GROWTH INTO A MARKET ECONOMY:
THE "INCREMENTAL APPROACH" IN CHINA

This paper was presented in a lecture in the Faculty of Social Sciences,
Lingnan College on 25 November 1993.

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GROWTH INTO A MARKET ECONOMY:
THE "INCREMENTAL APPROACH" IN CHINA

by

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Working Paper Series

1/93

Faculty of Social Sciences
Lingnan College
Hong Kong
1993
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Abstract

The transformation from a centrally planned system to a market economy is never an easy and smooth process from any point of view, even in the country like China which has taken the so-called "gradualist approach" to both institutional reform and industrial structural adjustment in the past 14 years since 1978. Along with the astonishing achievements are frustrating controversies, conflicts, fluctuations, setbacks and problems. The road ahead seems still clouded and any problem seems to have never a clear-cut solution with an agreement of majority. Maybe the only social consensus with majority agreement now is to restructure the economy further but to stay on the gradualism, as long as the economic income is still growing. This attitude to the economic restructuring, however, itself may cause problems: people intend to put off the real solutions from present agenda and take prescriptions which cannot kill real diseases but produce strong side-effects.

This paper provides a brief description of major achievements and remaining problems of China's market-oriented economic restructuring in the past, followed by an exploration of reform priority to promote the further development of market economy.
I. Institutional Reform in the Past

Three dimensions of economic reform

China's pre-1979 economic system was characterized by highly centralized planning control, administrative coordination and the absolute dominance of public (state) ownership. The theme of the reform has been the introduction of market force as an important coordinate mechanism, under the socialist political framework. The reform so far has taken place in following 3 dimensions since 1978:

1. Decentralization of decision-making powers within the state sector. The term "decentralization" or "decentralization reform" refers to a bundle of reform policies which redistribute the (administrative) decision-making powers from the central government to local government and from the government to the state enterprises without change of ownership structure. In nature, it is a kind of managerial system reform under the given ownership framework. By doing so, the previous highly centrally planned state-owned sector has been converted into a decentralized system, as the local governments and state enterprises have received autonomies to pursue their own interests under central authorities' regulations and restrictions.

2. Diversification of ownership -- After 30 years of state sector monopoly since 1949, other forms of ownership, including the household farming, self-employed business, private enterprise, corporative and share-holding company and joint-venture with foreign corporations, have been allowed to develop since 1978. The newly developed non-state sectors have contributed to a great extent to the overall economic growth, employment and budget revenue. Although it has been stressed until recent by the government officials that these sectors should not become dominant over the state sector, it seems impossible that the development of these sectors can be stopped. Corporatization and share-holding system has also been experimented in state enterprises since 1988 but is still far from great importance for nation-wide institutional change.

3. Internationalization or Opening-up to the outside world -- After 30 years of self-isolation, the government adopted the "open-door" policy since 1978 which encourages external economic activities, especially export-oriented businesses, technology transfers and foreign investments. Several "special economic zones" have been established in coastal areas in order to promote foreign trades and attract foreign capital inflows.

Major changes in economic institutions in different areas

The reform during 1979-1989 experienced two major stages: (1) 1979-1984, highlighted by the introduction of the "household contract responsibility system" (CRS) in rural areas and the expansion of autonomy for local governments and state-owned enterprises; and (2) 1984-1989, which focused more on "urban" reform, particularly the introduction of CRS into the state-owned industrial sector.

Household Farming. By the end of 1983, 98% of rural households has signed contracts with local collective economic authorities, which remained the owner of land. Since then, household-based production replaced collective farming as the major institutional arrangement of the rural economy. Although the state plan for agricultural production still plays a guiding role in contract-making and therefore determines agricultural production (especially the grain production) to some extent, the rural economy has now become much more market-oriented and farmers can pursue their own interests by conducting variety of business activities besides farming.
Rural Industry. One important development during the past decade has been the boom of rural township and village-owned industrial enterprises (TVEs), the business of which is almost totally market-oriented and outside of state planning control. The TVEs have become the main outlet for the rural surplus labor and one of major contributor to the country's industrial growth. By the end of 1991, the total output value of TVEs accounted for as much as 26.53% of total output value of society and 30.83% of total industrial output value. Further, more than 22% of the rural labor force worked in the TVEs. This has significantly eased the problems of unemployment and urban congestion.

Non-state-owned Sectors. In addition to the flowering of rural TVEs, another significant development was the growth of private business, including self-employed commercial and industrial activities, private enterprises, urban collective and corporative enterprises and foreign funded and joint venture corporations. In 1991, total output value of these sectors as a proportion of total industrial output value reached 11.36%. Meanwhile, the industrial output value of the state sector as a proportion of total industrial output value decreased from 77.63% in 1978 to 52.94% in 1991. About half of total output value of society was generated by the non-state sectors and it is estimated that up to about 60% of GNP was from these sectors in 1991 (see Table 1, Table 4 and Table 5).

