

**The Process of China's Market Transition (1978-98):  
The Evolutionary, Historical, and Comparative Perspectives**

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**Abstract**

In the past two decades, China's transition from a planned to a market system followed a different path from those countries in Eastern Europe and the former Soviet Union. So far the Chinese path has been a remarkable success. This paper provides detailed accounts of this process, which evolved in two stages. In the first stage (1979-93), the centrally planned system was reformed incrementally to improve incentives and increase the scope of the market in resource allocation. In the second stage (since 1994), new institutions supporting a market system are being built, but before old institutions are destroyed. To gain a deeper understanding of this transition path, the paper traces the roots to the evolution of the Chinese central planning system from 1958 to 1978, which differed significantly from the textbook model of the Soviet system. The Chinese path of transition challenges the conventional wisdom of transition but apparently fits well Popper's notion of "piecemeal social engineering."

I benefitted greatly from many discussions with WU Jinglian on the evolution of the Chinese economic system.

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## **1. Alternative Paths of Transition from a Planned to a Market System**

The twentieth century has witnessed two big transformations of economic systems around the world. The first was the transition from a capitalist market system to a socialist centrally planned system. The experiment of socialist central planning has been a failure. The second is a transition in a reverse direction, from a centrally planned system to a market system. This transition, started a decade ago, is still in the making.

The title of this conference, "Big-Bang Transformation of Economic Systems as a Challenge to New Institutional Economics," seems to suggest that this second transition, like the first one, has followed the "big bang" path. This is too simplistic. There are several different paths of transition. In Eastern Europe and the former Soviet Union, democratization preceded economic liberalization, which was followed by privatization. But even there, the paths of transition are not identical, and the results are also different. For example, while the Czech Republic and Russia implemented voucher mass privatization, Hungary and Poland did not.

Perhaps the biggest difference in transition paths is found in China (and also in Vietnam), where economic reform and transition to markets occurred without democratization, liberalization proceeded incrementally, and privatization was delayed until recently. So far the Chinese transition has been a remarkable success, and in the last two decades, China's per capita income has nearly quadrupled. The case of China can hardly be dismissed because China is a very significant country in the group of transition economies. By 1998, China accounted for about three-quarters of the population and more than one half of the total GDP of all transition economies. China will become even more important in the future: by Maddison's (1998) calculation, its per capita GDP (in purchasing power parity) is likely to surpass that of the 15 former Soviet Union countries in about 10 years.

This paper tells the story of the process of China's two-decades long transition to markets.<sup>1</sup> The dynamics of China's transition have been shaped by the interactions of changes in economic conditions, political constraints, and the official ideology. The prevailing economic conditions shaped the official ideology, which then induced reforms and led to institutional changes, and meanwhile, the form and extent

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<sup>1</sup> For an analysis of the institutional foundations of China's market transition, see Qian (1999).

of the reform were molded by political constraints of the vested interests. The institutional changes in turn affected economic performance which subsequently changed economic conditions. The cycle goes on, and the reform moves forward. China's transformation of its economic system seems to fit well with Popper's notion of "piecemeal social engineering."<sup>2</sup>

I will tell this story in three parts. In section 2, I account for the reform in the first stage, that is, the fifteen years between 1979 and 1993. This stage is further divided into three periods of five years each: initialization of reform, high waves of reform, and retreat and revival of reform. In this stage, reforms often featured schemes known as "particularistic contracting," through which the incentives of economic agents were improved and at the same time existing interests could also be protected. Through experiments and innovations, a variety of transitional institutions emerged and many of them took unconventional forms. They were the second-best arrangements but quite effective in providing the incentives. As a result, China's reform in this stage was much deeper, more comprehensive, and more consistent than that in Eastern Europe prior to 1990, which helps explain why reform was a success in China but not in Eastern Europe.

In section 3, I consider the second stage since 1994. By the end of 1993, the landscape of China's economy changed drastically compared to 1978. People's living standards had significantly improved on a broad basis, the state sector was no longer the dominant part of the economy, and most old revolutionaries were gone from the political scene. All of these changes facilitated a strategic shift in the official ideology to completely abandon central planning and embrace a market system with private ownership. Since 1994, particularistic contracting is being replaced by universalistic rules and market-supporting institutions based on the rule of law and incorporating international best practices are being established. But this process is again different from some Eastern European countries in that the new institutions are built before the old ones are destroyed.

Having examined China's process of market transition, I go further to answer deeper questions of

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<sup>2</sup> Murrell (1992) explicitly relates the "conservative political philosophy" of Burke, Popper, and Oakeshott to the discussion of the strategy of economic transition from plan to market. He compares characteristics of two general approaches to social change - piecemeal versus Utopian social engineering; and illustrates them with the example of privatization: piecemeal privatization versus mass privatization.

why China has followed a different path of transition compared to Eastern Europe. Transition is better understood as a path dependent evolutionary process. Reform strategy matters, but it depends on history. In section 4, I trace the roots to the pre-reform economic system by examining the evolution of the Chinese centrally planned system from 1958 to 1978. Two major waves of administrative decentralization of 1958 and 1970 had major impacts on the institutional structure of the Chinese pre-reform system. Specifically, the Chinese planning system was very much decentralized along regional lines, and local governments played an important role in economic decision-making and resource allocation. Related, central planning was usually crude, aggregated, and not comprehensive, and moreover, it was not "tight," meaning that plan fulfillment often was not a binding constraint. These prominent features represented a significant departure from the textbook model of the Soviet system. The Chinese decentralization not only led to the rise of many small scale state-owned enterprises financed from local government revenues, but also induced collective enterprises (such as Commune and Brigade Enterprises in rural areas, predecessors of Township-Village Enterprises) to emerge outside the state plan before the advent of reform. The interregional exchanges and exchanges between state and collective enterprises were legitimately supervised by local governments and were part of the official economy. This opened room for informal outside-the-plan allocation mechanisms to appear within the state sector and even more so between the state and collective sectors. It planted seeds for markets to emerge later in an incremental and decentralized way.

## **2. The First Stage of China's Transition: 1979-1993**

Starting from a planned system characterized by enormous distortions, reform started in a way to introduce simple incentives, align prices to the underlying supply and demand, and open the economy up to the outside world. The first stage of transition can be conveniently divided into three phases, each of which ran for about five years.

### **2.1. Initialization of Reform (1979-83)**

The Third Plenum of the Eleventh Chinese Communist Party Congress held in December 1978 was

widely regarded as the beginning of the reform era. The main achievement of the meeting was the shift of the Party's focus from "class struggle" to "economic development." Preceding this meeting was an intensive ideological debate in mid-1978 between Mao's orthodox version of Marxism-Leninism and pragmatism. Hua Guofeng, Mao Zedong's chosen successor, insisted that "whatever decisions Chairman Mao has made, we all support, and whatever instructions Chairman Mao has given, we all follow." Deng Xiaoping countered this dogmatism with the slogan "practice is the sole judge of truth," echoing his thoughts as early as in 1962: "It doesn't matter whether a cat is white or black so long as it catches mice." In the end, pragmatism prevailed, and the event was known in China as the first wave of "emancipation of the mind."

This allowed a shift of ideology from within the Communist Party, and it paved the way for initialization of reform. The accepted ideology during the first phase of reform was the idea of "planning as a principal part and market as a supplementary part."<sup>3</sup> This was a big change from Mao's ideology of abolishing markets. But it was by no means an accident; it reflected the deep feelings of politicians and the people over the terrible failure of the economy after the ten year Cultural Revolution, and the striking contrast between China's economic disaster and the outstanding economic performance of the four "Asian tigers" nearby. As Deng remarked later: "We have a consensus on the policy of reform and opening up. This should be attributed to the 10 year Cultural Revolution, the lessons from this disaster are too profound" (May 25, 1988). "Without the lessons from the Cultural Revolution, there would be no new policies (since 1979).... The Cultural Revolution has become our wealth" (September 5, 1988).

