

# Chapter 2

## Reform, Development and Stabilization Policies: The Case of China



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**Abstract** China's reform is aimed at achieving economic development and realization of industrialization drive by means of reforming economic system and adjusting economic policy. China's economic system is characterized by responsibility system, dual pricing system and coexistence of various ownership forms. This economic system is an inevitable outcome of the long-pursuit reform, and the four major problems—inflation, imbalanced structure, ubiquitous rent-seeking behavior (synonym for corruption) and lower efficiency—that are also inescapable because of the lack of theoretical preparation, the inconsistency between various reform measures and economic policies, and the underestimation of many latent crisis. Thus, the countermeasures adopted by Chinese government in the process of reform can be viewed as a kind of readjustment mostly suitable to China's pattern of development based on the actual conditions. China's reform marks that the economic system and policy, namely institutional factors, is seen as a two-edged sword which might be either beneficial or detrimental to the economic development. Finally, the paper tries to foretell the economic future of China based on the present policy of stabilization and adjustment and long-term reform measures.

**Keywords** Economic system reform · Stabilization policies · Economic participants

### 2.1 Introduction

During the last decade, China has experienced a grand transformation evidenced in general by the economic reform and opening to the outside world. In a sense, China's reform can be seen as a rather radical one, that is, the transition from a

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centrally planned economy to a kind of system combined with planning and market—the Chinese call it the planned commodity economy. To some extent, the Chinese authority utilizes this reform for fulfilling its industrialization drive and for gaining a foothold in the world. China has achieved undoubtedly an unprecedented success in the process of reform. However, we must confess that China's reform has now encountered a series of unmet troubles and difficulties—inflation, imbalanced structure, ubiquitous rent-seeking behavior (synonym for corruption) and lower efficiency—along with furtherance of the market-oriented reform especially in a country where central planning used to play a leading role. These problems and difficulties have seriously obstructed or impeded China's industrialization drive. China, under this circumstance, is rectifying its economic order and deepening its reform. This paper attempts, from different angle such as planning, capital market, responsibility system and special economic zones, to retrospect China's decade-long reform so as to have a better understanding of contents and implications of China's reform, and also to perceive the problems appeared recently and provide advices to government in scrutinizing the cause of these problems. The paper also tries to foretell the future of China based on the present policy of stabilization and adjustment and long-term reform measures. I would draw, in this process, a special attention to the analysis on the policies and measures, on the essence of system reform as well as its implication of economics. In order to make it clear, I would like, of course, to illustrate the framework of analysis upon which the paper is based.

## 2.2 A Framework of Analysis

The pressing problem that socialist countries especially the developing socialist countries like China are facing is economic development. Though the development usually involves political, social, cultural and economic variables, to push up production and to increase income—economic growth—is the core of the development in a long-run. There are multiple factors which may give rise to the economic growth. In classical works of comparative economics, Koopmans and Montias put forward a function:

$$O = f(E, S, Ps)$$

Among which, O indicates the economic outcome, Ps, S and E refer to policies, economic system and environment, separately (Koopmans and Montias 1971). In a relatively stable environment, it is quite evident that the economic outcome depends on policies and economic system. We admit, in a certain sense, that the environment (including technical level, quality and quantity of labor force, existing capital stock and natural resource endowment, etc.) has some impact on the system and policy as well as on economic outcome. Besides, many non-economic factors like social, political and random events can also influence the economic outcome. However, I do not consider these non-economic factors as having the same weight as system reform measures and policies. The change of environment, in a broad sense, is the

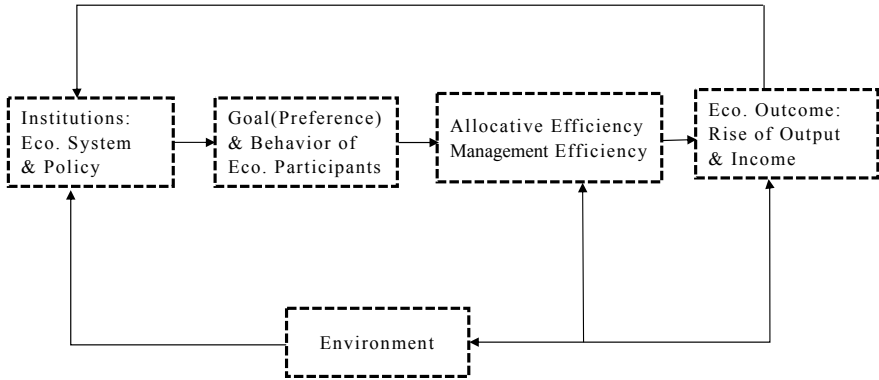
aftermath of the system and policy. Therefore, in line with Koopmans and Montais, the following empirical and theoretical investigation will be carried out under the assumption that it is the economic system and policy themselves (and their changes) that first determine the outcomes.

The economic outcome has dual implications on China, namely the aforementioned two core problems of development—to push up production and to increase income. It is apparent that the allocative efficiency and enterprise management (X-efficiency) are closely related to the economic outcome, which, we can say, is the goal of China's supreme policy-makers at any time. The realization of any goal is far and away the result of human action, which depends on the restraints and incentives one has. These restraints and incentives stem from or are determined by the institution the participants are in, presuming that the given institution determines the human behavior, even though the former is also created by man. The institution is generally composed of series of rules and explanation of these rules (Neale 1987). Concretely, the institution consists of system and policy.

The core of economic system has the following two parts, that are, ownership and method of resource allocation—planning versus market. It is evident that there exists strong consistency between the two parts, for example, public ownership is usually lined up with central planning. However, this kind of consistency is not absolute. Concretely, public ownership and market are not necessarily incompatible as fire and water. To admit this point is, so to speak, equivalent to having found the theoretical base for introducing the market in socialist planning economy. In these two parts, the ownership occupies the predominant position. In this context, the ownership not only refers to that the means of production are owned by the state, collectives and individuals, but also includes the proportion and changes between them. The rights of ownership represent the following three kinds: ownership-utilization, ownership-disposition, ownership-over-an-assets'-products (Montias 1976). Among which, the most important is ownership-disposition, namely, the right of transferability of property according to law. Its key lies in the fact that whether or not the right is exclusive, it exerts impact on human behavior by providing incentives.

There are two kinds of policies. One is economic policy in general sense, such as industrial, financial, monetary, exchange rate and pricing (adjustment) policy, etc. (of course, accumulation policy is included). The purpose of these policies is to ensure the stable economic growth and improve economic structure. The other is the policy which, in my opinion, appertains to the system, that is to say, assumes the function of establishing and transforming the system, like loosening the control over individual economy and price.

Needless to say, the assumption of the relation of cause and effect between the economic system and policy and economic outcome is important, but not sufficient. The most important is to illustrate theoretically the linkage between them. That is why I attach special emphasis on the media between them, namely, the preference and behavior of the participants in economic system. The economic participants here are mainly referred to enterprise and individual, who are all maximizers of self-interest. Just as mentioned before, the preference and behavior of participants are influenced and determined by the given economic system and policy, and so is



**Fig. 2.1** The relations between institutions and economic outcome

the efficiency—including allocative efficiency, management efficiency and economic outcome.

The relations between institutions and economic outcome can be illustrated by the following chart (Fig. 2.1).

Generally speaking, there are two ways to stimulate the economic development. One is to increase input, which entails a large amount of capital and abundance of resources. It is quite impossible for a developing socialist country like China to achieve this target in a short term. The other is to transform its institution, namely, to restructure the economic system so as to affect the participants' goal setting and behavior and to procure agreeable economic outcome. Therefore, it is quite comprehensible to rely on this method for achieving the industrialization and economic growth. This is the basic logic of China's reform.

## 2.3 Main Features of Reform Concept (1979–1988)

### 1. Alternatives of Reform

In terms of overall economic reform, Deng Xiaoping, the architect of China's reform and his main colleagues have confronted two kinds of alternatives. First, to work out thoroughly and systematically the procedures of reform and its target model, so as to coordinate various measures with relevant departments, and to substantiate and perfect each other. It is clear that this is an ideal approach. Second, to adopt the approach of proceeding in an orderly way and step by step, that is to say, to promote the reform relying on the trial-and-error method or solution to problems, since the general direction of the reform has been set. China adopted the second alternative which is vividly described as "Cross the river by feeling stones beneath your feet."

China's alternatives have also met with some criticism—the insufficient preparatory work for the reform. It can be fully understood that China's alternatives, in

**Table 2.1** Total industrial output by enterprise forms (calculated on comparable prices)

	Proportion (in percentage)			Value of output (billion Yuan*)	
	1987	1986	1987	1986	1987
Total value of industrial output	100	100.0	100.0	1119.40	1381.3
State-owned enterprise	80	68.7	59.7	620.14	825.0
Collective enterprise	20	29.2	34.6	263.68	478.2
Private enterprise and others	0	2.1	5.6	18.98	78.1

*Source* State Statistical Bureau, China Statistical Yearbook, 1987, p. 14, 1988, p. 24

\* Others include joint ventures, enterprises run by overseas Chinese and businessmen from Hong Kong and Macao, enterprises run by foreign investment and joint state-private or collective-private enterprises

\*Zhang is the basic unit of Chinese Money Ren Min Bi. The official exchange rate between yuan and US dollar in 1988 and first half of 1989 is around 3.71:1

current perspective, be the second best. One reason is that during the ten-year turmoil of China's cultural revolution (1966–1976), the understanding of the then economic situation was merely blank, and the statistical data were not sufficient and of lower reliability. It was quite different from East European Countries and the Soviet. The Adoption of trial-error approach has also some political elements, namely, to avert the criticism of opponents. Besides, this method is much consistent at the technological level—egalitarianism, which, in the terminology of economics, is viewed as exclusiveness or vagueness of ownership-over-an-assets'-products.

## 2. Changes in Ownership

Prior to 1978, with an exception of private property (mainly refers to means of livelihood), means of production and land were totally owned by the state and the collectives (see Table 2.1).

The so-called collective enterprises had almost no difference from the state-owned enterprises virtually, because the collective enterprises were merely in the transition stage to the state enterprises. At the same time, the products of collective enterprises were brought into the state plan or into plans of local governments at various levels. This kind of ownership structure is similar to unitary ownership that made the enterprises and workers' income irrelevant to its performance and met much criticism for making the nominal master of the social property extricated from the public property, which is vividly described as the "nobody-owned". The users had no or less incentives to effectively utilize the means of production. Therefore, the reform of ownership is inevitable. Considering that the public ownership is one of the cornerstones of socialism (another is distribution in accordance with one's workload), China has adopted the prudent policy regarding the reform of ownership. China's ownership reform has generally two approaches. One is to loosen the state control over three parts of ownership at different levels in state sectors, namely, the responsibility system. The other is to transform the unitary state ownership into pluralism of ownership, namely, the co-development of the state, collective and individual economy, so

**Table 2.2** Share of agriculture, light and heavy industries. Total = 100

	1952	1978	1987
Agriculture	56.9	24.8	25.3
Light industry	27.8	32.4	36.0
Heavy industry	15.3	42.8	38.7

*Source* Statistical Yearbook of China 1988, p. 32

as to provide prerequisites and to lay foundation for establishing a complete-set of new economic system—the model of socialism with Chinese characteristics.