<table>
<thead>
<tr>
<th>Table 1 Selected economic indicators</th>
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<tbody>
<tr>
<td></td>
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<tr>
<td>Growth rate of GNP (%)</td>
</tr>
<tr>
<td>7.81  4.48  8.75  10.32  14.58 12.73  8.31 11.01 10.89  3.55  5.00  7.70</td>
</tr>
<tr>
<td>Per Capita GNP (US$)</td>
</tr>
<tr>
<td>226.2 302.3 279.7 269.9 286.1 288.0 277.4 263.6 280.9 342.8 374.5 318.1</td>
</tr>
<tr>
<td>Per Capita GNP (US$)</td>
</tr>
<tr>
<td>227.3 257.1 265.0 283.8 309.6 351.0 391.2 417.7 457.1 500.2 512.6 523.4</td>
</tr>
</tbody>
</table>

Note:
1. Calculated with current prices and current exchange rates.
2. Calculated with domestic inflation and constant exchange rate of 1978.

Table 4. Composition of Total Output Value of Society (OVS) in 1991 (in percentage)

<table>
<thead>
<tr>
<th>As Total OVS</th>
<th>Total</th>
<th>Agriculture</th>
<th>Industry</th>
<th>Construction</th>
<th>Transportation</th>
<th>Commerce</th>
</tr>
</thead>
<tbody>
<tr>
<td>State owned Enterprises</td>
<td>50.41</td>
<td>2.99</td>
<td>52.94</td>
<td>67.92</td>
<td>81.50**</td>
<td>40.20</td>
</tr>
<tr>
<td>Non-state Owned Activities</td>
<td>49.59</td>
<td>97.01</td>
<td>47.06</td>
<td>32.08</td>
<td>18.40</td>
<td>59.80</td>
</tr>
<tr>
<td>Collective</td>
<td>35.70</td>
<td></td>
<td></td>
<td></td>
<td>17.80</td>
<td>30.50</td>
</tr>
<tr>
<td>Private or Individual</td>
<td>5.70</td>
<td></td>
<td></td>
<td></td>
<td>0.80</td>
<td>19.60</td>
</tr>
<tr>
<td>Others*</td>
<td>5.66</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>9.70***</td>
</tr>
</tbody>
</table>

* Including foreign funded and joint venture corporations.
** Based on the Volume of freight traffic measured in tons.
*** Retail sales by farmers to urban consumers.


Table 5. The Development of non-state sectors (all indicators in percentage)

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Output Value of Industry (OVI) as % of total OVI</td>
<td>24.0</td>
<td>25.3</td>
<td>25.6</td>
<td>26.6</td>
<td>30.1</td>
<td>35.2</td>
<td>37.7</td>
<td>40.3</td>
<td>43.2</td>
<td>43.9</td>
<td>45.4</td>
<td>47.1</td>
</tr>
<tr>
<td>Employment as % of total social employment</td>
<td>81.1</td>
<td>80.9</td>
<td>80.9</td>
<td>81.1</td>
<td>82.1</td>
<td>82.1</td>
<td>82.0</td>
<td>81.8</td>
<td>81.7</td>
<td>81.6</td>
<td>81.7</td>
<td>81.7</td>
</tr>
<tr>
<td>State budgetary revenue from non-state sectors as % of total state revenue</td>
<td>18.0</td>
<td>21.2</td>
<td>21.3</td>
<td>22.3</td>
<td>23.0</td>
<td>29.6</td>
<td>25.4</td>
<td>28.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Fixed assets as % of social total</td>
<td>33.9</td>
<td>36.9</td>
<td>38.6</td>
<td>38.7</td>
<td>34.4</td>
<td>34.1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail sale as % of social total</td>
<td>48.6</td>
<td>50.1</td>
<td>51.3</td>
<td>53.0</td>
<td>54.5</td>
<td>59.6</td>
<td>60.6</td>
<td>61.4</td>
<td>60.5</td>
<td>60.9</td>
<td>60.4</td>
<td>59.8</td>
</tr>
</tbody>
</table>


Reduction of central planning control. The decentralization in the state sector has undergone two major stages in 1980s. The first took place during the period from 1979 to 1984, in which (1) the “fiscal responsibility system” was introduced to reshape the central-local fiscal ties with the result that the local governments at various levels were entitled to greater autonomies of making economic decisions concerning local development; and (2) The bonus was put in use to provide incentives for workers to improve labor productivity. Some autonomous powers were given to the enterprises but were still not great enough to change the behavior pattern of the enterprises. The second stage took place from 1985 to 1989. The major step towards the decentralization in this period was the introduction of “contract responsibility system” into state enterprises. Under this system, the
enterprises sign contracts with the state based on the amount (instead of "rate") of taxes and profits remittance and retain all the rest of profits for their own use under the condition that the planned production quotas are met. Except signing contracts, setting planned targets and making regulations, the state in principle no longer interferes with the daily decision-making process of the enterprises and the enterprises receive partial autonomy\(^1\) in production planning, transaction, income distribution and investment. Another major institutional change in this period was that the local banks\(^2\) were also entitled with partial autonomies which allow them to making their own credit policies. For some periods (1985-1986, for instance), the state credit quota was lifted and the local banks therefore had greater decision-making powers. Due to the decentralization, the proportion of industrial production subject to mandatory planning has been gradually reduced from more than 90% in 1978 to about 40% in 1991.