In 1979 the government increased the grain procurement price by 20% and also decreased agricultural input prices. This shift of development strategy by focusing on agriculture and consumer goods themselves was not a system reform, but it created a more relaxed economic environment in which the government's control was relaxed and individual freedom could be better accommodated. Between

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<sup>3</sup> This idea can be largely attributed to Chen Yun, who said: "There must be two types of economy, throughout the socialist period: (1) The planned economy (the type that needs to be developed in a planned and proportionate way), and (2) the market-regulated economy (the type that is not subject to planning but is conducted in accordance with the changing market supply and demand, i.e., regulated in an unplanned way). The first type is fundamental and predominant; the second, though supplementary and secondary in nature, is indispensable" (March 8, 1979).

1979 and 1983, five major reforms were pursued: agricultural reform, opening up the economy, fiscal decentralization, state-owned enterprise reform, and support for commune-brigade enterprises.

- **Agricultural Reform.** Agriculture was collectivized in 1955-56, and the People's Communes were established in 1958. Under the commune system and since 1962, the production team, which consisted of about 50 households, was the basic unit for production and distribution, and the commune had the authority for allocating quotas for, say, the acreage for growing rice or cotton. This system survived for 20 years.

The major change was the introduction of "household responsibility system," which emerged spontaneously in poor areas by the peasants themselves. The first recorded practice of this kind took place in December 1978 in the Xiaogang Production Brigade of Fengyang County in Anhui Province, where 20 peasants representing 20 households put their fingerprints on a "contract" to divide the commune's land among the households. By doing so they also promised to fulfill the procurement quota of grain to the state. Under the household responsibility system households became residual claimants and obtained almost all control rights over production, except for the right to dispose of land. This practice soon spread to other parts of the Province, and received strong support from the provincial governor, Wan Li, at a time when no official endorsement was given by the central government. In fact, the 1978 Party meeting, which initiated reform, actually explicitly prohibited such a practice. It was not until late 1980 that the Communist Party for the first time officially allowed the household responsibility system to exist but only in poor areas (Party document #75 of 1980). The Party started to actively promote the household responsibility system only in early 1982. By the end of 1982, 80% of households adopted the household responsibility system nationwide, and by 1984, almost all of them had done so. By that time, the contracts of the household responsibility system were all extended to a period of 15 years.

Agricultural reform is recognized as the first successful reform in China. Wan Li, who later became vice premier in charge of agriculture, recognized: "Why did reform make its first breakthrough in the rural area? This is by no means an accident and has historical reasons. This is because peasants suffered the most under the old rigid system and thus had the strongest desire for reform. At the same time,

rural areas were the weak sector in the old system, and became the breakthrough point of reform." We may interpret "weak" here as weak vested interests by bureaucrats in opposing reforms. Indeed, bureaucratic interests in the agricultural sector at central and provincial governments were weak compared to the industrial sector, and the vested interests of local officials at the commune and the brigade levels were not well organized. Once some areas (often poor areas) made a breakthrough, other areas followed suit.

• **Opening Up the Economy.** Since 1949 the Chinese economy had been closed to the Western countries. When the conflict with the Soviet block broke in the early 1960s, the Chinese economy was also closed to the Eastern block, and by 1978, it was one of the most closed economy in the world. In 1979 the government decided to expand foreign trade and welcome foreign investment. Two provinces, Guangdong and Fujian, were in the forefront of the opening up process because of their geographic location. In July 1979, the central government decided that the two provinces should pursue reform "one step ahead" of other regions in the country, allowing them to adopt "special policies" (*teshu zhengce*) and to implement "flexible measures" (*linghuo cuoshi*). For example, the two provinces were allowed to retain all foreign exchange income after remitting 30 percent from the increased amount of exports (Zhou, 1984).

In 1980 China established four special economic zones: Shenzhen, Zhuhai, and Shantou adjacent to Hong Kong in Guangdong Province, and Xiamen in Fujian Province across the Taiwan Straits. Not only did these areas enjoy lower tax rates, but more importantly, they enjoyed a special institutional and policy environment and gained more authority over their economic development. For example, they were granted the authority to approve foreign investment projects up to \$30 million, while the authority of other regions remained much lower. While the rest of China was still dominated by central planning and public ownership, special economic zones were allowed to become market economies dominated by private ownership. Special economic zones were initially controversial and there was ideological opposition against them. But there were not many vested interests against them because these zones were set up outside the scope of central planning and did not disrupt planned production and allocation.

• **Fiscal Decentralization.** Although some fiscal decentralization was implemented even before the reform, the fiscal system as a whole was quite centralized in the sense that the Planning Commission at the

central government had the authority in determining local revenue and expenditure plans on an annual basis. This system was known as the principle of "unified revenue and unified expenditure" (*tongshou tongzhi*), meaning that all government revenue and expenditures had to go through the central government. In 1980, a major fiscal reform concerning the central and provincial relationship began, known as the "fiscal contracting system" under the nickname of "eating from separate kitchens" (*fenzao chifan*). Under the fiscal contracting system, budgetary revenue income was first divided between "central fixed revenue," all of which was remitted to the center, and "local revenue," which was shared. The contractual sharing rates varied from province to province. For example, Guangdong would pay a fixed amount, 1 billion yuan, to the central government and keep the rest, and Fujian would receive a fixed amount of subsidies from the central government. That is to say, the revenue sharing schemes made these two provinces "residual claimants" because they retained 100 percent at the margin. This particular type of contract became the dominant form after 1988. These schemes looked similar to the experiments in 1970, but there were at least two major differences: First, the contracts were now fixed for five years instead of negotiated annually; and second, provincial governments had the authority to determine the structure of their expenditures and their fiscal arrangements with sub-provincial governments. Similar schemes were copied by every two adjacent levels of government below the provincial level. In this sense, fiscal decentralization in China is deep.

The new fiscal system was designed to increase the incentives from the local governments for revenue collection and local economic development. Both the central government and local governments initially supported the new fiscal system because both got what they wanted. The fiscal contracting system greatly strengthened the link between local revenue and expenditures, and it gave local governments at all levels the authority and incentives to develop their local economies because the revenue they were able to retain was linked closely to local economic prosperity. Fiscal decentralization has created multiple power centers, and it has had a lasting economic and political effect on other reforms.

• **State-Owned Enterprise Reform.** The experiment of state-owned enterprise (SOE) reform started even earlier than agricultural reform. In October 1978, under Provincial Party Secretary Zhao

Ziyang, Sichuan Province selected 6 enterprises to undertake an experiment with the theme of expanding enterprise autonomy and introducing profit retention. In the following year about 100 industrial enterprises in Sichuan joined the experiment. The enterprises had an expanded autonomy including the right to produce and sell products to the market after fulfilling the plan quotas, and authority to promote middle-level managers without approval from the government. The enterprises also had profit retention schemes which allowed them to retain some profits after fulfilling the planned quotas.

In July 1979, the central government issued five documents to promote Sichuan's experience nationwide, but still on an experimental basis. By 1980, about 60% of SOEs (in terms of output value) joined the experiments and obtained some limited autonomy. The enterprises were required to put retained profits into three separate funds: welfare (e.g., housing), bonuses, and production development. Enterprises had control over the use of the funds within each category. In April 1981, the first document implementing the "Economic Responsibility System" in industrial SOEs was issued. In early 1983, encouraged by the outstanding performance of the agricultural household contracting system, the responsibility system got a boost under the slogan "introducing the responsibility system (from the countryside) into the city." But it was short-lived because there was no reform package to deal with the complexity of industrial planning (Zhou, 1984).

