

2 | China's Transition in Economic Perspective

Chinese economic reform is far more than simply an economic process. Nearly everything about China is changing, and our increasingly specialized disciplinary vocabularies are not well suited to cover the scope and interconnectedness of change of this magnitude. The channels of influence from economic changes to non-economic impacts are too numerous to be surveyed comprehensively. Yet two broad processes of economic change stand out as critically important in shaping contemporary Chinese society. The first is China's transition to a market economy according to its own distinctive transition strategy; the second is China's transformation from a predominantly agrarian economy to an increasingly urbanized, industrializing economy. The pace of change in contemporary China is so rapid precisely because China is undergoing both of these dramatic transformations simultaneously.

I will refer to these two processes by the labels "market transition" and "structural transformation." Market transition in China includes elements that are common to all market transitions, most prominently the shift from bureaucratic control of resources to market-determined allocation, and the corresponding shifts in the nature of political and economic power. While acknowledging the importance of such fundamental shifts, the discussion

here focuses on aspects of China's market transition that are distinctive to China. The first section of the chapter describes the distinctive elements of China's market transition during the first decade or so of transition, and then develops some of the noneconomic implications of the approach. The second section describes the ways in which the strategy of transition inevitably shifted during the 1990s, and brought transition more in line with the demands and processes of structural transformation. The third section focuses on the structural transformation and shows that it reinforces many of the social changes associated with market transition. The chapter concludes with speculations about the ongoing impact of reform.

China's Transitional Strategy and Its Social Impact

It is now broadly recognized that China followed a dual-track transition strategy, and "grew out of the plan."¹ I will characterize China's strategy by drawing contrasts with a stylized and simplified "East European" strategy of transition. In Eastern Europe, the predominant objective of the most committed reformers was to move as rapidly as feasible to a modern market economy.² Models of what that economy ought to look like were readily available and close at hand: reformers saw their own economies as potentially similar to those in neighboring Western Europe, and in need above all of a rapid and profound institutional transformation to quickly shed the legacy of communism. For these reformers, it was of critical importance to free prices so they could be determined by market forces as quickly as possible. With freely determined prices, all comers would have an equal opportunity to compete on a level playing field in all forms of economic activity. The objective was to eliminate as many distortions as possible as quickly as possible: it was felt that these economies were so distorted by government misallocations and misleading signals that it would be impossible for governments to successfully correct individual distortions. It was better to smash the entire edifice, eliminating as many distortions and privileges and the resulting rent-seeking opportunities as possible, and start all over from the bottom up. If in the process there was some short-term loss of output, so be it. Reformers thought it better to undergo the

costs early, in order to lay the foundation for healthy long-term growth later.

China's approach was quite different. In the first place, the imperative of economic development was constantly on the minds of reform policymakers. It was never conceivable to Chinese policymakers that their economy would "mark time," postponing economic development until after an interlude of system transformation. It was always assumed that system transformation would take place concurrently with economic development and, indeed, that the process of economic development would drive market transition forward and guarantee its eventual success. Partial system reforms were frequently judged to be effective or not depending on whether they contributed to the goal of short-run economic growth. Completion of market transition was not anticipated before the economy reached a moderate level of development.

The distinctiveness of the Chinese market transition derived partially from this growth imperative. Early reforms almost never eliminated distortions. Instead, early reforms created pockets of unregulated and lightly taxed activity within the system. Reformers allowed such pockets to open up because they were seen as contributing to developmental objectives. If rural collectives were allowed to run township and village enterprises they would be encouraged to invest more, leading to more rapid growth. If foreign businesses were allowed to operate freely in special economic zones (SEZs) they would invest in China, bringing additional capabilities. Such policies were seen as contributing to growth while not initially threatening the overall ability of the government to manage and direct the economy.

As a result, huge distortions remained in the system, but those distortions, on balance, tended to encourage resources (people, money, initiative) to flow into these less regulated "pockets." Individuals or communities saw "niches" available that they could exploit. First movers made high profits. There was almost never equal and fair competition: rarely did one see a "level playing field." The overall level of distortions in the system probably did not decrease very much in the initial stages of reform, but as dual price systems sprang up, distortions became more visible, because they could be

measured by the difference between market prices and plan prices for the same goods.

