This led to enormous social waste as economic fragmentation worsened. Regional specialization according to comparative advantage did not emerge as envisioned. As the central government began to lose control of the macroeconomic situation, inflation emerged and began to accelerate.

In the state ministries, increased autonomy again led to over expansion. State revenues were depleted. In desperation, the state contracted directly with the enterprises for delivery of profits. This increased the cost of negotiations between state and enterprise at each level and encouraged various types of short run opportunistic behavior. As profit targets were desegregated down to the enterprises, the management bodies intensified their interference into

¹⁰ See Wong (1987).

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the activities and decisions of subordinate enterprises to ensure that profit targets would be achieved. The command system was in effect revived.¹¹

The dual-track price system failed to evolve into a rational mechanism for coordinating decentralized decision making. In actual fact, adjusting state administered prices had little effect on production and the flow of resources, but precipitated an all round increase of prices, leaving relative price ratios unchanged. As prices rose, fear of inflation led people to dishoard savings adding fuel to the inflation. The system instead generated numerous opportunities for bureaucrats to exploit and maintain price differentials, social discontent mounted with what was generally perceived as widespread corruption. The old system of administered prices and central allocation of resources regained moral respectability.

The reforms came to a halt in 1988. Opinion among the top leadership was probably split, but the reformists were clearly in retreat having been discredited by runaway inflation and widespread corruption. Once again China was trapped in the vicious reform cycle of "decentralization giving life, life leading to chaos, chaos resulting in recentralization, and centralization causing death". The basic problem with the reform is that while there has been substantial devolution of decision-making authority, it was not accompanied by the establishment of a consistent system for coordinating decentralized decision making. The classic conflict between the plan and the market was not resolved.¹² The reforms had stopped short of abandoning the old system associated with the administrative approach. Price reform and the deregulation and privatization of state enterprises, which would have led to a complete

¹¹ See Naughton (1985) and Solinger (1989).

¹² See Prybyla (1987).

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transition to the market system and rationalized the economy, were only introduced partially. After a decade of reform, China was caught between the market and the plan and was experiencing the worst of both worlds.

THE REFORM: FAILURE OR SUCCESS

The explicit goal of the economic reform in the post-Mao era was to improve but not to replace the planning and management system. Decision-making power was decentralized, but most prices were still set administratively. Prices of numerous commodities, wage rates, interest rates, and foreign exchange rates were not free. As such the reform were unable to affect resource flows to close the gaps in supply and demand. Chronic shortages had to be continuously managed by an administrative apparatus. Some reform measure inadvertently widened the gaps. The temptation to reintroduce rationing was increased.

Many of the problems of the reform appeared because of the partial nature of the reform measures, particularly price reform. The decision to decentralize investment and credit decisions was not combined with a policy to free interest rates. It became the direct cause of over-investment and inflation. The introduction of foreign exchange retention schemes for enterprises and the decentralization of import and export decisions were not supported by a policy to free the exchange rate. This led to distortions in trade patterns and worsened the balance of trade. The decision to free prices on certain agricultural products and consumption goods was not accompanied by the freeing of urban wages. Wage subsidies and other ad hoc measures had to be reintroduced in the face of widespread deterioration of living standards. State budgets came under enormous pressure and administrative controls had to be reintroduced in order to balance the state's macro-finances.

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The partial nature of many reform measures cannot be explained on purely ideological grounds or attributed to the lack of understanding of what had to be done.¹³ Ultimately reform is a political process where various agents confront, conflict, and compromise with each other. Agents who operate those institutions associated with a state-administered economy naturally develop considerable vested interests in their perpetuation. A policy change not preceded by a breakdown of existing institutions, is often perceived as a threat to their vested interests. Potential beneficiaries of the new policy are often politically diffuse and whose perceived benefits are uncertain. The success of a new policy, even when it is backed by force, depends on highly skilful maneuvering to neutralize opposition and to generate political support. Immediate demonstrated success is often an essential condition to sustain the reform effort.

Agricultural reform was successful in part because disgruntled rural cadres were not a significant political force in an economic system whose traditional emphasis was on heavy industry.

The creation of a decentralized economic system where prices reflected economic scarcity would obliterate the need for an administered system. The monopolistic state enterprises, especially those in heavy industry, were clearly going to be the big losers in such a transition. During the reform decade the gross output of the state enterprises as a share in total industrial output dropped from 80 to 60 percent. The ratio of heavy to light industrial output declined from 57:43 to 50:50. Many monopolistic state enterprises were actively opposed to the reforms and were supported by the central planners.

¹³ Cheung (1989) argues that a "thorough responsibility system" would be an adequate substitute for private property rights, if the issues were merely to preserve the facade of state ownership and the image of a socialist system.

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The major achievement of industrial reform was to decentralize decision-making. These measures were supported by local and provincial authorities, especially those in the coastal areas and the Special Economic Zones, and some of the economic ministries, especially those in light industry and the primary products. Both groups believed that increased autonomy worked in their interest. The production of high priced consumer goods for the domestic market and the potential of export markets for these goods and other primary products promised enormous benefits. Decentralization in the Maoist era had enhanced the power base of the localities and the provinces. A return to central planning threatened their interest. The decision to create Special Economic Zones and to grant additional autonomy and privileges to the coastal cities and provinces gained the support of the most important elements in the reform coalition. It may well have been the single most important reason why the reforms were able to carry on for so long.