• **Support for Commune and Brigade Enterprises.** Although commune and brigade enterprises in rural areas emerged long before 1979, they did not begin to obtain the freedom to seek profits in industries other than those related to agriculture until after the reform. In July 1979, the State Council issued the "Regulation on Some Questions Concerning the Development of Enterprises Run by People's Communes and Production Brigades," which allowed provinces to grant tax holidays of 2-3 years to new commune and brigade enterprises. They were no longer restricted to the industries that served agriculture, such as producing chemical fertilizer and farm tools, and they were allowed to enter into most industries unrelated to agriculture where previously only state enterprises had accessed. They also no longer used only local resources and could sell beyond local markets. The industrial structure of rural enterprises became more diversified. Because light and consumer goods industries were characterized by huge profit

margins and short supply, commune and brigade enterprises chose to enter these industries. The share of light industry has risen from 44% in 1979 to 52% in 1984. Among the fastest growing industries were food processing, textiles, garments, building materials, and coal mining (Wong, 1988).

## **2.2. The High Wave of Reform (1984-88)**

By 1984 the success of agricultural reform became apparent and extraordinary. Between 1978 and 1984 per capita grain production increased from about 319 kilograms to 400 kilograms, and production of other agricultural products increased even more because they were more profitable than grain. Correspondingly, per capita rural real income increased by more than 50% in the 6-year period. This is in sharp contrast with the stagnation of agriculture over the previous two decades. In comparison, the SOE reform was disappointing. The industrial sector was much too complicated, involving prices, taxes, finances, and enterprise employment, all of which were under central planning. Any significant reform would need a package to deal with all these aspects.

Encouraged by the extraordinary success of agricultural reform, in October 1994, the Third Plenum of the Twelfth Party Congress adopted a decision on reform of the economic system aimed at the urban area. This document made a significant ideology shift, from "plan as a principal part and market as supplementary part" to "planned commodity economy," which put plan and market on equal footing, if not put more weight on market. Zhao Ziyang, backed by Deng, became the main figure in the Party to engineer the reform, and he made "dual-track market liberalization" and "contract responsibility system" in SOEs as his two primary reform programs in this period.

• **The Dual-Track Approach to Market Liberalization.** In May 1984, the government officially permitted the market track alongside with the planned track for industrial goods, but with a restriction of price ranges of the market track to be within 20% of the planned price. In February 1985, such a restriction was removed and the "dual-track" was formally in place. Under this system, the planned prices were maintained as before, together with the planned quotas for delivery. However, the above quota quantities produced by SOEs were allowed to be sold on the market and the prices were freely determined

by market supply and demand. In this way, any good legally carried two prices -- a planned price as before, and a true market price which was not regulated by the government. Because the planned quota is frozen, the market part was able to grow out of the plan (Naughton, 1995).

• **State-Owned Enterprise Reform through Contract Responsibility System.** The effort toward SOE reform by the government in this period continued along the lines of expanding enterprise autonomy and increasing profit incentives. In May 1984, the State Council issued a document entitled "On Regulations of Further Expanding Autonomy of State-Owned Enterprises" to expand SOE autonomy in ten areas (known as "Ten Articles for Expanding Rights," *kuoquan shitiao*), which was the basis of the "Enterprise Law" passed later in 1988. But the autonomy was rather limited and profit retention was negotiated on an annual basis. To address the financial incentive problem, starting in January 1987 the government promoted the "contract responsibility system" (*chengbao zhi*). Under this system, contracts lasted for at least 3 years to avoid annual bargaining. Compared with the previous rounds of enterprise reform, the contract responsibility system delegated more control rights to managers. But its main focus were the increased retained profits to enterprises and an adoption of various ways for dividing cash flow between the enterprises and the government. The contract responsibility system had a political advantage because it had something for all parties-enterprises, local governments, and the central government. By the end of 1987, about 80% of large and medium-sized SOEs adopted the contract responsibility system, and by 1989, almost all SOEs adopted it which continued through 1993.

• **Financial Reform.** Before the reform there was only one bank, the People's Bank of China (PBOC), which served both as the central bank and the commercial bank. In 1983, the State Council granted the PBOC the authority of a central bank and subsequently transferred commercial operations to four specialized banks: the Agricultural Bank of China (ABC) for the rural sector; the Industrial and Commercial Bank of China (ICBC) for the industrial sector, the People's Construction Bank of China (PCBC) for long-term investment, and the Bank of China (BOC) for foreign exchange business. Since 1984, the four specialized banks have been allowed to compete for deposits and loans in each other's previously monopolized markets, and enterprises are allowed to open accounts with more than one bank.

For example, the ABC is able to set up branches in cities and the ICBC is allowed to undertake foreign exchange business. However, all four banks have remained highly specialized in their operations.

Between 1984 and 1988, local governments at provincial, municipal, and county levels gained great influence over credit decisions through the regional branches of the central bank and state specialized banks. As reform proceeded, the local government carried more weight. It directly involved in credit plan formulation, imposed loans on specialized banks, and had the authority to decide whether an enterprise should pay back a loan.

• **Further Opening Up.** The success of Guangdong and Fujian Provinces and the four special economic zones led the central government in 1984 to declare additional fourteen coastal cities as "coastal open cities," which gave them new authority similar to that of the special economic zones. Two coastal open cities, Shanghai and Tianjin, obtained authority to approve foreign investment up to \$30 million; Dalian up to \$10 million; and the remaining 11 cities up to \$5 million. Each of these open cities also has the authority to set up "development zones" inside their regions to implement more liberal policies for attracting foreign capital and technology. In 1988, Hainan was added as the largest special economic zone when it became a separate province.

• **Entry and Expansion of Non-State-Owned Enterprises.** Despite the great effort in improving SOE performance, most economists agree that the most significant achievement in this period was made by the fast entry and expansion of urban and rural non-state enterprises. In China, they are referred to as both private and "collective" (i.e., local government) firms outside the state plan. These firms were under harder budget constraints and had better internal incentive structures. They also indirectly benefitted from the various reforms aimed at the state sector, such as fiscal decentralization, financial reform, the dual-price system, and expanding the SOE autonomy. For example, fiscal decentralization provides incentives for local governments to develop non-state enterprises because taxes so generated were not subject to sharing. The dual-track price reform also made all the previous black markets legal, which helped greatly non-state enterprises to grow.

Although private enterprises employing fewer than 8 people had been allowed to exist since 1980,

it was not until 1984 that private enterprises employing more than 8 people became legal. In 1985, the first wave of "jumping into business" (*xia hai*) began. Joint ventures between domestic and foreign investors mushroomed, especially in the development zones, to take advantages of the more liberal policy.

The most significant consequence was observed in the rural areas. In the "Central Committee Circular on Agricultural Work" of January 1, 1984, the government "encourages peasants to invest in or buy shares of all types of enterprises and encourages collectives and peasants to pool their funds and jointly set up various kinds of enterprises by following the principle of voluntary participation and mutual benefits." In March 1984, the former commune and brigade enterprises were renamed as "township and village enterprises" (TVEs), and the whole rural enterprise sector included group household and individual enterprises (i.e., private enterprises). Rural enterprises finally obtained legitimacy. True liberalization was applied to rural enterprises, and previous administrative restrictions against rural enterprise entry and expansion were removed from almost all industries. After the abolishment of the commune system, township and village governments enthusiastically supported rural industrialization because they relied heavily on the development of rural industry as the way to generate their revenue. Between 1983 and 1988 total rural enterprise output increased by more than fivefold, in comparison, between 1978 and 1983, it merely doubled. By the end of 1980s, rural enterprises had already become the pillars of national industry. No wonder Deng said in 1987: "The greatest achievement that was totally unexpected is that rural enterprises [both TVEs and private enterprises] have developed" (June 12, 1987).