Almost all of the most important early reforms fit into this pattern. Township and village enterprises were allowed to sell a wide range of products beginning in 1979. With few price controls and limited competition, they were initially remarkably profitable. Because of pervasive market shortages, they were able to charge relatively high prices even for goods of dubious quality. In 1980 the average total rate of return to capital for China's township and village enterprises (TVEs) was an enormous (and unsustainable) 32 percent per year. The dual-track system for state-owned enterprises (SOEs), in which SOEs were allowed to sell above-plan output at market prices, had a similar orientation. While SOEs were still required to fulfill planned output and delivery targets at planned prices, they were allowed to use whatever surplus capacity they had to produce market goods to be sold at unregulated prices. The foreign trade strategy based initially on the special economic zones and subsequently expanded to the coastal development strategy in 1987–88 also implied the granting of numerous exemptions from regulations and taxes for export-oriented producers. In each of these cases, producers were given access to profitable opportunities, the high profitability of which was at least partly contingent upon the maintenance of the rest of the planned economic system.

Alert individuals began to move resources into the unregulated pockets. Returns were higher, and so was risk. In the unregulated pockets of activity, prices were set by market forces, but these prices were initially a long way from their equilibrium values. Profitability was strongly conditioned by what was happening in the regulated (state) sector, and also by the level of taxation. The result was a kind of Swiss cheese economy, in which the regulated sector provided the matrix for all economic activity, while holes were opened up to provide space for private activity.

It is natural to see the Chinese approach as being distinctively Chinese, perhaps reflecting traditional Chinese culture. But in fact this approach to policy reform is also used in the developed market economies. For example, telecommunications reform in the United States began not with broad price deregulation but, rather, with the

entry of new service providers. Regulators allowed MCI to compete with AT&T to provide long-distance services. Previously, long-distance rates had been set high in order to give AT&T a financial resource to subsidize local telephone service. MCI understandably wanted to enter the high profit areas, if possible, to “cherry pick.” Selective entry is, in a sense, “unfair,” but has the merit of initiating change with a minimum of disruption and increasing competition immediately. Moreover, the new competitor could be counted on to articulate his own interests and, to a certain extent, the interests of other potential competitors. The same considerations applied in China. Reforms began smoothly; information about effective changes was elicited; and interest groups supporting further reforms were created.

Gradually, the process of attracting new entrants into “pockets” in the planned economy proceeded sufficiently far that the overall balance between plan and market began to shift. The plan, from having been the solid material out of which a few pockets were excavated to provide space for entrepreneurial activity, became more like a sponge floating in a sea of predominantly market activity. From this point, approximately 1991–92, a new phase of economic reform could begin. The focus of reforms shifted toward dissolving the compulsory plan and creating uniform rules and tax rates for all sectors of the economy. The dual-track plan and market system was phased out, and most prices were unified at market prices. This later phase of reform will be discussed in a subsequent section. Here, I note some of the implications of the initial transitional strategy for the noneconomic outcomes of the transition. Four are most important.

(1) The strategy worked, and worked surprisingly well. As a result, reforms began smoothly, without a significant drop in output. Over time, growth accelerated. When the time came to abolish the plan, in 1992–93, it disappeared without incident. Planning ended not with a bang, but with a whimper. The contrast with Eastern Europe is great, where the Big Bang created a large drop in output and a smaller but still significant drop in consumption. In China, development continued and growth accelerated. People were better off, and took advantage of improved conditions to acquire improved

skills and enhanced capabilities. Successful development eased bottlenecks and permitted a broader process of change to unfold.

The opportunities presented to those who first took advantage of opportunities in the lightly regulated pockets were significant. Savings, investment, and entrepreneurship were forthcoming to take advantage of those opportunities. Household savings increased, and local government entrepreneurship surged. It was not merely that growth did not collapse: it accelerated. The plan framework provided some stability for future expectations and allowed many profitable undertakings to proceed. Export enclaves succeeded in expanding exports, relaxing the constraint on foreign exchange, and allowing China to import a broader range and greater amount of investment goods and production inputs, also fueling growth acceleration. Growth acceleration contributed to structural transformation.