### (1) Responsibility System

The principle difference between china and other socialist countries is that China is still on the route of industrialization. The agricultural population has made up around four-fifths (eight hundred million) of the total population. From 1949 to 1978, though the share of agriculture in gross value of industrial and agricultural production kept declining, its percentage was still high. From Table 2.2, we can see the importance of agriculture. Grain production has remained a big problem in China, which has a large population. It is quite easy to understand that China initiated its reform in rural area, if we also consider the negative growth in 1977 and in 1978.

To understand the original mechanism in China's agriculture is very conducive to comprehend the implications of reform. Prior to 1978, China's agricultural production was on the basis of production brigades, with peasants as their members. Under the guidance of brigade leaders, the peasants engaged in collective production, e.g. to cultivate and build irrigation systems. Apart from the products for peasants' own consumption and compulsory purchase by the state, if there were any surplus, they would be distributed equally according to one's labor time (calculated on date) instead of quality of work at the end of the year.

The so-called family-based responsibility system refers to that the primary property—land, which is legally owned by the cooperatives or by the state, had been contracted equally to the peasants on basis of family. The contract term was enlarged from three or five years at first to above fifteen years later. Except for the procurement quota of cereals and cotton set by the contract, the peasants enjoyed ownership-utilization and ownership-over-an-assets'-products. In other words, the peasants could decide what and how much to produce and to benefit from selling their surplus on market at market price that was much higher than the contract price. In order to avoid the polarization, the transferability of property was restrained at the elementary stage. Along with the process of the reform, there had been showing that the restraints of transferability of land would be alleviated especially for the purpose of enhancing scale economy and labor productivity. Taking policy for example, the state has thus initiated some flexible measures to encourage cooperation on a voluntary basis among farmers' families, and they are allowed to hire some people or lease the land to others if they have something more lucrative to be engaged in. The flexible polices comprise making it easier for those households to conduct cooperation to get loans from the bank and to obtain a supply of agricultural inputs such as chemical

fertilizers, pesticides and seeds. Meanwhile, authorities at various levels have done something to put flexible policy in force in an attempt to promote the development of the so-called specialized household, a kind of farm enterprise (run by a single family) that benefits from producing one agricultural product, e.g. the professional grain-calculator or pig-raiser, as well as from the rise of purchasing price of agricultural products, if the total index of purchasing price of agricultural products was 100 in 1979, 177.5 would be in 1986. Agricultural output had yielded a tremendous achievement, for instance, the average growth rate of crops was 2.7% between 1971 and 78, 5.6% between 1980 and 82, and 4.2% between 1983 and 86. Prior to the reform, the state enterprises, under the Stalinist model, were strictly controlled by the state planning in reference to three parts of ownership. They were merely the “tools” for pursuing the mandatory plan of central government. They had almost no right to transfer the property (means of production) and to make decision on income distribution (the managers’ salary and workers’ wages were determined by the state in a unified way). Although the enterprises were the users of means of production, their right was limited in terms of the way of using them (what and for whom to produce). As a result, a great loss of incentives and efficiency appeared, when the planning itself was far from perfect and the people were losing their enthusiasm.

The reform of urban enterprises run by the state is, in a sense, no more than the copy of rural reform. The basic idea is to follow the road of alleviating the restraints of ownership rights, with an expectation of giving new incentives to the enterprises and the individuals. This practice is easy to be understood since great achievements have been made in agriculture. This also reflects, from one aspect, the adoption of “trial-error” approach in China’s reform. Because the means of production in form of capital is different from the land, it cannot be expected to achieve the clear definition of property right by equally distributing the means of production in form of capital just as easy as what the land has been distributed according to family members. Therefore, the state sectors have introduced the similar responsibility system based on enterprise level, that is to say, the enterprises “sign contracts” with government (to fulfill a part of mandatory planning targets: physical or pecuniary quota), and the above-quota can be freely handled by themselves. As of 1985, the rights of using depreciation fund had been transferred from the state to enterprises as a part of their reinvestment fund. The depreciation rate for state enterprises was raised from 3.7% in 1978 to 4.7% in 1985.

The responsibility system has, in general, the following models: (a) the so-called “Asset Management Responsibility System (AMRS)”, (b) Contracts Based on Losses, and (c) Contracts Based on Progressive Increase in Profits paid to the state. China introduced AMRS in 1985. Its features are as follows:

In addition to the obligations or duties as mentioned above, managers have to take the fixed assets increment stipulated in contract seriously, on account of that the fixed asset increment is closely related to the profits he or she will earn when their contracts approach expiry.

The way in which the managers chosen or selected has deeply changes from being appointed by government departments at various levels to public bidding. The group of tender-invites is often composed of the representatives from ministries, local

government departments, the worker's committee, bank, notary bureau and lawyers. Those who offer the most favorable bidding will finally defeat their opponents.

Certainly, there exist some kinds of sanctions against the failure of fulfilling the contract for two successive years during the contract period between four and six years. For instance, such managers would receive no bonus and have half of salaries deducted. The workers' wages would also be reduced by a certain degree.

It is necessary to briefly describe the other two model of RS, which have been adopted in China widely. One is Contracts Based on Losses, the other is Contracts Based on Progressive Increases in Profits Paid to the State. The contract term of the former one is usually for one year. Central and provincial authorities initiated this RS for annual losses and issue financial subsidies accordingly for each enterprise. At the end of the year, if the losses incurred exceed these limits, no more subsidies will be granted. If the losses fall below the limits, any remaining subsidies will be retained by the enterprise. The latter one applies to enterprises that have experienced stable growth in production, marketing and profits. The term of the contract often lasts from two to four years. The government and enterprises discuss and decide on a base sum to be handed over to the state treasury in profits, and an annual growth rate. Any amount exceeding the progressive growth rate may either be retained by the enterprise or shared by the state and the enterprise. To control excessive enterprise expenditure and encourage production expansion, the authorities usually stipulate that a certain percent (e.g. 9.60%) of profits retained by enterprises should be reinvested in enterprise construction (Zhang 1989).

By the end of 1987, the state enterprises had introduced different responsibility system accounted for 87% of the total. By the end of 1980s, the figure reached more than 90%, with one-third of enterprises being contracted by public bidding. Consequently, a number of entrepreneurs have emerged. More than half of contracted enterprises have adopted the practice that the total volume of wages is articulated with economic efficient indicators, such as growth of productivity, stipulated by the contract.

The essence of ownership reform evidenced by the responsibility system is to redefine the rights of center and small economic units (enterprise and family-based agriculture) so as to clarify the contents of various parts of ownership rights, to make them exclusive as much as possible, and consequently to touch upon one's preference and behavior that determine the efficiency finally.

## (2) Pluralism of Ownership Structure

The main content of China's ownership reform is to make China's ownership shift from monism to pluralism of ownership structure—coexistence of state, collective and private sectors. Having mentioned before the changes of the ownership of the state enterprises, evidenced by the responsibility system (see Tables 2.1 and 2.3), I would like to elaborate the following two points. One is the development of individual or private economy in China, and the other is denationalization of collective enterprises.

In 1953, China fell to transform the capitalist industry and commerce that were out of existence up to 1958. The State Council promulgated three regulations separately in



**Table 2.3** Absolute and proportion of retail sales by ownership

	1980		1982		1987	
	Absolute figure	Proportion (%)	Absolute figure	Proportion (%)	Absolute figure	Proportion (%)
Total value of retail sales (rmb 100 million)	2140.0	100.0	2350.0	100.0	5820.0	100.0
State-owned	1801.9	84.2	1880.6	80.0	2249.0	38.8
Collective	254.9	11.9	341.5	14.5	2079.6	35.7
Joint ownership	0.4	–	1.1	0.1	18.8	0.3
Individual	14.7	0.7	37.4	1.6	1011.6	17.4
Sales by peasants	89.4	3.8	69.0	3.2	461.0	7.9

Source Statistical Yearbook of China 1981, p. 331, 1988, p. 24

1981, 1984 and 1988. The purpose of these regulations was to protect and encourage industry and commerce of the none socialist development, and to bring them under the state guidance at the same time. As a result, the domestic individual economy had developed apace, and most of their business were located in commercial area. Starting from scratch, the private enterprises can hire eight or more workers. Although the development of private enterprises was relatively speedy, its percentage of gross industrial value of output was not high. In accordance with sample investigation of 50 private enterprises in Hebei province, more than 60% of fund was self-financed by themselves. In terms of employment, by the end of 1987, there were more than 13 million household dealers (referred to who had registered for the business licenses), among them, 225 thousand had employed at least 8 persons. The employment reached 3.6 million, accounting for about 0.7% of total labor force employed in 1987 (Liang 1988).

The development of private sectors has its inevitability in the process of China's reform. First, after the rural reform, the peasants had a portion of surplus for their own use except a part handed over to the state according to the contracts. This made them enter into the market to make more profits. Therefore, the household dealers have emerged. Second, much surplus labors exist in both rural areas and urban cities. Third, the shortage caused by the centrally planned economy for quite a long time provides many profit-making chances. Once the door is open, they will spring up like mushrooms. In view of the government, the loosening of the control over individual economy is, on the one hand, a part of existing policy, at the same time, the individual economy in rural area has become a reality, and on the other hand, to assuage the pressure of unemployment, and to push up production, especially to make it play a complementary role for invigorating the market.

In the process of loosening the control over individual economy, the development of socialist theory, ideology or the break of antiquate concept have also played a

certain role. For instance, the attitude towards the exploitation, especially in the so-called theory of preliminary stage of socialism, (which had been spelt out in passed document of 13th Congress of CPC 1988), suggests an appropriate reason for the existence of the exploitation. Being at the preliminary stage of socialism, China is not a qualified socialist country. It is quite apprehensible and bearable or probably even beneficial that non-socialist factors be in existence. In line with this point, China has started to abandon inefficient equity in distribution and put forth the slogan which allows a number of people to become rich first.

At present, the individual economy, owing to the short time and very small proportion, cannot shake off its dependence on the state economy. This finds expressions in the strong interference of the state policy on its performance. The most important thing is that the raw material, financial fund, equipment, and technology they need are derived from the state or collective economy.

To encourage the foreign direct investment, as a part of China's open-door policy, can also be regarded as an effort of loosening the control over the private sector. As for the content of foreign direct investment, I would like to detail it later. All in all, the loosening of the control over individual economy, judging from different angle, is essentially an impetus to the complete reform of clear definition of ownership.

According to general rule, the property of collective enterprises should be owned by the workers, in other words, the right of use and allocation and right of earning by using and allocating the property should also belong to the workers of collectives. However, it is very hard for us to see any difference between collective and state enterprises regarding the problem of ownership prior to 1978. Both of them were strictly controlled by the government at different levels. Since the reform, there have been great changes evidenced by the expansion of autonomy in collective enterprises, for example, some managers have been chosen by election in the enterprises. The enterprises have been on the way to extricate from the state planning and entered into the market. Only the state fiscal and monetary policies have impact on the collective enterprises. The former refers to the differential taxation and the latter refers to the interest rate and state's credit plan (it decides, under a given interest rate, whether or how much to launch a credit loan). The possibility of collective enterprises to receive subsidy from the state is much less than that of the state enterprises. These enterprises are likely to be truly responsible for their own profits and losses. What they are facing is market. It is noteworthy to talk about the fast development of so-called township enterprises that is a kind of collective enterprises run or funded by the production brigade in rural areas or by township government—China's government at the lowest level (see Table 2.4).

