Introductory
Introduction: China’s economic reform in comparative perspective

The traditional Soviet-style economic system scarcely exists any longer, but its impact and legacy will be felt well into the next century. Major economic reform programs are now underway in a dozen formerly socialist command economies. These reform programs differ in their speed, coherence, and general approach, but in all these countries an irreversible process of transition away from the Soviet model has begun. Each of the former planned economies is struggling to devise strategies of economic change while coping with the burdensome legacy of past development choices, and it is clear that the process of transition will be protracted. Economic reform of a planned economy is a process that takes decades, and several different paths lead through the borderlands separating planned and market economies.

Among this large and diverse group of nations, China has a particular claim on our attention. The chain of events that led to the collapse of Soviet-style socialism by the end of the 1980s can be traced back to the very beginning of the decade. At that time, profound change of radically different character began in two widely separated socialist countries. In China, beginning in 1979, radical economic reforms marked the first fundamental attempts to change the command economic system since the Yugoslav reforms of the 1960s. In Poland in 1980, the independent labor union Solidarity was formed, marking the first fundamental break with the Communist Party’s monopoly of the political system. Both these innovations were one-sided. Polish political revitalization was not accomplished by realistic attempts to grapple with economic problems until a decade later in 1990. Chinese economic progress was accompanied with political relaxation but no democratization, and even relaxation was substantially curtailed after 1989. These two innovations – one political, the other economic – touched off a process of change that was at first resisted, but eventually embraced, in the Soviet Union, and that then echoed and amplified throughout the socialist world,
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until it finally culminated in the dissolution of the traditional economic system and the collapse of the Soviet Union.

The early successes of Chinese economic reform were important in convincing Soviet economists that reform was not only desirable, but also feasible. Although some argued for imitating the Chinese approach, this was not the dominant strand. Rather, the Soviets found evidence in China as well as in Hungary that there were feasible alternatives to the classical command economy, and that there were different approaches to reform that were compatible with continued or accelerated economic growth. Soviet leaders were encouraged to explore reforms of their own after seeing the success the Chinese had with exploratory reforms. Change in the Soviet Union would not have unfolded as rapidly as it did without the prior example of Chinese economic success.

During the annus mirabilis of 1989, China suddenly lost its position as a pioneer of socialist reform. The violent repression of the student movement at Tiananmen Square in June of 1989 put an end to the steady liberalization of the late 1980s. Moreover, China’s new hardline leadership, in its drive for political control, seemed determined to reverse many of the hard-won gains of economic reform. In Eastern Europe, multiple revolutions brought rapid political change and a new determination to change economic systems. Most Eastern European countries made plans to change over to market economies as rapidly as possible. The contrast between China and Eastern Europe was symbolized by the fact that on the very day of the Tiananmen massacre – June 4, 1989 – Poland held the first free elections in a Communist state, marking the successful completion of its first stage of democratization.

Yet it soon became clear that China’s economic reform process had not been halted by the post-Tiananmen hardline leadership. Indeed, its bumbling attempts to reassert control over the economy only demonstrated that the economic changes that had already occurred in China were more profound than many had realized, and were virtually irreversible. Moreover, beginning with Poland’s economic “big bang” on January 1, 1990, the Eastern Europeans discovered that they were entering a period not only of accelerated systemic change, but also of serious economic recession. Still another contrast was emerging between China and Eastern Europe. While the Eastern Europeans and residents of the former Soviet Union were purchasing significant economic change at the cost of substantial foregone growth, the robust growth that accompanied Chinese reforms was continuing and even showing signs of accelerating. To be sure, China’s superior growth performance partially reflects the advantages China enjoyed from...
having started the reform process a full ten years earlier than the Eastern Europeans. But even this simple truth draws attention to the fact that China has been undergoing a genuine process of economic transition. China was the only socialist country to undertake system transformation without tumbling into profound economic crisis. Indeed, since the early 1980s, China has been the fastest growing large economy in the world, and by a large margin. Contemporaneous with social and political changes that are complex and often disappointing, the Chinese economic reform process has been resilient and profound, and accompanied by accelerated economic growth that has lifted a huge portion of the world’s population out of poverty.