(2) The process was Pareto-improving in its early stages, and provided opportunities to buy off opponents.³ Influential and powerful people at both central and local levels took advantage of opportunities, along with others who were simply more alert or better equipped for a market economy. These individuals were made clearly better off, while nobody was made obviously worse off. There were surprisingly few diehard opponents of reform, and those who were initially opponents were generally bought off. After Zhao Ziyang was removed from power by conservative Communist Party leaders, it did not take the new leaders very long to adopt the main elements of Zhao’s approach to reform. They then found that this approach to reform was extremely well adapted to a neo-authoritarian approach to political relations.

(3) During the transition, complex interdependencies developed between the waning but still predominant state-owned economy and the less regulated individual and collective (or community-owned) economy. Individuals learned to “work the system,” taking what they could get from the old system while simultaneously exploiting new opportunities. While some individuals who were willing to bear risk took the plunge into unregulated sectors, many individuals maintained links with the regulated sector for insurance purposes. The “one household, two systems” model was a particular version of this:

one family member stayed in the state sector in order to obtain subsidized housing, medical care, and social insurance, while his or her spouse launched a market-oriented enterprise. In that sense, the two “tracks” of the economy had a mutually supportive relationship. Another example of a mutually supportive relationship was the commercial relationship between TVEs (especially in Jiangsu) and SOEs (especially in Shanghai). TVEs often got their start working for urban SOEs, which would subcontract activities to rural TVEs to expand output despite their own space constraints. Competitive relationships were important as well. As the market sector expanded relative to the bureaucratic sector, SOEs increasingly felt the pressure of market competition.

(4) Government revenues eroded. Even with economic growth, there had to be some loser for all the winners, and that loser, generally speaking, was the “public treasury.” As nonstate actors were allowed into more and more of the protected niches previously monopolized by state agents, the state’s ability to earn and harvest monopoly revenues declined. This can be seen by examining patterns of fiscal revenues and expenditure. Total budgetary revenues were 35.2 percent of GDP in 1978, on the eve of reform. After 1978, revenues as a share of GDP declined every year until 1995, when they reached a minimum of only 11.2 percent of GDP. Subsequently—and only after a major tax reform was finally implemented during 1994—revenues finally stabilized. According to preliminary figures announced as part of the finance minister’s budget report, total revenues in 1997 equaled 12 percent of GDP, a small but significant recovery from the 1995 minimum. Since budget deficits have been maintained at around 2 percent of GDP or below, expenditures show the same basic trend as revenues. There are four broad categories of budgetary expenditure. Overt subsidies have been a major component of spending since the late 1970s, but have been cut back substantially since their peak in 1981–1983. Military spending has declined fairly steadily since 1978. Investment outlays have accounted for the largest share of the reduction in budgetary expenditures, dropping from about 16 percent of GDP to less than 3 percent. Finally, civilian current expenditures have shown relatively little change, particularly through the early 1990s. Throughout the

1980s, current expenditures hovered around 10 percent of GDP. Since the early 1990s, however, they have begun to slip below the level previously sustained, and by 1995 civilian current expenditures amounted to only 8.4 percent of GDP. Fiscal decline was reinforced by the dissolution of the agricultural collectives, which in 1978 had controlled funds—drawn from net collective income—equal to another 2.8 percent of GDP. Overall, there was a huge decline in the size of the public sector.

These four implications together have complex and ambivalent implications for the social impact of reform. On the one hand, reform fed development and growth so there were increasing real benefits provided to the general population. Living standards improved, with more than just material implications. Demands for information, for new kinds of cultural products, for new careers, and for new kinds of political participation increased. Moreover, groups were created with a powerful vested interest in reform, and these groups helped to ensure that economic reforms did not expire after Tiananmen, but rather, after a brief pause, resumed with undiminished intensity.