At present, these enterprises are mainly scattered in rural areas and in small towns. The development of township enterprises may contribute to the following reasons: A. The price rise of agricultural products has made the industrial sectors to allocate more funds to the agricultural sectors, reaching 167.9 billion yuan according to 1978 constant price) during 1978–1986 period. B. The introduction of responsibility system has raised the agricultural productivity and created surplus of labors. C. The enterprises have won the support from the government, for example, the government has stipulated the policy of exemption of taxes and policy of loans, and has abandoned

**Table 2.4** Indicators of the development of township enterprises

	1978	1984	1987
Gross Value*	493.07	1709.89	4743.10
% of gross value of industrial output	11.6	22.4	34.3
Employment**	2826.56	7617.00	8776.40

Source Statistical Yearbook of China 1988, pp. 44, 293, 294

\*Hundred million RMB yuan

\*\*Ten thousand

the decree that limited the peasants to engage in non-agricultural production. D. The management of township enterprises is of efficiency which is the decisive factor of their survival. E. The pursuance of responsibility system by the state enterprises has provided the possibility of obtaining the raw materials and industrial equipment.

The development of township enterprises has far-reaching significance for China—a developing socialist country. It has paved a new way for the industrialization with Chinese characteristics. As a socialist country, China cannot follow the road of industrialization on which the peasants are allowed to go bankrupt or to swarm into cities. The development of township enterprises has addressed, to a great extent, the problem of unemployment of agricultural surplus labors (0.7 billion people were employed by township enterprises in 1987). At the same time, the development of township enterprises has played a major role in encouraging the transition of China's agricultural economy from autarky to commodity economy. It has also accelerated the popularization of urban technology in rural areas, and has promoted the construction of small cities and towns in the countryside, with 2,600 cities and towns in 1990, and 11,000 in 1986.

The reform of and experiment on China's ownership have shown the reform architects' will and efforts for restructuring the ownership based on China's actual conditions. The changes of ownership have shown that China has abandoned the concept that the state ownership is sole and supreme form of public ownership, and has accepted the idea that various ownerships may exist simultaneously, and has confessed that the state ownership also differ. The change of ideological thinking and practice has provided conditions for creating an economic system at the preliminary stage of socialism in China. It is worth mentioning that China's ownership reform does not mean to eradicate the public ownership—the rudimentary feature of socialism, but intends to find out the most suitable form of ownership in China. Under the condition that the public ownership takes the dominant position, the state and collective enterprises are required to cover the production value by two-thirds.

### 3. Planning versus Market and Centralization versus Decentralization

#### (1) Dual-Pricing (or Double-Track) System

I have in fact already touched upon the so-called dual-pricing system, while discussing the responsibility system. The contents of contracts, as we know, have usually two major quotas. One is concerned with the pecuniary quota, such as profits

(or tax) delivered to the state or increment of the contracted assets: the other is physical ones requiring the enterprises to ensure specific products quotas similar to the state order) to be sold to the state. This part of products of some enterprises will be brought at the fixed or contracted price by the state. The purpose of this is that the central government is likely to guarantee the fulfilment of the contracts and mandatory plans by distributing and transferring among various regions as well as state enterprises at the fixed price. As for an enterprise, it can “buy” some products (raw materials and semi-finished products) at the fixed price while honoring the obligations committed in the contracts. Considering the fact that the contracted enterprises can enjoy the rights of marketing the above-quota products in the marketplace at so-called indicative or guidance prices that are always much higher than that of fixed ones and whose ceiling and base level of floating price is set by the state. In China, there are two kinds of prices, notably-known as “dual pricing system”, which, of course, also exert influence on industrial products. While recalling the responsibility system initiated in the rural area, we can also find the dual pricing system in crops selling. In this way, pricing mechanism has been introduced in China’s economy, which is expected to play a role in improving allocative and management efficiency, and in making the plan.

Theoretically speaking, there are a tripartite pricing system in China: the compulsory fixed price, guidance price and free market price. But actually, what really exists is the dual pricing system because its ceiling price is always higher than or tantamount to the free market price.

China has adopted prudent policies in process of price readjustment due to its both economic and political sensitivity. Besides raising the procurement price of agricultural products mentioned above, the central government has also increased gradually the fixed prices of raw materials, energy, transportation and communication, and removed step by step the price control over several commodities, for instance, cigarette, alcoholic drinks, and vegetables, etc. Meanwhile, urban residents are subsidized directly or indirectly in the way of rationing on some major foodstuffs, which is the typical case of “shortage”. Comparatively, the dual pricing system embodies the fundamental changes in restructuring the pricing system rather than the price readjustment.

China’s reform is essentially an attempt to integrate organically the planning with market, with much emphasis on taking the advantage of merits of both and avoiding shortcomings of each. It is quite apparent that this kind of thinking is clearly expressed in the introduction of system. The mandatory plan and compulsory fixed price will secure a well-coordinated and stable development of economy. Under the mandatory plan and guidance price, the market mechanism will be introduced to a great extent. Along with passage of time, the share of mandatory plan has been gradually declining. This can be indirectly elaborated by Table 2.5.

**Table 2.5** Means of production allocated by planning and market (percentage)

	1979	1986	1987	1988
Planning	50	44.1	44.1	32.3
Market	50	55.9	55.9	67.7

*Source* Gao, *China's Economic System Reform (1978–1987)*, Beijing, 1987; State Council, Document No. 24 (1989a, b)

**Table 2.6** Major raw and semi-finished products marketed at state-fixed prices (percentage)

	Prior to 1979	1986	1987
Cement	100	33.3	15.6
Steel	100	60	47.1
Coal	100	50	47.1

*Source* Gao, “China’s Economic System Reform (1978–1987),” p. 49, Beijing, 1987; Yang, “Review of Planning System Reform in China,” *Ji Hua Jing Ji Yan Jiu* (Planning Economy studies), Supplement I, 1988, p. 39

## (2) Primary Stage of Capital Market

The introduction of dual pricing system and responsibility system in the state enterprises, and family-base agriculture, the policy of denationalization of collective enterprises (especially the development of a large number of newly rising township enterprises) and rising of private sector have shown that China has been changed from a centrally planned economy into a trinitarian mixed economy with publicly-owned enterprises at the dominant position. One of the inevitable results is the advent of a certain kind of “capital market”, more accurately speaking, the market of means of production. The large scale of development of China’s capital market and decline of the role of mandatory plan can be demonstrated by Table 2.6 (also see Table 2.5).

In general, the well-functioned capital markets, based mainly on share-holding system, enjoys high efficiency either in the adjustment of capital stock or in investment of fixed assets with relatively lower transaction cost. That is probably one of the basic points of many theoreticians who advocate the implementation of share-holding system in China, compared with the rigid and exhausting central planning. At present, it is much prevailing that the collective especially the private enterprises amass funds by issuing the stocks, since the government does not impose much interference on them. However, the share-holding system practiced in the state enterprises is just at the experimental stage. The main reason is that China has no such prerequisite to introduce the share-holding system throughout the country. That is not only because of the ideological impediment, e.g. for fear that the income disparity will be widened or long-pursuing socialism will be abandoned, but also because of the actual difficulties—people are reluctant to take risk of buying the stocks, and some even think that since the public property is owned by the people, it should be returned to the people, but why ask people to buy. Another reason is that some people are

not willing to lose their benefit brought by the existing system. From the technological point of view, there are also some obstacles ahead: in which way and by what criteria to “privatize” the public property while silencing this process. Judging from the ongoing experiment, a small number of state enterprises have issued the stocks only within their enterprises, and the stock buyers are workers and staff, with the purpose of accumulating circulating funds. Facing with the austere financial policy, it is natural that these enterprises have an urgent need to issue the stocks. Moreover, it is deemed as a convenient way by some enterprises to erase taxes—imposed on bonus funds in an attempt to control consumer demand: dividend differs from bonus. The efforts of reformers to expand gradually the market of means of production, to adjust the investment of fixed assets and its orientation, and consequently to improve its resource allocative performance in light of efficiency standard expressed in China’s “Bankruptcy Law” in terms of trial implementation and a series of other regulations concerning the annexations among enterprises of different forms. In 1988 alone, more than 2000 enterprises suffered from poor performance—meager profit-making and loss-making—were annexed. Although the annexation is in its trial period, with only 0.4% of total number of enterprises in China in 1988, this practice can be viewed as somehow a decisive step in the reform with an attempt to adjust capital stock by depending on market. Besides, the government also expects to heighten the management level of the enterprises through bankruptcy and annexation, to diminish the subsidy, to adjust the industrial structure, to foster the supremacy of enterprises, and to erase the shortage of financial resource for the industries whose output is badly needed. More often than not annexations are compensative. The asset appraisal of the enterprises involved in merger is evaluated by and large according to the current ones. There are two main concrete ways. One is the merger accomplishes the purchase with capital, the other is the merger bears the obligation of repayment of debts of bankrupt enterprise. The merger and the annexed include either the collective enterprises or private and state enterprises. Because the annexations mostly occur between the three sectors (the government does not take care about annexation among the private enterprises), the government at all levels play a major role in the process of annexation.

The most significant thing of the establishment of “capital market”, even though at its elementary stage, nowadays lies in the fact that the enterprises have started to enjoy within some limitation the rights of ownership-disposition. This has, to a great degree, led to efficiency both in the field of resource allocation and inter-enterprise management.

### **(3) Changes of Decision-making Structure**

We can see clearly from the foregoing discussion that China’s structure of decision-making has changed greatly, for example, it has been promoting the transition from centralization evidenced by mandatory plan to decentralization characterized by responsibility system, co-existence of enterprises with multiple ownership forms and dual-pricing system and emergence of capital market. Through this transition, the enterprise had possessed relatively larger decision-making power.

In this process, the decentralization between central government and local government ensued, which has far more significance in China's reform. In other words, the local government in this process, has far more decision-making power than before. First, prior to the reform, the investment project exceeding 10 million yuan must be approved by the State Planning Commission, but today the figure has risen to 30 million yuan. That is to say, the provincial government and municipal government have now the autonomy to approve the investment project involving less than 30 million yuan. Second, the local governments have the right to reduce or exempt the taxes of collective and state enterprises. Third, last but not least, the financial revenue and expenditure of the local government are not controlled by the central government as they used to be. After the reform, the tax income came to be shared by between the central government and local government. The relation between local government and central government is tantamount to the contractual relations between enterprises and their upper bodies—ministries of central government or local governments at myriad levels. So long as they hand over the obligatory quotas of the tax income (it increases annually at a certain rate which is often negotiable) to the central government as financial revenue, the rest can be retained by the local governments in a bid to stimulate the regional economic development and to give them more opportunities to take their own comparative advantages. The state financial revenue made up 31.9% of national income in 1979, dropped to 25% in 1986. The centrally controlled proportion of the state revenue is now only half of total fiscal revenue. As a result, China's budgetary management system has been changed from vertical management via commissions under the central government to a horizontal management via local governments.

