

Introduction: China's economic reform in comparative perspective

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

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

until it finally culminated in the dissolution of the traditional economic system and the collapse of the Soviet Union.

The early successes of Chinese economic reform were important in convincing Soviet economists that reform was not only desirable, but also feasible. Although some argued for emulating the Chinese approach, this was not the dominant strand.¹ Rather, the Soviets found evidence in China as well as in Hungary that there were feasible alternatives to the classical command economy, and that there were different approaches to reform that were compatible with continued or accelerated economic growth. Soviet leaders were encouraged to explore reforms on their own after seeing the success the Chinese had with exploratory reforms. Change in the Soviet Union would not have unfolded as rapidly as it did without the prior example of Chinese economic success.

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

Yet it soon became clear that China's economic reform process had not been halted by the post-Tiananmen hardline leadership. Indeed, its fumbling attempts to reassert control over the economy only demonstrated that the economic changes that had already occurred in China were more profound than many had realized, and were virtually irreversible. Moreover, beginning with Poland's economic "big bang" on January 1, 1990, the Eastern Europeans discovered that they were entering a period not only of accelerated systemic change, but also of serious economic recession. Still another contrast was emerging between China and Eastern Europe. While the Eastern Europeans and residents of the former Soviet Union were purchasing significant economic change at the cost of substantial foregone growth, the robust growth that accompanied Chinese reforms was continuing and even showing signs of accelerating. To be sure, China's superior growth performance partially reflects the advantages China enjoyed from

having started the reform process a full ten years earlier than the Eastern Europeans. But even this simple truth draws attention to the fact that China has been undergoing a genuine process of economic transition. China was the only socialist country to undertake system transformation without tumbling into profound economic crisis. Indeed, since the early 1980s, China has been the fastest growing large economy in the world, and by a large margin. Contemporaneous with social and political changes that are complex and often disappointing, the Chinese economic reform process has been resilient and profound, and accompanied by accelerated economic growth that has lifted a huge portion of the world's population out of poverty.

The story and problem of economic reform

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

At the same time, there is clearly no single story of economic reform. On the contrary, the reform process is woven together from many strands and from the actions of millions of individuals pursuing their own interests. Economic reforms can only be understood as part of a process that includes economic development strategy and macroeconomic policy as well as system reform more narrowly defined. Moreover, the ultimate objective is to analyze the reform process and identify its really distinctive and interesting

aspects. This clearly requires an analytical approach that is to some extent in tension with the book's narrative organization. The required analysis, though based on economic reasoning, is never technical and should not present problems to anyone with an interest in the general topic. The book combines an overall narrative organization with stretches of economic analysis – the aim has been to make it about 30% policy narrative and 70% economic discussion.

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

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

temic and macroeconomic characteristics, has ceased to exist. Inevitably, then, industry is the main character in the reform drama.

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

The distinctiveness of China's economic reform

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

There are a number of characteristic features of the Chinese transition process. The discussion begins here with the characteristic feature that is most closely linked to the core institutions of the command economy – with the coordination mechanism in industry. Here the characteristic feature has been the adoption of a dual-track system as a transitional device. From the dual-track system, the discussion of characteristic features is gradually broadened to encompass nine distinctive features that define the Chinese transi-

tion process, and concludes with a note on the ex-post coherence of the process. In the subsequent section, these features are contrasted with two other models of the economic reform process.

The dual-track system

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

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

Growing out of the plan

The mere existence of a dual-track system is not itself sufficient to define a transition strategy. All planned economies have something of a dual-track system, in the sense that none of them ever completely eradicates various kinds of black market trading that inescapably takes place at market-influenced prices. Thus it is a crucial feature of the Chinese transition that economic growth is concentrated on the market track. I coined the phrase "growing out of the plan" in 1984 after Chinese planners in Beijing had de-

scribed in interviews their intention to keep the size of the overall central government materials allocation plan fixed in absolute terms. Given the obvious fact that the economy was growing rapidly, this implied that the plan would become proportionately less and less important until the economy gradually grew out of the plan. Planners concurred in this description: Chinese policymakers were making a generally credible commitment to freeze the size of the traditional plan. This guaranteed a long-run dynamic process that would gradually increase the share of non-plan, market transactions in the economy and made the dual-track system into an unabashed transitional device. The phrase "growing out of the plan" has already achieved some currency in the English language literature (Byrd 1987: 299; Hartland-Thunberg 1989; Naughton 1986: 605; Shirk 1989: 354–57; Wang Xiaoliang 1993: 36).