On the other hand, the distribution of these gains was “unfair.” Crony capitalism was prominent. In localities, enormous power was amassed by some local officials. New combinations of economic power linked emergent entrepreneurs with established bureaucrats. New configurations of economic power are hardly unique to China. In Russia, for example, one of the new capitalists has recently boasted that he and six other businessmen control half of the Russian economy.⁴ The Chinese economy is vast and quite competitive, and the devolution of very large state-owned industries has remained limited, so there are not yet private Chinese business groups of a scale comparable to the largest Russian groups. But one may hypothesize that there is greater continuity in China between the former political elites and the new business elites. It is only in China that the children of the former top political elites—the so-called princelings—have emerged as key economic elites. It would be interesting to know whether such continuity is as apparent at local levels as in Beijing.

Political and social issues have played out amid the backdrop of

continuous fiscal shortage. Over the long run, the erosion in government revenues is likely to cause some reduction in the quality of basic human capital (health and education) that is one of the important preconditions of sustained economic development. As of 1978, China had invested a great deal in public health and education (relative to its income level at that time), and also in certain kinds of public infrastructure. These expenditures have slipped, however, along with the general erosion in budgetary resources. For example, total government health expenditures (excluding outlays for the government insurance program that covers government employees only) were still 0.8 percent of GDP in 1986, but declined to only 0.5 percent in 1993. Current outlays for education were still over 2 percent of GDP in 1985, but had declined to 1.66 percent in 1994. There is some evidence that we are seeing the effects of these problems in measurable nonfiscal indicators. The mortality rate of children through the age of five has ceased declining since 1985, notwithstanding continued gains in income. There is evidence of deterioration in infant mortality rates in some of China's poorer inland provinces.

Government interventions in the economy to limit the growth of inequality, and even to enforce the rules against its own agents, have become increasingly problematic. With fiscal resources in decline, there have been ongoing struggles over the definition of the public interest and over the division of revenues between center and locality. Deprived of formal taxation authority by the central government, local officials resorted to various informal and often illegal practices in order to replace lost revenues. In some cases these informal practices were local attempts at self-taxation to provide desperately needed public goods; but in other cases they were just corruption. In response, the government in some respects tightened its control over its agents in other ways, with ambiguous outcomes, as discussed in Chapter 6.

Change within Transition: Reform since 1992

Since 1992 the focus of Chinese reform policymaking has shifted away from the previous strategy of creating pockets of decontrol in

which entrepreneurship can flourish. The thrust of policymaking has shifted toward the creation of general rules that govern the entire economy and permit competition across a broad range of activities and on a level playing field. This process is far from complete, and there are many regulations and barriers that protect different parts of the Chinese market, but the direction of change is clear.

The transformed transitional strategy was clearly evident by 1993, when the compulsory plan and most of the remnants of the dual-track system were abolished. In the same year, a decision was made in principle to extend equal treatment to enterprises under different ownership systems. Two major unifying reforms were subsequently adopted on January 1, 1994. The first was the unification of the exchange rate, which was followed by a gradual shift to current account convertibility; the second was the creation of a new fiscal system with a broader tax base and lower, nearly uniform rates primarily based on a value-added tax.

Just as important—though less obviously successful—have been the efforts to push forward with the restructuring of state-owned industrial enterprises and commercial banks. Limited conversion of SOEs to joint stock companies began in 1992–93, but was then scaled back until a uniform company law could be promulgated. After the company law and a related banking law were passed in 1994 and 1995, restructuring picked up again in 1996 and 1997. SOE restructuring was very much on the agenda by mid-1997, and although it is too soon to determine the outcome of this latest reform initiative, it is clear that the conversion of SOEs to a modern, uniform commercial form—along with significant distribution of ownership shares to private parties—will be a primary element of the reforms. These changes share the characteristic that they envision systems in which all firms are treated equally, subject to essentially the same rules, tax rates, and price-setting mechanisms.

When market transition reached this stage, it began to interact in explosive ways with the process of structural transformation. Market transition measures of this kind have in common with structural transformation the fact that both involve much more factor mobility than before, and both create a demand for a much stronger set of

administrative institutions in order to regulate and order the interactions between these increasingly fluid and equal economic agents. Market transition and structural transformation both imply a greater mobility of labor between sectors and jobs, and of capital among various competing uses. Structural transformation in general implies the evolution of increasingly complex and sound institutions in order to regulate an increasingly anonymous mass society, replacing the former face-to-face interactions that governed smaller-scale rural society. As market transition moves to a new phase it tends to create the same demands.