The story and problem of economic reform

The aim of this book is to present a comprehensive view of Chinese economic reform. The first task must inescapably be to provide a narrative of the reform process as a whole. Surprisingly, despite the widely acknowledged importance of Chinese reforms, there is no currently available account that covers the main events of the reform process. Yet a narrative approach is strongly indicated by one of the most distinctive characteristics of the Chinese reform process: Reforms have been gradual and evolutionary. Reforms were not clearly foreseen or designed in advance, and so the elements of the reform have inescapably been time dependent. Reforming without a blueprint (Lin 1989), neither the process nor the ultimate objective was clearly envisaged beforehand. The Chinese expression for this process is “groping for stones to cross the river,” a metaphor that implies that each step depends on the previous step. Since the reform process has been marked by substantial ex post coherence, and by significant resilience as well, such an approach might be admired as the strategy of not having a strategy, or as we might say, of “muddling through” (Lindblom 1959). But to appreciate such a process, we must look at the “what” or the reform process, the particularity of how one thing led to another. This book is thus concerned not only with the outcome of economic reform, but also with the sequence of reform-induced changes.

At the same time, there is clearly no single story of economic reform. On the contrary, the reform process is woven together from many strands and from the actions of millions of individuals pursuing their own interests. Economic reforms can only be understood as part of a process that includes economic development strategy and macroeconomic policy as well as system reform more narrowly defined. Moreover, the ultimate objective is to analyze the reform process and identify its really distinctive and interesting
aspects. This clearly requires an analytical approach that is to some extent in tension with the book’s narrative organization. The required analysis, though based on economic reasoning, is never technical and should not present problems to anyone with an interest in the general topic. The book combines an overall narrative organization with stretches of economic analysis – the aim has been to make it about 30% policy narrative and 70% economic discussion.

In order to achieve a broad view of system change while keeping the narrative intact and the material manageable, I have focused on industry and macroeconomic policy. Other areas are brought in occasionally, when they are indispensable to the overall story, but they do not receive comprehensive treatment. The neglect of agriculture and foreign trade is particularly regrettable, since these are very important to the economy, and relatively successful aspects of Chinese reform. The justification is that both agriculture and foreign trade can be at least partially separated from the most difficult problems of system change. Both involve a relationship between the institutions of the traditional command economy and institutions in another sector that operate on different principles. In the case of agriculture, these are peasant households, which operate with hard budget constraints and strong incentives for economically rational behavior; in the case of foreign trade, it is the competitive world marketplace. In these sectors, the incentives and opportunities from outside the planned economy can be used to further institutional change, as long as the links with the planned economy can be significantly loosened. Moreover, these sectors have been relatively well covered in the literature, and the interested reader can refer to a number of excellent works.²

By contrast, reform of industry is especially difficult, for industry is the central component of virtually every aspect of the traditional command economy. Industry is the focus of development strategy. It is the sector in which the traditional control techniques of the command economy – such as material balance and quantity output planning – are most developed, and as such it is the exemplar of the traditional command system. Finally – and this is less generally appreciated – industry is also the crux of macroeconomic relations in the command economy. Because of the way price relations are structured in the command economy, state-run industry serves as the government’s cash cow and carries out the bulk of national saving, while also being the recipient of the greatest part of national investment. Industry is thus the main element determining both the government’s fiscal policy and the overall balance of savings and investment in the economy. When industry is successfully reformed, the old command economy, with its distinctive sys-
temic and macroeconomic characteristics, has ceased to exist. Inevitably, then, industry is the main character in the reform drama.

These perspectives on industry also serve to remind us of the fundamental problem of reform of socialist economies. That problem is that all the elements of the old system were interrelated. Replacing one coordination mechanism with another – switching from plan to market – is only one part of a broader transition process. The output structure of the economy must change – there must be a process of reindustrialization. The macroeconomic mechanisms must make a transition, such that there are alternative sources of saving in order to maintain the investment essential for growth and reindustrialization. A whole set of new institutions must be built to serve the new economic system. There are different ways to approach these problems, and not all approaches have been equally successful.