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

Entry

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

reform. Large size and diversity meant there was scope for competition among firms in the "public sector," even if each of these firms remained tied to government at some level.

Prices that equate supply and demand

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

Incremental managerial reforms in the state sector

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

often leads to a short-run "abandonment of the enterprise" as the attention of reformers shifts away from short-run performance and to the difficult task of privatization. Conversely, the sense that privatization is not imminent lends urgency to the attempt to improve monitoring, control, and incentives in the state sector.

Disarticulation

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

Initial macroeconomic stabilization achieved through the plan

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

initial shift toward a more labor-intensive development strategy was motivated in part by the need to provide jobs for a large group of unemployed young people.

Macroeconomic cycles persisted throughout the reform process

After the beginning of reforms, a pattern developed in which bold reform measures tended to be implemented after stabilization had achieved some success. Reform measures then contributed to renewed macroeconomic imbalances, eventually leading to a new period of macroeconomic austerity. As a result, macroeconomic policies have been of fundamental importance in determining the success or failure of reforms during individual periods.

At the same time, the alternation between expansionary and contractionary phases of the macroeconomic cycle has contributed to marketization of the economy over the long run. Periods of macroeconomic austerity led to abundance of goods and the temporary elimination of shortages. Under those conditions, the demand for planning was reduced, and the position of markets strengthened. More generally, the planning apparatus has been buffeted by the rapid change in economic conditions, and its importance receded as a result of its inability to respond quickly to quick changes in the economic environment. The almost intractable task of planning an economy can only be carried out in conditions of artificially imposed stability; without that stability, the inadequacy of attempts to plan the economy became increasingly evident.

Continued high saving and investment

Steady erosion in government revenues – ultimately traceable to the dissolution of the government industrial monopoly – led to a sustained reduction in government saving. At the same time, though, steady increases in household income and the increasing opportunities in the economic environment led to a rapid increase in household saving. These offsetting changes meant that total national saving remained high sustaining high levels of investment and growth. One consequence has been a vastly enhanced role for the banking system, serving as an intermediary channeling household saving to the enterprise sector. While this process has been relatively smooth, it has been difficult for the government both to acquiesce in and to manage the decline in its resources, and macroeconomic policymaking has become more complex and more difficult.

Ex-post coherence

The preceding nine features have been the crucial distinctive elements of China's systemic transition within industry. It can be seen, ex-post, that there is substantial coherence to these different elements. Reduction of the state's monopoly led to rapid entry of new firms. Entry of new firms, combined with adoption of market prices on the margin, led to enhanced competition, and began to get state-sector managers accustomed to responding to the marketplace. Gradual price decontrol was essential. Competition eroded initially high profit margins for state firms, and induced the government, as owner of the firms, to become more concerned with profitability. The government experimented with better incentive and monitoring devices, and this improved state-sector performance. Nonetheless, the state sector grew more slowly than the newly entrant sectors. The economy gradually grew out of the plan, as both the plan itself and the state sector as a whole became less dominant elements in the economy as a whole. Yet this occurred with the stability attributable to the maintenance of the planned sector as an anchor, and to continued robust saving and investment. Some summary reform indicators of the overall process over fifteen years are given in Table A.1.

Three models of reform

It is possible to contrast the Chinese dual-track approach with two alternate models of reform. The first model is the "rationalizing reform" that guided reform efforts in the 1960s in the European command economies (ECEs).³ The second model is the "big bang" approach popularized in the 1990s, initially in Poland and then to varying degrees in Czechoslovakia and Russia. These three separate models or ideal types can cover virtually all attempts at serious economic reform in the socialist command economies.