The price reform also contributes to the reduction of planning control and introduction of market forces. Most price controls on consumer goods have been lifted and the proportion of volume of intermediate goods traded at market prices increased to about 80% in 1991. Further reduction of planned production and price control have been taking place in 1992. Due to decentralization and price reform, fiscal policy and monetary policy have been playing more influential roles in macroeconomic management where direct planning control used to be the only instrument.

The External Reform. In the process of domestic reform and opening up to the outside world, external sectors have also undergone reforms including (1) decentralization of trade decisions to local levels; (2) introduction of licensing to replace the foreign trade plan; (3) introduction of a parallel foreign exchange market; (4) use of foreign loans and encouragement of foreign investment; (5) establishment of special economic zones to promote use of foreign capital, technology, and management know-how.

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\(^1\) The "partial autonomy" refers to an important feature of decentralized system of public ownership, in which the central planner and enterprises share the decision-making powers in the same areas of all areas, not in the way of dividing areas for distinctive responsibilities of different parties.

\(^2\) The "local banks" refer to the financial institutions which (1) are not the private commercial banks like what exist in an private market economy; (2) not simply the local agents of the central bank, which simply represent the central bank and take actions under the central bank's command; (3) not again a bank owned and run by the local government (there is no such banks in China so far). It is a complex or a hybrid of all -- a particular local bank (1) may work in some special area such as industrial sector lending and agricultural lending, like some commercial banks do; (2) it should be, in principle, and is required to be subject to the all commands from the central bank; but meanwhile, (3) it is not only required to accommodate the development of the local economy, but also in fact under the leadership of local governments -- the managers of the local banks, for instance, are usually appointed at least with local government's recommendations or approvals.
II. Economic Restructuring and Development: Achievements and Problems

The institutional reform has been viewed by many, not without justification, as the main stimulus to the decade-long rapid growth on the one hand and, on the other hand, to current economic and social problems.

Achievements in Economic Development

Economic Growth. The 1980s turned out to be a decade of rapid growth for China. The average annual growth rate of GNP was 9.6% during the period 1980-1989. Per capita GNP increased from US$ 226.2 in 1978 to US$923.5 in 1990 if calculating with constant exchange rates (China’s currency was devaluated by almost 300% during the period). According to United Nations International Comparison Project, China’s real GNP per capita measured by purchasing power parities(PPP) was US$2,470 in 1988 (UNDP 1991).

Industrial Restructuring. The rural reform in the early 1980s generated an increase in agricultural output value as a proportion of total output value of society from 24.8% in 1978 to about 30% in 1983-84, but it fell to 22.9% in 1989 as industrial output grew by 4-8 percentage points more than agricultural output in most years in the later 1980s. In industrial sectors, light industry grew at an average annual rate of 11.6%, more rapidly as compared to an average annual growth rate 9.7% for heavy industry (including raw materials manufacturing and infrastructure construction). This eased the shortage of consumer goods in the early 1980s but led to the problem of “bottle-neck” of basic industries and infrastructure, and this trend continued to the end of the decade. Further, change has occurred in the regional economic structure as the southeast coastal areas developed more rapidly than northwest inland areas that widened the regional disparity.

The brisk development of rural industry has changed the rural economic structure to a significant extent. Agricultural output value as a proportion of total rural output value declined from 68.9% in 1980 to 42.92% in 1991, while industrial output value increased from 19.48% to 42.92%.

And rural industry contributed 24.4% of the country’s total exports in 1989.

Exports and imports grew rapidly at an average annual rates of 16.6% and 14.57% respectively during the period from 1979 to 1991. Export as a proportion of GNP increased from 5.2% in 1978 to 13.9% (US$71.9 billion) in 1991 and imports increased from 4.7% to 12.4% (US$63.79 billion) of GNP for the same period. Considerable trade deficits were registered during 1985-1989, with an average deficit of 22.7% of total annual trade value. In 1990, China recorded its first annual trade surplus since 1984 (US$8.74 billion), partly because of the dual devaluations of Chinese currency. Meanwhile, the net capital inflow increased continuously from US$338 million in 1979 to US$6204 million by 1990 and foreign investment increased from US$1.98 in 1983 to US$11.55 in 1991. Debt service as a percentage of export fell from 7.49% in 1980 to 6.9% in 1988 and total debt as a percentage of GNP was 9% in 1988.

The Social Sectors

While economic growth has been at the center of China’s focus since 1978, social sectors, including education, health care, social security, environmental protection, transportation and communication, have also registered progress more or less precipitated by the increase in national income.