### **2.3. The Retreat and Revival of Reform (1989-93)**

The economic woes of inflation and corruption in 1988 and the political backlash following the Tiananmen Square incident in 1989 put economic reform on hold. An austerity program was implemented in 1989 and 1990 to cool down the over-heated economy. During that period, the conservatives gained political, ideological, and military power for a possible reversal of reform. In 1990, they discussed the possibility of "recollectivization" of agriculture and also tried to recentralize investment and financial powers from the provinces.

However, all of these efforts failed. The Governor of Guangdong Province and the Mayor of Shanghai City refused to turn in more revenue to the central government and many other governors followed their lead. On the other hand, the central government's political deadlock did not halt all reform progress. Because of the previous decentralizations, some reforms actually accelerated, but in a decentralized way. In fact, reforms in many southern regions went ahead despite action (or inaction) from the central government.

Unhappy with the economic slowdown (the GDP growth rates of 1989 and 1990 were, respectively, 4.4% and 3.9%) and the standstill within the central government, Deng Xiaoping made his famous southern tour in January and February of 1992. Among his stops were several special economic zones. Using regional support for further reforms, Deng's visit tipped the political balance of the central government. Nationwide reform reached a new high level in 1992. On May 21 all the price caps imposed on stock at the Shanghai Stock Exchanges were removed, and in three days the stock price index soared by 570%.

• **Phasing Out the Planned Prices.** Because of the tight monetary policy, market price levels in 1990 declined, and the difference between the planned and market price was also reduced. Price liberalization moved very fast after the Tiananmen Square incident, partly because the difference between planned and market prices became insignificant. Guangdong Province took a lead in price liberalization (such as grain), and other provinces followed suit. By 1993, dual-prices had almost ended for most industrial products. In retail, the plan track accounted for only 5% while in agricultural procurement it accounted for about 10%.

• **Further Opening Up.** In 1992, most cities along the Yangtze River and the borders of the country were also granted special privileges as coastal cities, and in addition, Shanghai was granted even more autonomy. As a result, numerous "development zones" were established to attract foreign and domestic investment which also gave rise to a real estate boom. For example, many inland cities which did not qualify as either special economic zones or coastal open cities established numerous development zones inside their regions to enjoy some of the tax benefits and autonomy, and in many cases, without approval

from the central government. Foreign direct investment (FDI) increased from 4.4 billion US\$ in 1991, to 11 billion US\$ in 1992, and further to 28 billion US\$ in 1993 when China became the second largest country to attract FDI, next to the U.S.

- **State-Owned Enterprise Reforms.** The contract responsibility system in SOEs was not interrupted by the Tiananmen Square incident. In fact the system was enhanced by the "Regulations on Transforming the Management Mechanism of State-Owned Industrial Enterprises" issued in July 1992 to grant enterprise managers the "14 rights" of control, covering foreign trade, investment, labor, wages, etc.

- **Rural Enterprises as an Engine of Economic Recovery.** Some rural enterprises suffered greatly during the 1989-90 austerity program when they experienced substantial credits cuts. About three million rural enterprises went bankrupt or were taken over by other enterprises in 1989 (People's Daily, March 23, 1990). The total employment in township and village enterprises fell from 48.9 million in 1988 to 47.2 million in 1989 and to 45.9 in 1990, reversing the trend of expansion of more than 10 years. However, because rural enterprises were market oriented and were under hard budget constraints, they adjusted themselves quickly. Rural enterprise employment increased by 10% and 17% in 1992 and 1993 respectively, and the industrial output increased even more, leading the economic recovery.

### **3. The Second Stage of China's Transition: Since 1994**

The first fifteen years of reform succeeded in substantially improving people's living standards, and as a result, reform received solid and popular support. However, by the end of 1993, the economic system as a whole was still a half-way house between a plan and a market economy. In the next stage, China would need to achieve at least three objectives: first, to set the goal of transition to a market system, second, to establish market-supporting institutions incorporating international best practices, and third, to privatize and restructure state-owned enterprises.

#### **3.1. The Achievements and Problems of the First Fifteen Years**

The most profound structural change came from the entry and expansion of the non-state sector,

despite the fact that major reform efforts had been concentrated in the state sector. It was the dynamism of the non-state sector that drove reform to the next stage. In 1984, state industry was still central to the Chinese economy. By the end of 1993, due to the growth of the non-state sector and even without closing down any SOEs, the state sector was no longer the major part of the economy. In industry, the state's share of output accounted for 43% of the national total in 1993, down from 78% in 1978, and the share of SOE employment of total non-farm employment was also down to about 30% from 60%.

In the first fifteen years, reforms mainly tried to loosen government control and bureaucratic restrictions and improve incentives. Prominent economist, Liu Guoguang, remarked that in this stage of reform, "we mainly delegated powers, shared benefits, and used material incentives to arouse the enthusiasm of enterprises, localities, and workers" (Shirk, 1993; p. 136). To achieve that, reform policies generally took the form of "particularistic contracting" between the government and subordinate units, such as agricultural contracting between the government and farm households, fiscal contracting between the central and local governments, and industrial profit contracting between the government and state enterprises. The magic words were *bao* (or contracting) and *baogan* (or lump-sum transfer contracting). Both, especially *baogan*, entailed strong incentive effects because they provided high rewards at the *margin*.

Contracting won out over reform policies taking the form of uniform rules (such as tax reform and ownership reform), because it stimulated incentives in the short run and at the same time it also made nobody worse off than before and thus had compelling political logic. It also stimulated improvement of incentives without systemically changing institutions. Correspondingly, the first stage of reform also had two big failures. First, it failed to establish a rule-based market system incorporating international best practice institutions, and second, it also failed to address the ownership and property rights issues. But before that, China needs first to make the market system as the final goal of its reform.

### **3.2. The Strategic Move: Setting the Goal for a Market System**

Establishing the goal for a market system was an evolutionary process in China. I will highlight

four consecutive milestone events in September 1992, November 1993, September 1997, and March 1999, respectively, to show how this strategic move has evolved progressively over time.

• **The Fourteenth Party Congress of September 1992.** During his southern trip in the spring of 1992, Deng made the point that "both plans and markets are economic means." He also criticized the debate on whether a reform was socialistic or capitalistic, saying: "Do not debate on this issue any more." "Carry out a reform so long as it is beneficial to the increase of social productivity, the country's overall strength, and the peoples' living standards." Following his remarks, the big ideological breakthrough occurred at the Fourteenth Party Congress in September 1992 when the Party, for the first time, endorsed the "socialist market economy" as China's reform goal. This was known as the second wave of "emancipation of the mind."<sup>4</sup>

• **The Decision of November 1993.** In 1993, the Communist Party's Economics and Finance Leading Group, headed by Party Secretary General Jiang Zemin, worked together with economists to prepare a grand strategy for transition to a market system. Several research teams were formed to study various aspects of transition, ranging from taxation, the fiscal system, the financial system, and enterprises, to foreign trade. The final output was the "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure" adopted by the Third Plenum of the Fourteenth Party Congress in November 1993.<sup>5</sup> With the objective of a market system in mind, this landmark document made four major advances in the areas of reform strategy, a rule-based system, building market-supporting institutions, and property rights and ownership respectively. It was the turning point on China's road to markets.