European rationalizing reform

During the 1960s, significant economic reforms were attempted in nearly every European command economy. The results were uniformly disappointing. The most important characteristic of the 1960s reforms is that they were designed to make the command economy work more smoothly, and not to eliminate it or replace it with a market economy. It was hoped that reliance on scientific methods and sophisticated indirect steering would improve planners' control of the economy. For this reason I call these tools "rationalizing reforms." Indeed, reform as rationalization was the only approach that

Table A.1 Reform indicators

	1978	1985	1988	1990	1993
<i>Proportion of total retail sales</i>					
Market Prices	3%	34%	49%	45%	95%
Guidance Prices	neg.	19%	22%	25%	
Fixed Prices	97%	47%	29%	30%	5%
<i>Proportion of agricultural procurement</i>					
Market Prices	6%	40%	57%	52%	90%
Guidance Prices	2%	23%	19%	23%	
Fixed Prices	92%	37%	24%	25%	10%
<i>Ownership structure of industrial production</i>					
State	78%	65%	57%	55%	42%
Collective	22%	32%	36%	36%	40%
Private	neg.	2%	4%	5%	9%
Foreign	neg.	neg.	1%	2%	7%

Sources: Prices: *Price* 1991: 466; Tian Yuan and Qiao Gang 1991: 203; Sun Xiangyi 1993: 10; Niu Genying 1994. Industrial Output: *Industrial Statistics*, various years; 1993 is estimated based on SSB 1994.

was ideologically acceptable before the 1980s. Rationalizing reform was never a strategy for transition to the market; rather, the object was to introduce some market-like elements in order to improve or “perfect” the planning system (Augustinovic 1975).

Both in its conception and in its practice, rationalizing reform maintained the fundamental framework of the existing system, most crucially the state monopoly over the critical core sectors of the economy. Reformers hoped to compute a set of optimal prices that could be combined with improved reward functions to create a planned economy with the efficiency of a market economy. They were after a “computopia” that would combine the best aspects of plan and market, and in which perfect computation would substitute for real competition.⁴ The objective of rationalizing reform was to increase the efficiency of the state sector by instructing managers to behave like profit-oriented businessmen, while remaining within the framework of the state plan. In rationalizing reform, planners believed that by manipulating the objective functions of state-sector managers, they could reduce or eliminate conflicts of interest between the government and enterprise managers.

Rationalizing reforms were in practice taken the furthest in Hungary, and there is an extensive literature on the Hungarian reforms (Berend 1990; Friss 1969; Kornai 1986). The Hungarian “New Economic Mechanism” was characterized by the outright abolition of compulsory plans and material allocation. However, centralized allocation was replaced by a vaguely defined “horizontal cooperation” between enterprises that falls well short of true market coordination. Planners turned to the use of “indirect instruments” or price levers. Prices were adjusted and subsidies reduced, but prices remained controlled by planners explicitly in order to allow them to steer production and investment decisions. Capital charges were implemented to encourage enterprises to economize on capital and regulate their own investment demand. Incentive schemes were revamped, shifting attention from physical output targets to value targets such as sales, cost reduction and, ultimately, profits. Enterprises were allowed to finance some of their investment from retained funds, particularly profit, and from bank loans. Finally, some parts of the “second economy” were legalized, permitting private business in a narrow range of activity, typically including some petty trade and repair services, and some housing construction.

These were important changes in the 1960s, but the limitations on this type of reform are more fundamental than the changes that were instituted. We can identify three crucial limitations: First, planners never renounced the effort to guide all fundamental economic decisions. The market was intended to be an instrument in the hands of central planners, rather than an autonomously functioning institution. Even the recourse to self-financing by enterprises was seen as a modest softening of central control that would not obstruct the basic ability of central planners to choose large investment projects and determine the overall direction and rate of investment (Brus and Laski 1989: 76–77). This is a vision – rather than a plan – of a computopia, in which the economy is optimally steered through the control of prices. Second, prices were never set free to equilibrate supply and demand. Third, the administrative hierarchy that controlled the economy remained intact, and with it the state monopoly of crucial industrial sectors. Maintenance of this monopoly was quite explicit. As Friss (1969: 17) put it:

The dependence [of the enterprise] on the state is reflected in the principles that enterprises can be founded only by a minister or leader of a national authority or by the executive committee of a local council, and that the founder has the right to determine the sphere of activity of the enterprise, as well as to appoint and discharge its director and deputy director.