**The distinctiveness of China’s economic reform**

A distinctive pattern characterizes China’s economic reforms. Because of the coherence of Chinese reforms, I will sometimes refer to a Chinese strategy of economic reform. However, this term should be used with caution. Strategy implies conscious design of the sequence of reforms, or at least that certain principles about how to respond to contingencies could have been described in advance. This was not true in China. But China’s reforms also did not develop purely fortuitously: A limited number of crucial government decisions and commitments were required in order to allow reform to develop. In certain periods, policymakers acted as if they had a commitment to a specific reform strategy. The overall distinctive pattern of reform, though, emerged from the interaction between government policy and the often unforeseen consequences of economic change. Only through this evolving process did the goal of a market economy gradually emerge as the generally agreed upon objective of the transitional process. By the later stages of the transition, there were clearly leaders who saw and embraced it as a strategy, but this should not be taken to mean that it was seen as such at the outset.

There are a number of characteristic features of the Chinese transition process. The discussion begins here with the characteristic feature that is most closely linked to the core institutions of the command economy – with the coordination mechanism in industry. Here the characteristic feature has been the adoption of a dual-track system as a transitional device. From the dual-track system, the discussion of characteristic features is gradually broadened to encompass nine distinctive features that define the Chinese transi-
tion process, and concludes with a note on the ex-post coherence of the process. In the subsequent section, these features are contrasted with two other models of the economic reform process.

The dual-track system

The first distinctive element of the Chinese reform process is described by the phrase “dual-track system.” This Chinese term (shuangguizhi) refers to the coexistence of a traditional plan and a market channel for the allocation of a given good. Rather than dismantling the plan, reformers acquiesced in a continuing role for the plan in order to ensure stability and guarantee the attainment of some key government priorities (in the Chinese case, primarily investment in energy and infrastructure). Having a dual-track implies the existence of a two-tier pricing system for goods under that system: A single commodity will have both a (typically low) state-set planned price and a (typically higher) market price.

It is important to stress that the dual-track refers to the coexistence of two coordination mechanisms (plan and market) and not to coexistence of two ownership systems. By the mid-1980s, most state-owned firms were still being assigned a compulsory plan for some output, but had additional capacity available for production of above-plan, market goods. Thus, the dual-track strategy was one that operated within the state sector – indeed, within each state-run factory – as well as in the industrial economy at large. This was essential, because it meant that virtually all factories, including state-run factories were introduced to the market, and began the process of adaptation to market processes. The dual-track system allowed state firms to transact and cooperate with non-state, marketized firms, allowing valuable flexibility. But the growing importance of collective, private, and foreign-invested firms should be considered apart from the dual-track system strictly defined, since most of these firms were predominantly market-oriented from the beginning.

Growing out of the plan

The mere existence of a dual-track system is not itself sufficient to define a transition strategy. All planned economies have something of a dual-track system, in the sense that none of them ever completely eradicates various kinds of black market trading that inescapably takes place at market-influenced prices. Thus it is a crucial feature of the Chinese transition that economic growth is concentrated on the market track. I coined the phrase “growing out of the plan” in 1984 after Chinese planners in Beijing had de-
scribed in interviews their intention to keep the size of the overall central government materials allocation plan fixed in absolute terms. Given the obvious fact that the economy was growing rapidly, this implied that the plan would become proportionately less and less important until the economy gradually grew out of the plan. Planners concurred in this description: Chinese policymakers were making a generally credible commitment to freeze the size of the traditional plan. This guaranteed a long-run dynamic process that would gradually increase the share of non-plan, market transactions in the economy and made the dual-track system into an unabashed transitional device. The phrase “growing out of the plan” has already achieved some currency in the English language literature (Byrd 1987: 299; Hartland-Thunberg 1989; Naughton 1986: 605; Shirk 1989: 354–57; Wang Xiaoqiang 1993: 36).

The commitment to growing out of the plan was of great importance for the individual enterprise as well. With their plans essentially fixed, enterprises faced “market prices on the margin.” Even those firms with compulsory plans covering, say, 90% of capacity, were in such a position that future growth and development of profitable opportunities would take place at market prices. The plan served as a kind of lump-sum tax on (or subsidy to) the enterprise. So long as the commitment not to change it was credible, it really had no impact on any of the enterprise’s decision-making. Current decisions would be based on market prices. If the enterprise was induced to operate as a profit-maximizing firm, that profit maximization would be carried out on the basis of market prices. In that sense, the plan was irrelevant (Byrd 1989).