The other essential component for industrial reform to succeed is price reform. Unfortunately few interest groups can be certain that they will benefit from comprehensive price reform. The only exception may be those who worked in the small private and collective enterprises. Some were students and workers whom were sent to the rural areas during the Cultural Revolution, but had since returned. Because their numbers were large the State was forced to relax restrictions placed on self-employment and the collective enterprises so that they could be gainfully employed. These enterprises existed outside the state plan but were economically increasingly important. In the decade of reform, the gross output of collectively run enterprises as a share of industrial output increased from 19 percent to 27 percent. The share

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of private enterprises rose from zero to 2.4 percent. Nevertheless, politically they had little power.

Many of the newly created local and provincial state owned enterprises in the reform period were protected from competition by officials at various levels in the bureaucracy. These enterprises welcomed increased autonomy and benefited from a distorted dual price structure, but had little incentive to actively support price reform. Most supported the half-reformed system as it existed. The partial nature of the reform against a background of administrative control and local self-interest had created a mercantilist system infested with state and local monopolies. There was little interest in seeing a competitive market emerge.

While the reform did not succeed in creating a market economy it did significantly loosened the grip of the central planners over the economy. Economic reform in China had proceeded without a comprehensive plan. Reform had proceeded by incremental stages, with each successive policy initiative leading to seemingly unanticipated adverse consequences. These consequences were at times addressed by yet more far-reaching reform and at times by backtracking. Throughout the process direct confrontation with ideological issues were avoided or sidestepped. This piecemeal process accounts for the unevenness of the reform and its ultimate limitation. Yet there is considerable merit in the argument that the absence of a comprehensive reform plan at the outset may well have been a blessing in disguise. A debate on any comprehensive reform plan may well have brought out irresolvable conflicts among various contending groups and paralyzed the reform process at the outset.¹⁴

¹⁴ See Lardy (1991).

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The very fact that reform has been sustained for so long has created a substantial constituency in China for further reform. Those who support reform are not limited to a small urban intellectual class that supports economic reform because of the expectation it will lead to political reform. The vast majority of China's population has benefited from the first decade of reform and their interest in further reform appears to be substantial. This constituency includes hundreds of millions of rural farm households; tens of millions of households that have benefited from the rapid growth of village and township industry; and several tens of millions of urban Chinese who live in the various special economic zones, open cities, and technical and economic development zones that have benefited from China's opening to the world economy.

These groups, by and large, have resisted the efforts toward recentralization that have occurred in the past two years. Their success is evident from a variety of figures and developments in 1989 and 1990. Rural (or township and village) enterprises were supposedly squeezed by the retrenchment policies. Yet these enterprises outperformed the state sector by a wide margin in both 1989 and 1990. For example, the value of output of the rural enterprises grew twice as fast as that of state owned firms in 1989. Indeed in manufacturing, the whole non-state sector, including collective and private firms of all types as well as joint ventures has continued to expand its share of total manufactured goods output. In 1988, the share was 43.4 percent, a year later the share had risen to 44 percent and in 1990 it is expected to rise even further. There is reason to believe that two-thirds of China's national income is now produced in the non-state sector over which the state has only an indirect control.

In the area of foreign trade there is again much evidence that reform has not been turned back. The annual rate of increase in exports during 1980-89 was 12.5 percent. In 1989, the

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figure fell to 10.5 percent, but in the following year the figure had rebounded to 18.3 percent, well above the growth rate for the previous decade. The value of Chinese exports in 1990 amounted to US\$62 billion (with a trade surplus of US\$8.7 billion) and accounted for 16.98 percent of China's GDP, the highest level attained in her history. The foreign exchange rate is now probably closest to the market rate than at any time in the past decade. At the end of 1990 it stood at 5.2 yuan to the U.S. dollar as compared to 3.7 yuan in 1988, having depreciated from 1.5 yuan at the beginning of the 1980s. The swap rate stood at 5.4 yuan in late 1990 and 6 yuan in 1988. The renminbi is probably less overvalued now than at any time in recent years. The volume of foreign exchange transactions expanded from US\$4 billion in 1987 to US\$6.3 billion in 1988, rising further to US\$8.6 billion in 1989 even as the austerity program was in full swing. The amount is expected to grow significantly large in 1990. The importance of the external sector to China's reform is probably paramount. The increasing importance of foreign market prices on domestic prices, due to the growing size of the external sector and a more realistic exchange rate will undoubtedly improve the prospects of furthering reform.

Reform and innovation in domestic financial markets have continued. The state has made active use of interest rate policy to influence private consumption and savings behavior. But as an increasingly large share of the economy passes out of the state sector, the task of controlling inflation and maintaining macroeconomic stabilization in a semi-reformed system becomes increasingly difficult with existing institutions. The opening of the Shanghai Securities Exchange, where government bonds may be traded, may have far-reaching consequences. It would force the state to adjust its yield on new bond issues in order to be competitive with yields on existing issues traded on the secondary market. In short it will face pressure to mover from a

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system of compulsory assignment of new bond issues to a system of compulsory purchases. Interestingly in 1989, the state found it increasingly difficult to "place" government bonds with semi-autonomous enterprises. A formal secondary market will make available a market determined interest rate. The creation of an active secondary market for government debt is also a prerequisite for conducting open market operations and make it possible for government to control macroeconomic variables like inflation through market rather than administrative measures.

In short, a semi-reformed system can be faulted for failing to go all the way, thereby generating internal contradictions that lead to backtracking. On the other hand, China's experience has shown that it can also propel the system forward in furthering reform. On balance the fate of economic reform may well be uncertain, but it is far from being dead.

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