Even in the late 1980s, after several additional waves of reform, the state monopoly remained basically intact. Legal provisions restricted or prohib-

ited transactions between state-owned firms and the private sector (Kornai 1990: 94).

It should be clear that these limitations are not mere accidental shortcomings. They represent a coherent and internally consistent attempt by planners to maintain state control over the price system and to maintain the state monopoly over crucial sectors that is inseparably related to that control. Individual prices could always be "rationalized," even adjusted to accord with world prices. But the overall structure of prices, of markets, and of the pattern of entry was to be firmly controlled by the same planners who had managed the pre-reform economic system. The objective was to prevent market prices from "autonomously" determining all the important income and resource distribution issues in the economy. Instead, planners wanted to maintain as separate realms, under their control, the determination of income distribution and the determination of the level and composition of investment. Prices could not be allowed to jointly determine all of these, as in a market economy (Klaus 1990: 68).

There is an overwhelming consensus that rationalizing reform in these countries failed. In Schroeder's (1979) memorable phrase, the Soviet economy was trapped "on a treadmill of reforms." Even in Hungary, where rationalizing reforms were taken the furthest, there is broad agreement that reform did not qualitatively improve, or even much change, the way the economy operated. Rationalizing reforms were designed to salvage the ideal of state socialism. Today, this model has been discarded by the very economists who were most influential in its development. Brus and Laski (1989:73–86) refer to "central planning with a regulated market – the flawed model" and link its fundamental failure to the desire to maintain control of investment in the hands of state planners. Kornai (1986) refers to advocates of this model in the earlier periods – including himself – as "naive reformers," and later (1990: 17, 57, 72) makes a fundamental distinction "between experiments in simulating a market by 'market socialism' and the introduction of a genuine free market." He concludes (1990: 58) that "the basic idea of market socialism simply fizzled out."⁵

Big bang reforms

Given gradual disillusionment with rationalizing reforms, the sudden removal of political constraints at the end of the 1980s was followed by the emergence of big bang reform strategies. These are exemplified by the Polish program adopted on January 1, 1990. Able for the first time to contemplate abandonment of the command economy, reformers were faced with the

close interrelationship of every element of the traditional economic system, as described earlier. Their response was essentially that disentangling the elements of the system was impossible, and therefore it had to be destroyed at a single blow and replaced as quickly as possible. (Ironically, in the Polish case, household farming had survived, so reformers could not very well begin by decollectivizing agriculture.)

The big bang solution to the challenge of the interdependence of the elements of the command economy has been to stress the necessity of first trying to improve the quality of the price system in as short a time as possible (Klaus 1990; Gomulka 1991). This requires the removal of price controls on as many goods as feasible and, in most cases, adoption of some form of currency convertibility so that most domestic prices will conform to international prices. The urgency of these initial measures is heightened when, as in Poland, macroeconomic imbalances have severely distorted the economy, either through open inflation or through serious shortages (Lipton and Sachs 1990). In the Polish case, currency convertibility was combined with a fixed exchange rate, helping stabilize the economy.

In principle, big bang transitions aim to come as close as possible to a simultaneous transformation of as many aspects of the economic system as possible. For example, in cases where macroimbalance is serious, fiscal and monetary policies must be restructured simultaneously with price liberalization. In other respects, though, it is easy to overestimate the degree of simultaneity in the transition. Indeed, even if movement begins on all fronts simultaneously, liberalization of the price system will be achieved much more rapidly than other aspects of the transition (Gelb and Fischer 1991; Dhanji 1991). Even liberalization of the price system usually covers only product markets at first. In Poland, both the exchange rate and the wage rate were fixed by government fiat in order to provide "nominal anchors" to the economy. The nominal anchors help the economy converge to the appropriate price *level* while equilibrium price relationships are being worked out by the marketplace. Without some nominal anchors, the process of price determination would be confused and delayed by the uncertainty individuals felt about where overall price levels would end up. Even with these limitations, price liberalization takes place much more rapidly than institutional transformation and structural adjustment.