First, unlike the previous strategy of "groping for stones to cross the river," the "Decision" emphasized the importance of coordination among various aspects of reforms. It advocated a coherent package and an appropriate sequencing of reforms, known as "combining package reform with

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<sup>4</sup> It is important to distinguish the Chinese socialist market economy from "market socialism" as was advocated by some Eastern European reformers in the 1970s and 1980s. In market socialism, the market is a simulated one to serve the purpose of socialism based on public ownership (Kornai, 1992). In contrast, in a socialist market economy, "market economy" is the goal and "socialist" in an adjective. Therefore, a socialist market economy differs from market socialism in a fundamental way and is closer to the "social market economy" of Germany.

<sup>5</sup> For the full text of the "Decision," see *China Daily, Supplement*, November 17, 1993.

breakthrough in key areas."

Second, the "Decision" called for a rule-based market system to create a level playing field replacing particularistic contracting. This included the decision to unify the foreign exchange rate and tax rates among all enterprises regardless of ownership. Shortly before the "Decision," China already had adopted Western accounting rules in its enterprises.

Third, the "Decision" focused on the building of market-supporting institutions to incorporate best international practices, such as formal fiscal federalism, a centralized monetary system, and a social safety net. For example, the separation of central and local taxes and their administration was a critical step in moving toward formal fiscal federalism. Revenue transfers between the central and provincial governments were to be based on a fixed formula rather than bargaining. Another example was centralization of the operation of the central bank to minimize the local government's influence on monetary policies.

Finally, the "Decision" addressed the enterprise reform issue in terms of property rights and ownership, rather than, as before, one of "expanding enterprise autonomy." It intended to transform SOEs into "modern enterprises" with "clarified property rights, clearly defined responsibility and authority, separation of enterprises from the government, and scientific internal management." It also, for the first time, left the door open regarding the privatization of SOEs: "As for the small state-owned enterprises, the management of some can be contracted out or leased; others can be shifted to the partnership system in the form of stock sharing, or sold to collectives and individuals." But the major breakthrough on ownership issues had to wait awhile longer.

• **The Fifteenth Party Congress of September 1997.** In the "Decision" of November 1993, state ownership was still regarded as a "principal component of the economy" while private ownership was a "supplementary component of the economy." The Fifteenth Party Congress held in September 1997 made a major breakthrough on ownership issues: State ownership was downgraded to a "pillar of the economy" and private ownership was elevated to an "important component of the economy." In Chinese politics, these subtle changes of rhetoric mean a big change in ideology. Although the rhetoric of public ownership was maintained, its meaning was redefined, because public ownership can have many "different realization

forms," such as joint stock corporations with investment by many owners. At this time, the official ideology toward private ownership finally became "friendly." This is known as the third of "emancipation of the mind."

- **The Constitutional Amendments of March 1999.** Private ownership and the rule of law were incorporated into the Chinese Constitution in March 1999. An amendment of Article 11 of the Constitution places private businesses on an equal footing with the public sector by changing the original clause "the private economy is a supplement to public ownership" to "the non-public sector, including individual and private businesses, is an important component of the socialist market economy" (*China Daily*, March 16, 1999). Immediately after the amendment, local governments started to relax local restrictions on private enterprises. For instance, the Jiangsu Provincial Government adopted a new policy to give private enterprises equal treatment as state-owned and collective enterprises in the areas of granting business scopes and credit access (*People's Daily*, April 9, 1999). Furthermore, Article 5 of the Constitution was amended to include the principle of "governing the country according to law" (*China Daily*, March 16, 1999). These Constitutional amendments demonstrated China's commitment to a full market system based on the rule of law.

### **3.3. Major Accomplishments in the First Five Years (1994-98)**

Following the "Decision" of November 1993, a series of radical reforms were launched starting in January 1994. So far, China's progress has been steady, and it has been able to avoid the bad mistakes made by some other transition economies.

- **Foreign Exchange Reform.** Before 1994, liberalization of foreign exchange markets followed a dual-track approach and there existed an official rate and a "swap rate" (i.e., the market rate). Because of the dramatic growth of the market track, by 1993 the share of the plan allocated foreign exchange had fallen to less than 20 percent of the total. On January 1, 1994, plan allocation of foreign exchange was completely abolished, and the two tracks were merged into a single market track. However, for those organizations which were used to receiving cheap foreign exchange, annual lump-sum subsidies in the

domestic currency sufficient for purchase of the previous allocation of foreign exchange, were offered for a period of three years to compensate for their losses. In December of 1996, China went one step further to announce current account convertibility of its currency. However, it did not move to capital account convertibility but still maintained capital control. This is one important reason that China weathered the Asian financial crisis rather well. Between 1994 and 1998, the exchange rate remained stable and even appreciated slightly from 8.7 yuan per US\$ to 8.3 yuan per US\$. Both exports and foreign direct investment increased dramatically, and the country's foreign reserves increased from 21 billion US\$ to 145 billion US\$. Despite the Asian financial crisis, China continued to attract foreign direct investment of about 45 billion US\$ annually in 1997 and 1998.

• **Tax and Fiscal System Reform.** On January 1, 1994, China introduced major tax and fiscal reforms more aligned with international practices. This reform introduced a clear distinction between national and local taxes and established a national tax bureau and local tax bureaus, each responsible for its own tax collections. This tax reform has made it very difficult for local governments to reduce national taxes as they did in the past. Reform also established fixed tax rules between the national and local governments. For example, under the new system, the value added tax (VAT) became the major indirect tax shared by the national and local governments at a fixed ratio of 75:25. But local governments were compensated for their revenue losses for three years.

In 1995, the new "Budget Law" took effect. It prohibited the central government from borrowing from the central bank and from deficit financing its current account, but the central government could have deficit financing in its capital account although it had to finance the deficit with government bonds. It also imposed more stringent restrictions on local governments: Local governments at all levels were required to have their budgets balanced (as before), and furthermore, the law strictly controlled their bond issuance and restricted their borrowing in the financial market (a change from the past). To ensure enforcement of the "Budget Law," an independent auditing system was also introduced. Tax reform, together with the implementation of the "Budget Law," made local governments' budget constraints much harder.

• **Monetary Reform.** Before 1993, 70 percent of the central bank's loans to state banks were made

by the central bank's local branches, which were heavily influenced by the local governments. In 1993, the central bank centralized its operation after Vice Premier Zhu Rongji became its governor. Since then, its local branches have been supervised only by the headquarters of the central bank, not as before also by the local government of the region in which they reside. In 1995 China passed the "Central Bank Law" to give the central bank the mandate for monetary policy independent of the local government. These reforms substantially reduced the local government's influence on monetary policy and credit allocation decisions. This is one of the main reasons that the overall budget constraints of local governments became much harder in the 1990s than in the 1980s, in fiscal channels because of the tax reform and in financial channels because of the monetary reform. In 1998, the central bank further replaced its 30 provincial branches with 9 cross-province regional branches as in the U.S. Federal Reserve system.<sup>6</sup> This reform further minimized the local governments' influence on monetary policies.

• **Financial System Reform.** The Asian financial crisis demonstrated the importance of prudential regulation. China has followed a U.S. model of banking regulations along the lines of the Glass-Steagall Act; not only is commercial banking separated from investment banking, but also commercial banks cannot hold shares of stock in companies. Three different government agencies now separately regulate commercial banks, security firms, and insurance companies. Before 1998, the state always bailed out troubled financial institutions, but for the first time in 1998, several high profile banks and investment companies, such as Hainan Development Bank and Guangdong International Trust Investment Company, closed down or went bankrupt. This signalled an important change on the part of the government: it was determined to discipline state financial institutions. Although the government might have incurred some short-run costs for doing that, it gained credibility which is important in the long run.