The life expectancy at birth of a Chinese has gone up from 68.2 years in 1978 to 70.1 years in 1990. Mortality from major infectious diseases dropped from 2.41 to 0.9 of 100 thousand people
for the same period. The infant mortality was 0.37% in 1981; in 1988, it was 0.139% for cities and 0.236% for counties. (See table 2)

The enrollment rate of school age children reached 97.4% in 1990 and the adult literacy rate increased from 77.19% in 1982 to 84.12% in 1990. Enrollment in institutions of higher learning (including college students and graduate students) increased from 0.856 million in 1978 to 2.08 million in 1989, with an average annual growth rate of 8.4%. (See table 2)

The average living space for urban residents was enlarged from 3.6 square meters in 1978 to 6.9 square meters in 1988. (See table 2)

Table 2. Selected social indicators

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<tbody>
<tr>
<td>Life expectancy at birth (year)</td>
<td>68.2</td>
<td>69.0</td>
<td>67.9</td>
<td>64.9</td>
<td>69.1</td>
<td>70.10</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Infant Mortality (%)</td>
<td>34.68</td>
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<tr>
<td>Adult literacy (%)</td>
<td></td>
<td>76.3</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enrollment of school age children (%)</td>
<td>94.0</td>
<td>93.0</td>
<td>93.0</td>
<td>93.2</td>
<td>94.0</td>
<td>95.3</td>
<td>95.9</td>
<td>96.4</td>
<td>97.2</td>
<td>97.2</td>
<td>97.4</td>
<td>97.4</td>
</tr>
<tr>
<td>Hospital beds per 1,000 people (# of beds)</td>
<td>1.94</td>
<td>2.02</td>
<td>2.02</td>
<td>2.02</td>
<td>2.05</td>
<td>2.08</td>
<td>2.11</td>
<td>2.14</td>
<td>2.20</td>
<td>2.25</td>
<td>2.28</td>
<td>2.30</td>
</tr>
<tr>
<td>Urban average living spaces (square meter)</td>
<td>4.20</td>
<td>4.96</td>
<td>5.27</td>
<td></td>
<td></td>
<td></td>
<td>6.70</td>
<td>8.00</td>
<td>8.50</td>
<td>8.80</td>
<td></td>
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</tr>
<tr>
<td>Population with access to tap water (%)</td>
<td>81.0</td>
<td>81.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>81.0</td>
<td>86.6</td>
<td>86.3</td>
<td>87.9</td>
<td></td>
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</tr>
<tr>
<td>Public Green area per 1,000 population (hectare)</td>
<td>1.06</td>
<td>0.96</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.37</td>
<td>2.16</td>
<td>2.21</td>
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</tbody>
</table>

Data Sources:


The employment increased at an average annual rate of 2.7% (the average growth rate of population was 1.5%); as a result, total employment as a percentage of population increased from 41.7% in 1978 to 49.8% of 1989. The urban unemployment rate has been kept rather low — through most of the 1980s, it was below 2.0%, with the highest rate of 2.6 in 1989.

According to household income surveys, the national Gini coefficient has remained below 0.3, while for urban households it was lower than 0.25 and for rural areas it was lower than 0.3 in most areas with a few exceptions up to later 1980s3 (The Gini coefficient for total rural population increased from 0.21 of 1978 to 0.30 of 1988). The percentage of rural people in absolute poverty3 was reduced from 47.37% (i.e., 399.8 million people, by the recent Statistic Bureau figure) in 1978 to 6.9% (38.58 million people) of total rural population in 1989.

During 1981 to 1989, the volume of waste water discharge per million (RMB yuan) output value decreased from 4.5 tons to 2.21 tons and the treatment ratio of industrial waste water increased from 15.6% to 28.2%. Discharge of industrial dust was reduced by 1.2% and the receiving ratio of industrial dust increased from 6.7% to 60.5%. The volume of industrial residue discharge per million (RMB yuan) output value was reduced from 0.073 tons to 0.046 tons and the reutilization ratio of industrial waste residues increased from 27.0% to 35.1%. The green area in cities per 1000 residents expanded from 1.06 hectares to 2.64 hectares during 1978 - 1989. The percentage of the urban population with access to tap water increased from 81.0% in 1978 to 87.9% in 1989.

Due to this progress, China was recently classified as a "medium human development country" with a (UNDP) Human Development Index (HDI) ranking of 82 among 160 countries while its GNP per capita ranks only at 133 based on the data of 1988 (UNDP 1990).

The progress, however, seems not to be fully parallel with the economic growth. Evidence show that the disproportionate development between the social dimensions and economic sectors needs to be given more attention. Before 1978, China's economic development program was not very successful, and at the same time it did not achieve most of social goals which the government has committed. The new record of development since 1980 has also raised the question of how to maintain proportionate development of social sectors which will not automatically and necessarily progress in parallel with economic prosperity, while continuously giving the economic growth the top priority in a low-income developing country.

Current Problems

As the result of an ambitious growth program and economic reform characterized by decentralization and introduction of market forces, China experienced its first period of severe inflation. According to official statistics. Inflation rates were of single digits in most years but reached a high of 18% in 1988. The high inflation pushed the government to adopt a three-year retrenchment plan to curb the over-heated economy. It caused a major recession during 1989-1991.

The economic fluctuations were accompanying the transformation of economic system not only in late 1980s3. Other 2 minor up-down cycles were registered during 1979-1982 and 1985-1986 periods. The state's capability of macroeconomic management has been weakened as the conventional

3. By the official poverty line in monetary term, the urban absolute poverty is negligible. Some studies done by the Research Institute of State Statistic Bureau show, however, that the current cost of a minimum basket of food and other basic subsistence needs of an urban resident is about 670 yuan. Taking this as the urban poverty threshold, there are about 4.9% of urban population in absolute poverty.
administrative control power has been decentralized to local governments, while the new market-based macro-management mechanism is still too immature to work effectively.