Institutional transformation refers to the complex set of changes relating to the creation of new economic institutions. Privatization is the most significant, but also the most difficult and contentious element of this transformation. Indeed, privatization is entangled with two other crucial elements of the transformation: demonopolization and restructuring of enterprise ac-

counts and balance sheets to permit them to accurately reflect economic realities. Further institutional change is necessary in the banking system, the tax system, the legal framework for business – indeed, virtually every aspect of a modern economy. Almost inevitably, big bang transitions imply that the attempt to rationalize the state sector is abandoned. Market prices are to be followed as rapidly as possible by large-scale privatization, and the ultimate shift to a market economy characterized by mixed ownership forms dominated by private enterprise. As institutional transformation is unfolding, the economy, now guided by the proper price signals, will begin the difficult process of structural adjustment, referring to change in the mix of output that is produced. Command economies produce many goods that have no future in an open market economy, and producers must shift into a range of goods in which they have comparative advantage. This process of structural change unfolds gradually in the wake of the big bang deregulation of the price system.

Big bang strategies clearly can succeed in destroying the command economy and eventually creating a market economy. The controversy surrounding big bang strategies revolves around the question of whether it is wise to concentrate so many of the costs of transformation in the early stages. Early price liberalization and currency convertibility exposes domestic producers to dramatic change, increased competition and high levels of uncertainty with little preparation. The experience of Poland and other countries that have adopted this strategy shows that it is very costly in terms of foregone output and unemployment. Proponents of big bang approaches argue that these costs are inevitable, and better taken at the outset and all at once. They argue that the consistency of the old system, the entrenched behavior patterns of existing interest groups, and the need for a credible once-and-for-all transformation dictate a big bang strategy. Skeptics doubt whether populations with new and fragile democratic institutions will tolerate the exceptional short-run burdens placed on them, and worry that excessive economic disruption will erode long-term support for the necessary economic transformation.

China and Eastern Europe

Fundamentally, the Chinese reform pattern resembles big bang transitions more than the rationalizing reforms of Eastern Europe. Both Chinese dual-track reforms and the big bang lead ultimately to a market economy (even if this was not known in China at the outset). Both involve fairly quick acceptance of market-determined prices, and large-scale entry of non-state producers. Because of this dynamic, both involve a sharp decline in the govern-

ment's direct control over resources, as measured by budgetary revenues as a share of GNP, and a concomitant increase in control over resources by households and enterprises. None of these characteristics was shared by rationalizing reforms.

Chinese reforms are sometimes lumped together with rationalizing reforms because both appear to be gradual or partial reforms. This is inappropriate. Gradualism is not in itself a defining characteristic of reform strategies, and in any case, rationalizing reforms were not necessarily gradual. The most important case – that of Hungary – involved the adoption of an integrated package on a single day, January 1, 1968. This was the “big bang” of its day. Chinese reforms are also confused with the European reforms because they often use a similar vocabulary to describe their aims. In fact, as this book will demonstrate, the apparent similarity of vocabulary disguises fundamental differences in approach. Indeed, the similarity of vocabulary can be readily explained by Chinese use of Eastern European concepts to justify early reforms, and by the need to reassure conservatives that reforms would not lead to economic disorder. The fundamental objectives and processes of rationalizing reforms differ so much from Chinese dual-track reforms that it is quite inappropriate to put them in a single category.

To be sure, Chinese reforms do share with European rationalizing reforms the maintenance of the administrative hierarchy that manages production and, even worse for China, the continuance of Communist Party power. As unfortunate as this is, the context within which economic management takes place has been so profoundly altered by the steady introduction of market forces and competition that the negative effects of continued government oversight in China have been greatly attenuated. In addition, China's reforms differ from the big bang approach primarily because Chinese leaders were unwilling to undergo extreme short-term shocks to the economy. Big bang transitions inevitably involve large short-run adjustment costs, generally including discontinuous changes in the price system and sharp increases in unemployment. By contrast, the Chinese leadership has acted as if it were constrained to maintain both inflation and open urban unemployment within fairly narrow limits. The Chinese have acted as if minimizing short-run adjustment costs (at the expense of prolonging the overall adjustment process) were an important argument in their overall transition strategy. Doubtless this is related to a sense of precariousness among some (at least) of the Chinese leaders – lacking the firm popular backing that, for instance, the early Solidarity government had in Poland, the Chinese leaders have felt that it would be unwise to impose drastic adjustment costs on a population that is already somewhat alienated from the government. Maintenance of a planned

sector allows the government to use direct controls over finance and investment to begin restructuring output. More specifically, it provides a degree of stability during the transition process, and China thus clearly differs from the big bang approach in the pace of change. Finally, the absence of significant early attempts to privatize large state-owned firms distinguishes China from some of the big bang cases.