• **Government Reform.** Despite many early reforms, the basic government bureaucratic structure in China was still kept intact from the planning era, for instance, many industrial ministries remained for supervising SOEs. In early 1998 a major reform for streamlining the government bureaucracy took place.

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<sup>6</sup> The nine regional branches are located in Shenyang, Tianjin, Jinan, Nanjing, Shanghai, Guangzhou, Wuhan, Chengdu, and Xi'an.

Most industrial ministries, such as the textile and machinery industries, were abolished and replaced by much smaller corresponding bureaus, which were then absorbed into the State Economic and Trade Commission. Some new ministries were created, such as the Ministry of Social Security. The number of ministries in the central government was trimmed from 45 to 29 (a similar action will be taken at the local level in 1999), and the number of civil servants was cut by half, from 8 million to 4 million. To compensate for the losses, displaced civil servants were sold apartments at discount prices according to their seniority and were given an option to study for undergraduate and graduate degrees with tuition and stipends paid by the government for three years.

Chinese enterprises have had close ties with the government. Sometimes such a tie is an advantage, as in the case of TVEs, but in some other cases, the disadvantage clearly outweighs the benefits. This is particularly true with business enterprises owned and managed by the military, police, and judiciary branches of the government. In the second half of 1998, the government severed all the ties between these government agencies and their business enterprises. The military, police, and judiciary branches of the government now solely rely on tax revenues to maintain their operations, not on business incomes. The earlier reforms of downsizing the government bureaucracy set good precedents for severing the ties of the military with business enterprises.

• **Privatization and Restructuring State-Owned Enterprises.** Privatization of SOEs and layoffs of state workers began to occur on a large scale in 1995.<sup>7</sup> Privatization of SOEs started initially by local governments as experiments in a few provinces, such as Shandong, Guangdong, and Sichuan. Later, the central government promoted it with the slogan of "grasping the large and letting go the small" (*zhuada fangxiao*)." One interpretation of "grasping the large" is to keep about 1,000 large enterprises as state owned. Privatization of small SOEs was very significant for China, because, in contrast to Eastern Europe and the Soviet Union, China's industrial SOEs were dominated by small- and medium-sized enterprises. In 1993, they accounted for 95 percent in number, 57 percent in employment, and 43 percent in output of the

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<sup>7</sup> The Chinese do not use the term "privatization," relying on several other terms, such as "transformation of ownership" (*zhuanzhi*) or "restructuring of ownership" (*suoyouzhi gaizao*). Similarly, the Chinese use "non-public ownership" as a substitute for "private ownership."

state industrial sector. Most of these enterprises were under the supervision of county and city governments. By the end of 1996, up to 70 percent of small SOEs had been privatized in pioneering provinces and about half were privatized in many other provinces. In addition, about ten million workers from SOEs and urban collectives were laid off by the end of 1996, and an additional 11.5 million workers were laid off in 1997. This layoff itself was a big achievement for reform: never before had state employees been laid off and state enterprises closed down.

#### **4. Tracing the Roots: The Evolution of the Chinese Planning System from 1958 to 1978**

To answer deeper questions of why China and Eastern Europe have followed different paths of transition, I will trace the historical roots in the evolution of the planned system in China in the two decades before the market oriented reform.<sup>8</sup> Like all other socialist countries, China's political and economic systems were characterized by the undivided power of the Marxist-Leninist Party, the dominant position of state ownership, and a preponderance of bureaucratic coordination through central planning (Kornai, 1992). But the Chinese planning system evolved into a quite different form of central planning from the standard Soviet model, which has important implications for its later transition to a market system.

##### **4.1. The Official Critiques of Over-Centralization: 1957**

In 1953 China began to implement the first five-year plan (1953-57), which was formulated with the help of the Soviet experts. The plan centered around 694 large projects in which 156 key projects were designed by the Soviets. By the end of 1956, the basic framework of the Chinese central planning system was established. China attempted to copy the Soviet model of central planning, which featured concentration of authority in the central government. The number of enterprises subordinated to the central government increased from 2,800 in 1953 to 9,300 in 1957, and their output accounted for 50% in state industry. The number of material items allocated by the Planning Commission of the central government increased from 55 in 1952 to 231 in 1957, and from 227 in 1953 to 532 in 1957 if ministries of central

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<sup>8</sup> Information in this section is from Zhou (1984), otherwise noted.

government were included. As a result, the main emphasis in planning was by industrial branch (i.e., *tiaotiao*), rather than by region (i.e., *kuaikuai*). During the first five-year period, the central government's budget accounted for 75% and local government 25%. The role of local governments was very limited, and so was the enterprise autonomy.

In the mid-1950s, criticisms of over-centralization grew in all centrally planned economies, including the Soviet Union and Eastern Europe. Mao's criticism focused on incentives rather than allocative efficiency. Mao believed in people's initiatives and incentives, although he did not believe in profits or material incentives but political incentives. Mao's two formulas were: decentralization of government authority from central to local levels, and mobilization of people's consciousness through political campaigns and mass movements. In his 1956 speech, "On Ten Important Relationships," Mao argued:

Our territory is so vast, our population is so large and the conditions are so complex that it is far better to have the initiatives come from both the central and the local authorities than from one source alone. We must not follow the example of the Soviet Union in concentrating everything in the hands of the central authorities, shackling the local authorities and denying them the right to independent action.

The central authorities should take care to give scope to the initiative of provinces and municipalities, and the latter in their turn should do the same for the prefectures, counties, districts and townships; in neither case should the lower levels be put in a strait-jacket (Mao, 1977).

In September-October 1957, the Third Plenum of the Eighth Party Congress adopted three decisions for improving management in industry, commerce, and the fiscal relationships between the central and local governments respectively. Although the decisions also included expanding enterprise autonomy, the main emphasis was clearly about improving the central and local relationships. The decisions proposed to delegate supervision authority of all state enterprises, except large ones, to the local governments and at the same time to expand local government authority in fiscal affairs, material allocation, planning, pricing in non-important goods, personnel management, etc.

The Chinese way of criticizing over-centralization has deep historical roots from its long

experience during the war. Because the revolutionary bases of the Communists were in rural areas which were divided and surrounded by enemies, mobilization of incentives for production in each base and assurance of self sufficiency became the main considerations. Based on the experience in these bases before liberalization, China always used local governments, not the central government, to plan agriculture (Zhou, 1984, p.218). During the first five-year plan, the Soviet experts recommended making all SOEs subordinate to the central government, but China did not follow this advice and there were still many SOEs subordinate to local governments even before the big decentralization of 1958 (Zhou, 1984, p.217).

#### **4.2. The First Wave of Administrative Decentralization: 1958**

In 1958, the Great Leap Forward called for a high growth rate to overtake the Great Britain and catch up with the United States in fifteen years. In this setting, two main institutional changes took place: ownership changes in rural areas by establishing the People's Commune; and decentralization within the planning system to alter the relationship between the central and local governments.

Mao was enthusiastic about the People's Commune because it combined "industry, agriculture, military, learning, and commerce" together into one entity, which fitted well into his dream of a new world of communism. Under Mao's initiatives, within two or three months, 99% of the peasants were organized into 24,000 People's Communes, with an average size of about 5,000 households. In December 1958, the State Council decided to delegate many state organizations in rural areas (e.g., commerce, grain procurement, and banks) to communes, and the communes were responsible for fiscal revenue remitment targets as well.