The reform in this respect has seemingly some contractual flavors in terms of the responsibility system being expanded from house-hold and enterprise level to government level. The merit of the reform is to make local governments—instead of limiting the enterprise or family in countryside level—engage in management based on actual local conditions and be more energetic, so as to combine the controllable financial revenue for national economic development with regional economic development and heighten the government managerial level.

#### **4. Economic Policy**

We should say that it is very hard to separate the change of economic system and change of policy. This is not only because that two things aim at the same target—to raise the efficiency and ensure the economic development and growth, but also because of the interaction and overlapping between them. Hence, it is necessary to discuss the policy in particular. Since I have mentioned so many times that the government coordinated the economic development by exploiting various economic levels, here, I would like to detail the adjustment of China's economic development target and policy of opening to the outside world.

### (1) Adjustment of Economic Development Target

The implementation of China's strategy of quadrupling the gross value of industrial and agricultural production can be divided into two stages. One is the rudimentary stage (1981–1990), in which the speed of development slowed, focusing on the adjustment of industrial structure and economic system reform. The other is fast development stage (1991–2000).

The main content of the adjustment of industrial structure is to stimulate the development of light industry and agriculture, and to relatively slow the development of heavy industry. Judging from the changes of proportion of agriculture, light and heavy industries (see Table 2.2), the development of heavy industry is faster than that of light industry and agriculture. It is necessary for a country like China who is on the road to industrialize her economy. But if this situation continues, it will be dangerous if the living standard of people cannot be improved. In the process of reform, to stimulate relatively fast development of light industry and agriculture through various economic policies, on the one hand, is to enable people to benefit from the fruits brought about by the reform so as to gain the support from the people; on the other hand, perhaps regarding the long-term significance, the ever-growing market consumption demands, along with the proceeding of the economic system reform, will affect the output structure of light industry and agriculture on account of its close linkage with people's life, and eventually affect the heavy industry structure in a proper way. This is at least our expectation.

Here, it is necessary to brief the changes of China's military expenditure and policy of military industry. In order to make the limited resource use for economic purposes, the proportion of China's military expenditure, in total budgetary expenditure, during a decade-long reform, was kept on decreasing (see Table 2.7), and China declared in

**Table 2.7** Expenditure of national defense & expenditure on agriculture. RMB100 million yuan

Year	National defense	National defense (as percentage of total budgetary expenditure)	Total expenditure on Agriculture	Proportion of financial Expenditure (%)
1978	167.84	15.1	150.66	13.6
1979	222.66	17.5	174.19	13.7
1980	193.84	16.0	149.95	12.4
1981	167.97	15.1	110.21	9.9
1982	176.35	15.3	120.48	10.4
1983	177.13	13.7	132.83	10.3
1984	180.76	11.7	141.30	9.1
1985	191.53	10.3	153.62	8.3
1986	200.75	8.6	–	–
1987	209.77	8.6	–	–

Source "Statistical Yearbook of China." 1988, p. 756, pp. 758–759



1985 the disarmament by one million. Perhaps, the most significant thing is China's strategy of shifting the military industry into civilian industry. In 1987, the national fixed assets amounted to around 800 billion yuan, 300 billion yuan was evolved in military industry (Ma Hons 1988). Nonetheless, the accurate statistical data are not available, a majority of durable consumer goods are produced by the enterprises that used to encase in production for military purpose. Judging from this viewpoint, it is very beneficial for China to seek a peaceful international environment for economic development.

## (2) Policy of Opening to the Outside world

The change from the policy of "close door" to the policy of "open door" is the main component of China's reform. Apart from the expansion of foreign trade, which had reached a new height in 1988, showing the magnitude of China's open policy, another major step of the "open door" policy is to establish four special economic zones (SEZs, Chinese name of free trade zone) along China's southeastern part of coastal areas, and consequently to set up the Hainan province (the second largest island in China) as the fifth special economic zone. To establish SEZs is subject to the following considerations. First, to absorb foreign direct investment so as to make up the shortage of capital in China. As for the foreign investors, China is a huge market with its potentials remaining unknown after the long-term policy of "close door", or full of risk. It is of symbolic significance to set up SEZs and artificially create a favorable investment environment so as to bring along a large scale of investment. Second, to implement China's import substitution strategy. A large majority of products made by the Sino-foreign Joint ventures are marketed inside China. One of the main reasons is that it is more profitable to do so for its official exchange rate being overestimated even though RMB was depreciated for many times. In the past few years, exchange rate between USD and RMB was 1:1.98 in 1983, and then consistently depreciated from 1:2.33 in 1984, to 1:2.94 in 1985, to 1:3.7 in 1986, to 1:3.72 in 1988, and to 1:4.72 in 1990. We have to admit that China has not done a good job in strictly controlling the import, which is one part of import substitution strategy. For example, between 1980 and 1985, China had spent \$5.2 billion on automobile import, higher than the China's total investment in automobile industry during 1949–1985 period. Third, to introduce advanced foreign technology and managerial skill. Though the economic development in SEZs is fast, there are still some criticism saying that it would have been more profitable and efficient, if the investment in building up SEZs (small cities and towns) had been used in Shanghai and Tianjin with more infrastructure and human capital.

In view of the policy of introducing the foreign capital, I would like to discuss the problem of equity share, apart from the preferential policy stipulated by the government. Differing from other socialist and developing countries, in order to effectively coordinate the joint ventures, China does not require that the equity share of Chinese side should be up to 51%, but insist that the post of chairman of the board of directors be held by the Chinese side. At the same time, China also stipulated that the foreign investment should not be less than 25%. There is another point to add

**Table 2.8** China's introduction of foreign capital (Million U.S.\$)

	Total	Foreign loans	Foreign direct investments	Other investments
<i>Amounts contracted</i>				
1979–87	62,509	36,736	22,868	2,905
1979–82	20,548	13,549	6,010	989
1983	3,430	1,513	1,732	185
1984	4,791	1,916	2,651	224
1985	9,867	3,534	5,932	401
1986	11,737	8,407	2,834	496
1987	12,136	7,817	3,709	610
1988		10,200	5,238	
<i>Amounts disbursed</i>				
1979–87	37,500	26,548	8,909	2,043
1979–82	12,457	10,690	1,166	601
1983	1,981	1,065	636	280
1984	2,705	1,286	1,258	161
1985	4,647	2,688	1,661	298
1986	7,258	5,014	1,874	370
1987	8,452	5,805	2,314	333
1988	9,840	6,500	2,620	

Source Statistical Yearbook of China 1988; Statistical Bulletin, February 28, 1989; Beijing Review, March 6–12, 1989

that in order to encourage the foreign private capital investment, China, under the condition of inconvertibility of RMB, has purchased some of joint ventures' products by means of hard currency (see Table 2.8). The issue of convertibility of currency will be discussed later.

The birth of Coast Development Strategy in 1987 is the symbol of China's larger scale of opening to the outside world. To change from extensive to intensive development and to strengthen the infrastructure and capital-technology-intensive processing industries is the next target of China's industrialization drive. A large amount of capital is required for reaching this target. Along with the development of rural reform, many surplus labors, who used to be underemployed or be organized to engage in production, such as constructing irrigation system, have emerged. According to the evolution of industrial structure in general, the agricultural labor force should be adapted to relatively capital-intensive industries. (This has been witnessed in the development of township enterprises). To absorb this part of labor force, it also requires a large amount of capital. As a result, the competition for capital and resource has become more acute. In this aspect, the contradictions between township enterprises and state enterprises have been snowballing. Apparently, it is quite impossible for such a big country like China to solve the problem of shortage of

capital by contracting foreign loans. It is also impossible that China only rely on self-accumulation of capital and involvement in international division of labor by exploiting its comparative advantage. Therefore, China should find out the way for the healthy development of its industrialization.

China's comparative advantage has been mainly manifested by the cheaper labor force. China should greatly expand the labor-intensive industries and sell its products at the international market, and support the development of infrastructure and capital-technology-intensive industries by using the foreign exchange earnings, and virtually to push China's High-tech products into international market. This is the basic logic of coastal development strategy. Coastal industries are comparatively well-developed in southeastern China where is densely populated and transport and communication facilities are much available. Therefore, China has rested the focus on the coastal area for fulfilling this strategy, aiming at establishing an export-oriented economy in China's coastal areas instead of limiting open-door policy to a few cities such as SEZs, in order to overcome the latent difficulties in balance of international payment which might stem from the enforcement of China's Import Substitution Strategy. As a part of the strategy, some preferential policies and regulations have been promulgated.

## **2.4 Difficulties in China's Reform and the "Diagnosis"**

### **1. Major Existing Problems Facing China**

To be frank, China has made remarkable achievements in the process of its industrialization since 1949, especially the recent decade-long reform has made China soar up to a higher tier. The gross value of industrial and agricultural production in 1987 was doubled than that in 1980, and average per capital income has increased by a big margin, from 227 yuan in 1980 to 510 yuan in 1987 (according to then prices). The industrial structure has also been transformed, which, to some extent, could be reflected by Table 2.9.

Because a large number of people in many state enterprises have engaged in tertiary industries such as clinic and nurseries run by the enterprises, the actual employment in tertiary industry is relatively higher. Like many countries and regions, China has also met some problems and difficulties in its development. It is a lie that these problems are of no importance. Generally speaking, these problems can be classified into four categories: imbalanced industrial structure, high inflation rate, X-inefficiency and rent-seeking behavior. Besides, along with China's opening to the outside world and utilization of foreign capital, a hidden debt crisis will probably occur. We should say that these difficulties and problems are closely interrelated and interacted.

**Table 2.9** Labor force employed by three sectors of economic activities (end of Year)

Year	Total 10 thousand	Absolute figure			Total = 100		
		Primary sector	Secondary sector	Tertiary sector*	Primary sector	Secondary sector	Tertiary sector
1952	20,729	17,317	1,531	1,881	83.5	7.4	9.1
1965	28,670	23,396	2,408	2,866	81.6	8.4	10.0
1978	40,152	28,373	6,970	4,809	70.7	17.4	11.9
1985	49,873	31,178	10,418	8,268	62.5	20.9	16.6
1987	52,783	31,720	11,762	9,301	60.1	22.3	17.6

Source Statistical Yearbook of China, 1988, p. 157

\*Because a large number of people in many state enterprises have engaged in tertiary industries such as clinic and nurseries run by the enterprises, the actual employment in tertiary industry is relatively higher

### (1) Imbalanced Industrial Structure

The imbalance of industrial structure can be expressed by a series of phenomena. The typical one is the imbalance between supply and demand. For instance, China is now suffering from some bottle-neck problems. In 1987 alone, 25% of production capacity could not be in normal operation because of lack of electricity. It was estimated that the loss was at least 150 billion yuan, making up about 13% of GNP (Li et al. 1988). Apart from the lack of electricity, the development of China's infrastructure lagged far behind the development of processing or manufacturing industries. This point can be witnessed clearly from the Table 2.10 of outpacing coefficient of basic industries during the period of "Sixth Five-Year-Plan" (1981–1985). In general, outpacing coefficient of the country, which is on the way forwards industrialization or modernization, ought to be at least greater than zero. The backwardness of infrastructure resulted in many unhealthy phenomena. Besides the losses made by the lack of electricity, there was also a problem in import. The outpacing processing or manufacturing industries required to import raw materials in order to keep the operation, e.g. China's import of steel was high, making up one-third of total demands, and the same was true of the import of component parts, mostly for the production of color TV sets and refrigerators.