Along with the macroeconomic instability is the low efficiency of production. Concerns are that the economic development of the past decade was still essentially extensive through the reproduction of capital rather than intensive through increasing productivity. Economic growth has been limited by the "bottle-neck" of infrastructure and basic industries that became severer as the annual increase of output of energy (4.3% for standard coal equivalent), construction (7.1%), transportation (0.5% for length of railway, 1.6% for length of road) lagged behind that of manufactures (8.7% for GNP, 14.5% for industrial output value) during 1984-1991 (see table 3.).

Table 3. Industrial Structure

<table>
<thead>
<tr>
<th></th>
<th>Average Annual Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1978–1991</td>
</tr>
<tr>
<td>GNP</td>
<td>8.7</td>
</tr>
<tr>
<td>Total output value of industry</td>
<td>14.5</td>
</tr>
<tr>
<td>Energy (standard coal equivalent)</td>
<td>4.3</td>
</tr>
<tr>
<td>Railway (kilometers)</td>
<td>0.5</td>
</tr>
<tr>
<td>Road (kilometers)</td>
<td>1.6</td>
</tr>
</tbody>
</table>

* Values are in constant prices.


At the enterprise level, economic reform so far has not brought about a fundamental improvement of state firms' performance. Surplus labor in state enterprises accounted for 20%-30% of total state workers. The state enterprises become less and less profitable. The profit rate of state enterprises within central budget dropped from 16.1% in 1979 to 2.9% in 1991; pre-tax profit rate lowered from 24.8% in 1980 to 11.8% in 1991; 2/3 of state enterprises are currently in financial trouble either having "visible" losses or with due debts which cannot be repaid by the "profits" in the books (so-called "hidden loss"). According to some surveys, the total visible losses of state large and medium-sized enterprises within central budget reached more than 100 billion yuan in 1991 and the amount of "hidden losses" is typically 1.72 time of the visible losses (B. Wang, 1992). Subsidies from state budget to loss-making enterprises increased from 32.4 billion yuan in 1986 to 57.9 billion yuan in 1990. This accounts for one sixth of total budget revenue.

Although efforts were made to reduce the size of government bureaucracy, employees of government increased from 5.8% in 1978 to 6.7% in 1991 as a proportion of total social employment. The government administrative expenditure increased 16.9% annually during the period 1978 to 1991, compared to the annual increase rate of 9.95% of total budgetary expenditure for the same period. As the result, the administrative expenditure as a proportion of total budgetary expenditure rose from 4.4% in 1978 to 9.85% in 1991. Meanwhile, due to defects of licensing regulation, ineffective
enforcement of laws, "double-truck" price system and the low pay to government employees, the "rent-seeking activities" became quite a common practice for officials at various government levels. Increasingly wide spread corruption turned out to be one of the most important causes for the political unrest in the late 1980s. According to official statistics, in 1989, a total of 20794 bribes involved in 116763 corruption cases were prosecuted; the total amount of illegal income recycled from corrupt officials amounts to 482 million yuan; and more than 70 officials involved held high ranking positions before prosecuted (See Li Peng, 1990).

III. Rethinking of Reform Priorities

1992 earmarks the new stage of China's market-oriented system reform and economic development. It even becomes a new fashion to talk about "market economy". The issue now is how to develop a real market mechanism as fast as possible under current various constraints.

When thinking about reform policies for 1990's, it will be beneficial to recall the lessons from the past. The following two lessons may be the most important and suggestive for rethinking of the strategic priorities of institutional reform and economic development in 1990's. First, the decentralization within the unchanged ownership framework cannot solve the fundamental problems of the old system. Second, the success of so-called "gradualist approach" to economic transformation relies on the development of non-state sectors.

The limit of decentralization reform

Although many reform policies have been taken or experimented, the main strategy for reforming the traditional centrally planned state owned economic sector in the past was decentralization. It is worth noticing that when entering a new stage of reform, most reform policies are designed for further decentralization: further cutting off the government interference into enterprises' operation and giving state enterprises greater autonomy not only on production plans and labor hiring-firing, but also on wage increase, welfare expenditure, investment decision-making, and credit borrowing. There are still many government officials, enterprise managers and economists who believe that the problems facing public ownership economy are all and only rooted in the excessive government interference and the lack of autonomy for the enterprises. They believe that by enlarging the autonomy of local government and state enterprises or by decentralizing the decision-making powers more thorough and complete, without changing the ownership structure, all problems would be solved, and therefore a "market economy" could be created.