In the urban areas, in 1958, after only one year of the central planning system's full establishment, China began to restructure it by deviating from the standard Soviet model. The government proposed dividing the country into 7 "cooperative regions" (*xiezuoque*), requiring each of them to have a complete industrial structure to achieve fast industrialization. The so-called "administrative decentralization" had several major features. First, most SOEs were delegated to local governments. The number of enterprises subordinated to the central government was reduced from 9,300 in 1957 to 1,200 in 1958. The share of

industrial output from SOEs under the central government's supervision shrunk from 40 percent to 14 percent of the national total. Second, central planning was changed from having a national to having a regional basis. Correspondingly, the number of products controlled by the Planning Commission at the central government was reduced from over 300 in 1957 to 215 in 1959, and material allocation by 75%. Third, most decisions over fixed investments were made by local governments, and for large projects, the local government were only required to submit a brief planning report to the central government. Fourth, local expenditures were determined by revenue and it was supposed to be fixed for five years (but it later changed to one year). As a result, the share of central revenue decreased from 75 percent to about 50 percent. Furthermore, extra-budgetary revenue increased from 8.5 percent of within-budget revenue to 20.6 percent in 1960.

Initially, local responses to both the communes and decentralization were enthusiastic. For example, local small industries boomed for the first time (steel mills were in every backyard). In 1958, the People's Commune established a large number of commune and brigade enterprises, the predecessors of the later TVEs. By the end of 1958, these enterprises employed 18 million people and yielded a total output of 6 billion yuan, which increased to 10 billion yuan in 1959 (Byrd and Lin, 1990).

But quickly, both turned out to be disasters. The institution of communes and their public dining halls, together with bad weather, led to the biggest famine in human history, causing about 20-30 million deaths. Between 1958 and 1962, the agricultural net output value declined by 5.9% and light industry by 2% annually, and the national income also declined by 3.1% annually.

The economic disaster forced the government to reverse the 1958 policy. In January 1961, a new policy of "readjustment, consolidation, replenishment, and upgrading standards" was adopted. In response to the chaos, Chen Yun was recalled to work, who adopted two measures. One was a more liberal policy in rural areas. Production teams, with an average size of about 40-50 households, became the basic production and accounting units. Communes remained, but became a less powerful institution. The government also allowed peasants to cultivate small private plots, run sideline productions, and open rural free markets. In some places, contracting production to households occurred, which was the predecessor of

the later "household responsibility system." These liberal policies were known as "free trade, private plots, responsibility for profit and losses, and contracting production to households" (*sanzi yibao*) and were supported by the pragmatists inside the Party, including Deng Xiaoping.

Chen Yun's other measure was recentralization of planning. Some recentralization had already taken place in 1959: airlines, coal mines, and petroleum prospecting teams had already begun put back under the supervision of the central government. Beginning in 1961, all large and medium-sized industrial enterprises were again subordinated to the central government, including the defense industry, railroads and major harbors. Between 1959 and 1965, central government enterprises increased from 2,400 to 10,533. By 1965, industrial output from central government enterprises increased to 42.2% of the national total. The number of planning indicators were restored to the 1957 level. Material allocated by the central government increased from 132 in 1958 to 503 in 1961 and then to 579 in 1965. The number of industrial products under central government planning was about 60% in terms of output value, 70% for agricultural goods and retail. The central government also took back the approval authority of all large fixed investments.

#### **4.3. The Second Wave of Administrative Decentralization: 1970**

In 1962, Mao was forced to make a self-criticism of his 1958 policy. He regarded this self-criticism as a big humiliation. He did not like recentralization, or small free markets. Mao's dislike of bureaucracy increased as the effort to recentralize continued in the first half of the 1960s. Eventually he initiated the Cultural Revolution in 1966 in order to create a "new world," a system relying on political campaigns and mass movement rather than bureaucracy and market.

The Planning Commission at the central government did not make annual plans in 1967 and 1968. Planning at the central government level essentially stopped. This seriously damaged in the economy, but not critically. The national economy contracted modestly in two years, -7.2% in 1967 and -6.5% in 1968.

In 1969, the political issues were settled and the economy recovered dramatically, agricultural and industrial output increased by 23.8% over the previous year. In 1970, nine government ministries,

including State Planning Commission, Economic Commission, Price Commission, Statistical Bureau, Labor Ministry, and Material Ministry, were merged to form a new State Planning Committee with only 619 employees, about 11.6% of the original staff before the Culture Revolution. In the same year, the second wave of administrative decentralization began. There were two immediate reasons for this round of decentralization. First, the Fourth Five-Year Plan (1971-75) discussed in early 1970 set a goal of high growth; for example, steel production was required to double in five years. To achieve this goal, the government believed that it must mobilize local initiative through decentralization. Second, Mao assessed that a Soviet invasion and the beginning of World War III was imminent and thus he made "preparation for war" as the "key link." To that end, in February 1970, the government proposed dividing the country into 10 "cooperative regions" (*xiezuoqu*), making each a relatively complete and self sufficient industrial system to deal with the war. The planning system was changed to one mainly along "regional lines" (*kuaikuai weizhu*), as Mao put it: "Planning must rely on local governments, mainly by provinces" (Zhou, 1984, p. 233).

The 1970 decentralization shared many features of the 1958 decentralization but went much further. First, most large-scale SOEs were again delegated to provincial and municipality governments. After decentralization, the central government only supervised 142 SOEs, down from 10,533 in 1965, and the share of industrial output produced by SOEs under the central government's control dropped from about 50% in 1965 to only 8% in 1970. Second, local governments were made responsible for material allocation and the amount of material allocated through the central government was reduced from 579 in 1966 to 217 in 1971. Third, local governments gained more authority over fixed investment. The share of within-budget fixed investment by local governments increased to 27 percent in 1974 from the 14 percent level in 1969. During this period, 52% of investment in the steel and iron industries came from local governments (Wong, 1985). Fourth, lump-sum transfer fiscal contracting (*dabaogan*) was introduced. Provinces contracted on an annual basis to remit or receive a fixed sum from the central government and they retained all the above-target revenue.

But again administrative decentralization created some chaos and some recentralization began in

1973 under the name of "consolidation" (*zhengdun*). For example, the amount of material allocated through the central government increased again to 617, back to the level of 1965. But in comparison with 1958, the extent of the 1970 decentralization was greater and the recentralization afterwards was much weaker. Common in both waves of decentralization was that the administrative decentralization focused only on the relationship between the central and local governments and not that between the government and enterprises. As a result, government control over enterprises remained very tight. Nor did decentralization cover farmers in the rural areas and the commune system remained essentially unchanged in the 1960s and 1970s.

#### **4.4. The Initial Conditions for Reform: Differences between China and Eastern Europe**

It interesting to compare China with the Soviet Union. Amid criticisms of over-centralization, in 1957 Khrushchev established 105 Regional Economic Councils to replace the ministries of the central government. This reform failed because of "localism." In 1965 the government replaced Regional Economic Councils with the previous central government ministries. Recentralization entailed a complete reversal, and since then, the number of planned products continued to grow along with the size of the economy. In comparison, in China, recentralization in the early 1960s only restored it to the 1957 level, and before long the Cultural Revolution erupted and then came the even greater decentralization of 1970.

Granick (1990), an expert on Eastern European and the Soviet economies, later recognized the Chinese difference of the planning system. He observed that China's planned economy before the reform had special features which were prominent enough to represent a radical departure from the standard Eastern European model. He noted that these peculiarities could not be attributed solely to China's state of economic underdevelopment. It was the planning system after administrative decentralization which produced the systematic difference. Decentralization within the Chinese state sector took the form of regional governments constraining central decision-making via their recognized property rights, rather than having it occur through the center granting power to lower bodies so as to best achieve the center's own goals. None of them existed in the Eastern European model.

Below I highlight some major differences in the central planning systems between China and Eastern Europe.