**Table 2.10** Outpacing coefficient\* of basic industries' development (1981–1985)

Coal	Crude oil	Electricity	Steel products	Water supply	Railway building	Highway building
-0.36	-0.7	-0.42	-0.43	-0.02	-0.45	-0.04

Source "Collection of Industrial Policy studies" (Vol. I), edited by State Planning Commission of China, p. 71

\*Outpacing Coefficient = (growth rate of some basic industries/growth rate of processing industries) - 1

The industrial structure of every province and municipality is now suffering from the problem of convergence that reflects, from another angle, the imbalance of industrial structure. China has a vast territory, however, there is a sharp difference between the development of productivity and resource endowment. For instance, 61.5% of China's total coal reserve is concentrated in Shanxi province and Inner-Mongolian Autonomous Region (in China's energy consumption, coal makes up two-thirds). In Shanghai, the per capita of GNP reached \$1600 in 1987, but the poorest, only \$30. The division of labor between resource-rich provinces and provinces based on processing and manufacturing is becoming more and more confusing. The former developed desperately its processing industry in order to make more profits, and the latter could not obtain their raw materials they need and have to leave many equipment idling. Consequently, neither the advantage of processing capacity nor the advantage of rich resource has played its due role. In another aspect, all the provinces are competing to introduce blindly the equipment from foreign countries. These industries do not necessarily have their advantages, but just for meeting the needs of "outpacing" consumption. By the end of 1985, China's various provinces and municipalities had introduced 116 assembly lines for producing refrigerators and 117 assembly lines for producing color television sets. This had intensified the momentum of convergence of the industrial structure of at the provinces (Ma 1988).

The lower technical level is another phenomenon of industrial structure crisis. 95% of China's machine tools are the replica of 1950s, and the labor productivity of China's automobile industry is one-twentieth, compared with that of the US (Hu and He 1988). All these have almost made China's cheap labor force lose their competitiveness. Because of the lower technical level, China's material and energy consumption is considerably higher. The most worrisome is that this trend is still deteriorating (see Table 2.11).

**Table 2.11** Energy and steel consumption per US\$ 1 of GDP (kilogramme standard coal equivalent)

Country	Energy consumption	Steel consumption (kilo)
France	0.39	0.133
Japan	0.37	0.213
Brazil	0.33	0.203
<i>Federal</i>		
Germany	0.51	0.116
U.S.A	0.80	0.197
India	0.80	0.435
China	2.31	0.451

Source World Economics Herald, Oct. 3, 1998

**Table 2.12** General index of prices and change of interest rate (annual rate %)

	Growth rate of retail price	Nominal interest rate	Real interest rate
1980	6.0	5.40	-0.60
1981	2.4	5.40	3.00
1982	1.9	5.76	3.86
1983	1.5	5.76	4.26
1984	2.8	5.76	2.96
1985	8.8	7.20	-1.60
1986	6.0	7.20	1.20
1987	7.3	7.20	-0.10
1988	18.5	—	—

Source State Statistical Bureau, "Statistical Yearbook of China," 1988: Jia Ge Li Lun Yu Shi Jian (Price Theory and Practice), No. 10, Oct. 1988

## (2) Inflation

All the socialist countries embarking on the reform have met the inflation problem, China is not an exception (see Table 2.12).<sup>1</sup> Inflation, especially the inflation rate of 1988 (18.5%), touched off widespread social discontent. From July to August 1988, there appeared panic spree and bank run owing to the people's worrisome about the inflation. According to the report of the State Statistical Bureau, the sample survey conducted in 13 major cities shows that the living standard of around 39% people has decreased (State Statistical Bureau 1989).

In order to have a deep understanding of China's inflation, we should examine the changes of means of production, apart from dealing with the general index of increasing prices. The result of sample survey in 40 state enterprises, which might be deemed as a general situation, manifests that a majority of enterprises considered that increasing price of means of production before 1987 as quite acceptable. But, in 1988, the price was so high that it became intolerable (see Table 2.13). For this, all the enterprises felt panic (Du et al. 1989).

The evil consequence of the price hike of the means of production finds expressions mainly in imposing the unhealthy impact on China's economy after the reform. Specifically speaking, it may probably ruin the responsibility system. Because of the gloomy future of paying the taxes according to the contract under the condition of price hike of means of production, nobody would dare to make contract. On account of the excessive instability of the market, the enterprises have lost their confidence in market. They are even willing to give up their autonomy they already have and ask to be brought back to the state planning again, in an attempt to secure the supply of raw material and energy. Under the condition of high inflation rate, the newly

<sup>1</sup>Statistical Yearbook of China only gives the general index of prices, which can generally reflect the level of inflation in China.

**Table 2.13** Price hike of means of production\* (1988)

Item	Unit	Price in January (yuan)	Price in September (yuan)
Steel products	ton	2200	5,800
Copper products	ton	7000	15,300
Aluminum	ton	4000	13,000
Lead	ton	2650	7,000
Imported paper pulp	ton	3000	5,500
Coal	ton	135	250

Source Du et al., "The Behavior of State-owned Enterprise under the Inflation," *Jing Ji Yan Jiu* (Economic Research) No. 2, Feb. 1989, p. 41

\*Sample of 40 State-owned enterprises in Jiangsu Province

established contractual linkage between the enterprises has begun to disintegrate. And even worse, the state mandatory plan frequently falls to be fulfilled. Because of the attractiveness of the high price on the market, the enterprises are not willing to market their goods (compulsory quota) at the state fixed price. That is why those enterprises are being accessed to the raw materials under the state planning make the pretext for their unfulfillment of the state mandatory plan.

### (3) X-inefficiency or Imperfect Micro-management

The losses caused by the micro inefficiency in China's economy can be evidenced by the following two aspects: overstaffing of enterprises (especially state-owned ones) and slowdown of total factor productivity growth. According to the sample survey conducted by the Beijing municipality, in the first half of 1988, there was no enterprise whose average efficacious labor time reached 50% (namely, half of 8 h, the highest was 3.2 h). Joint ventured enterprises were much better, around 70%. Throughout China, hidden unemployment within the enterprises was amounted to 15 million, which accounted for 10% of then state enterprises, even if the same number of skilled workers were scare (Yang 1989).

Total factor productivity is a main indicator which reflects the management efficiency (especially including the entrepreneurship and enthusiasm of the staff) at enterprise level, and the intensively expanded reproduction of the enterprises. Its calculated formula is as follows:

$$Z = r + aL + bK$$

Among which, "z" refers to national income or growth rate of GDP, "r" indicates growth rate of total factor productivity or the residue derived from subtracting the contribution of labor and capital imputes. "L" and "K" stand for the growth rate of labor force and capital stock input, "a" and "b" represent the elasticity of output

**Table 2.14** Sources for growth of industrial net value of state enterprises (at 1952 constant price)

Period	Growth of industrial net value	Total factor productivity	Contribution of increase in labor force	Contribution of increase in capital stock
	(Z)	(r)	(aL)	(bK)
1952–1960	23.5	0.82	9.48	13.2
1961–1969	8.8	3.36	1.12	4.32
1969–1977	10.4	0.36	3.68	6.36
1978	17.1	7.60	3.08	6.42
1979	7.4	−2.62	5.40	4.62
1980	10.1	−1.46	7.48	4.08
1981	11.0	5.56	2.32	3.12
1982	5.7	−0.58	2.32	3.96
1983	8.8	2.80	1.68	4.32
1984	13.6	8.94	1.72	2.94
1985	17.5	2.22	11.56	3.72
1986	10.1	−3.58	6.12	7.56

Source Zheng, “The Analysis of Factors’ contribution to Industrial Economic Growth,” Gong Ye Jing Ji Guan Li Cong Kan (*Journal of Industrial Economic Management*), No. 12, 1988, p. 9

respectively with respect to labor and capital. On account of the China’s actual conditions, the labor and capital output elasticity are assumed to be 0.6 and 0.4. The total factor productivity growth in industry, during the period of 1978–1986, can be illustrated by Table 2.14. We can see that, from 1978 to 1984, the reform bore much better results, so that the growth of total factor productivity was fast. But till 1985, the situation became deteriorating, and in 1986, there was a negative growth. It might give a hint that the economic system reform has probably “diminishing returns”, or the economic system reform was imperfect.

#### (4) Corruption Stemming from Rent-seeking Behavior

The so-called rent-seeking behavior refers to the behavior of economic participants who are desirous of gaining direct unproductive profits to maximize their own profits, or who seek profits rather than create wealth. The rent here refers to cost of all kinds of factor of production in general. Under this circumstance, the rent stems from the price difference when the demand for a certain production factor rises and its supply can hardly increase due to specific reasons. Once the rent occurs, rent-seeking activity is inevitable. The rent-seekers try to set the privilege of rent-possession by every legal or illegal means, such as lobbying, seeking powerful man for support and offering bribes, etc. Corruptions also occur due to this cause. These activities may result in the scare social resource waste, unfair income distribution and impossibility of efficient resource allocation (Wu 1988; Colander 1984).



Rent-seeking behavior is much prevailing, probably due to the massive rent generated since China's institution reform. According to a well-known economist's estimate, in 1987, owing to the difference of exchange rate and price, etc., 200 billion-yuan worth of rent was generated, accounting for about 18% of GDP (Su 1989). Though there is no accurate figure at present to illustrate the evil consequence brought about by the rent-seeking behavior, there are two negative implications. First, rent-seeking behavior seriously hurt the hearts of a majority of people. Though the majority of people have obtained some profits from the decade-long reform, the income gap, judging from the welfare level, has been widened along with the rise of the level of welfare as a whole. Therefore, it is natural that people feel discontent and political turmoil seem to become unavoidable. Second, the new profit takers of the rent-seeking behavior together with the vested interest under the existing system might become the hinderance in furtherance of the reform.

### (5) Potential "debt crisis" and undesirable exp/imp

With the peak of repayment of external debt approaching, a potential debt crisis' in China has become a hot topic among the Chinese economists.