**Entry**

The central government’s monopoly over industry was relaxed. In China, the protected industrial sector was effectively opened to new entrants beginning in 1979. Large numbers of start-up firms, especially rural industries, rushed to take advantage of large potential profits in the industrial sector, and their entry sharply increased competition and changed overall market conditions in the industrial sector. Most of these firms were collectively owned, and some were private or foreign-owned. But local governments also sponsored many new start-up firms during the 1980s, and these firms were often “state owned.” The crucial factor is that the central government in practice surrendered its ability to maintain high barriers to entry around the lucrative manufacturing sectors. This lowering of entry barriers was greatly facilitated in China by the nation’s huge size and diversity, and the relatively large role that local governments play in economic management even before
reform. Large size and diversity meant there was scope for competition among firms in the “public sector,” even if each of these firms remained tied to government at some level.

*Prices that equate supply and demand*

Flexible prices that equated supply and demand quickly came to play an important role in the Chinese economy. Beginning in the early 1980s, a significant proportion of transactions began to occur at market prices, and in 1985, market prices were given legal sanction for exchange of producer goods outside the plan. This meant that state firms were legally operating at market prices, since virtually all state firms had some portion of above-plan production. Gradual decontrol of consumer goods prices – initially cautious – steadily brought most consumer goods under market price regimes (see Table A.1). An important benefit of the legitimacy given to market prices was that transactions between the state and non-state sector were permitted, and they developed into a remarkable variety of forms. Simple trade was accompanied by various kinds of joint ventures and cooperative arrangements, as profit-seeking state-run enterprises looked for ways to reduce costs by subcontracting with rural non-state firms with lower labor and land costs.

*Incremental managerial reforms in the state sector*

This market framework for the state firm facilitated the maintenance and incremental reform of the management system of state enterprises. As state firms faced increasing competitive pressures, government officials experimented with ways to improve incentives and management capabilities within the state sector. This experimental process focused on a steady shift in emphasis away from plan fulfillment and toward profitability as the most important indicator of enterprise performance. Moreover, as discussed in Chapter 6, there is substantial evidence that the combination of increased competition, improved incentives, and more effective monitoring of performance did improve state enterprise performance over the 1980s. It is characteristic of China’s reform that the improved – and in some ways intensified – monitoring of state enterprise performance was an alternative to large-scale privatization. Logically, there is no reason why privatization cannot be combined with a dual-track transitional strategy, but practically there are obvious reasons why they would tend to be alternatives. Urgent privatization tends to follow from a belief that state sector performance cannot be improved, and
often leads to a short-run “abandonment of the enterprise” as the attention of reformers shifts away from short-run performance and to the difficult task of privatization. Conversely, the sense that privatization is not imminent lends urgency to the attempt to improve monitoring, control, and incentives in the state sector.

**Disarticulation**

Along with measures to reform the core of the planned economy, Chinese reforms also advanced by identifying economic activities that were the least tightly integrated into the planning mechanism and pushing reform in these limited areas. Chinese reform might thus also be labeled a strategy of “disarticulation,” in which successive sections of the economy are separated from the planned core, which persists. This was clearly not an intentional strategy, but rather one that emerged from the nature of the policy process and from the concern of Chinese policymakers not to disrupt the core economy. The early establishment of Special Economic Zones is the most obvious example of such policies – export-oriented enclaves were created that initially had almost no links to the remainder of the economy. This approach is also one of the reasons that reforms succeeded first in the countryside. Policymakers realized that it was not necessary that all the countryside be integrated into the planned economy. Beginning with the poorest areas, some regions were allowed to detach themselves from the planned economy. So long as the state could purchase sufficient grain to keep its storehouses full, it could afford to let the organizational form in the countryside devolve back to household farming. (Poland, of course, ran a command economy along with household farming from the 1950s until 1990.) Cautious policymaking led to a reform strategy of disarticulation.

**Initial macroeconomic stabilization achieved through the plan**

Macroeconomic stabilization and reorientation of development strategy were initially carried out under the traditional planned economy. Rather than combining stabilization and reform into a single rapid but traumatic episode, the Chinese used the instruments of the planned economy to shift resources toward the household sector and relieve macroeconomic stresses at the very beginning of reform. This dramatic shift in development strategy created favorable conditions for the gradual unfolding of reform. Particularly striking is the fact that reforms began within a strengthening of the government’s guarantee of full employment to all permanent urban residents. Indeed, the