The experience of the past 13 years, however, has shown quite clearly that this is not true. It is no doubt that the efficient management of enterprises needs autonomy and that the managerial system of state enterprises needs to be further improved. The managerial reform in the past has contributed a significant improvement of enterprise performance, and further reform of management system including enlarging enterprise autonomy will improve the enterprise performance. The point is, however, that when decentralization reform provides more incentives and flexibility for the enterprises to pursue their own interests and therefore improve the efficiency at microeconomic level, it would not make them more self-constrained and would create problems to the macroeconomic stability. The effectiveness of decentralization or managerial system reform in respects of efficiency improvement and macroeconomic stability is limited by the state ownership. This can be observed in following facts:
1. The so-called "Short term behaviors". After giving the managers and workers greater autonomy, the enterprises receive incentives and are able to make decisions by themselves to improve the efficiency in order to increase enterprises revenue. In many cases, however, they do so at the expense of the long term development and dynamic efficiency of the economy. Wage (plus various welfare) rises rapidly as a share of total enterprise revenue. It can be expected that if there would be no state control, no one would report any profit (like the situation happened in some other former socialist countries). When the enterprises are "allowed" to use their own funds to make their own investment, investments financed by their internally accumulated funds decrease sharply in contrary to the wishes of policy makers. In many cases, maintenance of fixed assets was postponed and technological upgrading projects and development research programs were either put off or terminated. Further, it has been reported that in many cases the degeneration of state assets become more severe after decentralization and corruptions have been out of control, which is the typical result of abuse of the autonomy. These so-called "shorter term" behaviors indicate the absence of representative of the capital owner at enterprise level and the lack of clear definition of property rights between one enterprise and all others under state ownership. It shows that when the "contracted responsibility system" are introduced into the enterprises for the managers and workers, which was the major reform measure adopted in the past, the lack of responsibility for capital assets become even more noticeable, rather than being improved.

2. The "softness of budget constraint" refers to the fact that a state enterprise can stay in business even having heavy losses. Very few enterprises have gone bankruptcy, although there are more than 2/3 SOEs which are unprofitable, and the Bankruptcy Law was passed in 1988. In contrary to the wishes of many people, the enterprises with greater autonomy are "responsible" for their profits, but are not responsible for the losses of state capital assets. Actually, no one could be responsible because no one is the owner of the capital. As the matter of fact, a state firm is always backed by the credit of the state which could never fail, so a SOE is always in a good position in biding loans for survival no matter how much it is in debt already. The consequences are as follow. First, this spoils the market competition which is supposed to eliminate the loss makers from the game for more efficient allocation of resources. Second, this causes shortage or raises the inflation pressures as it leads to monetary expansion of aggregate demand. Under this situation, price movement in fact does not reflect the changes of costs because the enterprises do not care about the costs in trade or in production. In many cases the enterprises even give up part of the profits to its trade partners as part of the deal for its own interests. In any case as described above the "market" cannot be real but only remain as a fake or a "simulation".

3. The impossibility of separating the government from enterprises. Many efforts have been made to separate the government from the enterprises. But both are still tightly banded together. The government control on the enterprises could not be removed and sometimes has become more rigid. The government bureaucracy and the special interests of government officials in various departments and at various levels should be blamed for this. The fundamental reason for this, however, is that there must be someone in the economy that functions as the owner of state assets. This "agent of state ownership" should supervise the use of assets, protect the state assets from abuse and profits from being "eroded" by wages. The agent of state ownership is supposed to be something central, unique, common-interested, superior to any individual or individual group, as the representative of the "public" as a whole. Quite naturally, it is the government or part of the government that should be responsible. The problem is if the government is separated from the enterprises, who will be the owner of the assets in the state enterprises? Not in nominal but in real terms.
4. The cyclical movement of "decentralization-recentralization". When abuse of the autonomy prevails in state enterprises, and when it leads to high inflation and over-heated economy, "recentralization" of decision-making power takes place. The reason for this is simple: when the enterprises cannot be self-constrained, they must be disciplined from outside. It turns out to be a bad cycle: when the system is centralized, it is easy to protect the state assets, keep the profits, and maintain macroeconomic stability, but the enterprises will have no incentives and flexibility to maximise profit opportunity and improve efficiency as such growth rate will be low, shortage will occur and the state will earn small profits; when it is decentralized, the enterprises can be more flexible and profit-oriented, but one can observe that when decision-making powers are abused, public funds will be spent on non-production purposes without constraints, and profit rate will be lowered. As a result, there will be inflation, overheated growth, economic instability and no profits for the state to collect. On the one hand, decentralization reform does solve some problems, but on the other hand, it creates some problems. Those problems raise the issue of "re-centralization" that leads the economy into a cyclical movement as China has experienced in the past.

✓ It is predictable that the demand for further decentralization will continue until nothing can be further decentralized, and that before the state gives up control on everything there must still exist a believe that the problems of state enterprises are due to the lack of autonomy or due to the excess government control. However, it is important to realize from China's own experience and lessons from other countries such as Yugoslavia, current Russia and the Eastern European countries, further expansion of state enterprises' autonomy before any change of ownership structure may be dangerous for overall economic development, especially for the macroeconomic stability and structural readjustment. The "new wave" of decentralization within current ownership framework is not in the right direction of achieving a real market economy.