Success and failure

Generally speaking, the Chinese reform process has been a success, and in this book, reform is generally treated as a success story. But there are many aspects of Chinese reform that have not succeeded, and there are competing definitions of what success is. Nevertheless, when the Chinese reform process is viewed as a whole, what is most striking is the succession of incremental, steadily accumulating measures of economic reform that have gradually transformed the economy in a fundamental way. By the end of the 1980s, the Chinese economy had become open to domestic market forces and world market opportunities in a manner without precedent in the socialist world. Indeed, after initial successes in the early 1980s – especially obvious in the agricultural sector – the period from 1984 through 1988 emerges as a second period of successful transformation, this time most apparent in the fields of industry and foreign trade. Clearly, gradual – indeed, often piecemeal – approaches to economic reform can meet with substantial success. Other approaches to economic reform may also be viable and indeed under some circumstances may be preferable. But the argument that reform must be rapid and discontinuous because that is the only feasible path does not stand up to scrutiny in light of the Chinese experience.

Comparative experience shows us that no reform strategies are perfect in practice. All wind up seriously distorted by the need to accommodate political realities, by the long and difficult process of building new administrative capabilities, by the legacy of past development choices, and by the unavoidable fact of human error in policy choice. China's experience is interesting in part precisely because reform has been adapted to the limitations imposed by primitive political institutions and the problems of underdevelopment and poverty. China's reform program has been extraordinarily *robust* under difficult circumstances. Always improvised, never clearly formulated in advance, the program has nevertheless been shaped by a distinctive logic and set of circumstances that have given it considerable coherence. China has experienced substantial marketization, liberalization, and opening to the outside world, all in the context of rapid economic growth.

It has been, in short, a success. Therefore, the Chinese approach to economic reform needs to be taken seriously and put in the context of other socialist reform processes.

Underlying this assessment is of course the fact of economic growth, and the undeniably better living standards that the majority of Chinese enjoy after fifteen years of reform. Of course, growth in itself cannot be the only criterion. A short-term acceleration of growth, purchased at the expense of macroeconomic imbalance, environmental degradation, external debt, or other costs, might not be an adequate standard. Growth must be sustainable to confirm an economic strategy: The ultimate criterion is broad-based development. Clearly, the measurement of China's development is beyond the scope of this book, but certainly by most measures, China's development is quite broad-based and reflected in substantial sustained improvement of living standards. Broad-based growth is the key to China's success.

There is a view – more prevalent in the media than in scholarly accounts – that whatever success Chinese reforms have encountered comes from the performance of the non-state sector. In this view, agricultural households, and subsequently rural enterprises and foreign investment, have driven continued economic growth. State-run enterprises, however, remain stubbornly unreformed, and the government as a whole has failed to adapt to the needs of the reform era. A more sophisticated version of this approach describes the Chinese reform process as “surrounding the cities from the countryside” (Findlay and Watson 1992). While this view, by stressing the growth of non-state sector, contains a kernel of truth, it is simply not adequate to describe the entire reform process. First, it ignores evidence of improving performance in the state sector. Second, it sees the state and non-state sectors as being essentially independent phenomena, when the evidence is strong that they are both interdependent and in competition. Third, it is essentially enterprise-based – that is, it ignores all the other institutions in the economy that must be reformed.