• **Planning.** Consider the number of commodities subject to the central government's plan allocation. This indicator specifies the degree of fineness to which the central planners partition total output and measures the degree of detail incorporated into the central government's material balance planning. The gap is filled in by local governments and enterprises. For the Soviet Union, beginning in 1928, the number of planned commodities increased from 0 to over 500 by the early 1940s. For China, beginning in 1953, the number increased from 0 to about 500 or more by 1957. However, for the Soviet Union since 1941, the number of planned commodities continued to increase to 1,600 in 1951, reaching as many as 60,000 in the 1970s. In comparison, for China, because of the two waves of administrative decentralization in 1958 and 1970 and despite the subsequent recentralization effort, the number of planned commodities in 1978 was only slightly higher than the 1957 level, even though the economy had become much larger in two decades (Naughton, 1995, p.41). This helps explain why decentralization in the Soviet Union was disastrous and it had to have a complete reversal: At the time of decentralization in 1957, the number of planned products was more than 2,000, compared to just over 500 in China in the same year.

• **Industrial Structure.** Decentralization had a long lasting effect on China's industrial structure. The first effect was the expansion of local state-owned small industries, most of which were agriculture-related industries, producing farm tools and machinery, chemical fertilizers, cement, and coal. Local governments, mostly at county and prefecture level, invested in local SOEs to develop local industries in supporting agriculture. For example, in the early 1970s, more than 300 counties or municipalities set up small steel mills and about 90 percent of counties set up repair factories for agricultural machinery. Between 1970 and 1978, the number of enterprises increased from 195,000 to 348,000, mostly in small industries. Local government had control over the output of products even in categories of goods subject to central government planning. For example, by 1978, portions of total output under local allocation included 46% of coal, 20% of steel, 64% of cement, 65% of machine tools, and 25% of trucks (Wong, 1985). In 1978, the share of industrial output of state-owned enterprises supervised by the central

government contributed less than half to the total state industrial output, the remainders coming from enterprises controlled by provincial, city, prefecture, and county governments. For example, among the 58 enterprises making automobiles, most were controlled by the local governments (Qian and Xu, 1993). In Eastern Europe and the Soviet Union, by contrast, almost all enterprises making automobiles were directly controlled by the central government.

The second effect of decentralization was the parallel development of small industries by communes and brigades in the rural areas. During the campaign of agricultural mechanization, many communes and brigades set up small enterprises to repair tractors and pumps. These commune and brigade enterprises were collective, rather than state enterprises. Total output value from commune and brigade enterprises tripled from 9.25 billion yuan in 1970 to 27.2 billion yuan in 1976. In 1978 there were more than 1.52 million such enterprises, and their output value reached 49.3 billion yuan (Byrd and Lin, 1990).

An unintended consequence of local industrialization was the fact that rather than too few small enterprises as in Eastern Europe and the former Soviet Union, China had too many small scale enterprises scattered around the country. Although they were inefficient in terms of scale economies, they formed a potentially competitive industrial structure which eliminated some major problems faced by Eastern European countries, which are industrial concentration and lack of competition.

• **Spontaneous Horizontal Transactions.** This administrative decentralization, together with local industrialization, created many local "economic centers" which were officially sanctioned and encouraged under the slogan of "self-reliance." These multiple economic centers eroded central planning and the center's power to control regional economies, but naturally induced horizontal non-planning channels for resource allocation purposes. From the practical point of view, the central government had to tolerate spontaneous outside-the-plan trading.

Such horizontal transactions occurred both among state enterprises supervised by different local governments and between state and collective enterprises. The economic relations between different regions outside the planning system were called "cooperation relations," and the goods purchased in this fashion were known as "cooperation materials" (Wu and Zhao, 1987). Because they were not part of the

plan, rural enterprises had to rely on informal channels to buy and sell goods. Furthermore, because of their small scales, these enterprises also often had to sell their products at higher prices (than the planned prices) in order to cover their costs. Therefore, for the survival of these enterprises, the central government tolerated the higher prices they charged. The dual plan and market prices already emerged before the reform.

## **5. China's Great Transformation: A Challenge to What?**

Both China and Eastern European countries have experienced a two-stage process moving from a centrally planned system to a market system. In Eastern Europe, reforms started as early as 1968 in Hungary, 1980 in Poland, and 1985 in the Soviet Union, but their reforms prior to 1990 were a failure (Kornai, 1986; 1992). It is this Eastern European experience that led Kornai (1992) to conclude his book, *The Socialist System*, as follows: "In spite of generating a whole series of favorable changes, reform [in socialist countries] is doomed to fail." "The system is incapable of stepping away from its own shadow. No partial alternation of the system can produce a lasting breakthrough." It is precisely this reform failure that eventually led to a political revolution that jump-started the transition to a market system. To some extent, the big bang transformation in Eastern Europe after 1990 was an alternative to its early unsuccessful piecemeal social engineering.

In contrast, China had two "big bang" transformations of its own prior to 1978: one was the Great Leap Forward in 1958, and the other was the ten year Cultural Revolution from 1966 to 1976. The market-oriented reform after 1978 represented an alternative approach to social transformation, and this time it followed the approach of piecemeal social engineering. In the two decades between 1978 and 1998, China has transformed itself incrementally from a centrally-planned economic system to an emerging market economic system. China differed from Eastern Europe in that its first stage reform was a remarkable success. Building upon this success, China's second stage of reform, that is, its transition to markets, evolved smoothly without any political revolution.

The Chinese path of transition fits well Popper's notion of piecemeal social engineering, but it

poses a challenge to the conventional wisdom of transition based on the Eastern European experience, at least in the following two aspects. First, in the conventional view, reforming a socialist system in a piecemeal manner cannot be successful. The Chinese experience has shown that this claim is not always true. Second, the conventional view holds that a political system under the Communist Party is unable to change its dogmatic ideology and thus a political revolution of democratization is necessary for pushing the reform into the transition stage. The Chinese experience has demonstrated that this expectation is not necessarily valid either.

China's transition to markets is better viewed as a path-dependent evolutionary process. As early as in 1958, Mao criticized the rigid Soviet model of central planning and recognized the disadvantage of over-centralization. In response, Mao initiated his "third-road" model of "administrative decentralization" together with political campaigns and mass movements to arouse the local governments' and people's enthusiasm. A strong minority voice, which was constantly criticized by Mao, came from Chen Yun, who advocated the idea of "big plan, small freedom." It was known as "bird-in-the-cage," that is, the plan (the cage) should be supplemented by the market (space in the cage). Deng Xiaoping was even more pragmatic, since he did not mind the larger role of a market if it was good for increasing productivity. After Mao's death, the pragmatism of Chen and Deng prevailed. Unlike in Eastern Europe, the "market socialism" idea has never taken root in China.

While differing from the transition in Eastern Europe, the process of China's transition to a market system seems to share some common elements with the "Industrial Revolution" in the eighteenth century England and the general historical pattern of institutional development in the West. The industrial revolution is not just an economic development phenomenon, it is also a process of fundamental institutional changes. As is well known, the transition to modern capitalism was a bottom-up process, and it first took place in Manchester and Birmingham in northern England, not in the traditional commercial centers of the south. The northern England had weak government regulation, which was conducive to institutional innovation and change. Similarly, China's reform did not start in the existing industrial centers such as Shanghai or Northeast China where the state had strong control, but in the south, in Guangdong

Province and other areas where state regulation was weak. Furthermore, China's path of transition appears to fit in the historical institutional development pattern in the West: markets developed first, and the rule of law and democracy followed afterwards. Therefore, from a longer historical perspective of development, the Chinese path of transition is not that unusual.

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