The development of non-state sector

The development of non-state sectors, including TVEs, private and individual businesses, and joint-venture corporations, were initially due to policies designed to promote rural industries, reduce urban unemployment and attract foreign investment. These non-state economic components are not merely an additional contributors to national income, but also the new institutional elements which make the market system to start working and evolving. (See table 5)

Many shortcomings may be found in operations of non-state owned enterprises. For instance, in many collectively owned TVEs the definition of ownership is not clear, suffering the same problems of undivided, untransferable, non-tradable public ownership; local government interference becomes more frustrated when businesses grow into an important source of local government's revenue; and numerous illegal practices such as bribing can be observed especially in their early development. Nevertheless, some fundamental behavioral differences between TVEs and SOEs can be predetermined. The most important difference is that when a TVE fails in market competition, it cannot increase its liabilities on the state budget and rely on financial support from the state subsidies to survive. Second, it cannot borrow further, like the state enterprises usually do, from the banking system after it fails to repay the previous borrowing. Due this difference, non-state sectors may not be technological efficient in terms of input-output ratios, but are more efficient in terms of financial performance and macroeconomic stability.

From many points of view, it was mainly the development of non-state sectors that supported the emergence of the market machnism and kept the Chinese economy growing dynamically in the past 14 years. The growth of these new elements also provides more favorite conditions for the
reform of state sector. It creates job opportunities which make it easier to replace the surplus labor from state sector. (See table 5) Further, it pushes state enterprises into market competition and breaks down state monopoly. It also keeps the national income growing, and thus making it possible to compensate those who suffer temporary losses in the economic restructuring such as price reform and housing reform. It would be a serious mistake to overlook the importance of the development of non-state sectors for a country which is undertaking the gradualist approach to transformation from centrally planned public ownership system to a market economy.

Table 5. The Development of non-state sectors (all indicators in percentage)

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<tr>
<td>Output Value of Industry (OVI) as % of total OVI</td>
<td>24.0</td>
<td>25.3</td>
<td>25.6</td>
<td>26.6</td>
<td>30.1</td>
<td>35.2</td>
<td>37.7</td>
<td>40.3</td>
<td>43.2</td>
<td>43.9</td>
<td>45.4</td>
<td>47.1</td>
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<td>Employment as % of total social employment</td>
<td>81.1</td>
<td>80.9</td>
<td>80.9</td>
<td>81.1</td>
<td>82.1</td>
<td>82.0</td>
<td>81.8</td>
<td>81.7</td>
<td>81.6</td>
<td>81.8</td>
<td>81.7</td>
<td>81.7</td>
</tr>
<tr>
<td>State budgetary revenue from non-state sectors as % of total state revenue</td>
<td>18.0</td>
<td>21.2</td>
<td>21.3</td>
<td>22.3</td>
<td>23.0</td>
<td>29.6</td>
<td>25.4</td>
<td>28.6</td>
<td>33.9</td>
<td>36.9</td>
<td>38.6</td>
<td>38.7</td>
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<tr>
<td>Investment in Fixed assets as % of social total</td>
<td>34.1</td>
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<tr>
<td>Retail sale as % of social total</td>
<td>48.6</td>
<td>50.1</td>
<td>51.3</td>
<td>53.0</td>
<td>54.5</td>
<td>59.6</td>
<td>60.6</td>
<td>61.4</td>
<td>60.5</td>
<td>60.9</td>
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The foreign investment and joint ventures have played great roles not only in economic development, but also in the institutional reform. Foreign investments are not only capital inflow, or a technology transfer, they are also new institutional element in the economic system. They set an additional ownership constraint to joint-venture company, change the relationship between enterprises and government, bring new management and international standards into the system. It is predictable that in the 1990s the foreign investments will continue to play important roles in China’s transformation towards market economy. This view is supported by recent government’s emphasis on the use of foreign capitals.

Rethinking of the strategic priority of China’s reform

The Chinese government has committed itself more explicitly to the market economy. To scheme this goal, it seems necessary to consider the re-adjusting its reform priorities for the next stage of economic restructuring. One major adjustment which should be proposed is to shift from decentralization to the reform of ownership structure. Two major measures should be taken into consideration.

The first is corporatization. This mainly refers to operations to convert the state owned enterprises into share holding corporations and convert the state ownership into stock ownership with the state as the main stock holder at the beginning. Initially, this operation does not change the ultimate ownership of state assets from the state into individual hands (although in the process a distribution of certain small proportion of shares to workers would be desirable), but to re-define the property rights in a more flexible and efficient manner in order to make the ownership of state assets
dividable, tradable and transferable. Corporatization without change of ultimate ownership of state may not bring much immediate improvement in enterprise efficiency. A corporation system, however, would provide better conditions for the further adjustment of ownership structure in the future in accordance to market development and efficiency requirement. It is an unavoidable stage of ownership reform. Corporatization should also be encouraged in the collective-owned enterprises, which suffer the common problems of public ownership. In the process of corporatization, more emphasis should be given to the redefinition of property rights, rather than to stock-trading. Most enterprises should be corporatized, but only a few will be traded in the stock market, especially at early stages.