The irrationality of import and export structure, and other major aspects of the imbalance of industrial structure, are naturally regarded as top considerations. Because of lower technical level, China's earning of "hard currency" relies mainly on the export of primary products. The export of manufactured goods, especially the high value-add electric and mechanic products, is hardly to increase steadily, but the percentage of export of light industry and textile products is ever increasing. The improvement of this situation in recent ten years has been far from satisfactory. (see Table 2.15) In order to make full use of the advantage of China's cheaper labor force,

**Table 2.15** Commodity composition of exports in selected years (by SITC system) value unit: U.S.\$100 million

Year	Total products	Primary products		Manufactured goods		Of which, light industrial and textile products	
		Value	% of total	Value	% of total	Value	% of total
1979	136.58	73.15	53.6	63.43	46.4	48.45	35.5
1980	182.72	97.62	53.4	85.10	46.6	61.53	33.7
1981	208.93	103.60	49.6	105.33	50.4	67.35	32.2
1982	218.19	104.63	48.0	113.56	52.0	64.45	29.5
1983	221.97	102.65	46.2	119.32	53.8	70.61	31.8
1984	224.16	121.79	49.9	122.37	50.1	75.38	30.9
1985	159.15	140.34	54.2	118.81	45.8	82.76	31.9
1986	270.14	117.92	43.7	152.22	56.3	96.93	35.9
1987	347.11	134.52	38.8	212.59	61.2	140.00	40.3

Source "Almanac of China's Foreign Economic Relations and Trade" 1988, pp. 359-360

**Table 2.16** Imports of raw and intermediate materials value unit: US\$ 100 million

Year	Value	% of total	For industrial use		For agricultural use	
			Value	% of total	Value	% of total
1979	87.90	56.1	78.67	50.2	9.23	5.9
1980	100.45	51.4	86.20	44.1	14.25	7.3
1981	90.78	46.6	76.69	39.4	14.09	7.2
1982	89.78	51.4	75.96	43.5	13.82	7.9
1983	113.21	61.1	95.37	51.5	17.84	9.6
1984	153.48	60.5	132.61	52.3	20.87	8.2
1985	174.74	50.9	159.83	46.6	14.91	4.3
1986	161.83	48.9	152.74	46.2	9.09	2.7
1987	158.50	47.5	142.66	42.7	15.84	4.8

Source "Almanac of China's Foreign Economic Relations and Trade" 1988, p. 361

China has put forward the Coastal Development Strategy—to push the enterprises located in coastal areas into world market so as to solve the problem of shortage of raw materials and alleviate the pressure of unemployment. Judging from this point of view, the dependence on exporting the primary products cannot be drastically changed in a short term. Moreover, China's import structure and policy, as shown in the case of export of steel and automobile, is the most worrisome (see Table 2.16). It is not superb or normal international division of labor for the developing countries to develop their economy by depending on import of semi-finished products and spare parts to keep the operation. At the same time, it will be detrimental to China's strategy of substitution import. In order to deal with the problem of external debt, the Chinese government had worked out the plan to repay about US\$7 billion worth of principal and interest in 1990 and 10 billion in the next successive three or four years.

## 2. Some Analysis of the Troubles

The achievement of China's reform is enormous. This is agreed upon by almost all the Chinese people. All the measures taken in the reform conform to the historic trend of the time and have transformed China from a centrally planned economy into a planned commodity economy mixed economy. As far as problems and difficulties are concerned, it is quite inevitable that these problems and difficulties appear in the process of reform. The following paragraphs attempt to discuss these problems from the perspective of policy and economic system.

### (1) Localism

The localism, as a result of the reform, could be divided into two categories. One is the over-decentralization of power, and the other is the failure of forming a unified economy in China.

**Table 2.17** Extra-budgetary expenditure as percentage of budgetary one (1982–1987)

1981	1982	1983	1984	1985	1986	1987
59.1	74.1	79.9	81.0	83.3	79.5	90.4

Source Li et al. "An Analysis and Counter-measure of Developing Bottle-neck Industry," Jing Ji Yan Jiu (Economic Research), No. 12, Dec. 1988, p. 5

Under the traditional system, it was the state who enjoyed the right to invest. The taxes collected by the local governments at different levels were, subtracting the part handed over to the central budget, generally used for local expenditure, such as culture, education, health care and security, etc. Taxes used for large scale investment are comparatively less, and the local governments must obtain the approval from the state Planning Commission. But, along with the reform of fiscal system, the tax income, we may say, can be shared by the central and local governments and the financial resource for investment at local government's (mainly, provincial level) disposal has drastically augmented. That is also the main reason the extra-budgetary funds have soared sharply. This point can be reflected by the changes of proportion between the budgetary investment determined by central planning and extra-budgetary investment including the funds accumulated by the enterprises apart from the local governments' investment (see Table 2.17). The main target of the local government is the growth rate of gross value of industrial and agricultural production, upon which the performance of the local leaders will be evaluated. Therefore, it is quite natural that the local governments do their best to put the limited capital into the production (of color television sets, refrigerators and tin beverage for example) which can make profits in a short term, but not into the basic industries with low profits and a long period. In addition, the local governments also back the enterprises by using their power, for instance, abating and exempting these enterprises from taxation. It is undoubtedly one of the most direct reasons that resulted in the irrationality of China's industrial structure at present.

Local government is the growth rate of gross value of Industrial and agricultural production, upon which the performance of the local leaders will be evaluated. Therefore, it is quite natural that the local governments do their best to put the limited capital into, or to back the enterprises by using their power such abating and exempting them from taxation, the production which can make profits in a short term, the production of color television sets, refrigerators and tin beverage for example, but not into the basic industries with low profits and in a long time. It is undoubtedly one of the most direct reasons of irrationality of China's industrial structure at present.

Judging from another angle, the phenomenon of centrifugal local regime in China is serious. In China's territory, there has been neither rational division of labor between the provinces nor a unified market on the principle of allocation and management efficiency. In pursuit of doubling the gross value of industrial and agricultural production, some provincial governments have intimate knowledge that it will be a great loss to them if they provide other provinces with production resources which are relatively cheaper. But China has a vast territory and the scattered distribution of

resources. Therefore, many provinces abundant in resources are active in investing in processing industry construction so as to avoid letting the profits flow into others' hands. As a result, on the one hand, the basic industries cannot be developed, on the other hand, the production capacity of other provinces are made idle. It is also the reason that resulted in drastic price hike of raw materials outside the state planning. In China, the protectionism between the provinces and cities has thwarted or impaired the internal rational division of labor. It can be deemed as one of the important reasons of irrationality of industrial structure and distribution and division of labor of China today.

Here, it is worth noting that the irrational price system does also exert an impact upon the direction of investment.

In China, the comparative price of raw materials, energy products and traffic transportation has been relatively low, though the price has been raised for many times during the reform. It is undoubtedly a reason that these industries, compared with the processing ones, are not flourishing. All the enterprises and local governments would not like to invest in these industries because of long maturity, in particular, more inputs and less expected revenue. On the other hand, they would like to become "free-riders", and incline the central government not to solve these problems, so that they may sit idle and enjoy the fruits' of others' work. Consequently, almost all the money for the industrial investment covered by the central government financial expenditure is used for the infrastructure, raw materials and energy, but the demands have not yet been met. Here, I would like to point it out, though the price signal, in the process of market-oriented reform, does not play a larger role than that in the industrialized countries, it has after all given considerable incentives to the main bodies of various behavior—individual, enterprise, local government—who pursue maximum profits. It is just in this sense that irrationality of price system is not conducive to the adjustment of industrial structure.

## (2) Imperfection of Capital Market

As we know, there are now two backbones in China's capital market. One is the market of means of production, the other is annexation of enterprise. Both of them have encountered a great hinderance in the development. This finds expression in the slow development of so-called annexation of enterprise with efficiency as the criterion. The main reason is the ownership of enterprise (in other words, ownership-disposition) does not have enough exclusiveness. The annexation among the private enterprises, between private and collective enterprises and among the collective enterprises is relatively easier, but the annexation among the state enterprises and the annexation of state enterprises by other enterprises with different ownership form or the auction of mini-sized state enterprises is difficult. Apart from the vagueness of the ownership and because the enterprises with different ownership forms enjoy different levels of welfare, the working staff of the state enterprises are not willing to see their enterprises to be annexed or auctioned. This is also an obstacle in the development of capital market. In early 1990, in Beijing municipality, while two small-sized state enterprises were auctioning (50 enterprises were planned to be

auctioned), the auction was suspended due to workers' reluctance of loss of welfare enjoyed in the state enterprise (such as free medical treatment, higher pension and employment security), if their enterprises were auctioned to the private or collective ones. Under these circumstances, some of the annexations are much like the administrative adjustment, but not a volunteer grouping. While facing the restraints of soft budget, the enterprises have undoubtedly less stimulation to annex other enterprise according to the efficiency criterion. The annexation means the loss of power of the annexed. All this has probably made it impossible for China, with state economy being at the predominant position, to improve the allocative efficiency by depending on the adjustment of capital stock.

As for the market of means of production, it has been influenced by high inflation rate and by unhealthy phenomenon of rent-seeking behavior. Therefore, it is far beyond the expectation of the reform architects who wish that the market of means of production could adjust the investment structure depending on market mechanism. All in all, the premature capital market, especially under the condition that the central planning has been weakened to a large extent, has not played its full role of guiding the resource allocation.

### (3) **Lack of Entrepreneurship**

Provided that the innovation of an enterprise manager is driven by greed and fear, the manager, under the restraints of soft budget, has far less probability of making innovations than those who run enterprises under hard budget restraints. Though the economic man's assumption is very popular and useful, the greed-driven and fear-driven stimulations are not great in China because the "big pot" (synonym for China's equalitarianism and paternalism) has not been thoroughly broken. These have undoubtedly impeded the innovation activities. Though China as well as some other socialist countries have spent an abundance of man power and materials on the research and development of scientific technology, and have achieved remarkable results, they can hardly apply them to production. I am afraid that it is because of lack of innovative mechanism (Schaffer 1987).

Judging from another angle, though there are some entrepreneurs in some state, collective and private enterprise, they are far from forming a stratum in China. The important external environment in which the entrepreneurs exist and develop, despite the pressure of competition and profit-making motive—fear-driven and greed-driven, is "entrepreneur market", that is, the value of entrepreneur is determined by his performance, achievement and potential capability. In other words, the entrepreneurs have their own interest and rules—the fittest survives. It is evident that there have been no such conditions in China, e.g. many managers of the contracted state enterprises must be appointed by the upper bodies. As a result, a majority of managers are those who used to be. Furthermore, the performance of enterprises is sometimes determined, to a large extent, by the manager's interpersonal relations and his capability of bargaining with their upper bodies. Besides, innovation in general, introducing new techniques, exploring new products and new markets, engaging in innovation

of management and introduction of technology, can be hardly achieved by the enterprises' self-accumulation. In addition, the existence of a financial market full of flexibility, risk and opportunity is the prerequisite of the existence of entrepreneurs. However, this kind of financial market has not been in existence in China, though the role of bank has been increasing, e.g. the fiscal budgetary allocations without compensation have been changed to bank loans.

Undoubtedly, innovation is not only the business of "entrepreneurs", but also a matter of every working staff. During the present reform, it is quite imaginable that the working staff, in the economic system, be lack of entrepreneurship.