Moreover, such views simply do not “add up.” We can do an experiment. If one took all the rural enterprises and foreign-invested firms, and stripped them away from the remainder of the economy, how fast would the remainder of the economy be growing? Relatedly, we could mentally detach China's five most dynamic provinces, all of them along the coast – Guangdong, Fujian, Zhejiang, Jiangsu, and Shandong. This would mean subtracting the provinces with the fastest growing industry, accounting for almost a quarter of China's total GNP. Moreover, it would mean subtracting about two-thirds of the foreign investment and rural industry. What happens to China's economic growth rates when these dynamic areas are conceptually amputated

from the rest of the economy? Between 1978 and 1991, the official real GNP growth rate for all of China was 8.6% annually. When the "gold coast" areas are removed, the real GNP growth rate for the remainder of China falls, but only to 7.7%. The key feature is across-the-board high growth rates, *not* regionally concentrated growth (see also Denny 1991).

Conversely, another view attributes success primarily to the policies adopted by Chinese leaders. Needless to say, the most energetic purveyors of this view are in the Chinese propaganda apparatus. In this semi-official view, Chinese leaders adopted cautious, experimental reforms. Policies were tried out first in local experiments, and policies that worked were spread nationwide. Reforms began in rural areas, and achieved great success. As a result, a second stage of urban reforms was attempted and, although this was harder, it also eventually achieved success. Reforms succeeded because Chinese leaders were flexible and pragmatic. This is a highly sanitized account of the reform process, sufficiently misleading to count as misinformation: It distracts us from the real dynamics of the reform process in favor of an oversimplified morality tale. The official view centered on leaders and policies veers from oversimplification to dishonesty when it deals with changing policies and leaders in the past, since it seeks to always justify the current leadership. For example, in 1992 a comprehensive *Encyclopedia of Chinese Reform* was published in China (Tong Wansheng and Zuo Xiangqun 1992). This remarkable multi-volume work, totalling almost 5,000 pages, manages simultaneously to generally attribute reform successes to enlightened policy-making and to never once mention the name of Zhao Ziyang, who was in fact the most important single leader in the reform process, but was purged after the Tiananmen incident. The continuing flow of misleading information coming out of Beijing inevitably ends up distorting the interpretation of the reform process.

In fact, through much of the reform period, Chinese policymakers have failed to achieve consensus about or articulate a vision of the post-reform economic system. One of the reasons China's reforms were *gradual* was simply because so much time was *wasted* pursuing dead ends and even regressive policies. The Chinese leaders have never been able to articulate coherent visions of, for example, ownership structure, or a fully renovated financial system. Thus, for significant parts of our period, Chinese leaders have not so much been systematically groping for stepping stones in order to cross a river as they have been slogging around in a swamp.

Moreover, such a perspective cannot account for the very significant failures of the Chinese reform process, even with respect to issues that were viewed as critical by top government leaders. Indeed, the reform process

during the 1980s was marked by four fundamental, closely related failures. These were the failure to create a new fiscal system, the failure to clarify or restructure property rights, failure to put real accountability into the investment system, and repeated and excessive delays in reforming some of the more distorted aspects of the price system. All four of these failures were the result of a continuing inability of the Chinese government to design and carry through coordinated or rationalizing reforms. At first, so many changes needed to be made that it was acceptable to defer the tasks that were most difficult administratively and ideologically. Later, it was easier to make these changes, because there was a far broader market context that could be used to shape these changes. Today, so many of the other changes have now been accomplished that the deferred rationalization and restructuring of the system is now the most immediate, pressing task. Thus, the Chinese political and economic systems continue to be profoundly challenged.

I view Chinese policymakers as weakly rational. The Chinese government, like governments everywhere, made vital economic decisions with inadequate information, often in near-crisis situations, and subject to numerous economic and non-economic constraints. As a result, the reform process was reactive and disjointed rather than smooth. The administrative capability of the government was strained to the limit during a process of wide-ranging change, and the government rarely had the ability to design and then carry out long-term, multi-stage reform programs. Moreover, improvised policy responses were made within the bounds of ideology, factional rivalries, and bureaucratic power and interests. But once economic policy choices were made, they met with varying degrees of success depending upon the nature of the underlying economic conditions. Policies that failed economically left their advocates extremely exposed: They tended either to abandon the policies or found themselves replaced by individuals willing to try other approaches. Successful economic policies tended to bring political success to their patrons. Thus, I argue that economic issues became part of the contemporary political agenda mainly for economic reasons that are readily understandable, and major policy shifts have usually occurred in response to changes in economic conditions that we can trace. That is to say, there was an economic logic to Chinese economic reform that is quite strong.