Mass privatization seems unacceptable in the predictable future. Unlike what happened in the former Soviet Union and Eastern European countries, the state sector in China seems far from completely hopeless and the majority of state employees can still expect to receive income increment from the this sector (or from income transfers from other sectors). Under such circumstance, few would accept a reform program like mass privatization which brings radical changes and may cost a decline, though temporarily, in income. The resistance from some powerful interest groups may create social chaos which most people would like to avoid. From this point of view, immediate and drastic mass privatization is not recommendable at the present stage, not because it is unpractical technically but because it is unpractical socially or politically.

The second is economic liberalization. Economic liberalization is a broad concept referring to all reform policies which reduce planning control and government interference in the areas where the market can work efficiently. The decentralization reform in the past included some measures of liberalization such as lifting government price control and allowing private businesses to develop. However, decentralization is essentially different from liberalization as the former focuses on the re-division of administrative decision-making powers between central government and local government, and between the government and state enterprises within the state sector. Liberalization in the contrast gives greater emphasis on economic freedom, individual initiative, private entrepreneurship, and deregulation. It focuses more on boosting the development of non-state sectors and private business outside the state sector.

To date, the evolution of non-state sectors is still limited by a great deal of institutional, even constitutional, barriers. Discriminations can be observed in many areas such as credit competition, employment, technology transfer, exportation, social security program, and social status. For instance, more than 80% of national savings is allocated through state banking system to government institutions and state enterprises which only produce less than 50% of national income and many of which are loss-makers, while the profitable TVEs and private business suffer from shortage of financial means for their expansion. Under such credit discrimination and state monopoly of financial reallocation, the economic system of state sectors which is the target of the reform is reproduced and expanded, while the development of non-state sectors is impeded. And quite curious to many observers is that when the Chinese government makes a great effort to encourage the expansion of businesses of foreign capital in China, it discourage in many areas the growth of national capital.

Following reform policies are recommendable for promoting the development of non-state sectors:

1. Improving the legal status of corporative and private firms. One of major barricade to the growth of corporative and private businesses so far is the lack of legal protection of property rights. Private business men would spend a huge amount of profits on luxury consumer goods (many of them are imported) rather than reinvestment. A considerable amount of national wealth has flowed out of the country which needs capital badly for growth. Many private and individual businesses remain
in small scale for a long time. It is the government's responsibility to provide a better institutional environment to protect any kind of legal property in order to encourage the reinvestment.

2. It is important to remove discriminations against non-state sectors and setting up conditions for fair competition. All forms of ownership should be given equal treatment no matter whether it is public or private. From an economic point of view, equal treatment means free entry, free trade and resource allocation to the most profitable use by any kind of economic agent. No special favorite conditions such as tax exemption, loan guarantee or supply of low-priced materials to a firm simply for the reason of ownership status. At present, it is important to remove discrimination against non-state businesses in the financial market. Economic liberalization requires the government to give up the control on allocation of financial resources and let the credit market select according to profitability criteria.

3. All employees or the self-employed should be included in the new social security programs which is currently in formation. The more equally treated the employees in different sectors, the easier for any one to shift from one to another, e.g., from the state enterprises to private and individual businesses or vice versa, and stay in the non-state sectors. The social security enjoyed by non-state employees will be also helpful for keeping productive relations between private owners and workers in the future.

Conclusion: The Gradualism

If anything in China could be called as a "social consensus" with majority agreement, it is the prevailing wish of going further on economic reform in modest manner without radical upside-down, that is, staying on the so-called "gradualism" path. Institutional reform is something that is not only an issue of economic optimization, but also an issue of "public choice" which involves various conflicts of interest groups. Although the radical approach may be less costly from the technical point of view of transformation, it may be more costly from the social point of view in terms of conflicts of interests. If a "shock therapy" would confront great resistance and therefore be excessively costly, it would not be optimal economically in terms of net benefits.

An alternative way to contemplate the difference between the "shock therapy" and "gradualism" approaches would be the following: The radical therapy is characterized by its direct and immediate attack on the old system, no matter how much resistance it will confront and how much costs it should pay, and then build the the new system on the ashes of the old one. In contrast, gradualism gives priority to the evolution of the new system first when the reform of the old system is too difficult and too costly in terms of social resistance. Sooner or later, the old system will be attacked anyway, but only gradually and progressing alongside the growth of new sectors which create better economic and social conditions for the reform. When the new sectors grow into greater proportion, the importance of old system diminishes in the economy as a whole and therefore reform will become easier and smoother. Neither simply putting off the real solutions to the real problems from current agenda nor merely taking "nominal reforms" which will never solve the real problem, in an attempt to avoid immediate social unrest is gradualism. The "gradualism", or better termed as "incrementalism"⁴, is not a concept of time, it is an approach, a strategy or a sequence of steps in right direction towards real solutions to the real problems. The steps that improve conditions or relax

⁴ See North, 1990.
constraints for changing the old system. The main conclusion from this theoretical speculation is that, given the time constraint, the success of China's gradualist reform will mainly depend on more rapid development of new elements of the economy, that is, the non-state sectors.

Therefore, in the 1990s, more attention and supports should be given to the development of non-state components in China's economy and the reform of state enterprises should only take a secondary position in present reform priorities. This will by no means slow down the speed of reform of state sector, but actually will make it faster.

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