All in all, the lack of entrepreneurship is the essential reason of X-inefficiency. At the same time, it will inevitably have unhealthy impact on the resource allocation efficiency as a whole. Many economists hold that progress of technology plays a decisive role in economic growth. But I think that progress of technology is only a reason on the surface. The real role is the attitude of entrepreneur and every producer towards the progress of technology or towards the opportunity for innovation. The latter is decided by the existing policy and economic system. In this sense, the level of total factor productivity is virtually the function of the specific institution.

#### **(4) Corruption and Dual Pricing System**

Dual pricing system is one of the main characteristics of China's reform. We should say that it is China's creation, and the only and inexorable alternative. Dual pricing system, together with responsibility system, is the product of eclecticism—to arouse the enthusiasm and creativeness of the enterprise by clearly defining the ownership relations and maintaining the advantage of the state planning. But, in view of present situation, the introduction of dual pricing system has accompanied by a couple of problems. Many leading officials have abused their rights to allocate and transfer the means of production and raw materials inside the state planning so as to gain exorbitant profits. These people directly engaged in speculations or accepted bribes, and those who offered bribes would resell the quick-selling materials they procured at the state-set price. Meanwhile, many enterprises and officially-run trading companies, by lobbying, claiming kinship and offering bribes, obtain the products at a price set by the state mandatory plan and resell them in the market in order to profiteer. All this is one of the component parts of corruption in China, and the widening of income distribution gap due to this cause has given rise to a strong social discontent. It can be argued that dual pricing system is the direct reason of the occurrence of a many rent-seeking behavior relevant to corruption.

Here, I must point it out, under the assumption of the economic man, all the human behavior is to maximize the self-interest. In other words, everyone is maximizer of self-interests under the restraints of a given system. If the irrationality exists, we can say, it is the system which is irrational but not human behavior. We can build up a society not on the basis of moral and virtue of human beings, but on the basis of system in which the efficiency can be improved.

Therefore, someone may hold that the abandonment of the dual pricing system can eliminate the phenomenon of rent-seeking behavior, which is one of the orientations

of the reform. Here, there are two alternatives to replace the dual pricing system. One is to return to the centrally planned economy, and the other is to completely eradicate the control of mandatory planning over the products of contracted quota and to market these products at floating price, but not at the state-set price. In terms of current situation, these two alternatives are not realistic. One reason is that they are not consistent with basic idea of China's reform. Furthermore, more realistic difficulties in eliminating the dual pricing system are observed as the facts that the products of contracted quota distributed and transferred by the planning commission and marketed at the fixed prices among the state enterprises. The contracted quota and the fixed prices are regarded as two key factors to avoid a latent overall inflation. Hence, we have to explore new ways of fighting against the corruption by strengthening the Chinese Communist Party's discipline and legal sanctions.

### (5) Budget Softness and Inflation

According to general rule, the inflation has the following types: cost-push inflation, demand-pull inflation, structural inflation and repressed Inflation. We must say that China's inflation is the mixture of the four. Since the reform, the volume of money issuance ( $M_1$ ) has increased rapidly from 1981 to 1985, and the ordinal rates are 14.5%, 10.8%, 20.7%, 49.5% and 24.7%. All this has given rise to the phenomenon that the aggregate demands exceed the aggregate supply. The rise of wages or income is the direct reason of the rising of consumption demand, and simultaneously, it is one of the reasons of cost-push inflation. From 1981 to 1985, the wage of workers in the state enterprises had raised averagely by 50.7%, far exceeding the productivity which had increased by 33.5%. Another reason of the cost-push inflation is the adjustment of China's pricing system, for instance, to increase the price of agricultural products, raw materials, transportation, and communication service, etc. The repressed inflation has become evident in China, where a number of daily necessities, such as eggs, meat, soaps, and even matches, are rationed. These products can be, of course, purchased at the higher price at free markets. Certainty, pluralism of interest caused by localism has also engendered inflation on its part as discussed above.

In this study, however, I hold that the fundamental reason of the inflation lies in the insufficiency of effective supply caused by irrationality of industrial structure, and consequently, one of the most important reasons of lack of effective supply is the soft budget restraints. The best thing which can reflect the softness of budget is the subsidy granted by the state to the loss-making enterprises. In 1988, the figure of subsidy was 44.7 billion yuan, about 4.5% of national income of that year (*Liao Wang Weekly*, No. 16, 1989). Theoretically, the market, if any, can orient the adjustment of industrial structure by the changes of demand. This is a "merciless" process—"survival of the fittest". Whereas, in the socialist country, there is usually a supreme target—to guarantee economic development and full employment can show their superiority. If we separate the industry into two parts—traditional industry and newly-rising industry, in order to pursue the designed target under China's existing system, the restraints of soft budget—subsidy protection by custom tax and mandatory supply

with priority—will inevitably postpone the process of evolution of industrial structure. Because some industries which should be streamlined in the structural evolution still remain existent, it is natural that the limited resources be transferred to the traditional industries, and therefore, some new potential or promising industries will be driven out or “squeezed”. This point can be reflected, on the one hand, by the subsidy given by the state to the loss-making enterprises (some deserve the subsidy, to be frank, because of the irrational system of comparative prices), and on the other hand, by the imbalance of industrial structure. As a result, the buyers are not likely to buy all the sellers’ products which fail to meet the market demand while they have to face the supply bottlenecks, and sellers are lack of sufficient impetus to transform resource from products kept long in stock and being in the “sunset” industries or goods into the “sunrise” one. Therefore, inflation has naturally appeared.

There is another point to add, if the central government adopt the austerity policy so as to lower its inflation rate, the aggregate demand may probably coincide with aggregate supply, but it may also make the structural problem deteriorating. Under the existing system rules, it is not the enterprises of newly-rising industry but traditional state enterprises in urban cities which are in the monopolistic position have much capacity of survival. If we make supplementary investment in bottle-neck field and in newly-rising industries, then, the inflation will follow. This is the dilemma China is now facing.

Now, we could come to the conclusion that inflation in China is mainly a “systematic inflation” which is engendered by imperfection of the reform, and is consistent with the methodological framework in Sect. 2.1.

It is evident that the causes of four major problems mentioned above are mutually overlapped and interrelated. In my personal opinion, all these causes could contribute to the imperfection of China’s existing institution.

## **2.5 Measures of Stabilization Adopted by Government and Evaluations in Brief**

There are two solutions to these problems: to rely on policy of stabilization to ease various tensions in a short run; or to rely on the transformation and imperfection of economic system to bring substantially all behavior of economic participants onto the track of improving efficiency in mid-and-long run. Of course, the difference between policy of stabilization and system reform is not absolute, and both of them are mutually supportive aiming eventually at reaching the goal of quadrupling the gross value of industrial and agricultural output.

In the government work report made by Premier Li Peng in March, 1989a, the pursuance of economic stability is the top priority in the following two or three years. One of the main contents is to lower inflation rate by easing the contradiction between aggregate supply and aggregate demand. Therefore, a series of policies of stabilization have been worked out.



### **1. To Encourage Savings Deposit and Inhibit Consumption**

Actually, China's so-called improvement of economic environment and rectification of economic order, started from September of 1988, was mainly resulted from the advent of panic buying and bank run happened shortly after the central government's discussion regarding the probability of overall removal of the control over prices (mainly refers to readjustment the ongoing system of comparative price and gradually annual dual pricing system).

To adopt the policy of "value-guaranteed depositing" is the first response made by the Chinese government, which means that to grant interest compensation according to inflation rate while drawing to those who has deposited the money in fixed term for more than 3 years. To subsidize the interest rate according to the inflation rate started from Sep. 10, 1988, and "compensation" interest rate will be publicized quarterly and be usually higher than that normal one. At the same time, the bank has also raised the personal savings deposits interest rate. The annual fixed depositing interest rate has raised from 7.2% in 1987 to 11.34% at present. These measures have borne much results. Prior to April 30, 1989, the savings deposits of urban and rural residents had reached 421.1 billion yuan, 84.7 billion yuan more than that in corresponding time of the previous year. Meanwhile, the momentum of price rising has been held back. Of course, the aforementioned measure is only a part of austerity policy. Another important part is the government's efforts to curb the rapid growth of consumption demands. The concrete policies and measures are as follows: to firmly curtail social group consumption (e.g. to work out the commodity list which abandons or limits the purchasing power of the state enterprises or organizations at all government levels) and strictly control the increase of wages (including bonus), which will be detailed in the following subsection.

### **2. Austerity Policy**

The overheated economy, namely, overdevelopment of processing industries can be particularly viewed as one of the basic reasons which may give rise to an excess of aggregate demand over aggregate supply, and consequently to the inflation. Therefore, the austerity policy aimed at cooling down the overheated economy by curtailing fixed asset investment has been worked out. The government has decided to cut fixed asset investment by 92 billion yuan in 1989, 21% less than the previous year. Through economic, legislative and administrative means, the government should either manage well the budgetary investment inside the state planning or pay much emphasis on the strict control over extra-budgetary investment (including the some retraction from the rights of reducing and excepting taxes granted to the local government). The most powerful mean of implementing austerity policy is, to a great extent, to bring the management of bank credit loans under mandatory plan, namely, the scale and orientation of credit loans of the specialized banks (six all together in China) will be determined in a unified way by the central government, and forbidden any non-financial organizations engaging in any activities concerning the credit loans or investments, as well as to strictly control the issuance of currency.

The first goal of China's financial policy in short run is to make inflation rate in 1989 obviously lower than that of last year.

### 3. Industrial Policy

As we know, China's macroeconomic problems have mainly manifested by the unbalance of total supply and demand (aggregate demand outstrips the aggregate supply) and imbalance of industrial structure (coexistence of bottle-neck and idleness). The austerity policy aimed at keeping the balance of total supply and demands should be implemented according to different actual conditions of various industries, otherwise, the imbalance of structure will remain unchanged, and furthermore, total supply and demands will not be balanced, since the effectiveness of supply has not been enhanced. Therefore, the industrial policy explicitly put forth by the Chinese government in March, 1989, for the first time since 1949, is well reasoned. Its basic orientation and tasks are: to develop the basic industries, such as agriculture, energy, infrastructure and raw materials; to strengthen the development of industries which can increase their effective supply and can earn foreign exchange; to control the scale and speed of the development of processing industries and make them coincide with development of basic industries. The main concrete measures are as follows: to raise the purchasing price of contract quota of grain by 18% and increase the government input in agriculture; to promote the development of priority industries by using the discriminatory tax rate including investment tax (the highest point reaches 100%) and interest rate of the bank loans and to combine closely the austerity policy with industrial policy; and to get the collective enterprises (including township enterprises) and private economy (including foreign direct capital) under the influence of the industrial policy. In order to repay the foreign debt, the Chinese government has concrete countermeasures to increase export and reduce import and to prevent the latent debt crisis from coming true.

One of the most noteworthy things is the reform of fiscal system which is closely associated with the industrial policy. In the budget of government at provincial level, the accounts of recurrent fiscal expenditure and investment expenditure should be kept separately and consequently to bring the budgetary funds for investment of all provincial government into the budget of the central government so as to enable the latter to control effectivity this art of investment, namely, in light of the industrial policy, and to remedy the investment inflation brought about by localism and irrationality of investment structure.