If this perspective is correct, it means that over the longer term the pattern of reform was shaped more by economic conditions and the interaction between economics and politics than it was by ideology or politics. Indeed, the Chinese reform kept evolving in ways that policymakers didn't anticipate, and they had to scramble to catch up with the changes they had unleashed. Indeed, this is another sense in which the title of this book may

be understood. The reform process has typically unfolded in ways very different from those envisioned by reformers in the early phases. Unexpected consequences and accidental events proved important. In that sense, the economy and its reform both developed “out of the plan.” The Chinese approach is in some ways the path of least resistance, traced on an economic landscape by a political organism with limited abilities to map the terrain and chart a path on its own. This fact is part of what gives the Chinese experience a more general interest. Some features of the Chinese case will be repeated in other socialist and developing countries undergoing reforms as they struggle to cope with difficult and rapidly changing economic realities.

Synopsis of the book

The book follows a modified chronological organization. This introductory chapter presented some of the main themes and describes the basic ways in which China’s distinctive economic reform differs from the reforms instituted in Eastern Europe and the former Soviet Union. Chapter 1 describes the Chinese economy on the eve on reform. It is emphasized that although China’s economic system was basically similar to that of the Soviet Union, an important difference was that China’s economy was relatively underdeveloped. Partly as a result, the economy was not subject to the same high degree of centralized administrative control as in the Soviet Union, and there was more “space” for autonomous economic activity to emerge once liberalization began. Chapters 2 through 4 describe the first of three periods into which the reform era naturally divides. Each covers the period 1979 through 1983 from a different perspective, and together they describe the three most important processes of this early period: the reorientation of development strategy, institutional reforms, and liberalization and the growth of the non-state sector. Chapter 2 describes the crisis of the command economy at the end of the 1970s, and the initial response to that crisis. It asks why China initiated economic reform, and finds that the crisis was one of development strategy, and that the initial response to that crisis was a reorientation of development strategy (with significant macroeconomic consequences as well). Chapter 3 describes the earliest system reform measures that accompanied the reorientation of development strategy. It is stressed that these early reforms were carried out not so much *without* a blueprint as with a vague version of the rationalizing reform blueprint from Eastern European reform of the 1960s. Chapter 4 covers the initial liberalization that modified the state monopoly over the industrial sector, and permitted substantial entry of non-state producers, particularly in rural areas.

These early reforms, significant as they were, did not appear to be leading to a successful approach to continued reform. The rationalizing reform approach was simply not working. Chapter 5 discusses some of the crucial debates that grew up over reform strategy as experience in reforms (both successful and failed) was accumulating in the mid-1980s. While debate does not correlate exactly with policy change at the top, a crucial shift in policy did occur in 1984. Subsequently, the period between 1984 and 1988 emerged as the second and crucially productive phase of Chinese reform. This was the period in which the distinctive Chinese approach to reform, which I have called “growing out of the plan,” emerged fully. This period is covered in two chapters: Chapter 6 describes the fundamental institutional changes that were at the heart of this reform process, while Chapter 7 describes the macroeconomic dynamics that brought the period to a temporary close with the inflationary crisis of 1988–89.

A third period can be said to emerge after the Tiananmen incident in June 1989, and this is covered in Chapter 8. Marked by initial hardline dominance of policy, it gradually passed into a third period of reform, which ended with the economy ultimately growing out of the plan. This period also reflected a new approach to reform strategy, as transition to a market economy became the explicit aim of reform. Chapter 9 attempts to draw some of the main theoretical and practical lessons from the Chinese experience.

Because of the chronological organization, some economic issues are treated in more than one place, and some continuous time-series data is relevant to several chapters. Chapters 2 and 7 both cover macroeconomic issues, and have much in common. Chapters 3 and 6 both focus on reform policy, with an emphasis on state-owned industry. Some continuity is lost by separating the treatment of closely linked topics that occur in different periods. Because Chinese data often requires some manipulation to be meaningful, there is a statistical appendix at the end of the book, to which the reader is occasionally referred.