The initial approach to economic reform, whatever its merits, did not fully conform to the demands of structural transformation. Access to pockets of opportunity was limited to “locals.” Nothing was more emblematic of this aspect of early reforms than policy toward rural enterprises. Throughout the 1980s, the policy was “*litu bu lixiang*”—to have peasants move out of agriculture without leaving the local area. Peasants were encouraged to stop farming and work in local township and village enterprises, but strongly discouraged from leaving the locality. In particular, rural to urban migration was strongly discouraged by the system of residence permits. In the cities, labor mobility increased very slowly during the 1980s, and by the end of the decade nearly all urban workers were in the same enterprises to which they had originally been assigned. Despite the progress made in the 1980s, the basic framework of socioeconomic segmentation was maintained in place. Generally speaking, since 1992, those controls have been very substantially reduced. Ironically, explicitly political controls have often been strengthened, and can in some senses be seen as a replacement for reduced economic segmentation (see Chapter 6).

Since 1992 the system has increasingly begun to permit—or even encourage—substantial labor mobility. Instead of only being allowed to operate in the nearest free-market pocket, individuals have increasingly been able to move long distances and dramatically change their status and occupation. The ultimate unification of rules in Chinese society would of course be the abolition of urban residence permits. This would permit the longest-lasting and most pervasive form of dualism in Chinese society to be substantially reduced. However, while this process has begun, it is still far from completion.

Structural Transformation

Structural transformation is perhaps best examined by focusing on its single most significant process: the transformation of the labor force from agriculture to industry and other nonagricultural occupations. Through 1991, the pressure of population on employment opportunities was great, and policy did not encourage poor farmers to leave their localities. As a result, the absolute number of people employed in agriculture increased steadily, by over 5 million a year. Agricultural employment peaked in absolute terms in 1991, with a total employment of 387 million. Since then, agricultural employment fell to 348 million in 1996, shedding just under 8 million jobs annually over the intervening five years.⁵ From a peak above 70 percent at the beginning of the reform process, agricultural employment dropped to 60 percent of the total labor force in the thirteen years to 1991, and then to 50 percent in the five years to 1996.

Agriculture was able to shed labor after 1991 because the modern nonagricultural sector had finally grown large enough to soak up a substantial part of long-standing rural labor surpluses. Nonagricultural employment growth jumped from under 10 million jobs a year before 1991 to almost 17 million a year after 1991. Some of the nonagricultural growth was due to the ongoing structural transformation of the economy, but some reflected the steady growth of nonstate employers. By the 1990s private employers had become large enough that their rapid proportional growth was able to absorb significant numbers of people for the first time. Indeed, during the period up through 1991, most employment was provided by publicly owned enterprises (state or collectively owned) or by the government. After 1991, the “private sector” accounted for two thirds of nonagricultural job creation.⁶ Thus the liberalization in attitude toward different ownership forms that took place in the early 1990s quickly paid off in providing an additional source of employment growth.

Changes in the rate of growth of nonagricultural employment and in its ownership composition are emblematic of a whole series of changes reflecting a more mobile labor force. Jobs in state-owned enterprises, once held for life, are increasingly uncertain. The pace of quits and fires has accelerated: whereas less than one SOE em-

ployee in a thousand left the state sector in 1978 (for reasons other than death or retirement), the figure in 1996 was about one in fifty. Even this is a small part of job change, most of which occurs through layoffs in the financially troubled state sector. Laid-off workers usually continue to receive some minimal salary support, but no longer report to work. An official figure for laid-off urban workers at the end of 1996 was 8.2 million, almost twice the number of fully unemployed.⁷ As job mobility increases, there is some recent evidence that returns to education and other skills are increasing, even as political connections retain value as well.⁸