### 4. Efforts to Make RMB Yuan Convertible

In order to absorb foreign direct investment, the Chinese government has stipulated a series of policies of preferential treatment for the joint ventured, solely-foreign-funded enterprises, such as exemption and reduction of taxes, priority supply of raw materials and profits remittance abroad. But the foreign investors are much concerned about the inconvertibility of RMB yuan. On the one hand, the return of investment in RMB yuan (another art is hard currency) is inevitably the impediment of further development of joint ventured and solely-foreign-funded enterprises. On the other

hand, these enterprises have to accept the overestimated exchange rate of RMB yuan and suffered from a great loss when RMB yuan is in need.

The inconvertibility of RMB yuan may contribute to following reasons. Apart from the insufficient foreign exchange reserve, the most important is that if the RMB yuan becomes convertible, it will undoubtedly bring about free inflow and outflow of commodities and China's pricing system will be brought into world pricing system. China has now built up an independent and comprehensive system of national economy, with a huge market and some natural resources. Therefore, China should not and also could not totally incorporate itself into world market. The overestimation on RMB yuan may mainly contribute to the price subsidy of consumption commodities and to the implementation of China's import substitution strategy.

China expects, on the one hand, to absorb more foreign investment, and on the other hand, to try to safeguard the relative independence of China's economy. Judging from these two aspects, China has adopted a compromised proposal, namely, the Chinese government has decided to set up the so-called "foreign exchange regulation markets" in several big cities like Shanghai and Tianjin in second half of 1988. The buying and selling of foreign exchange can be conducted freely among the enterprises (including some enterprises specialized in production of export goods. In order to give them more incentives, they have been allowed to retain a certain percentage of hard currency since the reform) and transaction value will not be less than US\$50,000. As of Nov. 1988, the transaction volume amounted to US\$ 5.6 billion, doubling the foreign direct investment in 1988. The exchange rate between USD and RMB yuan was around 50–70% higher than the official quotation. This is a decisive step for China to follow the path of opening to the outside world.

## 5. Deepening the Reform of Economic System

The main contents of today's economic restructuring are as follows: to continue to improve and develop the responsibility system in state industrial and commercial enterprises and to foster a well-ordered market.

There are four steps for the improvement of responsibility system: (a) to perfect the bidding procedure of large-and-medium-sized enterprises and make it systemized and normative and alleviate the administrative interference when people make their bids for managing the factories; (b) to pursue the contract secured by the mortgage with all members' risk, namely, not only the successful bidder (manager) of enterprise will make a contract secured by the mortgage composed of his or her wages including bonus and some personal possessions, but also the managerial staff at all levels and all the workers will do so in an attempt to promote the combination of the interest and risks of managers and staffs with the performance of enterprise, and to reach the goal of hardening the soft budget restraints; (c) apart from the hand-over of profit or tax and production quota set by the mandatory plan, to articulate the technical progress and the decrease in the raw material consumption and to the rising of productivity, to articulate the technical progress with total volume of wages (including bonus), which is one of the principal approaches of the government to curb the consumption demands; (d) to optimize the division of labor within enterprise. Under

the prerequisite of fair competition, the workers will be selected for the employment on the basis of their qualification. The losers will become wait-to-be employed, and they can only receive 70% of their basic wages and have no bonus (bonus usually makes up one-third or more worker's total income). The enterprises will use the saved wages and bonus on the employee in a bid to make best possible use of them and truly observe the principle of "to each according to his work" and eventually to raise economic efficiency.

As for the fosterage of capital market, annexation (including the auction of small-sized state enterprise) will be encouraged, mainly under the guidance of industrial policy and persistence in principle of voluntariness and principle of compensatory transfer of the assets. At the same time, the experiment of stock-holding system will be carried out steadily. The stocks can be purchased by the working staff within the enterprise, and the enterprises can also purchase the stocks issued by other enterprises. Here, the most significant thing is that the government has started to enact the relevant regulations and rules and to choose some enterprises to appraise their fixed assets and do preparatory work for issuing the stocks, and try to openly sell some of the assets of state enterprises in 1990. It is expected, on the one hand, to promote the healthy development of capital market, and on the other hand, to deepen the reform of enterprise which have more exclusiveness of ownership relation. This step, in the reform, will have long-term and far-reaching significance.

## **6. Crackdown on Corruption**

To remedy the rent-seeking behavior mainly resulted from dual pricing system, and especially the corruption—the result of rent-seeking behavior which arouse the resentment of ordinary Chinese people, the central government has launched strict demand that any government officials, departments in charge and enterprises must not profiteer by buying cheap and selling dear the means of production inside the mandatory plan and raise the price of consumption products as well as service fee, and make mandatory planning truly possess its nature, namely, everyone should abide by the plan so as to eradicate the chance of profiteering by raising the price of products inside the mandatory plan. The ceiling price of means of production outside the state plan and price of necessary consumption products set by the state will not be exceeded (the so-called floating price indirectly controlled by the government has ceased to exist except in name). The government expects to "kill two birds with one stone" by enforcing this measure and to crackdown those who try to make exorbitant profits by hoarding and cornering. Any violator will receive penalty according to discipline and law. Other possible means of eliminating corruption are as follows: The governments at all levels should build up crime-reporting centers with hot-lines, so as to mete out severe punishment to corrupt officials and regain the support of the people; the government at all levels should implement the system of publicizing the personal possessions so as to bring them under the surveillance by broad masses.

The measures adopted by the Chinese government are directed against the problems appeared in the process of reform. Generally speaking, they could help government achieve its goal. The fact the market of means of production has been shaped

has provided, to great extent, relatively objective conditions for the implementation of industrial policy. Therefore, it is the most comprehensible step at the present to put forward industrial policy and make it as a starting point to enact various economic policies under the circumstance of imbalance of industrial structure. It is, theoretically, quite imaginable that China's industrial policy would bear some good results. Here, I will point it out that to achieve the expected results of industrial policy entails many prerequisites. The typical ones are the response of micro enterprise, which is preconditioned by the deepening of the reform, to policies and measures and effective control of the central government over localism. Under the condition of vagueness of ownership relation and its derivative—soft budget restraints, it is very skeptical of results of any so-called economic adjustment means. Undoubtedly, the reform of micro base is really essential in socialist countries including China.

It is also very comprehensible and feasible that, in the following two or three years, China's reform will be confined to the improvement or perfection of responsibility system and to the experiment of other radical changes in the state sector. From the viewpoint of economic theory, to make ownership relation more exclusive as mentioned in the first section of this paper, in a broad sense, may bring about virtually incentives and furthermore the improvement of efficiency by influencing the target and behavior of economic participants. The present practice and advocacy of the government have shown that it had already realized this point, at the same time, it has also been aware of multi-choices to make the ownership relation more exclusive. To achieve this is just the goal of deepening the reform of the state sector in China under the prerequisite of ownership of means of production remaining unchanged substantially. The introduction of share-holding system in the state enterprises is also one of the options. In view of current situation, the ownership reform undergoing in China's state sector might follow the path of perfecting and consolidating the responsibility system in the foreseeable future.

As for the ownership structure, some scholars hold that the percentage of state, collective and private economy in GNP covering 40, 30 and 30% separately or 40, 40 and 20% (Li 1989b) is the ideal one in future, and they hope that the development of collective and private sector could compel the state enterprises to raise their efficiency or competitive capability. In a sense, that is the purpose of reform designers who will continuously encourage the practice of annexation between the enterprises and auction of a number of small-sized state enterprises.

The austerity policy is, so to speak, a strong medical preparation for preventing the inflation. In a short term, it could achieve a certain result, but I must say that it is only a makeshift countermeasure. As analyzed before, China's high inflation rate does not only result directly in the excessive issuance of currency, etc. The more essential reason is the result of soft budget restraints—coexistence of so-called hunger for investment and lack of effective supply under the current system. From this point of view, the medium-term result of austerity policy might be especially determined by the deepening of the reform and industrial policy because the administrative austerity policy is usually a "rigid uniformity", put the other way around, it may be detrimental to the development of sunrising enterprises. It is also because that many large-and-medium-sized enterprises which should be eliminated or reorganized have

great vitality. The austerity policy might sooner or later be abandoned while facing the alternatives of stagnation and inflation to some extent.

We have discussed before that one of the basic reasons resulted in corruption lies in dual pricing system. Under the prerequisite of incapability to annul, at least for a short term, the dual pricing system (because it is the component part of responsibility system), to rely on perfecting the legal system and strengthening the discipline is the most rational option. It could be predicted that if the law and discipline can be observed and effectively put into force, the corruption which has more social and political flavors and is also one of the main unstable elements in China at present could be eliminated to a large degree. The expected results of implementation of the so-called “value-guaranteed depositing” policy and the establishment of the foreign exchange regulation market are favorable, and these results are not unpreconditioned. For instance, the introduction of foreign directive investment would largely be seriously affected by the unfavorable social and political environment.

## 2.6 Some Concluding Remarks

China’s reform, just as discussed in section one, is aimed at achieving economic development and realization of industrialization drive by means of reforming economic system and adjusting economic policy. As for the aim of reform, China’s reform architects wish to find out a development pattern the most suitable to China’s actual conditions, namely, “the socialism with Chinese characteristics”, which should fully exploit the merits of both planning and market and avoid the various demerits. To this end, China has adopted the trial-error method known as “crossing the river by feeling the stones beneath your feet”. In this process, especially after studying the experiments of other reformed socialist countries, China’s economic system has been shaped and characterized by responsibility system, dual pricing system and coexistence of various of ownership forms. This economic system is the inevitable outcome of long-pursuit reform, and same are the four major problems resulted from lack of theoretical preparation, inconsistency between various reform measures and economic policies and underestimation of many latent crisis. Judging from this angle, the counter-measures adopted by Chinese government in process of reform can be viewed as a kind of readjustment mostly suitable to China’s pattern of development based on the actual conditions.

As a socialist and developing country, China’s reform has provided the way of combining central planning with market. The following experience and lessons, if they are, might be learned or drawn by other countries: the great achievement and problems are closely linked with the existing system, or in other words, China’s reform has marked that the economic system and policy—institution—has been a two-edged sword which might be either beneficial or detrimental to the economic development: being a developing country, the experiment on developing industry in rural area in a bid to realize the industrialization is still an option though there are many problems; any reform might be actually the process

of readjustment of social interests, in which the social conflicts and tension are unavoidable, therefore, we should do utmost to solve these problems, especially the problem of egalitarian income distribution should not be neglected while pursuing the economic development. As for a huge country like China, strong and effective central control—economic, administrative and legislative control—is the prerequisite for the economic development, because the market could only play a limited role in adjusting the industrial structure, etc., or in other words, to minimize the conflicts between the role of market and maintenance of effective central planning is one of the targets. Last but not least, all the reform measures should be consistent with the country's actual conditions, which is a platitude, but is of great importance.

China has now been following the road of development and prosperity since a decade-long reform and opening to the outside world. China has no rounds and possibility to come to a standstill, though the pace or development of the reform may probably be affected by certain elements, for example, the curtailing of inflation, which may impede the reform of economic system, and social as well as political instability.

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