Urbanization causes major social changes everywhere, and the influence of urbanization, and to a lesser extent internationalization, is affecting every aspect of Chinese society. Again, reforms have heightened the impact of a change occurring because of structural transformation. Urbanization everywhere is associated with increased diversification and social freedom for individuals. During the 1990s reforms transformed the urban retail sector, increasing the diversity of goods and services available to urban residents and improving their quality. Such diversification of consumption contributes to an increasing voluntary diversification of individuals. More specialized service providers have sprung up, at least in the big cities, that are willing to respond to increasingly specialized demand segments (in part because they are privately run and can survive on smaller sales volumes). Whether or not one chooses to attribute political importance to such changes, it is clear that it is easier for individuals to sort themselves into lifestyle subgroups. At the very least, this reduces the monotony of city life, and may contribute to the emergence of new social groups.

Finally, there is one additional factor associated with structural transformation that must be mentioned: the demographic transition. Developing countries regularly experience major changes in the age composition of their population as birth rates drop and people live longer. In China, the impact of those changes is particularly strong because of China's draconian birth control policies, which have led China into a precocious demographic transition. There are few elderly—since life expectancies were low until recently—but also few children—because of strict limits on births. As

a result, the share of the population in the young adult age bracket is quite high. China's population is unusually adaptable, active, and resilient, because it is so young yet lacking a huge population of dependent children. Individuals under forty are much more willing and able to adapt to major work changes than workers over forty. The *median* age of the Chinese work force is now only thirty-two (it will increase steadily to forty in 2025). That means it is well positioned to cope with the dramatic social and economic changes occurring all around. Arguably, it makes the next stages of economic reform more feasible as well, since a young work force should be able to adapt to the necessary frictional unemployment caused by the restructuring of the state sector, which looms unavoidably on the horizon.⁹

Conclusion

The preceding discussion has helped explain why China's social transformation appears so broad and multifaceted today. Economic reform strategy was the crucial factor driving economic and social change during the 1980s. But successful reforms in that decade led to the exhaustion of that strategy in the 1990s and the need to progress to a different strategy. Inevitably the new approach to economic transition merged with the structural transformation of the economy to create intensified social change. In the 1990s, it is increasingly urbanization, migration, and career mobility that are driving economic change, instead of government economic reform policy. At the end of the 1990s, ironically, China looks perhaps less like a country in transition from socialism and more like an industrializing country in transition from its agrarian past.

This approach may help explain why China seems sometimes to be falling apart, or “deconstructing.” Reform strategy as formulated in the 1980s led inevitably to a kind of deinstitutionalization. Resources were diverted away from the building of institutions, and given ample opportunity to earn private returns in the less regulated sectors of the economy. Now, as population mobility and structural change accelerate, institutions often appear insufficiently strong to cope with the social forces unleashed. The government has re-

sponded to its declining direct control over resources, and to perceptions and fears of diminishing social order, by strengthening police forces and propagating a tough set of political rules that everyone is supposed to know. But whether this process of “government by law” and rule strengthening is leading to a stable process of institutionalization is difficult to judge.

The early phases of reform created numerous groups with an interest in seeing reform survive. A crucial unanswered question today, however, is to what extent these emergent interest groups may obstruct the implementation of further reforms. To what extent have the Chinese lost the ability to enforce publicly recognized standards of behavior on their own officials? To what extent is China undergoing a process of deinstitutionalization that may be difficult to reverse? More concretely, one worries that the process of actually subjecting the economy to a uniform and impartial set of rules (taxation, import-export, corruption) has made relatively little progress in the last three or four years. It is easy to worry that if a process of building legitimate institutions does not take hold more robustly, then in the long run (certainly not tomorrow), the foundations for growth might be severely undermined, and the growth and development process will falter. In those moments, it is easy to see China as entering a phase of its history in which it once again resembles a “sheet of loose sand.” It is important to recognize, however, that this deinstitutionalization is itself a by-product of an astonishing economic success. In the process of fashioning that success, Chinese institutions, however faulty, have repeatedly been capable of confronting and resolving their most serious challenges, while deferring additional tasks to an uncertain future. China today seems everywhere in motion, and often appears unstable. Yet we can take some comfort in the fact that the turmoil is a manifestation of the ceaseless striving of an intensely competitive and creative society.

II | Limited Political Reforms